PUBLIC POLICIES FOR THE VENTURE CAPITAL INDUSTRY:
THE BRAZILIAN AND NORTH AMERICAN EXPERIENCES

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I. INTRODUCTION

The main proposition of this paper is to investigate the public policies adopted in the United States and in Brazil for the venture capital industry. We will also advocate the use of venture capital as a financial tool to foster the growth and development of small and medium sized companies (SMCs) in Brazil.

This research can be useful either to compare the different cases’ environment and approaches, or to assess possible lessons to be learned from successful experience. It is worth mentioning that the author’s tasks as a manager in BNDES’s Venture Capital Department have given rise to his interest in this subject.

In the remaining sections, we’ll begin by reviewing the economic theory linking the development of the financial system and the economic growth of a nation. In that section, we will also show theoretical reasoning for government intervention in the financial system, and present evidence of the importance of small businesses for economic growth.

A brief overview of the venture capital industry will follow, describing the players in this market and their objectives. Also, we’ll summarize the investment process, and look at related issues such as length of investment, types of firms, corporate venturing, commitments and fund raising, capital calls, illiquidity, other types of funds, advisors and fund of funds, disbursements, exits (IPO and mergers and acquisitions), valuations, management fees and carried interest.

Next, we will present a description of the current situation regarding the Brazilian venture capital markets in general, and the public policies adopted by the federal government. Closer attention will be paid to the BNDES’s role, presenting its initiatives and programs.

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1 BNDES: The National Bank for Economic and Social Development is the chief federal agency for long term funding which aims to promote the country’s development.
Later, we will present the results of research done with institutions involved in the management of venture capital in the United States, either in the public or private sector, namely the Small Business Administration (SBA)\textsuperscript{2}, regarding its Small Business Investment Company Program, the National Association of Small Business Investment Companies (NASBIC)\textsuperscript{3} and the National Venture Capital Association (NVCA)\textsuperscript{4}.

This research involved a visit to the SBA, and an interview with their officers, which were of invaluable importance to provide insights and help us understand the public policies for the sector in the USA. Further research over the Internet and other sources, regarding market statistics and specific details of the public policies adopted in the U.S. was also conducted, as part of this work.

In the final section, we assessed possible lessons from the U.S. experience regarding public policies for the venture capital industry, which could be useful in the formulation of public policies for the sector in Brazil.

\textsuperscript{2} The U.S. Small Business Administration (SBA), established in 1953, provides financial, technical and management assistance to help Americans start, run, and grow their businesses.

\textsuperscript{3} The National Association of Small Business Investment Companies (NASBIC) is the non-profit industry association that represents SBICs before Congress and before Executive Branch agencies.

\textsuperscript{4} The National Venture Capital Association (NVCA) is the trade association that represents the venture capital industry. Currently, the NVCA represents 400+ member firms, representing the majority of venture capital invested in U.S. based companies.
II. FINANCIAL DEVELOPMENT AND THE ROLE OF GOVERNMENT; SMALL BUSINESSES AND ECONOMIC GROWTH

Recent studies in development economics acknowledge that there is a positive, first-order relationship between financial development and economic growth (Levine, 1997). Theoretical reasoning and empiric evidence have increased the belief that the development of financial markets and institutions is a critical part of the economic growth process.

Furthermore, a growing literature shows that differences in how well financial systems works, reducing information and transaction costs, influence saving rates, investment decisions, technological innovation, and long-run growth rates.

The quality of the functions provided by the financial system (such as facilitating the trading of risk, allocating capital, monitoring managers, mobilizing savings, and easing the trading of goods, services and financial contracts), may vary widely across countries. Countries with larger banks and more active stock markets tend to grow faster, and industries and firms that rely heavily on third party financing grow disproportionately faster in countries with well-developed banks and securities markets than in countries with poorly developed financial systems.

Given the links between the functioning of the financial system and economic growth, designing optimal financial sector policies is critically important. While some might disagree (Vallejo, 1994), there is substantial academic support for government intervention in the financial markets.

According to Stiglitz (1994), financial markets are markedly different from other markets, and market failures are more likely to be pervasive in these markets; and that there exist forms of government intervention that will not only make these markets function better but will also improve the performance of the economy.
Among the possible market failures that could be addressed by some form of government intervention, it is of special interest for this paper the issue involving missing or incomplete markets. In many countries, imperfect information, resulting in high transaction costs, led to limited trade or to the demise of the equity and long-term debt markets.

One common government action, in response to this challenge in the developing countries, has been the creation of financial institutions, to fill gaps in the types of credit not provided by private institutions.

Alternatively, programs of directed credit have been widely used to allocate funds for projects with higher expected social returns but which probably would not be funded by private sources. Among popular targets for directed credit are small business, technology-intensive and export-oriented industries.

An issue of special interest to this work is the availability of financial resources for the small businesses. It is becoming widely recognized that these companies are capable of making large contributions to any country’s economy.

For instance, in the U.S., according to U.S. Census Bureau and the Bureau of Labor Statistics data, small businesses (including the self-employed):

- Provide approximately 75 percent of the net new jobs added to the economy.
- Represent 99.7 percent of all employers.
- Employ 53 percent of the private work force.
- Provide 47 percent of all sales in the country.

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5 As cited by the SBA in its web page.
6 SBA's size standards define whether a business entity is small and, thus, eligible for Government programs and preferences reserved for "small business" concerns. Size standards have been established for types of economic activity, or industry, generally under the North American Industry Classification System (NAICS).
Provide 55 percent of innovations.
Account for 35 percent of federal contract dollars.
Account for 38 percent of jobs in high technology sectors.
Account for 51 percent of private sector output.
Represent 96 percent of all U.S. exporters.

From now on, we will use the above mentioned views as the basis for the central proposition of this paper, which is to analyze the use of public policies to support venture capital and its role as a financial tool to foster the growth and development of small and medium sized companies (SMCs) in Brazil, ultimately helping the country’s economic development.
III. OVERVIEW OF THE VENTURE CAPITAL INDUSTRY

The objective of this section is to provide basic knowledge of the mechanisms and the terminology of the venture capital, which will be useful in later sections. Although some of the definitions may vary according to the source, we will use those provided by the U.S. National Venture Capital Association (2001), which is believed to be the standard regarding these issues in the United States.

Venture capital is money provided by professionals who invest alongside management in young, rapidly growing companies that have the potential to develop into significant economic contributors. Venture capital is an important source of equity for start-up companies.

Professionally managed venture capital firms generally are private partnerships or closely held corporations funded by private and public pension funds, endowment funds, foundations, corporations, wealthy individuals, foreign investors, and the venture capitalists themselves.

Venture capitalists generally:

? Finance new and rapidly growing companies;
? Purchase equity securities;
? Assist in the development of new products or services;
? Add value to the company through active participation;
? Take higher risks with the expectation of higher rewards;
? Have a long-term orientation.

When considering an investment, venture capitalists carefully screen the technical and business merits of the proposed company. Venture capitalists only invest in a small percentage of the businesses they review and have a long-term perspective. Going forward, they actively work with the company's management by contributing their
experience and business savvy gained from helping other companies with similar growth challenges.

Venture capitalists mitigate the risk of venture investing by developing a portfolio of young companies in a single venture fund. Many times they will co-invest with other professional venture capital firms. In addition, many venture partnership will manage multiple funds simultaneously.

In the U.S., probably the most developed venture capital market, venture capitalists have nurtured for decades the growth of high technology and entrepreneurial communities resulting in significant job creation, economic growth and international competitiveness. Companies such as Digital Equipment Corporation, Apple, Federal Express, Compaq, Sun Microsystems, Intel, Microsoft and Genentech are famous examples of companies that received venture capital early in their development.

**What is a Venture Capitalist?**

In truth, venture capital and private equity firms are pools of capital, typically organized as a limited partnership, which invests in companies that represent the opportunity for a high rate of return within five to seven years. The venture capitalist may look at several hundred-investment opportunities before investing in only a few selected companies with favorable investment opportunities.

In the early days of venture capital investment, in the 1950s and 1960s, individual investors were the archetypal venture investor. While this type of individual investment did not totally disappear, the modern venture firm emerged as the dominant venture investment vehicle. However, in the last few years, individuals ("angel investors") have again become an increasingly larger part of the early stage start-up venture life cycle.

Venture firms come in various sizes from small seed specialist firms of only a few million dollars under management to firms with over a billion dollars in invested capital around the world. The common denominator in all of these types of venture investing is that the venture capitalist is not a passive investor, but has an active and vested interest in
guiding, leading and growing the companies they have invested in. They seek to add value through their experience in investing in tens and hundreds of companies.

**Investment Focus**

Venture capitalists may be generalist or specialist investors depending on their investment strategy. Venture capitalists can be generalists, investing in various industry sectors, or various geographic locations, or various stages of a company’s life. Alternatively, they may be specialists in one or two industry sectors, or may seek to invest in only a localized geographic area.

Not all venture capitalists invest in "start-ups." While venture firms will invest in companies that are in their initial start-up modes, venture capitalists will also invest in companies at various stages of the business life cycle. A venture capitalist may invest before there is a real product or company organized (so called 'seed investing"), or may provide capital to start up a company in its first or second stages of development known as 'early stage investing.' Also, the venture capitalist may provide needed financing to help a company grow beyond a critical mass to become more successful ('expansion stage financing').

The venture capitalist may invest in a company throughout the company’s life cycle and therefore some funds focus on later stage investing by providing financing to help the company grow to a critical mass to attract public financing through a stock offering. Alternatively, the venture capitalist may help the company attract a merger or acquisition with another company by providing liquidity and exit for the company’s founders.

At the other end of the spectrum, some venture funds specialize in the acquisition, turnaround or recapitalization of public and private companies that represent favorable investment opportunities.

**Length of Investment**

Venture capitalists will help companies grow, but they eventually seek to exit the investment in three to seven years. An early stage investment make take seven to ten
years to mature, while a later stage investment may only take a few years, so the appetite for the investment life cycle must be congruent with the limited partnerships’ appetite for liquidity. The venture investment is neither a short term nor a liquid investment, but an investment that must be made with careful diligence and expertise.

**Types of Firms**

There are several types of venture capital firms, but most mainstream firms invest their capital through funds organized as limited partnerships in which the venture capital firm serves as the general partner. The most common type of venture firm is an independent venture firm that has no affiliations with any other financial institution. These are called "private independent firms". Venture firms may also be affiliates or subsidiaries of a commercial bank, investment bank or insurance company and make investments on behalf of outside investors or the parent firm’s clients. Still other firms may be subsidiaries of non-financial, industrial corporations making investments on behalf of the parent itself. These latter firms are typically called "direct investors" or "corporate venture investors."

Other organizations may include government affiliated investment programs that help start up companies either through state, local or federal programs. In the U.S., one common vehicle is the Small Business Investment Company, under the SBIC program administered by the Small Business Administration, in which a venture capital firm may augment its own funds with federal funds and leverage its investment in qualified invested companies. As previously stated, we will examine the SBIC program more closely throughout this paper.

**Commitments and Fund Raising**

The venture capital firm will organize its partnership as a pooled fund; that is, a fund made up of the general partner and the investors or limited partners. These funds are typically organized as fixed life partnerships, usually having a life of ten years. Each fund is capitalized by commitments of capital from the limited partners. Once the partnership has reached its target size, the partnership is closed to further investment from new
investors or even existing investors so the fund has a fixed capital pool from which to make its investments.

The process that venture firms go through in seeking investment commitments from investors is typically called "fund raising". The commitments of capital are raised from the investors during the formation of the fund. A venture firm will set out prospecting for investors with a target fund size. It will distribute a prospectus to potential investors and may take from several weeks to several months to raise the requisite capital.

The fund will seek commitments of capital from institutional investors, endowments, foundations and individuals who seek to invest part of their portfolio in opportunities with a higher risk factor and commensurate opportunity for higher returns. Once the firm has raised enough commitments, it will start making investments in portfolio companies.

Making investments in portfolio companies requires the venture firm to start "calling" its limited partners commitments. The firm will collect or "call" the needed investment capital from the limited partner in a series of tranches commonly known as "capital calls". These capital calls from the limited partners to the venture fund are sometimes called "takedowns" or "paid-in capital".

Disbursements

The investment by venture funds into invested portfolio companies is called "disbursements". A company will receive capital in one or more rounds of financing. A venture firm may make these disbursements by itself or in many cases will co-invest in a company with other venture firms ("co-investment" or "syndication"). This syndication provides more capital resources for the invested company. Firms co-invest because the company investment is congruent with the investment strategies of various venture firms and each firm will bring some competitive advantage to the investment.

The venture firm will provide capital and management expertise and will usually also take a seat on the board of the company to ensure that the investment has the best chance of being successful. A portfolio company may receive one round, or in many cases,
several rounds of venture financing in its life as needed. A venture firm may not invest all of its committed capital, but will reserve some capital for later investment in some of its successful companies with additional capital needs.

Exits

Depending on the investment focus and strategy of the venture firm, it will seek to exit the investment in the portfolio company within three to five years of the initial investment. Again, the expertise of the venture firm in successfully exiting its investment will dictate the success of the exit for themselves and the owner of the company.

The initial public offering is the most glamorous and visible type of exit for a venture investment. In the U.S. markets, technology IPOs have been in the limelight during the IPO boom of the last six years. At public offering, the venture firm is considered an insider and will receive stock in the company, but the firm is regulated and restricted in how that stock can be sold or liquidated for several years.

Once this stock is freely tradable, usually after about two years, the venture fund will distribute this stock or cash to its limited partner investor who may then manage the public stock as a regular stock holding or may liquidate it upon receipt. Over the last twenty-five years, almost 3000 companies financed by venture funds have gone public.

Less publicized mergers and acquisitions, however, represent the most common type of successful exit for venture investments. In the case of a merger or acquisition, the venture firm will receive stock or cash from the acquiring company and the venture investor will distribute the proceeds from the sale to its limited partners.

Valuation

Like a mutual fund, each venture fund has a net asset value, or the value of an investor’s holdings in that fund at any given time. However, unlike a mutual fund, this value is not determined through a public market transaction, but through a valuation of the underlying portfolio. The investment is illiquid and at any point, the partnership may have both private companies and the stock of public companies in its portfolio. These public stocks
are usually subject to restrictions for a holding period and are thus subject to a liquidity discount in the portfolio valuation.

Each company is valued at an agreed-upon value between the venture firms when invested in by the venture fund or funds. In subsequent quarters, the venture investor will usually keep this valuation intact until a material event occurs to change the value. Venture investors try to conservatively value their investments using guidelines or standard industry practices and by terms outlined in the prospectus of the fund. The venture investor is usually conservative in the valuation of companies, but it is common to find that early stage funds may have an even more conservative valuation of their companies due to the long lives of their investments when compared to other funds with shorter investment cycles.

**Management Fees**

As an investment manager, the general partner will typically charge a management fee to cover the costs of managing the committed capital. The management fee will usually be paid quarterly for the life of the fund or it may be tapered or curtailed in the later stages of a fund’s life. This is most often negotiated with investors upon formation of the fund in the terms and conditions of the investment.

"Carried interest" is the term used to denote the profit split of proceeds to the general partner. This is the general partners’ fee for carrying the management responsibility plus all the liability and for providing the needed expertise to successfully manage the investment. There are as many variations of this profit split both in the size and how it is calculated and accrued, as there are firms.
IV. VENTURE CAPITAL MARKETS AND PUBLIC POLICIES IN BRAZIL

Venture Capital in Brazil is a relatively recent development. Despite some isolated government initiatives in the 1970s, only in the 1990s a real development on the subject could be perceived. In this decade, more players came to the market, and more diversified products became available to smaller companies seeking funds for their growth.

It is very likely that the change in the macroeconomic environment helped this trend, as the high inflation and interest rates which prevailed until the Real Plan in 1994 would drive potential investors away from this risky, long-term investment alternative.

Research conducted by Fundação Getulio Vargas (FGV) for the Brazilian Association of Risk Capital - ABCR\(^7\) (2001), showed that in 2000 US$747 million was invested by 31 private equity and venture capital funds, while in the U.S. the comparable amount was US$100 billion. Research also pointed out that in the first quarter of 2001, private equity and venture capital investment in Brazil totaled US$400 million, whereas projected investment for 2001 in the U.S. would fall to US$40 billion.

Development of venture capital in the country in the recent past is closely linked to the growing number of investment funds focused on private equity and venture capital. The latter, known in Brazil as “Fundos de Investimento em Empresas Emergentes (FIEE)”, were created and are regulated by the “Instrução CVM 209/1994”, issued by the “Comissão de Valores Mobiliários – CVM”\(^8\).

The basic characteristics of FIEEs are:

? Closed funds: no way to exit before the fund matures or expires; amortization depends on portfolio divestitures;

? Length of Investment: up to 10 years;

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\(^7\) ABCR – Associacao Brasileira de Capital de Risco, a Brazilian industry association representing venture capital and private equity firms.

\(^8\) CVM is the Brazilian equivalent to the Securities and Exchange Commission – SEC in the U.S.
To provide liquidity for the investors (limited partners), the funds may have their “quotas” listed on a secondary market, as long as some requirements have been fulfilled (the most important is that all the investment commitments should have been raised).

“Instrução CVM 209/1994” introduced a more favorable tax treatment, if compared with the previous regulation applied to the “Sociedades de Capital de Risco”, which were the instrument used for venture capital funds before 1994. It also allowed the Brazilian pension funds, until then forbidden to invest in closed companies, to invest in FIEEs, attracting a large amount of resources into the venture capital markets. While it also allowed foreign investors to participate in FIEEs, it was not enough to attract these, due to the existence of offshore funds in tax havens.

In the last five years, new private fund managers have established themselves in the private equity and venture capital markets. BNDESPAR (BNDES Participações), which is BNDES’s investment bank, has had an essential role in the structuring of the funds and also as a limited partner, leading other investors like pension funds into investing in venture capital.

Since 1994, around 20 private equity funds and 46 FIEEs have been created in Brazil. In most of the funds that are still operating, the federal government, through BNDESPAR, has acted as a catalyst in attracting other institutional investors and developing fund managers.

**Federal Government Initiatives**

BNDES has been the main source of venture capital to SMCs within the federal government. BNDESPAR has been providing equity capital to companies of varied sizes since its inception in 1973. Its objectives are to:

- Strengthen the assets and financial structures of the companies;
Reorganize industrial sectors, through merger and acquisition operations aimed at increasing competitiveness;

Support private equity investments in infra-structure;

Develop the capital markets, encouraging companies to go public and promoting greater liquidity for the stocks of such companies, with the aim of making these markets important mechanisms for private companies to raise funds.

Participation in share subscription operations can be direct - as in private issues - or indirect, as in public issues - in the underwriting of shares or convertible debentures.

It is important to note that BNDESPAR’s holdings in private companies are always temporary (on average five years) and a minority one - up to 33% of total capital, mostly in preferred shares. The sales of BNDESPAR’s holdings take place via public share offerings or block trades on the stock exchanges, promoting more widespread ownership of company capital and strengthening the capital market itself.

In the late 1980s, acknowledging the need of a differentiated approach for dealing with SMCs, BNDESPAR already had staff with the required expertise and exclusive focus on this market segment. Since then, several programs and special instruments have been created to allow more than US$100 million in direct investment in 76 SMCs.

In 1991, BNDESPAR created Contec (Program for Capitalization of Technology-oriented Companies) - through which it shares the risks with small and medium developers of new technologies. The goal is to help technology-intensive companies in the design, start-up, expansion or early development stages overcome funding barriers due to the risk they entail.

In this program, companies with annual turnover up to R$15 million9 are eligible for investment up to R$2 million, in equity or convertible debentures. Until 2000, over 40 SMCs had received support from Contec.

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9 Exchange rate (as of November 16th, 2001): US$1.00=R$2.53
Another program, derived from the previous, is **Simplified Contec**. In this version, companies with annual turnover up to R$7 million are eligible for investment up to R$1 million, in equity or convertible debentures.

Wagering on the potential of companies that are ready to move up their development scale and present a good management evaluation, BNDESPAR created the Program for Investment in Emerging Companies. In this program, companies with annual turnover up to R$60 million, and not affiliated to a corporation with net worth over R$120 million, and sound economic prospects can be invested in, through equity or convertible debentures.

Moving up in the company-size scale, the Pre-IPO Companies Investment Program offers financial support to companies with turnover up to R$150 million and likely to open its capital in the stock markets in a near to medium term.

In October 2000 BNDES Participações S.A. launched the SMC Risk Capital Investment Program for Support of New Listed Companies, created to meet two of the goals of its Strategic Plan: support for small- and medium-sized companies, and development of the capital markets. The program has an initial budget of R$ 300 million, able to be increased to R$ 500 million, to be invested over the next five years in subscription of shares or debentures convertible into shares.

The main features of this program are a reduction of interest rates on debentures, and an increase in the maximum limit of stockholding in the capital of the companies to be supported in return for the adoption, when the company makes its IPO, of minimum clauses in its bylaws to ensure respect for the rights of minority stockholders and transparency of information.

The purpose of the program is to support small- and medium-sized companies with net annual sales revenue of up to R$ 60 million in the last reported business year, which do not belong to economic groups with consolidated stockholders’ equity in excess of R$120 million. To qualify, the companies must also operate in attractive niche markets, have competitive advantages in their market, show prospects of rapid growth and high
profitability, and have effective and ethical management practices. This program also intends to support companies planning to open their capital in BOVESPA’s\textsuperscript{10} New Market (Novo Mercado)\textsuperscript{11}.

This program brings together two priorities in the BNDES Strategic Plan: support for Brazilian SMCs, and development of the capital markets. It aims to widen support already given to these companies, to create conditions to enable a new stockholding architecture, and to expand ownership of securities issued by the Brazilian capital markets to a wider base of investors.

In an attempt to increase venture capital resources available to SMCs, BNDESPAR has also operated indirectly, through local “Sociedades de Capital de Risco” or investing in FIEEs. Until July 2001, BNDESPAR has taken part in the structuring and creation of seven FIEEs, with commitments of capital ranging between R$12 million to R$50 million for each of these funds.

Three of these FIEEs are focused on small tech-based companies, and the individual investment does not exceed R$1 million for each invested company. Twenty-two SMCs have been invested in through these funds.

As an example, one of the latest funds created for SMCs was SCTec, or the Technology-Based Emerging Companies Mutual Fund, aiming to capitalize small- and medium-sized technology-based companies in the state of Santa Catarina. With contributions from the Inter-American Development Bank, SEBRAE (the Brazilian support service for micro and small companies), IEL (the Euvaldo Lodi Institute) of Santa Catarina, and other local institutions, the fund’s target net asset value is US$ 13.1 million.

BNDESPAR also offers institutional support for the creation and implementation of new regional mutual investment funds for emerging enterprises.

\textsuperscript{10} BOVESPA – Bolsa de Valores de São Paulo, is the main Brazilian stock exchange market.
\textsuperscript{11} BOVESPA’s “Novo Mercado”, is a special listing category for companies willing to fulfill more strict corporate governance practices than those required by law, protecting and thereby attracting minority shareholders. It is inspired in part by Germany’s “Neuer Markt”.
Besides attracting new investors to the venture capital markets, BNDESPAR also seeks to develop private fund managers’ expertise in venture capital. Its institutional role in promoting venture capital has been important, creating new investment products, providing advice in the design of new shareholders agreements, structuring rules and regulations for the investment funds. BNDESPAR has been developing these tasks by working closely with other institutions as CVM, BOVESPA and ABCR.

In 2000 BNDES carried out two new stockholding transactions in co-managed funds; and four new investment transactions totaling US$ 11.5 million were approved, and effected directly through investment funds. These transactions show that BNDES continues to offer support for development of the closed investment funds industry – which aims to stimulate adoption of good corporate governance practices, transparency, communication and good relationship with minority stockholders, as well as developing competent managers for risk capital funds.

The creation of these programs and the constitution of these funds will make it possible for corporate governance activities related to these holdings to be carried out, increasing the exchange of experience between the managers of the funds and the company, and increasing the potential of results achievable from the policy of support to small- and medium-sized companies.

Another government initiative has been through its Financiadora de Estudos e Projetos - FINEP\textsuperscript{12}, and its INOVAR Project, which seeks to provide technical assistance and meeting opportunities for the various players involved in the venture capital markets. FINEP’s partners in this project are FUMIN\textsuperscript{13}, SEBRAE and PETROS\textsuperscript{14}.

It is worth mentioning that a new Corporate Law (Lei 10.303/2001) has just been issued in October 31, 2001. This law introduces a series of improvements over the previous

\textsuperscript{12} FINEP is a federal government agency devoted to financing research and development activities in Brazil
\textsuperscript{13} FUMIN is IADB’s Multilateral Investment Fund
\textsuperscript{14} PETROS is Petrobras employees’ Pension Fund, and also one of the largest institutional investors in Brazil
Corporate Law (Lei das Sociedades por Acoes – n.6404/76), and is also known as “Nova Lei das Sociedades por Ações”.

Among the main changes introduced by the new Law are:

1. Non-voting shares up to 50% of all shares (up to 2/3 under current legislation);
2. Reintroduction of right of withdrawal in a number of corporate restructuring issues;
3. Compulsory tender offer in case of takeover events;
4. Enhanced voting powers for minority shareholders, either for common or preferred stockholders;
5. Enhanced powers for CVM intervention in the event of conflicts of interest between shareholders.

It is believed that this legislative reform will have a positive impact on the risk capital industry as it will require better corporate governance practices, including wider disclosure, which will most likely benefit the minority shareholders, thus creating incentives for higher investment levels.
V. PUBLIC POLICIES FOR THE VENTURE CAPITAL INDUSTRY IN THE USA

According to the National Venture Capital Association (NVCA) reports, during the year 2000, venture capitalists invested over $100 billion into over 5,000 companies in the U.S. NVCA considers that 2000 was a record year, and such high investment levels are not expected to be sustainable considering the current economic uncertainty. However, it believes, based on past years and the current investment pace, investment levels for 2001 should be on par with 1998 and 1999 levels. The following table presents investment data for the period 1990-2000.

<table>
<thead>
<tr>
<th>Year</th>
<th>No. Of Companies Funded</th>
<th>Investment Total ($millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1990</td>
<td>1,317</td>
<td>3,376.21</td>
</tr>
<tr>
<td>1991</td>
<td>1,088</td>
<td>2,511.43</td>
</tr>
<tr>
<td>1992</td>
<td>1,294</td>
<td>5,177.56</td>
</tr>
<tr>
<td>1993</td>
<td>1,151</td>
<td>4,962.87</td>
</tr>
<tr>
<td>1994</td>
<td>1,191</td>
<td>5,351.18</td>
</tr>
<tr>
<td>1995</td>
<td>1,327</td>
<td>5,608.30</td>
</tr>
<tr>
<td>1996</td>
<td>2,004</td>
<td>11,277.67</td>
</tr>
<tr>
<td>1997</td>
<td>2,696</td>
<td>17,207.05</td>
</tr>
<tr>
<td>1998</td>
<td>3,155</td>
<td>22,576.49</td>
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<tr>
<td>1999</td>
<td>3,956</td>
<td>59,163.93</td>
</tr>
<tr>
<td>2000</td>
<td>5,458</td>
<td>103,848.59</td>
</tr>
</tbody>
</table>

Source: NVCA

There are approximately 693 venture capital firms in the United States. The venture capital industry manages approximately $210 billion. In 2000, the average venture fund size was $145.4 million.

Venture capitalists invest in young and innovative companies that have great potential for growth. In the U.S., venture capitalists were instrumental in developing industries, such
as the computer, biotechnology and the communications industries. Today, the majority of venture capital is invested in high technology companies. However, venture capitalists invest in all types of companies in many industry sectors.

In the U.S. market, venture-backed companies are leaders in job creation, innovation and international competitiveness. Companies such as Federal Express, America Online, Compaq and Sun Microsystems are all examples of successful companies who were once venture-backed.

Venture capital activity impacts the U.S. economy by:

- Creating and developing innovative companies and new industries.
- Improving the standard of living through the acceleration of new technology, processes, products, and services.
- Generation of significant tax revenues and international exports

The SBIC Program

Differently from today, over forty years ago an entrepreneur looking for the capital to launch a small business in the U.S. had very few sources to turn to. There was no institutional resource to back up promising but untried ideas. Again and again, businesses with great potential for innovation failed - or never got off the ground.

To help solve this problem, in 1958 U.S. Congress created The Small Business Investment Company (SBIC) program. SBICs, licensed by the Small Business Administration, are privately owned and managed investment firms. They are participants in a vital partnership between government and the private sector economy. With their own capital and with funds borrowed at favorable rates through the Federal Government, SBICs provide venture capital to small independent businesses, both new and already established.
All SBICs are profit-motivated businesses. A major incentive for SBICs to invest in small businesses is the chance to share in the success of the small business if it grows and prospers.

Today there are two types of SBICs - the original, or "regular" SBICs and SSBICs -- Specialized Small Business Investment Companies. SSBICs were specifically targeted toward the needs of entrepreneurs who have been denied the opportunity to own and operate a business because of social or economic disadvantage. The Small Business Program Improvement Act of 1996 repealed Section 301(d), which is the piece of legislation that created SSBICs, and as a result, no new SSBIC licenses are being issued. However, existing 301 (d) licensees were "grandfathered" and still in operation.

With few exceptions, the same rules and regulations apply to both "regular" SBICs and SSBICs. Therefore in general, the SBIC name is used to refer to both SSBICs and "regular" SBICs simultaneously.

Small businesses that qualify for assistance from the SBIC program are able to receive equity capital, long-term loans, and expert management assistance. Venture capitalists participating in the SBIC program can supplement their own private investment capital with funds borrowed at favorable rates through the federal government.

Only firms defined by SBA as small are eligible for SBIC financing. The SBA defines a company as small when its net worth is $18.0 million or less, and its average net (after tax) income for the preceding two years does not exceed $6.0 million. For businesses in industries for which the above standards are too low, alternative size standards are available. In determining whether a business qualifies, all of the business's parents, subsidiaries and affiliates are considered.

The program is self-sustainable, in the sense that tax revenue generated each year from successful SBIC investments more than covers the cost of the program. Additionally, the U.S. economy benefits as the small businesses financed by SBICs have created hundreds
of thousands of jobs over the program life. As an example, it was estimated that in the year 2000 some 60,000 to 120,000 new jobs were created due to the investment in new businesses by the SBICs.

The foundation of a SBIC is its management team; people who have venture capital expertise and capital, and who want to form a venture capital investment company. A SBIC can be organized in any state, as either a corporation, limited partnership, or a limited liability company. Most SBICs are owned by relatively small groups of local investors. Many, however, are owned by commercial banks. Some SBICs are corporations with publicly traded stock.

SBA requires a minimum private capital investment of $5 million for an SBIC, $10 million if they intend to utilize participating securities. A minimum of 30 percent of this capital must come from sources unaffiliated with the management.

An SBIC in good standing, with a demonstrated need for funds, may receive leverage equal to 300 percent of its private capital. However, in no event may any SBIC or SSBIC draw down leverage in excess of $108.8 million. VC firms intending to seek leverage are eligible to seek a commitment for up to two tiers that is good for 5 years (one tier is equal to the SBICs regulatory capital). Once leverage is committed, funds are drawn down as deals close.

To obtain leverage, SBICs issue their debentures, which are guaranteed by SBA. Pools of these SBA-guaranteed debentures are formed, and SBA-guaranteed participation certificates, representing an undivided interest in the pools, are sold to investors through a public offering. Under current procedures, the debentures have a term of ten years, and provide for semi-annual interest payments and a lump sum principal payment at maturity.

The ten-year debenture does allow prepayment during the first five years. Thereafter, the debenture may be prepaid without a penalty. In either case, the rate of interest on the debenture is determined by market conditions at the time of the sale.
The diagram presented below helps us clarify how the capital flows within the SBIC program.

1. The Budget proposes total program level, subsidy rates, and appropriations. The subsidy rate is an estimate, stated as a percentage, of the amount to be reserved against possible program losses.
2. Congress sets the final appropriation. The required appropriation is calculated by multiplying the program level by the subsidy rate.
3. A prospective SBIC must raise between $5 million and $10 million in private capital before it can be licensed. After licensing, the private capital is always at risk first.

4. Money (leverage) can only be drawn from the Trust after application to and approval by the SBA. A full credit and regulatory compliance review is performed each time leverage is sought. Money drawn by SBICs is repaid in accordance with the terms of the securities.

5. SBA guarantees the payment by the Trust of all principal and interest due on the certificates sold to the public capital market.

6. Money for leverage is raised by quarterly sales of 10-year SBA-guaranteed securities bearing interest at a rate equal to that of 10-year Treasury Bonds plus an average of about 70 basis points.

7. Participating securities SBICs pay approximately 10% of their profits to the SBA.

8. Investments in small U.S. businesses may be in the form of loans, loans with equity features (e.g., options to obtain stock in the future) or purchase of equity (stock).

Besides the opportunities for government leverage, all SBICs can benefit from a number of tax advantages. Also, bank ownership in an SBIC subsidiary permits banks to invest in small businesses in which they could not have otherwise invested, because of banking laws and regulations. A bank may invest up to 5% of its capital and surplus in a partially or wholly-owned SBIC.

It is the function of the SBIC to act as a financier for small business concerns. SBICs have great flexibility in terms of financing options, which result in financings specifically tailored to the needs of each small business concern. SBICs can make long-term loans to small business concerns in order to provide them with funds needed for their sound financing, growth, modernization, and expansion.

An SBIC may provide loans independently, or in cooperation with other public or private lenders. SBIC loans to small business concerns may be secured, and should be of sound
value. Such a loan may have a maturity of no more than 20 years, although under certain conditions the SBIC may renew or extend a loan's maturity for up to 10 years.

An SBIC may elect to loan money to a small business concern in the form of debt securities - loans for which the small business concern issues a security, which may be convertible into or have rights to purchase equity in the small business concern. These securities may also have special amortization and subordination terms.

By law, the SBIC must provide equity capital to small business concerns, and may do so by purchasing the small business concern's equity securities. The SBIC may not, however, become a general partner in any unincorporated small business concern, or otherwise become liable for the general obligations of an unincorporated concern.

A Corporation, limited partnership, or limited liability company may apply to the Small Business Administration for a license to operate as a Federal Licensee under the Small Business Investment Act of 1958, as amended, and the rules and regulations issued thereunder.

The two primary criteria for licensure as an SBIC are qualified management and sufficient private capital. SBA reviews and approves prospective management teams based upon both their professional capabilities and character. If both of the above criteria are met, and the organizational and legal documents of the Applicant are in conformity with SBA's regulations, the SBIC Applicant will receive its license.

Once licensed, each SBIC is subject to annual financial reporting and biennial onsite compliance examinations by the SBA, and is required to meet certain statutory and regulatory restrictions regarding approved investments and operating rules.

The SBA, in the regulatory process, seeks to minimize its role in the day-to-day operations of SBICs. The regulations listed below exist to protect the interests of small business concerns and the integrity of the program, and to ensure its overall effectiveness:
TYPES OF BUSINESSES:
SBICs may invest only in qualifying small business concerns as defined by SBA regulations. SBICs may not invest in the following: other SBICs, finance and investment companies or finance-type leasing companies, unimproved real estate, companies with less than one-half of their assets and operations in the United States, passive or casual businesses (those not engaged in a regular and continuous business operation), or companies which will use the proceeds to acquire farm land.

CONFLICT OF INTEREST
An SBIC may not engage in "self-dealing" to the advantage of or with favoritism to its associates. The SBA defines associates broadly to include:
- Certain of its shareholders, officers, directors, and employees;
- In an unincorporated SBIC, its members, control persons, and employees.
The SBIC may not directly or indirectly provide financing to any of its associates. It may not borrow money from a small business concern it has financed, nor from the small concern's owner or officers.

CONTROL
An SBIC is not permitted to control, either directly or indirectly, any small business on a permanent basis. Nor may it control a small business in participation with another SBIC, or its associates. In certain instances, the SBA may allow an SBIC to assume temporary control in order to protect its investment. But in those cases the SBIC and the small concern must have an SBA- approved plan of divestiture in effect.

OVERLINE LIMITATIONS
Without written SBA approval an SBIC may invest no more than 20% of its private capital in securities, commitments, and/or guarantees for any one small concern.

COST OF MONEY
The cost of money on SBIC loans and debt securities charged to small concerns is regulated by the SBA, and is governed by applicable state regulations, or by SBA regulations, whichever is lower.
PROHIBITED REAL ESTATE INVESTMENTS
An SBIC may not invest in farmland, unimproved land, cemetery subdividers or developers, or any small concerns classified under Major Group 65 (Real Estate) of the SIC Manual, with the exception of subdividers and developers, title abstract companies, real estate agents, brokers, and managers.

PROHIBITED RELENDING, REINVESTING
SBICs may not provide funds for a small concern whose primary business activity involves directly or indirectly providing funds to others, purchasing debt obligations, factoring, or leasing equipment on a long-term basis with no provision for maintenance or repair.
However, SBICs and SSBICs may finance Disadvantaged Concerns engaged in relending or reinvesting activities (except agricultural credit companies, and those banking and savings and loan institutions not insured by agencies of the Federal Government).

PROCEEDS OF FINANCING
In general, investment funds used to purchase securities must go directly to the small business concern issuing the securities. They should not be used to purchase already outstanding securities such as those on a stock exchange, unless such a purchase is necessary to insure the sound financing of a small concern, or when the securities will be used to finance a change of ownership. The purchase of publicly offered small business securities through an underwriter is permitted as long as the proceeds of the purchase will go to the issuing company.

MINIMUM PERIOD OF FINANCING
Loans made to and debt securities purchased from small concerns should have minimum terms of five years. The small concern should have the right to prepay a loan or debt security with a reasonable penalty where appropriate.
Loans and debt securities with terms less than five years are acceptable only when they are necessary to protect existing financings, are made in contemplation of long-term financing, or are made to finance a change of ownership.
Program Statistics and Evaluation

Since 1958, the SBIC program has provided approximately $27 billion of long-term debt and equity capital to nearly 90,000 small U.S. companies, with $5.5 billion invested in 3,060 small businesses in fiscal year 2000 alone. A private-sector advisory council estimated that these investments have created well over one million jobs in manufacturing and service businesses.

As of December 2000, there were 404 SBICs with over $16 billion under management operating in 45 states, the District of Columbia, and Puerto Rico. In states not generally served by private venture capital firms, SBICs play an important role in financing local businesses. Of the $16 billion managed by SBICs, $10.8 billion is private capital and $5.2 billion is SBA-guaranteed capital.

Congress improved and strengthened the SBIC program with legislation passed in 1992. Additional legislative improvements were made in 1996, 1997, 1999, and 2000. Since 1994, when regulations implementing the 1992 changes were first published, there has been significantly greater private sector investment in SBICs. Since the beginning of 1994, SBA has licensed 254 new SBICs with over $3.9 billion in initial private capital. In 2000 alone, SBA licensed 60 new SBICs with $1.2 billion in initial private capital.

In the improved SBIC program, through the use by SBICs of Participating Securities, the government receives a portion of any SBIC profits. This is in addition to the return of any amounts advanced to an SBIC, plus a priority payment equivalent to an interest payment. The government's share is approximately 10% under most circumstances. The government has received over $250 million in profits in just six years.
Because of changes made since 1994, the SBIC program is safer than ever before from the perspective of U.S. taxpayers. In 1993, 25 of 280 SBICs required liquidation by SBA. In 2000, only five of 395 SBICs required liquidation.

The SBIC program will do more with less government involvement in fiscal year 2001. Program improvements, professional management, and increases in interest and fees paid by SBICs have reduced the cost to government. In 1995, it took $44.4 million in federal funds to make $355 million available that year for investments in small businesses. In fiscal year 2001, it will take only $30.1 million in funds—a 32% decrease—to make $2.15 billion—a 520% increase—available to augment SBIC private capital for investments in small businesses.

Total SBIC investments in small U.S. companies should total approximately $6 billion in 2001. For every taxpayer dollar expended, at least $200 will be invested in a small company.

**SBIC Program Statistics**

<table>
<thead>
<tr>
<th>Fiscal Year 2000</th>
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</thead>
<tbody>
<tr>
<td><strong>A. Number &amp; Size of Investments</strong></td>
</tr>
<tr>
<td>Participating Security SBICs</td>
</tr>
<tr>
<td>Debenture SBICs</td>
</tr>
<tr>
<td>Bank SBICs (No Guaranteed Leverage)</td>
</tr>
<tr>
<td>Specialized SBICs</td>
</tr>
<tr>
<td><strong>Total Investments</strong></td>
</tr>
</tbody>
</table>

*Notes:*

1. A total of 3,060 U.S. small businesses received SBIC financing in FY'00, a 54% increase over FY'99.
2. The median investment for bank SBICs was $1.46 million. For all SBICs it was $250,000.
3. The average non-SBIC venture capital investment in 2000 was approximately $12 million.
4. SBICs invested $1.35 million in Low and Moderate Income (LMI) area businesses in FY'00.
5. Participating Security SBICs have distributed $253 million in profits to the government since 1994.

Source: NASBIC
<table>
<thead>
<tr>
<th>B. Type of Financing Provided</th>
<th>Total $ Amount</th>
<th>Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Straight Debt</td>
<td>392,663,543</td>
<td>7.2</td>
</tr>
<tr>
<td>Debt With Equity Features</td>
<td>1,052,275,955</td>
<td>19.2</td>
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<tr>
<td>Equity Only</td>
<td>4,021,340,166</td>
<td>73.6</td>
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<tr>
<td>All Categories</td>
<td>5,466,279,664</td>
<td>100.0</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>C. Age of Small Business Financed</th>
<th>Total $ Amount</th>
<th>Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Under 1 Year</td>
<td>1,973,561,267</td>
<td>36.1</td>
</tr>
<tr>
<td>1 to 3 Years</td>
<td>1,453,853,531</td>
<td>26.6</td>
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<tr>
<td>3 to 6 Years</td>
<td>963,171,136</td>
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<tr>
<td>6 to 10 Years</td>
<td>393,911,316</td>
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<tr>
<td>Over 10 Years</td>
<td>681,772,414</td>
<td>12.5</td>
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<tr>
<td>All Categories</td>
<td>5,466,279,664</td>
<td>100.0</td>
</tr>
</tbody>
</table>

Source: NASBIC
VI. CONCLUSION

Small businesses have been receiving increased attention from public policymakers, both in developed and developing countries. They are now widely recognized as a leading source of income, employment, wealth, and technological innovation.

In order to allow small businesses to thrive and prosper, adequate sources of financial leverage should be available. In their stage of the business life cycle, long-term loans or equity capital are usually preferred over short-term financing.

Venture capital can be regarded as one of the best financial alternatives for small business. In addition to providing equity or long-term financing, venture capital firms also contribute to small businesses with management expertise, gained from helping other companies with similar growth challenges.

However, even in developed financial markets, private venture capital funds for small businesses can be scarce. In this case, if social returns are large enough, as a consequence of the economic benefits above mentioned, there is a role for government intervention.

Trying to address this market failure, governments have created programs to support small businesses through venture capital funding. This paper described such programs in Brazil and the United States.

In Brazil, the almost complete lack of private venture capital firms in the past forced the government to provide directed credit through its wholly owned bank, BNDES (more specifically, through its subsidiary BNDESPAR).

In the recent past, BNDES has increasingly shifted its emphasis toward indirect funding, as privately managed venture capital funds are coming to the market. It has been playing a decisive role in the development of an industry of private fund managers, as the best way to broaden the access for small businesses to financial resources.
In the United States, which has the world’s most developed financial markets, the same market failure rationale was applied in the creation of the Small Business Investment Companies program. In the SBIC program, administered by the Small Business Administration agency, federal funds help the leverage of private funds, invested by private-owned and managed investment companies (venture capital funds) in small businesses.

An interesting feature of this program is that a very small fraction of the total invested is actually public money. Through a smart mechanism, government-guaranteed securities are issued, and sold to institutional investors as pension funds, insurance companies and banks.

The proceeds of these sales are in turn used by the investment companies in providing financial support to small businesses. As described earlier in this paper, the multiplier effect of the federal funds is around 200; that is, for each taxpayer’s dollar, $200 will be invested in a small company.

In order to generate a higher leverage for the public funds invested in venture capital in Brazil, some goals should be pursued, such as:

? Increase the participation of institutional investors in venture capital funds. Among these investors are the pension funds, corporate investors and foreign investors. Government-guaranteed securities, as those in the U.S. market could be designed in order to match the more risk-averse profile of those investors.

? Increase liquidity conditions for the venture capital funds, either through the stock markets or other alternative mechanisms linked to guarantees provided by the government.

? Reduce restrictions and transaction costs imposed on venture capital funds. Changes in the regulatory and fiscal environment are necessary to provide better incentive to venture capital investment.
Although it seems that there is a long road ahead for the development of venture capital in Brazil, we are optimistic about its future, mostly because a clearer understanding of its important role as a financial instrument for the growth of small businesses is being reached. Better public policies are currently being devised, and an increasing interest from private investors also is being noted.

These conditions, coupled with a stable macroeconomic environment and a sounder legislation, shall lead to a stronger venture capital market in Brazil over the next few years.
VII. REFERENCES

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