Incubating Financial Development: Private Equity and the State

by

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Abstract

This dissertation is motivated by two observations. The first one is that three decades after democratization and liberalization reforms, capital markets in Latin America remain underdeveloped. The second one is the considerable amount of state-related funds behind private equity (PE) investments, both in emerging and developed economies. Combining these two observations and using comparative case analysis to study the emergence of private equity markets, this dissertation proposes a shift in arguments about financial development and corporate governance reform: it emphasizes the role of state-related investors instead of just focusing on the institutional—political and economic—determinants of investment.

This dissertation makes three main arguments. First, that private equity investors contribute to the development of financial systems by providing firms with a distinctive source of financing that has no bank-based substitutes. PE investors drive more institutional ownership and corporate governance structures, helping modernize business. Second, that state-related institutional investors play an important role in the emergence of domestic PE markets. Multilateral and domestic development financial institutions have an "incubating" role during the early stages of the PE industry, followed by the involvement of pension funds. And third, it advances a "quiet politics" explanation of the emergence of private equity. It emphasizes the public-private collaboration behind PE industry associations. These associations, in turn, help "co-create" the industry's regulatory framework, operating at the margins of partisan and legislative politics.

Ultimately, this dissertation makes three broad theoretical contributions: (1) it introduces private equity into the development debate; (2) prompts a shift in the discussion on financial development from institutional explanations focused only on rules—democracy and investor protections—to actor-based arguments centered on the role of institutional investors, in particular pension funds; and (3) characterizes a novel model of "financial" industrial policymaking.

Thesis Supervisor: Ben Ross Schneider
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Abbreviations

ABVCAP	Associação Brasileira de Private Equity e Venture Capital (Brazil)
ACAFI	Asociación Chilena de Administradores de Fondos de Inversión (Chile)
ACVC	Asociación Chilena de Venture Capital (Chile)
AMEXCAP	Asociación Mexicana de Capital Privado (Mexico)
AFORE	administradora de fondos para el retiro (Mexico)
AFP	administradora de fondos de pensión (Chile and Colombia)
ANSES-FGS	Administración Nacional de la Seguridad Social – Fondo de Garantía de Sustentabilidad (Argentina)
ARCAP	Asociación Argentina de Capital Privado (Argentina)
BANCOLDEX	Banco de Comercio Exterior de Colombia
BNDES	Banco Nacional de Desenvolvimento Econômico e Social (Brazil)
BNDESPAR	BNDES Participações (Brazil)
CAF	Corporación Andina de Fomento
CKD	certificado de capital de desarrollo
COLCAPITAL	Colombia Capital
CORFO	Corporación de Fomento de la Producción (Chile)
CVM	Comissão de Valores Mobiliários (Brazil)
DFI	development financial institution
EMPEA	Emerging Markets Private Equity Association
FINEP	Financiadora de Estudos e Projectos (Brazil)
FdF	Fondo de Fondos (Mexico)

FDN	Financiera de Desarrollo Nacional (Colombia)
FIP	fundo de investimiento en participacões
FONADIN	Fondo Nacional de Infraestructura (Mexico)
FONDCE	Fondo Fiduciario para el Desarrollo del Capital Emprendedor (Argentina)
GP	general partner
IDB	Inter-American Development Bank
IFC	International Financial Corporation
IPO	initial public offering
LAVCA	Latin American Venture Capital Association
LP	limited partner
MIF	Multilateral Investment Fund (IDB)
MDFI	multilateral development financial institution
MNC	multinational company
NAFIN	Nacional Financiera (Mexico)
PE	private equity
PPP	public-private partnership
SME	small-medium enterprises
SOE	state-owned enterprise
VC	venture capital

Chapter 1 - Introduction

This dissertation is motivated by two observations. The first one is that three decades after democratization and liberalization reforms, Latin American capital markets remain underdeveloped. The second one is the amount of state-related money that funds private equity (PE) investments. Combining these two observations and studying the emergence of private equity markets in Latin America, this dissertation proposes a shift in arguments about financial development and corporate governance reform: it emphasizes the role of state-related investors as an alternative to just focusing on the institutional—political and economic—determinants of investment.

Financial markets play a nodal role in capitalist economies. Well-functioning financial systems attract savings and channel them to productive investments. They encourage firm creation and competition, foster investment, and enhance productivity and innovation. There is strong evidence that a country's financial development is causally associated with its long-term economic growth and the material well-being of its population (Levine 2005; Levine, Loayza, and Beck 2000; Rajan and Zingales 1998; Samila and Sorenson 2011). While there is broad consensus on the importance of finance for economic development, there is less agreement on the political economy dynamics behind the high degree of variation in financial development observed across countries.

Mainstream political economy literature on financial development highlights the relevance of inclusive political and economic institutions. Open political systems, competitive markets and secured property rights curb incumbents power and inhibit expropriation, unleashing capital markets (Girma and Shortland 2007; Haber, North, and Weingast 2008; Menaldo and Yoo 2015; Rajan and Zingales 2003). Latin America made substantial advances in the key variables identified

by this literature. In the last three decades, by consolidating democracy, Latin American political institutions have become more inclusive and executive-powers more constrained. Macro-economies have mostly stabilized, privatization programs were implemented and trade was liberalized. The regulatory frameworks of most Latin American financial systems also came closer to those of advanced economies: interest rates were deregulated, capital controls lifted, and legal reforms were passed to protect investor rights (Abiad, Detragiache, and Tressel 2010). Still, in terms of outcomes, progress has been limited, in particular with respect to equity markets.

The market capitalization and liquidity of Latin American stock markets is significantly lower than what would be expected given the region's level of development (Heng et al. 2016; Schmukler, Gozzi, and De la Torre 2007).[1] Firm ownership structures remain substantially concentrated and institutional investors are mostly absent, even among listed companies (De La Cruz, Medina, and Tang 2019). Corporate governance remains organized around families and multinational companies, making Latin American capitalism more hierarchical, and arguably hurting its competitiveness and productivity (Caselli 2014; Schneider 2013).

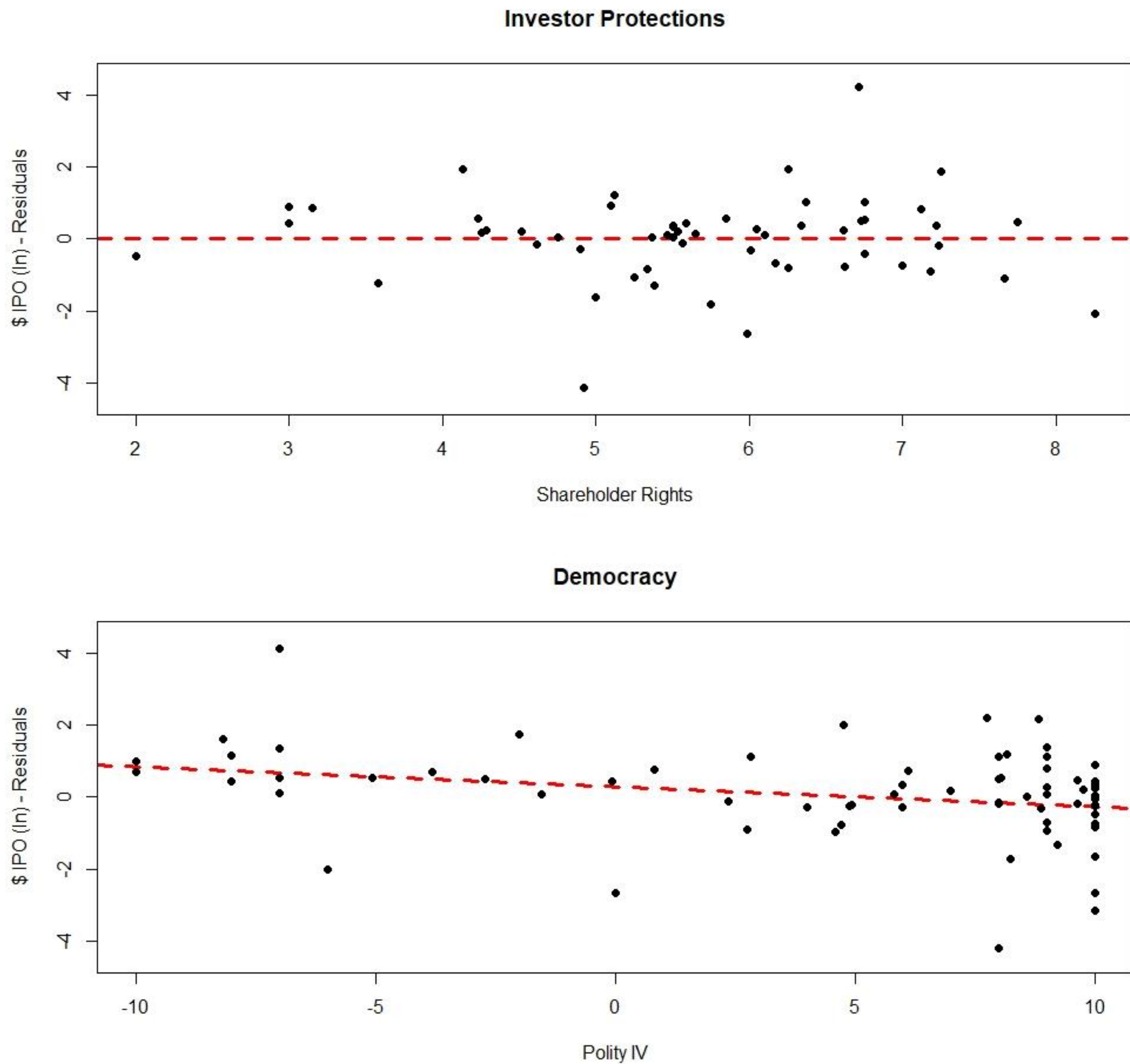
Beyond Latin America, and over the last two decades, inclusive political and economic institutions do not seem to have great explanatory power either. Figure 1 displays the relationship between capital raised through initial public offerings (IPOs) at the country level and average scores for investor protections and democracy.[2] Shareholder legal protections do not appear to be associated with IPO activity (Guillén and Capron 2016). And democratic institutions appear to have a—weak—but negative relationship with the amount of capital raised in stock markets

[1] See Figure 7 in Chapter 2.

[2] IPOs are the process through which a private company goes public by selling its stocks to the general public. IPO proceeds is, arguably, a better indicator of stock market development than market capitalization figures (see, for example, discussion in Rajan and Zingales (2003)).

(Huang 2010; Yang 2011). While far from conclusive, these correlations suggest that exploring arguments that go beyond an institutionalist framework based just on rules may be a worthwhile endeavor.

Figure 1: Investor protections, democracy and IPOs



Note: Data for IPOs was obtained from Capital IQ, and covers the 2002-2017 period for all countries with an active stock market. The y-axis plot the residuals after regressing the IPO proceeds ($) on country's GDP and GDP per capita. Data for shareholder protections comes from Guillén and Capron (2016), democracy and executive constraints scores are from Polity IV; controls were obtained from the World Bank. Results are directionally unchanged when including GDP growth as a covariate, using executive constraints scores instead of democracy, and excluding Hong Kong as an independent observation.

As for the second observation that motivated this dissertation, there is significant state-related capital behind private equity investors across both the developed and the developing world (Brander, Du, and Hellmann 2015). For example, Saudi money is behind the $100B mammoth SoftBank Vision Fund. Temasek and GIC, the two Singaporean sovereign wealth funds (SWF), are among the most active private equity investors, globally as well as domestically. The European Investment Fund (EIF) is Europe's largest investor in venture capital and mid-market private equity funds. Publicly-managed Canadian pension funds are one of the world's most sophisticated investors in alternative assets. And even in the US, the archetypical liberal market economy and where the private equity model is most extended, public pension funds are major investors in the asset class.

Even in Latin America, where states have weaker capacities and less developed financial bureaucracies, most countries have state-owned financial institutions investing in private equity. For example, BNDES *(Banco Nacional de Desenvolvimento Econômico e Social)*, a development bank, is a large private equity investor in Brazil; state-owned *Fondo de Fondos* had an important role in the emergence of the private capital industry in Mexico; CORFO *(Corporación de Fomento de la Producción)* has been running a government-funded risk capital program since the 1990s in Chile, and the new FDN *(Financiera de Desarrollo Nacional)* has been an anchor investor supporting infrastructure funds in Colombia.

Within Latin America, the development of equity markets does not reconcile well with rule-based institutional arguments based on macro-economic stability, open markets, constrained executives and investor protections either. For example, Brazil's volatile, closed, and interventionist economy, with recurring fiscal deficits and an underfunded pension system exhibits the region's largest and most institutionalized private capital industry, as well as the most active

stock market. Chile, the richer, more stable and market-oriented country in the region, with the largest privately-managed pension funds, exhibits a relatively smaller presence of private equity investors. And Chile's stock market, even though large in terms of market capitalization, is illiquid and shows limited fundraising activity. Then, what explains the emergence and institutionalization of PE and the development of stock markets in Latin America? And what can we learn from these experiences about more general questions on financial development and corporate governance reform?

This dissertation makes three main arguments. First, it argues that private equity plays an important role in the development of financial systems by providing a distinctive source of financing to firms that has no bank-based substitutes. PE investors drive more institutional ownership and corporate governance structures, helping modernize business.

Second, it argues that the role of state-related investors is a more relevant factor to explain the emergence of domestic PE markets in Latin America than macro-level investor protections. In particular, multilateral and domestic development financial institutions appear to have an "incubating" role during the early stages of the PE industry, followed by the involvement of pension funds.

Third, and regarding the politics behind the emergence of this new actor, my dissertation advances a "quiet politics" explanation. It emphasizes the role of industry-specific business associations created by the collaboration between public agencies and industry participants. These associations, in turn, help "co-create" the industry's regulatory framework. Operating at the margins of partisan politics and Congress, they pushed for regulations that allowed fund managers to tap into pension funds resources, obtain tax benefits, and create new investment vehicles, and

helped legitimize PE's investment activities.

It is important to clarify upfront that while my agency-based argument forefronts policymaking, my dissertation does not argue that state-related financial institutions are always effective, that bureaucrats have better capabilities to allocate capital than market participants, or that property rights are not important for development. Government programs aimed at enhancing private equity markets certainly face many trade-offs, and many of them fail and waste taxpayers' money. Recurrent state expropriation definitely inhibits financial development. And I do not challenge the vast evidence that suggest well-defined and strongly protected property rights foster long-term development. Instead, my argument is that it is very hard to develop a local private capital industry without a more active government role than the one acknowledged by the mainstream literature on financial development.

By providing evidence for these three arguments, this dissertation hopefully makes several broader contributions, beyond the narrow interest in the development of private equity in Latin America.

First, it updates the typology of business actors in emerging economies and introduces a novel investor to the development debate. Private equity financing can provide firms with a distinctive source of *institutional*, *risk* and *patient* capital that has no bank-based substitute. Private equity investors can be described as hybrid organizations in at least three ways: (1) they broker international finance with local management, (2) they manage external—mostly institutional—capital but act as owners, and (3) even though they are financial investors, their role goes beyond solving capital constraints and include an active involvement in firm governance and management (Fuller 2016; Taylor 2016). The dissertation highlights the centrality of finance, firm ownership

structures and corporate governance when thinking about productive development.

Second, it proposes a shift in the literature on financial development and corporate governance reform by presenting an actor-based approach that emphasizes the role of state-related institutional investors—in particular development banks and pension funds—as an alternative to rule-based explanations centered on investor protections and inclusive political institutions. Investor property rights, while certainly relevant, are by themselves insufficient to explain the emergence of more active private equity markets. This industry has to be actively nurtured by state-related investors. Moreover, the regulatory reforms that encourage the emergence of private equity investors are made mostly outside of Congress and partisan politics, and are not consistent with arguments that emphasize the relationship between democracy and financial development. Equity markets do not simply unleash with more constrained rulers. And reforms do not appear to be pushed by popular support. Instead, this dissertation provides visibility to the "quiet" public-private collaboration behind the institutionalization of private capital markets. Public agencies often play a role facilitating collective action and shaping interest representation in order to have organized business counterparts. Consistently across my cases I find that fund manager business associations emerge with direct support from public agencies. In turn, these business associations serve as the private-sector counterparts of their sponsors and other state agencies and help build the industry's regulatory framework. In this way, private sector organizational capabilities appear to be a pre-requisite for successful policy design and implementation. Overall, the findings from this dissertation introduce some skepticism on the literature's linear relationship between democracy, property rights protection and financial development.

And third, this dissertation introduces a novel model of "financial" industrial

policymaking. States promote private equity with the "horizontal" purpose of completing capital markets and making equity financing more accessible. And many policymaking initiatives also channel public resources through privately-managed equity funds in a more targeted way, focusing on specific sectors and industries. This new industrial policy model seems to be part of a paradigm shift in market interventions. It has finance at its core, intends to "crowd-in" other private investors, and has the private sector as the main provider of developmental solutions. At the expense of losing some control, states "outsource" productive development policymaking to PE firms. Doing so, they arguably achieve better governance schemes, improve their screening and monitoring capacities and discourage rent-seeking (Inoue, Lazzarini, and Musacchio 2013; Musacchio, Lazzarini, and Aguilera 2015).

The rest of this chapter is organized as follows: First, it introduces private equity. It describes private equity's investment model, discuss evidence about its performance, and contrasts it with other corporate governance arrangements prevalent in the region. Second, it makes the case for why Latin America is an interesting region to study this topic. Third, it discusses data sources and presents the dissertation's methodological approach. And fourth, it gives an overview of the dissertation.

1.1 What is Private Equity?[3]

I define this dissertation's object of study as those investors who share three characteristics. First, they are financially oriented, in contrast to typical corporate investors. Second, they have an

[3] For a general introduction to private equity, see Cendrowski et al. (2011). For an introduction to private equity in emerging markets, see Leeds (2015).

active approach to management and get involved in firm-level decision making.[4] And third, they exhibit a medium to long-term investment horizon, in contrast, for example, with a standard mutual fund. Regarding the *private* component of private equity, PE encompasses a group of "alternative" and mostly illiquid assets defined in opposition to traditional public securities such as stocks and bonds that trade in highly-regulated and more liquid markets. And PE investors mostly do *equity* investments rather than loans, which grants them ownership rights and enables them to have a more active approach to governance.

It is worth clarifying two concepts upfront. First, "public" securities refer to those financial instruments—typically stocks and bonds—that are listed on exchanges markets (e.g. New York Stock Exchange or B3 in São Paolo). The "public" characterization does not refer to these instruments being state-owned, but that they are traded in public markets. Second, throughout the dissertation I use private equity and private capital interchangeably, creating a broader definition that includes quasi-equity instruments such as convertible debt or mezzanine financing,[5] among others.

For the purpose of the dissertation, I group an "alternative" asset class that includes venture capital (VC), private equity (growth and buyout), as well as infrastructure investment.[6] Private equity, and private capital more broadly, serves as an umbrella term. The distinction between these

[4] By investors that have an active approach to management I refer to those that participate in the operational and strategic decision-making of their portfolio companies. I am not referring here to hedge-funds "raiders" that buy public shares, obtain a seat in the company's board and try to effect major changes in the company, usually described as "activist investors."
[5] Hybrid of debt and equity financing, typically senior only to common shares.
[6] The specific meaning of these different sub-classes is context-dependent and may induce some confusion. In its origin, private equity was mostly referred as venture capital, which was less associated to tech investments as it may be now. The term private equity was then more associated with leveraged buyouts. Given the industry's disparate reputations, different terms are also used to legitimize the activity (e.g. risk and venture capital over private equity or buyouts).

sub-classes is fuzzy and context-specific: it can be based on industry (e.g. tech vs. infrastructure), risk profile (e.g. early stage vs. mature) or transaction size. Beyond these blurry definitions, the main reason to group these sub-classes is that they follow a similar business model and share similar regulatory requirements, and therefore are typically part of the same industry associations.

Private equity allows the flow of institutional capital into firms outside of public markets. Institutional investors such as pension funds invest in private equity to complement their portfolio with more illiquid and risky assets, with the goal of enhancing their financial returns. They usually outsource the management of their PE investments to independent professional fund managers, typically organized into partnerships, who pool capital from various sources. Fund managers can specialize in a particular geography and/ or market segment. This allows them to better screen investment opportunities, structure transactions, and provide oversight and guidance to their portfolio companies. They invest in concentrated stakes in a few companies, instead of having a well-diversified portfolio of public securities, as traditional asset managers do.

PE managers are certainly distinguished by their financial expertise (Ivashina and Kovner 2011). But they also have a hands-on approach with regard to their portfolio companies. What makes the private equity phenomenon interesting is this dual role: they are not only external capital providers but also provide management and strategic guidance to the firms they invest in. As opposed to portfolio investors who just use the “exit” option, private equity investors make a more active use of their voice (Hirschman 1970).

PE fund managers typically exhibit a multi-level embeddedness as they are both closely related to international and local business communities, blending international finance with local management. In order to secure financing they have distinctive ties with international investors,

acting as brokers of external funds into the countries they operate in. International ties are typically fostered by career paths that include studying and working experiences outside of their home countries, mostly in the US. At the same time, these managers are also tightly integrated into the local business communities. They usually form dense working networks with multiple intermediaries and service providers such as law, accounting, and consulting firms, pension funds, investment banks, business associations and policymakers, among others.

In the US, the private equity model began associated with venture capital and small business financing. But the industry grew in the eighties through the—typically leveraged—buyouts of larger and more established firms. The consolidation of the industry followed changes in pension system regulations, laxer regulations facilitating take-overs, and a paradigm shift in theories of financial economics centered on shareholder value (G. F. Davis 2009; Gompers 1994). The growth of the PE model was part of a reaction to the agency costs of public markets and contributed to undermine the traditional model of a dispersed shareholder corporation with a clear separation between ownership and control. Jensen's (1989) seminal article argued that private equity firms would eventually become the dominant form of corporate organization, "eclipsing" the publicly held corporation with dispersed shareholders, low levels of debt and managerial autonomy (Jensen and Meckling 1976). As an alternative to Berle and Means' (1932) model of the firm and to Chandler's (1977) multi-division business conglomerates, leveraged buyout organizations emerged as a governance technology that would provide superior results for shareholders based on concentrated ownership stakes usually involving some level of control, intensive use of debt-financing, high-powered incentives both at the partnership and at the portfolio company level, concentration in core competencies and minimal overhead costs.

In this vein, PE is viewed as the ultimate expression of financial capitalism and the shareholder-value model. Certainly a controversial actor, it is often portrayed as extracting rather than creating value (e.g. Eaton, Howell, and Yannelis 2019). Below I discuss the existing evidence of its impact over different dimensions. More importantly, I compare the model as it operates in the US, where it first emerged and is far more developed, with its functioning in less develop contexts such as Latin America. The sharp contrast between these two contexts suggests differences in both the political economy dynamics behind PE and on its implications.

PE was introduced to Latin America after the liberalization reforms of the 1990s, having the American model as a blueprint. But in this region, as well as in other emerging economies, private equity does not substitute a governance model of publicly-listed companies with dispersed shareholders. Instead, it has to emerge from an environment characterized by scant external finance from both banks and capital markets, traditional ownership structures and no market for corporate control. In contrast with its role in more developed capital markets, where private equity concentrates ownership as a way to check managers' autonomy, in Latin America, private equity is an alternative to traditional governance models organized around families and individuals. In a context where stock markets with dispersed ownership and unchecked managers are notably absent, PE plays a very different role. It actually helps develop capital markets, modernize firm ownership and professionalize corporate governance models.

Notwithstanding these key contextual differences, PE in Latin America is certainly a force favoring the extension of markets and "financialization," as elsewhere (G. F. Davis and Kim 2015; Philippon 2015). Private equity investors are often portrayed as the forefront of financial globalization. And indeed fund managers often raise capital internationally, source deals in

multiple countries, and operate through off-shore vehicles. But crucially, this dissertation shows that the private capital industry is still anchored by national-level institutions. Behind a seemingly market-driven phenomenon, I find novel forms of policy interventions that actively promote this new corporate actor: states invest in nascent private equity ventures, encourage local institutional investors to follow their lead, help private equity investors organize into business associations and develop regulations to unleash the industry. But before engaging in the question about the industry's origin, I further describe some key elements of the private equity model and compare it to other ownership and governance models prevalent in the emerging world.

1.1.1 How are they Different? Finance, Governance and Operations

The main novelties of this organizational model can be noted by analyzing its distinctive approach to financial management, governance and operations (Kaplan and Strömberg 2001, 2009). On the financial side, a central characteristic of private equity investors is their intensive use of debt finance, particularly in the case of buyouts. Debt usually enjoys an advantageous tax treatment given the deductibility of interest payments, and leverage boosts returns and helps concentrate control. Moreover, the pressure to meet debt repayments helps discipline management avoiding slack and "empire building" practices. This aspect of the business model is often highlighted by its critics (e.g. Appelbaum and Batt 2014) as the heavy use of debt and the resulting high leverage ratios increase firm's risk profile, can induce moral hazard and ultimately jeopardize the business sustainability.

During the nineties in Latin America there were a few cases of leveraged buyouts, particularly in Argentina (e.g. Lerner, Hoye, and Pacanins 1997). But more generally, given the more volatile macroeconomic context and less developed debt markets, highly-leveraged strategies

do not seem to be a great fit with the Latin American environment. Transactions exhibit less leverage than in the US: the proportion of debt with respect to equity is lower, generating less risky capital structures. As I will show, in Latin America leverage is actually more closely associated with family control. There are no mega-buyouts such as the ones in the US and in Europe, which are usually the focus of critics to the industry. Instead, most transactions are in the equivalent of mid-and-small-market categories in the US. Transactions are usually growth-oriented and in most cases take place with the active cooperation of management and shareholders (Leeds 2015).[7]

Regarding the sources of capital, PE funds typically tap into large pools of institutional financing. The main sponsors of this business model are public and private pension funds, insurance companies, university endowments, sovereign wealth funds, as well as wealthy individuals and their family offices. Retail investors are notably absent, except indirectly as pensioners.

Some of the larger international partnerships investing in Latin America have access to large "global capital allocators." Regional-focused fund managers also typically secure capital commitments from national and multilateral development financial institutions, local pension funds, as well as from wealthy local individuals and families. As I discuss throughout the dissertation, developing a domestic base of fundraising sources is one of the key challenges for the

[7] A stark difference between the US and the Latin American more recent experience is the commonness of hostile takeovers. As opposed to what happens in the US, given Latin American shallow capital markets and concentrated ownership structures, most (if not all) deals are "friendly," meaning that they demand an active cooperation of existing management and founders/shareholders. Notably, both in the US and Latin America, private equity firms have regularly invested in companies that are suffering from financial distress. Their financial and legal expertise makes PE investors particularly skilled to deal with debt refinancing and overall corporate restructuring (e.g. see, Hotchkiss, Smith, and Strömberg 2010, Johnston-Ross, Ma, and Puri 2020).

Latin American industry.[8]

Private equity firms exhibit a distinctive approach to compensation based on performance, in an attempt to make managers act more like owners. PE fund managers have compensation structures that make them participate in the upside of their investments.[9] They are also heavy users of high-powered incentives when approaching the governance of their portfolio firms (P. Leslie and Oyer 2008). In order to align the interests of management and shareholders, for example, they grant aggressive stock option schemes to senior executives.

Moreover, private equity firms have a hands-on approach to operations, in contrast to other financial investors who are limited to the passive buying and selling of securities (Acharya et al. 2013). After an investment, they usually appoint new managers in key positions, who are recruited from their professional networks. And they also build more engaged boards of directors that usually include partners of the fund together with industry experts, in addition to founders or previous owners who may remain at the company.

Firm-level evidence shows PE's more aggressive financial, governance and operational model tends to improve firm performance. PE-owned firms are better managed (Bernstein and Sheen 2016; Bloom, Sadun, and Van Reenen 2015), grow faster (Bernstein et al. 2017; Boucly, Sraer, and Thesmar 2011; J. Cohn and Towery 2013; Fracassi, Previtero, and Sheen 2020), innovate more (Lerner, Sorensen, and Strömberg 2011) and increase their overall productivity (S.

[8] When it comes to deal sourcing there are also differences between the US well-institutionalized market and more informal Latin-American practices. Instead of investment-bank brokered deals and competitive bids, which are the norm in the more formal and institutionalized US environment, self-sourced proprietary deals appear to be much more common in Latin America (Leeds 2015). This reinforce the importance of having a local presence with managers well embedded in the local business communities (Klonowski 2013).

[9] Fund managers usually receive two types of compensation: they charge management fees (annual payments of around 2% of the capital committed). But they also receive a carried interest of typically 20% of the gains above a pre-established hurdle annual rate of return (often around 8%). To further align their incentives with their outside investors, they usually invest a substantial part of their wealth in the same funds they manage.

J. Davis et al. 2014, 2019; Kaplan 1989; Kaplan and Strömberg 2009). These results apply not only for buyouts, but also extend to the less controversial cases of PE/VC firms investing in high-growth firms (Puri and Zarutskie 2012; Rin, Hellmann, and Puri 2013).

Still, PE certainly raises a big question mark regarding labor relations. The strategies followed by new financial owners often entail layoffs and more flexible labor relations (Appelbaum and Batt 2014). Large-scale evidence from the US indeed shows buyouts increase the rates of job reallocation, i.e. greater job destruction and creation (S. J. Davis et al. 2014). For the case of public-to-private buyout transactions, where PE often plays a restructuring role, layoffs appear to be larger than new jobs, lowering net employment levels. In contrast, after private-to-private buyouts firm-level net employment actually tends to rise relative to control firms (S. J. Davis et al. 2019). Studies on the labor effects of buyouts also suggest they tend to augment inequality at the micro level by increasing the gap between productivity and earnings per worker (S. J. Davis et al. 2014, 2019; Kochan 2013).[10]

For venture capital and "growth equity" investments in less mature companies there are fewer concerns around their effect on employment levels. These type of transactions are more comparable to the ones observed in Latin America. The empirical literature on private equity's impact on labor is mostly US-based. I am not aware of any systematic work done in Latin America beyond some reports from multilateral institutions on the employment generated by the funds they invest in. Still, given the type of transactions more prevalent in the region, PE investments are more likely to have an effect on Latin America's workforce productivity and formalization, rather

[10] There is an emergent empirical literature of the effect of private equity on labor. See for example Agrawal and Tambe (2016) work on private equity's effect on workers skills and their long-term career paths, or Cohn, Nestoriak, and Wardlaw (2019) on PE and workplace safety.

than in overall employment levels.

1.1.2 How are they Different? Groups, Multinationals and State-Owned Enterprises

Private equity investors propose a different governance arrangement than those traditionally prevalent in Latin America: business groups, multinational companies (MNCs) and state owned enterprises (SOEs). Table 1 compares these models on some key dimensions. This comparison is further developed below.

Table 1: PE in Comparative Perspective

Legend ● High ◐ Medium ○ Low

Dimension	PE	Business groups	MNCs	SOEs
Foreign capital	◐	◔	●	○
State-related capital	◐	○	○	●
Kinship ties	◔	◕	○	○
Hierarchical structure	○	◕	●	◔
High-powered incentives	●	◐	◐	◔
For profit	●	●	●	◔

Business Groups

Schematically, private equity shares three key characteristics with business groups: both private equity firms and business groups exhibit a diversified portfolio across various and possibly unrelated industries, they invest in concentrated—majority or minority—positions and they are domestically embedded, although in different ways.

Many business groups have professionalized their management and integrated into global

financial markets by developing ties to international investors. Similarly to private equity firms, business groups can function as brokers of international financing and domestic ventures. And "modern" business groups, who leverage their reputation in international financial markets and a distinctive pool of domestic managerial talent, have been characterized as a longer-term version of the private equity fund model (Colpan and Hikino 2018; Khanna and Yafeh 2007).

Still, it is important to highlight some key differences between business groups and private equity, even acknowledging the significant variation in the origin, evolution, structure and strategy of business groups (Schneider 2009). In sharp contrast to the kinship relationships that often underlie business groups, members of PE partnerships and portfolio companies are professional managers who are not usually related through family ties. In contrast to business groups, the vast majority of the capital PE firms control is provided externally, although to align incentives managers normally invest some personal wealth in the funds they manage. Therefore, business groups are possibly less constrained and less accountable to their financiers. Also, business groups usually have "buy-and-hold" investment strategies with longer investment horizons relative to the typical 5-7 year timeframe of private equity investors.

Business groups typically have a more defined sectoral affiliation, in contrast with the sector-agnostic approach of PE. Moreover, it is quite common for business groups to cross-subsidize their different business units and to use pyramid schemes rather than keep portfolio companies independent, which is the norm for PE firms.

Interestingly, business group owners are significant PE investors, usually through family-offices that manage their wealth. Still, these family offices frequently prefer to invest directly rather than delegate investment decisions to independent managers. And usually diversify geographies and invest in a different regions from where the main business assets are located.

Multinational Companies and FDI

While both PE and multinational companies can channel money from external sources, the contrast between them is starker.[11] There is a clear hierarchical structure between MNCs parent company and their local subsidiaries, in contrast to PE portfolio companies' stand-alone status. Crucially, private equity firms have much greater autonomy in their capital allocation strategies and management than multinationals do. MNCs more bureaucratic management style is at odds with PE's financial conception of the firm and the heavy-use of high-powered incentives. And rather than focusing on the mid-market, multinationals usually control some of the largest companies in Latin America. Nevertheless, multinationals can enable private equity firms to complete their investment cycle. Multinationals may sell some of their operating units to PE funds, and most importantly, they often provide an exit strategy to private equity firms, who sell their portfolio companies to MNCs.

Beyond its impact on corporate governance, the significance of PE investors also stems from the perspective of financial flows into emerging economies. As mentioned, private equity partnerships raise capital from various sources. Even though the share of domestic investors is significant, PE partnerships are vehicles of external funds into emerging economies, similar to MNC.[12]

Both PE and MNC channel FDI into emerging markets. PE investors are certainly financial players, as opposed to multinationals who have a more "strategic" and industry-specific approach. Still, the capital that PE investors mobilize would generally be categorized as FDI rather than as

[11] For an insightful comparison of the upgrading potential of MNC and VC-backed companies, see Fuller (2016).
[12] For the case of Brazil, for example, around half of the PE capital is reported to come from foreign sources (KPMG-ABVCAP 2016).

portfolio flows.[13] In line with the definition of FDI, private equity firms are usually foreign entities that through investment establish effective control, or at least have a substantial influence over a local business, certainly above the often used 10% voting-power threshold (OECD 2008).[14]

Private equity investments suggest a novel dimension to the typology of foreign direct investments: that of "financial" FDI. Crucially, it can combine local management with foreign funding. Inquiring into the origins and impact of this new type of financial flow can contribute to "heterogeneities" arguments usually made about FDI (Alfaro 2017; Cohen 2007). PE investors can be present in a wide range of sectors, including commodities, infrastructure, services and manufacturing, and can have market-seeking as well as export oriented strategies. In the M&A vs. Greenfield distinction, private equity—broadly defined—can fit both.[15] But PE-investments are certainly distinct from traditional FDI channeled through integrated MNC. As mentioned, PE investors often enjoy substantial autonomy from its international investors. But since they are basically financial intermediaries, they do not necessarily have industry expertise nor integrated

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[13] PE investment is arguably less pro-cyclical than traditional portfolio flows but more volatile than traditional FDI. As mentioned, investments in private companies are fundamentally illiquid and cannot be easily cashed-out during an economic downturn. Fundraising volumes do follow international interest rates and global appetite for risk and exposure to emerging markets, but from the moment the capital is committed until it is deployed there can be a non-trivial period of time, arguably making the deployment of capital somewhat less volatile. Moreover, once the capital is deployed it is expected to remain locked-in for at least 5 to 7 years. Bernstein, Lerner, and Mezzanotti (2019) show evidence of PE's less pro-cyclical behavior during 2008's financial crisis.

[14] It is conceptually clear cross-border PE investments are under the FDI umbrella (OECD 2008), still, in terms of measurement this categorization is more challenging. If the interest on FDI does not come from its macroeconomic impact on the balance of payments, usual metrics of FDI flows are probably flawed (Kerner 2014). For example, deals done by private equity firms are commonly conducted using offshore vehicles, both by the sell and the buy sides of the transaction; and debt from both international and domestic sources is used to finance the deals. These features obscure the way private equity investments are captured in cross-border accounting. Alternatively, when FDI accounting is approached using a survey or census microdata, it is not entirely clear whether portfolio companies managed by locals but ultimately "owned"—at least partially—by foreign capital would be considered as FDI. In any case, besides its empirical relevance, this measurement discussion helps distinguish conceptually whether the external origin of capital or the identity of the control/management is the relevant feature of FDI. Fuller (2016) argues the identity of firms' management, and not the origin of the capital, has a bigger influence on the type of operational strategy they pursue, which in turn has the greatest impact on technology upgrading and development.

[15] While traditional buyout operations are classified as M&A, VC funding or investment in new infrastructure projects would be considered as Greenfield investments.

operations, and therefore are not likely to serve a role in transferring (non-managerial) technology. And they have no clear home country or "nationality" (e.g. Wellhausen 2014), at least in what refers to the origin of capital since they pool money from diverse sources and investment decisions are made by fund managers, and not by investors.

State-Owned Enterprises

Finally, even if PE's approach to management may seem at odds with how we think about "bureaucratic" state-owned enterprises that combine for-profit with social goals, there are some key connections between the two models.

As I develop throughout the dissertation, state-related investors are important sources of capital for private equity firms. PE funds raise a large portion of their funding from the pension system, partly from pension funds in developed countries, and increasingly from local pension funds. Many of these pension funds are publicly managed. Development financial institutions are also investing in PE, in both advanced and emerging economies. And sovereign wealth funds are also large private equity direct and indirect investors (Bernstein, Lerner, and Schoar 2013; Braunstein 2019), particularly in emerging economies. Crucially, PE/VC funds are utilized by states as vehicles to "outsource" industrial policymaking, arguably replacing the majority-owned SOE as a policy instrument.

Beyond financing, there are other interesting connections between SOEs and private equity. PE investors have entered new markets across different regions by participating in the privatization of state-owned enterprises. And many private equity investments are also made in companies "surrounding" SOEs as well as in public concessions (e.g. in Latin America Petrobras' pre-salt exploration and production activities, PPP programs, etc.).

1.2 Why Latin America?

At first glance, Latin America is not the most obvious region to study the development of private equity markets. Its private capital industry is quite recent and does not show high levels of penetration, in line with the region's overall under-developed capital markets. Still, there are good methodological and substantive reasons that makes it a worthwhile object of study.

Methodologically, the region exhibits common macro-trends that "fix" some variables and enhance the comparability of the cases. The literature on financial development highlights the origin of a country's legal system (e.g., civil vs. common law) as one of the key long-term determinants of the depth of its capital markets (Aminadav and Papaioannou 2020; La Porta et al. 1998). Similarly, cultural arguments emphasize norms related to religion and the strength of kinship ties as important determinants of external finance (Bertrand and Schoar 2006; Stulz and Williamson 2003). Latin American countries share common colonial origins, and therefore are comparable in terms of the origin of their legal systems and broader cultural characteristics (e.g. Catholicism, strength of family values, etc.). Latin American countries also followed similar patterns in terms of the timing of their democratization and liberalization. Countries are at—roughly—similar levels of development, and are exposed to common international shocks (e.g. commodity cycle, capital flows to emerging markets, etc.). Still, there is significant variation in the development of the private equity industry—across countries but also within cases and through time—that helps provide empirical support for my arguments.

Analyzing most countries in a region instead of identifying lessons from successful cases also avoids biasing results by selecting on the dependent variable. Moreover, Latin American states are comparatively weaker—less capable and autonomous—than for example, those in East Asia

(Stephan Haggard and Kaufman 2008; Schrank 2007), in particular, with regards to their financial bureaucracies. Latin America is therefore a hard testing ground—a "least likely" region—for an argument based on the role of state-related investors and their capacity to shape business.

From a substantive perspective, corporate governance reform is a fairly novel topic for political economy academic work in Latin America. It is well documented how Latin America's extensive deregulation and liberalization in capital flows has tightened government budget constraints and limited the autonomy of economic policymaking (Campello 2015; Stephen Haggard and Maxfield 1996; Mosley 2003). But there is less understanding of how this increased financial integration affected corporate governance models nor of the politics behind it. My dissertation contributes to closing this gap.

Most political economy work on corporate governance models in Latin America stresses either the stability (Aguilera and Crespi-Cladera 2016; Schneider 2008, 2013) or the adaptation of previous models (Musacchio and Lazzarini 2014). Schneider (2008, 2013) points to continuities across countries and through time, given the complementarities between MNC, business groups, the political system and other characteristics of "hierarchical" Latin American political economies. In contrast, this dissertation focuses on change. It inquires on the emergence of a new model of firm financing and governance. In particular, this dissertation focuses on the role public policies have in fostering these changes.

Beyond scholarly novelty, other substantive reasons make the topic relevant. I already noted that the institutional environment in Latin America is very different from the one in the US, where this model originally emerged and is more developed. This different context calls for a different argument about the emergence of private equity. It also suggests that private equity can

have different implications. In Latin America, the sources of medium and long term financing are scarce. Beyond a few large business groups, firms are usually atomized, productivity levels are low, informality is high and traditional governance structures and management practices centered on families prevail (Caselli 2014; Herrera and Lora 2005; Lemos and Scur 2012; Pagés 2010; Remes et al. 2019). This context urges the need for scale, consolidation and professionalization in order for firms to be competitive. These are all outcomes that can arguably be driven by PE investors.

The link between external finance and economic growth is pretty well established. More recently, a compelling literature emphasizes the impact of management on productivity and overall firm performance and growth (Bloom et al. 2013; Bloom and Van Reenen 2007; Bruhn, Karlan, and Schoar 2010). In this realm, too, Latin America seems to lag behind (Bloom and Van Reenen 2010; Lemos and Scur 2012). As mentioned, PE's role is not only to provide capital but also management and strategic guidance to the firms they invest in. PE-owned firms are closer to international best practices and the managerial frontier (Bloom, Sadun, and Van Reenen 2015).[16] In Latin America, private equity firms are not usually agents driving cutting-edge technical innovation and leading the transition towards technological sophistication, maybe except for a few venture capital investors. The main role of PE firms is more mundane but perhaps even more important: to generate financial returns and create value by increasing productivity and modernizing the business. PE firms increase productivity by allocating capital more efficiently, funding expansion into different sectors, professionalizing management, modernizing governance

[16] For further evidence of the role of PE/VC investors on firm-level outcomes, see, for example, Bernstein et al. 2017; Bernstein and Sheen 2016; Chemmanur, Krishnan, and Nandy 2011; S. J. Davis et al. 2019; Lerner, Sorensen, and Strömberg 2011.

and management practices, reducing operating costs, achieving scale, consolidating markets, cracking down on informality, and eventually by helping firms upgrade functionally.

Overall, there are good methodological and substantive reasons to focus on the comparative study of Latin America countries, even if in this region PE is far less developed than in advanced economies. Moreover, as the next section shows, PE is also a significant source of external equity into firms in otherwise quite shallow capital markets.

1.2.1 PE Investment Volumes

Figure 2 compares annual private equity investments with capital raised through initial public offerings (IPOs) in Latin American stock markets.[17] IPOs are the process through which a private company goes public by selling its stock to the general public. Comparing private equity investments to the capital raised through initial listings seems natural: stock markets are the alternative to raising external equity financing.[18] It can be observed that, especially after a buoyant 2007,[19] public and private equity investments are of the same order of magnitude and roughly comparable. Beyond size, there are several reasons that arguably make private equity investments more consequential than IPOs.

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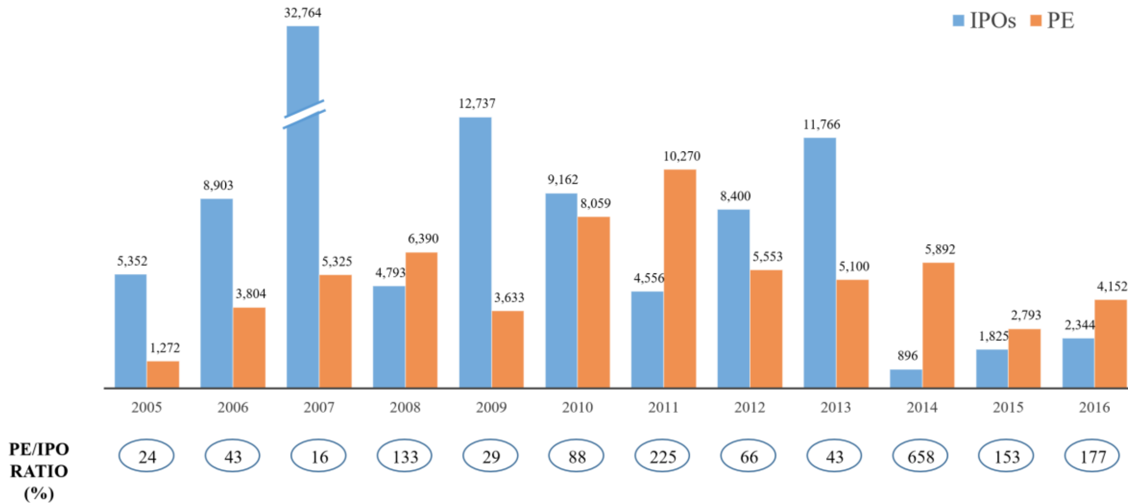
[17] Bogotá, Buenos Aires, Lima, Mexico, Santiago and São Paulo's stock exchanges.

[18] Comparing private equity investments figures (flows) with overall market capitalization or GDP (stocks) would not give an appropriate benchmark to grasp the relevance of this new asset class. "External" capital refers to investors from outside the firm, not necessarily foreign.

[19] Note that, for presentation purposes, I broke the scale of the 2007 IPO bar.

Figure 2: IPOs vs. PE Investments in Latin America ($ MM)

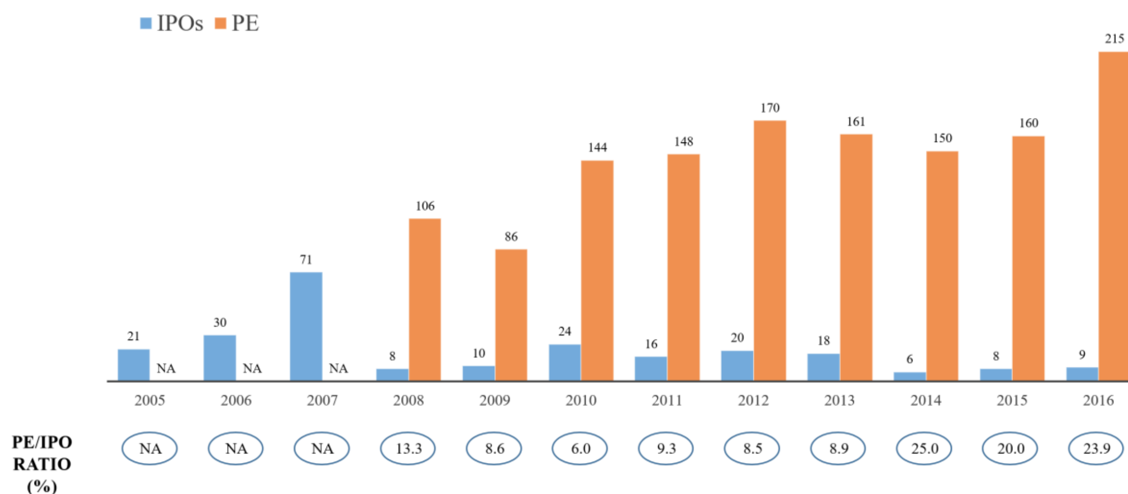


Source: LAVCA, EMPEA and Capital IQ

Stock markets often provide capital to much larger firms than the average company targeted by PE investors. IPO figures above include large banks, oil companies and diversified holdings, many of them resulting from full or partial privatizations. These companies are well above the average size of Latin American private equity transactions. As Figure 3 shows, the average private equity investment is of around $30 million, compared to an average of $470 million raised by an initial offering during the same period.

Initial public offerings are usually limited to a small proportion of the total shares of the company, particularly in the case of firms not previously backed by a financial investor. Moreover, these shares are usually bought by a pool of passive investors who do not have a significant direct impact on the governance of the firm. In contrast, PE investors often buy larger chunks of the total equity, in most cases provide active management support and participate in leading the companies. Often PE investors also achieve control of the firm.

Figure 3: IPO vs. PE in Latin America (# of investments)



Source: LAVCA, EMPEA and Capital IQ

Crucially, as Chapter 3 shows, IPOs are endogenous to previous private equity investments. In Brazil, and to a lesser extent in Mexico, more than half of new listings are PE-backed companies that went public as part of the completion of their investment cycle (A. M. Minardi, Ferrari, and AraújoTavares 2013). The public market provides PE investors a feasible exit for their investments. Beyond blurring the comparison, this complementarity between private equity and stock markets has theoretical implications.

As the theory chapter discusses more thoroughly, in emerging markets private equity functions less as a substitute and more as a complement to other forms of financing. PE is one of the main drivers of new stock-market listings. PE investors also need deep debt markets and banks to help finance their acquisitions. In this vein, this dissertation suggests the need to overcome the outdated dichotomy between bank and capital markets based finance (Hardie et al. 2013). This dichotomy is a core assumption of classic comparative political economy (Zysman 1983) that hardly applies to present-day emerging economies: banks do not provide equity capital to firms

and even in their loan business, they are mostly focused on consumer financing (Beck et al. 2012). While PE firms are certainly a financial player representative of liberal market economies centered on shareholder value, their illiquid concentrated holdings actually resembles the block-holders of coordinated systems.

From a political science perspective concerned with how power is projected from the private sector into the political sphere, private equity is particularly interesting because it usually entails changes in firm ownership and control. Most political science work on finance is focused on bank debt and capital markets (Stallings and Studart 2006). Debt does not directly change firm ownership. On the contrary, it mostly leverages the stake of incumbents. And the free-float[20] of Latin American listed companies is usually limited to a small portion of their total shares (De La Cruz, Medina, and Tang 2019) and therefore, public transactions are not very consequential in terms of control either. Chile is the clearest example of this: public market capitalization figures are impressive, at similar levels to those of developed countries, as the main business groups and several multinationals are listed in the domestic stock market. But the portion of total shares that are actually traded in the market is quite low.[21] Family-controlled groups often retain a majority and therefore have control over decision-making.

Overall, private equity seems to be a relevant asset class, both in value and in the number of companies invested. In a context of quite shallow public equity markets, private capital funds are an important source of external equity into companies. Moreover, even if the magnitude of PE in Latin America is incipient compared to other regions, there are good methodological and substantive reasons that make it worthy of study.

[20] Proportion of outstanding shares that are available to the public for trade.
[21] At the end of 2017, the average free float in Chile's listed companies is of only 16% of the total shares, see De La Cruz, Medina, and Tang (2019). Relatedly, its stock market turnover and liquidity ratios are also quite low.

1.3 Data and Research Methods

The prominence of business as a key economic and political actor in Latin America contrasts with its absence from the region's research agenda. This void exists not only in political science, but it is widespread to other disciplines. It has been argued that this gap in the literature responds, at least in part, to methodological reasons. Outside of the US, the costs of acquiring systematic information on business are high, at least compared with other topics (Schneider 2014). This is especially true for the type of investors we are focusing on: "private equity" encompasses a group of private assets defined in opposition to public securities. Public securities are traded in open and transparent markets where information is widely available; instead, private companies have much less demanding—if at all—disclosure requirements and are therefore more secretive and obscure. If PE is in general an opaque asset class (G. W. Brown et al. 2015; L. Jeng and Lerner 2016), this is even worse in low-institutionalized markets such as Latin America (Leeds 2015, 8).

The lack of information makes it particularly cumbersome to evaluate the financial performance of these investment funds.[22] The study of "abnormal returns" (i.e. the difference between the actual and the expected return of an asset) is the focus of empirical finance. The relative returns of PE investments is not the focus of my research, although it is contextually relevant as it affects the sustainability of the business model. This dissertation is more interested in the question of its origins and development. I triangulate different data sources in order to tackle this question and build the country case studies that are the empirical backbone of the dissertation.

Regarding secondary sources, I had access to several data providers. These include reports

[22] See Harris, Jenkinson, and Kaplan (2014); for this discussion applied to the Brazilian case, see Minardi, Kanitz, and Bassani (2014).

and data compiled by regional private equity business associations such as EMPEA and LAVCA. I use these sources as a complement to firm-level manually-collected data from securities regulators. To develop each case I also leveraged information from domestic private equity associations in each country, even though the quality of this data may be questionable since it is mostly used for promotional purposes. Comparisons among countries are not straightforward given the heterogeneity in regulations and the lack of standards and common definitions about what is considered private equity. Other providers of financial information such as Prequin and Capital IQ also helped identify private equity partnerships in the region and some of their portfolio companies. These different data sources helped measure the relative penetration of private equity in each country. I am not aware of other comparative analysis of the emergence and institutionalization of PE/VC across Latin America. Still, there are several industry reports, case studies and program evaluations by multilaterals (e.g. Rodríguez Guzmán, Elorza, and Mejia 2015), as well as some—mostly finance-oriented—academic literature that helped me build the case studies. Most of these sources are country specific. Brazil is the case that has more secondary sources available, given it is the country with the oldest and most institutionalized PE industry.

Most importantly, I complemented all these secondary sources of information with extensive primary fieldwork. I traveled to the business centers of the five countries that are the focus of the dissertation: Bogotá (Colombia), Buenos Aires (Argentina), Mexico City (Mexico), Santiago (Chile), and São Paulo and Rio de Janeiro (Brazil). In each of these cities I conducted semi-structured interviews with relevant actors involved in the sector in order to understand the emergence of their private equity market, and the role of the different actors involved in it.

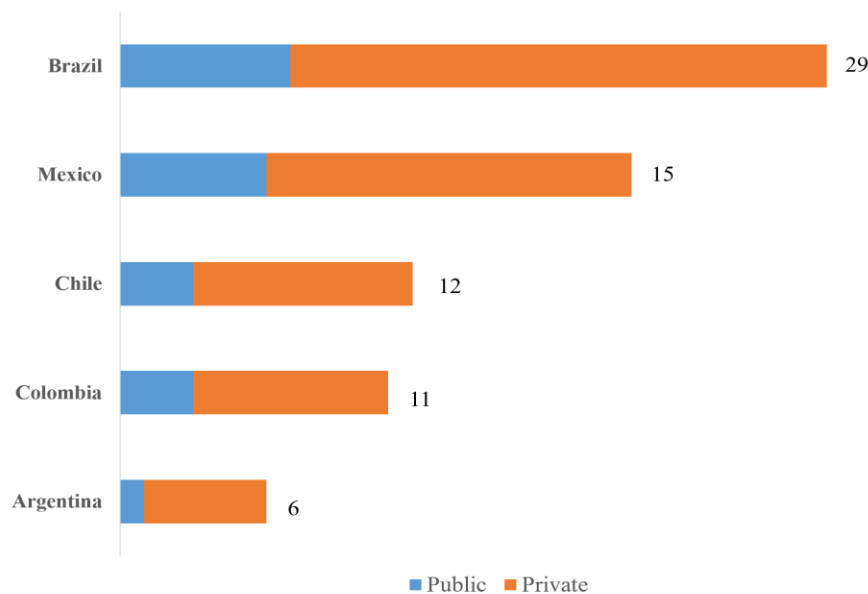
On the private sector side, I interviewed businesspeople with and without private equity

experience, pension fund managers, entrepreneurs and lawyers. I also engaged with the private equity business association of each country, as well as with the regional industry association. Regarding the public sector, I interviewed current and former officers of domestic and multilateral development financial institutions, securities and pension regulators, among others. While most of the interviews were conducted in-person during field trips, I also interviewed relevant actors in Boston and New York and conducted a few interviews remotely.

Figure 4 gives an overview of the 73 semi-structured interviews I conducted, by country and sector (public vs. private). Slightly less than a third of the interviewees were working in the public sector at the moment of the interview. Still, many private sector interviewees had previous experience in the public sector (interestingly, this is a quite common pattern, particularly in Mexico and Brazil). Argentina is the country where I conducted the least number of interviews. This is both because of Argentina's small domestic private capital market, but also because I had a previous understanding of the case, given my background.

I also participated in several industry conferences. Most importantly I attended ABVCAP's —Brazil's private equity association—two-day 2018 annual meeting. This is the largest industry conference in the region. It gathers fund managers, public and private investors, regulators and service providers. ABVCAP's meeting allowed me to see these different actors in action, as well as how they interact.

Figure 4: # of Interviews by Country and Sector



Moreover, I did a two-month internship at IDB Invest, the private sector arm of the Inter-American Development Bank. IDB Invest helps promote the private equity sector through its investment activity. During the internship, I had the chance to interact with multilateral investment officers on a daily basis, which helped enrich—and validate—my analyses.

The empirical leverage of this dissertation comes mostly from the detailed case studies that trace the emergence of domestic private capital markets in each of Latin America's largest and more modern countries: Argentina, Brazil. Chile, Colombia and Mexico.

These cases exhibit some common patterns that support my main arguments: the presence of state-related investors, the public sponsorship of business associations and the "quiet politics" logic of the industry's regulation. My argument is also backed by cross-national comparisons. Institutional variables, on their own, can hardly explain the variation observed across cases.

Instead, the extent of public support does a better job. I find that where there was an earlier and more intense public support for the industry, private equity markets are also more developed; even considering the many flaws government investment programs have. Within case, cross-time comparisons also provide leverage for parts of my argument.

This qualitative approach, in line with the tradition of comparative political economy, is well-suited to understand the role of different actors, which is central to address the origins question. This approach can also lead to more concrete policy implications, as it is closer to the trade-offs faced by the different actors. Since private equity is still quite an incipient phenomena in many emerging economies and data quality is challenging, it is harder to take a broader cross-national approach.

A micro-level approach is best suited to study the "consequences" and not the origins of private equity. In order to evaluate some of the implications of this corporate governance model I complement the qualitative approach with firm-level analyses. I collected raw data from each country securities regulator and systematized it. The result is a novel dataset of the detailed ownership structure and family ties of all companies that listed in Latin American stock markets since the early 2000s. High-quality data from listed companies, together with individual-level biographical data, allowed me to evaluate the relationship between private equity and corporate governance at the micro-level. This analysis, displayed in Chapter 3, suggests that PE investors are indeed a driver of more modern corporate governance models: PE investors are behind a large proportion of new stock market listings and companies backed by PE investors appear to have a more dispersed shareholder structure and less kinship ties within their leadership positions.

Finally, I also gathered primary and secondary data on a variety of emerging and developed

countries outside of Latin America, in order to contextualize my cases and provide external validity to my arguments. In particular, I inventoried both present and historical state-related programs aimed towards the development of private equity markets in the US, Europe and Asia. I also benchmark my argument about the politics behind the emergence of private equity markets with some cases outside the region. Chapter 6 presents this broader analysis.

1.4 Plan of the Dissertation

This introductory chapter frames the dissertation by presenting the puzzle of the under-development of Latin American capital markets. In the last couple of decades Latin American countries have liberalized both economic and politically, and passed reforms granting investor protections—conditions identified as key determinants for financial development. Still, their capital markets exhibit limited progress. This dissertation proposes to focus on the role of state-related institutional investors, rather than just focusing on institutional rules. To develop this argument, I propose to narrow my object of study to the emergence of private equity markets in Latin America. This first chapter introduced the PE investing model and discussed its relevance. Then, it presented the dissertation's methodological approach centered on five case studies that cover Latin America's largest economies, and complemented by firm-level evidence.

Following this introduction, Chapter 2 presents the main theoretical contributions of the dissertation and discusses with the existing literature on the topic. It connects the question about the origins of private equity markets with the broader literatures on financial development and corporate governance reform. Mainstream institutional arguments focused on the long-term determinants of investor protections can hardly account for the emergence of private capital markets. Instead, this dissertation forefronts the role of different types of institutional investors—

multilateral and domestic development banks, and pension funds—and discusses how they nurture capital markets. With respect to existing arguments on corporate governance reform, it discusses the literature's focus on macro-societal variables such as regime type or the strength of organized labor. Instead, my argument highlights the "quiet politics" role played by state-related development financial institutions. These institutions help industry participants organize into business associations, who in turn, lobby to create a favorable institutional framework. This policy-based argument also contributes to update arguments that associate state intervention in financial markets with bank-based financial systems. And introduces a novel model for financial industrial policymaking.

The theory chapter is followed by four empirical chapters. Chapter 3 provides firm-level evidence to support the argument that private equity investors are indeed drivers of more institutional—as an alternative to family-centered—corporate governance structures. PE-backed companies have more dispersed ownership structures and exhibit fewer kinship ties among its leadership. Moreover, this chapter ranks the penetration of private equity across Latin American countries by triangulating between multiple data sources, and shows that the evidence is not consistent with the main hypotheses from the literature. Brazil, the most closed and interventionist country in the region is the clear leader in the industry and overtakes other countries who outperform in most of the variables that the literature associates with the development of capital markets.

Chapters 4 and 5—the core empirical sections of the dissertation—introduce and analyze the case studies. Chapter 4 shows how in all cases, state-related financial institutions have promoted the private capital industry by channeling capital into privately-managed equity funds.

This is the case of BNDESPAR in Brazil, *Fondo de Fondos* in Mexico, and of CORFO in Chile. And more timidly, of Bancoldex in Colombia and FONDCE in Argentina. Crucially, the case studies confirm that the entrance of domestic pension funds as capital providers is an essential step for the viability of the nascent PE industry.

Chapter 5 explores the politics behind the key regulations that helped institutionalize the emerging private capital industry. It provides evidence that domestic and multilateral agencies promoted fund managers' collective action and helped them establish asset-specific business associations. In turn, it shows how these industry associations lobbied to obtain some key regulations. In particular, they pushed for the creation of tax-incentivized investment vehicles and for access to pension fund resources. Notably, these business associations actively tried to keep their policy arena outside of the domain of Congress and large partisan politics. Suggestively, this "quiet politics" behavior is at odds with the mechanisms implicit in arguments that associate democratic politics with financial development and corporate governance reform.

Chapter 6 extends the scope of my argument outside of Latin America and explores cases from other regions. Indeed, it finds evidence that the state also acted as an investor in the US, Europe and Asia, playing a key role for the emergence of private equity markets in those regions. In most of the cases analyzed, state-related financial institutions together with pension funds are the largest investors in the asset class. This grants external validity to my argument, and shows that more successful cases outside of Latin America also exhibit a pervasive role of state-related financial institutions. Beyond the state's role as an investor, I also find evidence outside of Latin America that different public agencies helped organize PE fund managers into asset-specific business associations. In turn, these associations had an important role co-producing the industry's

regulatory environment. And more generally, I observe that outside of Latin America most of the reforms that help structure private capital markets also appear to follow a quiet politics logic.

To wrap up, the conclusion discusses the main contributions of this dissertation, explore some of its implications and acknowledge its limitations. Most importantly, it emphasizes the nodal role of institutional investors—in particular pension funds—in shaping firm ownership and corporate governance practices. And propose a research agenda on the political economy of financial development and corporate governance reform based on the role of pension funds.

Chapter 2 - Private Equity, Financial Development and Corporate Governance Reform

Even after democratization and widespread liberalization, Latin American financial markets are underdeveloped, and other than through privatizations, corporate governance models remained mostly unchanged (Aguilera et al. 2012; Schneider 2008). Stock markets are shallow, and the ownership of the region's largest firms is concentrated among business groups and multinational companies (De La Cruz, Medina, and Tang 2019). The prevalence of firms organized around families has proved enduring, and kinship ties remain widespread in the corporate world. Lack of external finance[23] and traditional corporate governance models are arguably behind the region's low levels of investment, scant firm creation and competition, poor management practices (Lemos and Scur 2012), firms small size (Beck et al. 2008; Pagés 2010), low levels of innovation (Remes et al. 2019; Schneider 2013), and high levels of labor informality (Bruhn and Love 2014; Catão, Pagés, and Rosales 2009); all factors that significantly affect the region's long-run economic growth, disparity in income distribution and incidence of poverty.

While most of the literature focuses on explaining the continuity of this low-level equilibrium (e.g. Schneider 2013), I study the sources of corporate governance reform. In order to do so, I focus on Latin America's emerging private equity markets. As a key source of arms-length equity into companies, private equity investors, who source capital domestic and internationally, are one of the few drivers of institutional equity investments and more professional management in the region.

In line with a recent wave of research in political science that argues for paying more

[23] For "external finance" I refer to funds obtained outside—external—the firm (e.g. bank loan, equity investor), not necessarily from external—foreign—countries.

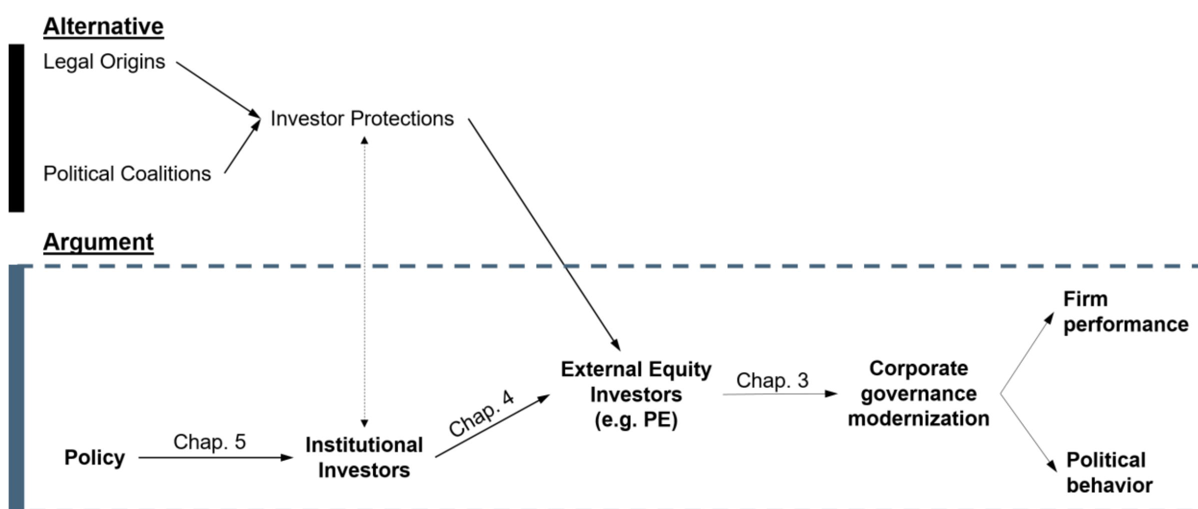
attention to business and the private sector as an explanatory variable when thinking about development,[24] my dissertation highlights the importance of bringing back finance into the productive development debate. More specifically, I help introduce a new type of investor, asset managers focused on private equities, into the development debate (Fuller 2016). The main goal of the chapter is to frame the dissertation's contributions into the broader literatures about financial development and corporate governance reform. To do this, I will first discuss how a focus on private equity in emerging economies is actually relevant to these broader topics. Then, I discuss with these established literatures and lay out the main contributions of my argument focused on the emergence of private equity. My argument is sketched in Figure 5.

As portrayed at the top of Figure 5, most of the existing work on financial development focuses on the long-term more structural determinants of investor protections. As I discuss below, arguments can be broadly grouped in two: the legal origins (La Porta et al. 1998) and the political institutions views (Haber, North, and Weingast 2008; Rajan and Zingales 2003). In contrast, my agency-based argument, shown in the bottom of the diagram, has a shorter time-frame and focus in one narrower asset-class: private equity. Chapter 3 shows private equity investors are among the few drivers of institutional ownership in companies and ultimately of more "modern" corporate governance models. Chapter 4 focuses on the more proximate drivers of change, in particular, on the role of different types of state-related institutional investors—multilateral and domestic development banks, and pension funds—and how they nurture private capital markets. And while analyzing the politics behind the emergence of this industry, my findings depart from existing hypotheses about corporate governance reform. Instead of focusing on macro-societal variables

[24] See, for example, Fuller 2016; Jones Luong and Weinthal 2010; Post 2014; Taylor 2016; Wang 2015; Yadav and Mukherjee 2016.

such as regime type or the strength of organized labor, my case studies highlight micro-level dynamics. In particular, Chapter 5 shows that in addition to the role as investors, different state and multilateral agencies also foster private sector collective action and help organize the incipient industry. In turn, these industry-specific business associations, established as instances of private-public collaboration, lobby for the regulatory framework that helps institutionalize the asset class.

Figure 5: Theory Diagram



Throughout this chapter—and the whole dissertation—I engage with two intimately related bodies of scholarship: on one side the political economy literature on financial development; on the other, the literature on corporate governance reform. These two literatures can be viewed as two sides of the same coin, at least in the developing world. External finance into companies, in particular in the form of equity, is the object of financial development, and changes in the types of ownership and control of firms driven by these external investments is a core corporate governance question. As I also show, in Latin America, private equity investors are a crucial vehicle to

modernize firm governance.

These two bodies of literature come from somewhat different traditions. Financial development is typically associated with new economic institutionalism. Its main argument is aligned with an institutional approach to development centered on the importance of the rule of law, property rights and contract enforcement and less focused on the direct role of actors. This literature conceives financial development mostly in a unidirectional way, rather than portraying various models of structuring financial markets and firm's corporate governance. With a thin theory of change and more functionalist mechanisms, the implications of institutional arguments are also more detached from active micro-level policy-making. While I do not challenge the overall importance of property rights for development, I argue they are insufficient as an explanation/institution, at least for the case of equity markets (Guillén and Capron 2016). To explain the emergence of domestic private equity markets, I present an actor-based theory that emphasizes the role of state-related institutional investors, in particular development banks and pension funds. These institutional investors, it is important to highlight, are not just intermediaries in a longer causal chain that goes from investor property rights protections to firm-level outcomes. The origin of these institutional investors is hardly market based, even if once they are in operation, they follow a more or less "commercial" approach to investing. Development banks are, by definition, policy driven. And as for pension funds, they have emerged as a by-product of the social security system. They raise funds from mandatory—forced—savings and their operations are heavily regulated. Different to institutional-based arguments, usually related to minority shareholder rights, my dissertation focuses directly on the role of a different type of investors and shows how, by organizing, they also help drive regulatory reform. While my argument grants to the state a more active market-making role than is usually acknowledged, the outcome of interest

is still private-sector development.

Arguments focused on corporate governance reform, on the other hand, come from a comparative political economy tradition that is certainly more actor-based, usually having a macro-coalitional focus around the balance between labor and capital (Gourevitch and Shinn 2005; Roe 2003). In contrast, my dissertation takes a micro-level approach that highlights the "quiet politics" (Culpepper 2010) role played by state-related domestic and multilateral financial institutions that help organize the emergent industry participants, who in turn, lobby to access pension funds resources and to establish the legal and fiscal fundamentals of the industry.

Crucially, the argument I make is better portrayed as the emergence of a new industry rather than as a reform. Private equity in Latin America plays a different role than in more advanced economies. In the US as well as in other advanced economies private equity emerges as a reaction to managerial extensive autonomy. It actually concentrates ownership in order to reduce agency costs and better align the incentives of managers and shareholders (Michael Cole Jensen 1989; Kaplan and Strömberg 2009). But as Chapter 3 shows, in Latin America, private equity actually drives relatively more dispersed shareholding structures. With very few widely-held (i.e. with a dispersed shareholder base) companies to begin with, without a relevant role for autonomous management, in Latin America, private equity is an alternative to the prevalence of family firms and arguably empowers more professional management. Private equity investments are actually related to arms-length, as opposed to kin-based, relationships across firm's leadership, and generate more institutional and dispersed ownership structures.

Corporate governance can have different meanings across different audiences, fields and regions. In the US, where institutional capital is widespread and large companies usually have dispersed ownership structures, corporate governance research usually focuses on the micro-level

behaviors and regulations underlying the relationship between shareholders and managers (e.g. poison pills, staggered boards, executive compensation, etc.), a topic mostly approached by corporate lawyers and financial economists (Bebchuk and Weisbach 2010). From a political economy perspective interested in comparative development, I do not conceptualize corporate governance just as the mechanisms to solve the agency problems that arise from the separation between ownership and control. Instead, I take a more macro-approach that compares different corporate governance models prevalent outside the US and that deals with more fundamental questions related to the type of firm ownership and control, ultimately centered around who holds decision-making power across corporations: families, professional managers, banks or bureaucrats (Morck 2005).

In the rest of this chapter, first, I justify my focus on private equity financing and explain how it is related to financial development and corporate governance reform. Second, I discuss the literature's almost exclusive focus on investor protections. Third, I discuss different—typically macro-societal—hypotheses regarding the sources of corporate governance reform. And fourth, I engage with the literature about the role of the state in financial markets. Each of these sections also review the implications of the different hypotheses of the literature applied to Latin America.

2.1 Financial Development and Private Equity

The connections between finance, growth and overall economic development are well established. Historical arguments around the relationship between capital accumulation and development (e.g. Gerschenkron 1962; Goldsmith 1969) were augmented in the recent decades by a large empirical literature in economics. Addressing issues of causal identification through innovative research designs and rigorous econometric techniques, a series of studies presented

conclusive evidence to support the claim that the availability of capital is an important causal antecedent of economic performance, and not just its consequence (Rajan and Zingales 1998; Samila and Sorenson 2011).[25] Finance indeed fosters new investments, firm entry and competition, and through that, determines economies' long run growth. While this literature mostly agrees there is a causal relationship between finance, growth and economic development, the discussion about the political economy drivers of financial development is less settled. I propose to complement rule-based arguments built around the centrality of investor protection with an actor-based argument centered on the role of institutional investors.

My working definition of financial development is one focused on the availability of external capital for firms and entrepreneurs (Rajan and Zingales 2003), rather than on individual's access to financial services—for example, on access to banking or the digitalization of payment methods.[26] Within firms and entrepreneurs access to arms-length external financing, I focus on the availability of external sources of equity financing. More specifically, I focus on a particular type of equity financing: one that is provided privately, as an alternative to just considering "public" stock markets. In the rest of this section, first, I explain my focus on equity investors rather than on external capital more broadly, such as bank loans. And second, I discuss the relevance of private investors as opposed to more standard investors focused on public equities.

Equity holders are owners. And owners are key political economy actors. This is the ultimate reason to focus on equity financing. As owners, equity-holders often have political rights

[25] See King and Levine 1993; Levine, Loayza, and Beck 2000; Beck et al. 2008. For a summary see Levine (2005) and for a more recent evaluation of capital markets growth Laeven (2014).
[26] For a comprehensive discussion of the multiple dimensions of financial development, see World's Bank Global Financial Development framework (Cihak et al. 2012). Latin America has overall quite reasonable levels of access to financial services, at least given its level of development. But its financial markets, in particular equity markets, are significantly underdeveloped, see Heng et al. (2016).

(i.e. voting rights on issues such as board of director membership, the establishment of corporate objectives and policy, etc.) that grant them significant influence over a firm's decision-making (Aguilera and Crespi-Cladera 2016). As opposed to equity, debt or bank loans do not affect the ownership structure directly. And their holders do not typically get any political rights besides some broadly-defined covenants, and therefore have an indirect influence on decision-making. Equity holders are the ones who have a central role in the governance of the firm, and determine the firm's management. In particular, external equity investors, those unrelated to the firm's founder, drive arms-length management and control of firms, helping to modernize corporate governance and crowding-out kinship ties.

Importantly, this type of ownership and management—institutional as opposed to family-based—has been convincingly related to firm's productivity and performance (Bloom and Van Reenen 2007, 2010; Bloom, Sadun, and Van Reenen 2015; S. J. Davis et al. 2019; Parise, Leone, and Sommavilla 2018). And beyond management practices and productivity, different types of ownership and management have also been argued to affect firm's political behavior. For example, family businesspeople are typically more connected politically than professional managers (Morck and Yeung 2004; Post 2014; Puente, Balan, and Dodyk 2019; Schneider 2013).

Related to the distinction between debt and equity, the literature on comparative capitalisms presents a sharp dichotomy between bank-based and capital market-based financial systems (Bril-Mascarenhas 2016; Hall and Soskice 2001; Zysman 1983). This dichotomy seems outdated. As argued by Hardie et al. (2013), banks can hardly function as a reliable source of patient capital. Having shifted their funding from traditional deposits to market-based instruments, banks themselves are now much more market based, and are less able to mitigate the impact of

financial market pressures on their long-term client relationships, which was the key defining characteristic of banks as patient capital providers in coordinated market economies. Banks are increasingly focused on household lending (e.g. consumer credit and mortgages) rather than on long-term corporate loans (Beck et al. 2012). Relatedly, it is very hard for commercial banks to invest directly into the equity portion of businesses. The Basel Framework has made banking regulation increasingly homogenous, and severely limits the ability of banks to hold stock of non-financial firms, given the enhanced risk and illiquidity, even from listed companies. At least in Latin America, banks very rarely hold any third-party stocks in their balance sheets and their loan business is mostly retail-oriented. Moreover, the sharp increase in the participation of foreign banks in Latin America (Moguillansky, Studart, and Vergara 2004) not always favored firm's access to credit. Quite to the contrary, there is some evidence that foreign bank entry actually limited firm and household access to finance.[27] So no matter the role banks played in post-war coordinated market economies or in East Asian developmental states—arguably providing long-term loans and holding equity stakes in non-financial firms with which they had established relationships—this can hardly be their role in contemporary Latin America. In terms of patient capital it is quite clear that there is no bank-based substitute for an active equity market.

Indeed, private equity is usually associated with the heavy use of debt financing, especially in the US. In order to optimize a firm's capital structure, part of the private equity playbook includes leveraging portfolio companies with significant debt (Kaplan and Strömberg 2009). This helps concentrate ownership and discipline management, and can magnify investor returns at the expense of increasing the company's risk profile. In emerging economies such as those in Latin

[27] For example, Beck and Martinez Peria (2008) associate the increase of foreign banks participation in Mexico with a decline in bank's outreach. Beck, Ioannidou, and Schäfer (2018) show for Bolivia, that foreign bank loans are of shorter maturity than domestic bank loans (to the same group of firms) while relying more on collateral. Also see Mian (2006) and Gormley (2010). For a review of the literature on foreign banks, see Claessens and Van Horen (2014).

America, where sources of debt are less abundant and macro-economic conditions more volatile, highly leveraged private equity buyouts are rarer (Leeds 2015). Therefore, the association between private equity and debt is less straightforward. In fact, debt is less associated with private equity than with family ownership. As Chapter 3 shows using a cross-section of firms that listed in Latin American stock markets since the 2000's, and in line with empirical work in finance in Brazil and Chile, high leverage levels are correlated not with private equity but with family ownership and control.[28]

External equity into companies may come either through private or public equity markets. As showed in the first chapter, private capital markets are in terms of volume, at least, as relevant as public markets. Moreover, private equity investors are a significant driver of firms listing in the stock market. Therefore PE could be thought of as an important antecedent condition for the growth of public equity markets: PE-backed companies appear to be more prone to listing in the public market, and when they do, they are more likely to have a more dispersed shareholder structure and a more significant free-float (i.e. proportion of the outstanding shares of a company owned by the investor public). Given their larger—and more illiquid—stakes, private equity investors are more actively involved in decision-making at the firm level, in contrast to portfolio investors in listed equities, who usually take a more passive approach to governance. And related to this activism and the illiquidity of their stakes, they are also usually more patient investors, holding their stakes for several years (typically 5-7 years).

[28] See for example, for the Chilean case, Larrain and Urzúa I. (2016) and Donelli, Larrain, and Urzúa (2013), who shows that ownership structure for business groups in Chile, most of them family controlled, didn't change while the economy liberalized extensively. In terms of capital structure, if any, these groups seem to have concentrated ownership and increased leverage. In Brazil, Kayo et al. (2018) shows that family-owned firms tend to be more leveraged than non-family firms.

In more developed capital markets, the growth of private equity appears to be related with the decline in the number of listed companies (Ewens and Farre-Mensa 2019; McKinsey & Company 2019). Take-private buyouts de-list companies from stock markets, and increasingly larger private fundraising rounds delay—or avoid altogether—IPOs. This trend also certainly influences emerging economies. The "end-state" is not necessarily the Berle-Means type of corporation, with completely atomized shareholdings and an absolute separation between ownership and management, instead, it most likely involves the coexistence of several large, institutional, block-holders.[29]

Without vigorous public markets to substitute, in an emerging context the main distinction in terms of corporate governance is less about public vs. private equities and more about the extent to which institutional investors replace traditional corporate governance models organized around individuals and family ownership, either through public or private equity stakes. Ownership and control type—institutional vs. individual/family—is then a more fundamental variable than, for example, ownership concentration. The presence of institutional shareholders seems to be a more basic distinction than how dispersed these shareholders are, even if institutional investors raise their own agency issues (Bebchuk, Cohen, and Hirst 2017; Çelik and Isaksson 2013). While the Berle and Means model of atomized ownership structures certainly empowers autonomous management, institutional ownership, even when concentrated, also creates room for professional management unrelated to the ultimate owners and crowds-out kinship within the firm, modernizing corporate governance (Aggarwal et al. 2011; Hellmann and Puri 2002).

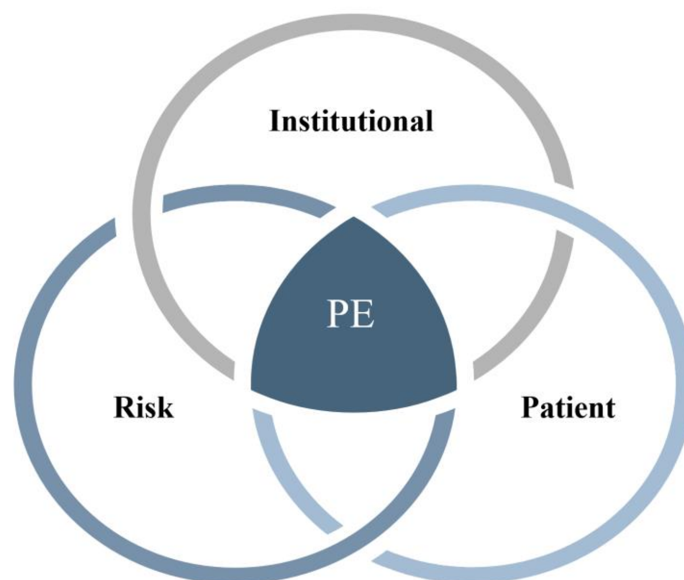
[29] The lack of atomized shareholders shift corporate governance from a principal-agent to a principal-principal problem. The key relationship is no longer the relationship between professional managers and dispersed shareholders but rather between controlling shareholders and minority shareholders (see for example, Young et al. 2008).

Overall, studying private equity capital markets, broadly defined as to include all segments of this market (e.g. venture capital, growth equity and buyouts), allows me to engage the broader literatures on financial development and on corporate governance reform. Moreover, different attributes—adjectives—of alternative sources of capital are often highlighted as desirable: institutional origin, riskiness and patience. As illustrated in Figure 6, private equity arguably displays these attributes.

Raising capital from different institutional sources such as pension funds, and typically managed by professional investors, private equity funds are a distinctive source of *institutional capital,* as an alternative to family-related capital, otherwise prevalent in the developing world. Investing on the more risky tranches of a firm's capital structure, and different than providing loans against some collateral, PE also provides firms with *risk capital*. Moreover, given the illiquidity of their holdings and the more active approach to management, private equity investors usually have relatively long holding periods, arguably warranting being classified as a source of *patient capital*, at least among the class of financial investors, compared, for example, with portfolio investors (Ivashina and Lerner 2019). The sources of patient capital is a core political economy question that is widely discussed in comparative political literature (Deeg and Hardie 2016). Patient capital is typically associated in the VOC literature with bank-based finance in coordinated market economies. Highlighting the centrality of large pools of institutional capital, this dissertation contributes to update this discussion and make it extensive to emerging contexts. Also, it helps clarify the role of different actors in the investment chain, who are sometimes confused (e.g. portraying pension funds and private equity funds as alternative models, when actually pension funds are typically the largest source of capital then deployed by private equity firms). In sum, when considering the intersection between the three sets that contain different forms of

financing that share some key characteristics—institutional, risk and patient—in Figure 6, there are hardly any substitutes to private equity investors.

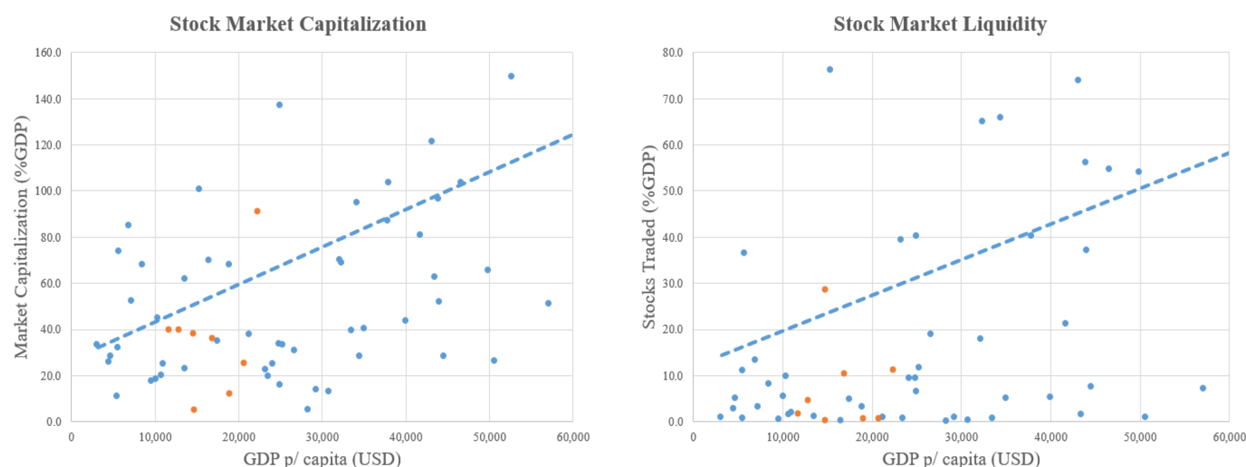
Figure 6: Capital with Adjectives



Across Latin America, the absence of external capital into firms, in particular in the form of equity, is notorious. The region's stock market are significantly shallower than what it would be expected given the region's middle-income development levels, as showed in Figure 7 that plots country-level data on stock market capitalization and liquidity as a proportion of GDP (Latin American countries are highlighted in orange). And private equity is only very timidly emerging. The interventionist ISI period generated concentrated shareholdings and scant external capital; capital markets were re-launched only after the liberalization that started in the late eighties. But still, more than twenty years after extensive macro and micro level reforms, the Latin American financial systems remain underdeveloped, and, if any, primarily bank based (Beck 2016; Heng et

al. 2016; Stallings and Studart 2006).

Figure 7: Stock Market Development - Cross-National Comparison



Note: Latin American countries are highlighted in orange. Data is from World Bank's Development Indicators.

In the nineties, the initial enthusiasm that followed successful programs of macroeconomic stabilization and extensive financial liberalization—that included both deregulation and openness—soon gave room to disappointment. Despite intense micro-level reform efforts across the region (Abiad, Detragiache, and Tressel 2010), that included changes in corporate law, privatizations and pension system reforms, high expectations were not met and capital markets remain underdeveloped (Heng et al. 2016; Schmukler, Gozzi, and De la Torre 2007). In a related manner, after close to three decades of quite extensive liberalization, we do not observe major changes in corporate governance models other than those resulting from privatization programs (e.g., Aldunate et al. 2020).

While it has been well documented that extensive deregulation and liberalization in capital flows has limited the autonomy of macro-economic policymaking (Haggard and Maxfield, 1996; Mosley, 2003; Campello, 2015), there is no clear understanding of how this increased financial

integration affected corporate governance models nor of the politics behind it. Most scholarly work on corporate governance in Latin America stresses either the stability (Larrain and Urzúa I. 2016; Schmukler, Gozzi, and De la Torre 2007; Schneider 2008, 2013) or the adaptation of previous models (Musacchio and Lazzarini 2014). In contrast to Schneider (2008, 2013), who signals broad continuities both across countries and through time given the reinforcing complementarities between multinationals, business groups, the political system and other characteristics of Latin American hierarchical political economies, this dissertation will focus on one of the few drivers of corporate governance change.

The under-development of Latin-American financial markets, particularly when it comes to its capital markets, does not make the topic less relevant, but arguably more pressing. Their continued shallowness despite the consolidation of democracy and extensive efforts of liberalization and reforms, is in itself theoretically puzzling, and calls for explanations alternative to those that focus exclusively on institutional environments. More substantively, scant levels of external capital into firms is arguably one the key bottlenecks to the region's private sector development, affecting firm productivity and competitiveness, and the long-term prospects for economic development.

While explaining the emergence of an incipient private equity industry across different countries of Latin America, this dissertation shines light on broader—and more important—questions about financial development and corporate governance reforms. As an alternative to institutional arguments about financial development based on investor protections, my dissertation emphasizes the more proximate role of state-related institutional investors. And regarding corporate governance reform, it argues against macro-level political explanations of reform.

Instead, it zooms into micro-level regulations and shows extensive public-private collaboration behind the creation of the new industry.

2.2 Beyond Investor Protections

As part of the institutional consensus around the long-term causes of development that focus on the importance of the rule of law, contract enforcement, and the overall protection of property rights (Shirley 2005), the research agenda on financial development appears to have settled around the centrality of investor protections. Together with macroeconomic stability, most explanations agree that well-established property rights, in particular the protection of minority shareholder rights, are the key mechanism behind the growth of financial markets (Haber, North, and Weingast 2008).[30] While there are competing hypothesis around the origins of investor protections, there is not much discussion of whether or not this is the key causal mechanism driving financial development.

The logic underlying the investor protections argument is straightforward (e.g. La Porta et al. 2002). Investors will only allocate their capital into a company's equity—with no guarantee of fixed return, just the claim to residual cash flows after every other claimant such as workers, government, suppliers and debt holders, have been paid—if they are confident they will not be expropriated by managers, majority shareholders or the state. Specific pieces of legislation that protect minority shareholder rights and improve information transparency are enacted to lower monitoring costs, and penalize and discourage the expropriation of outsider investors. Countries who have stronger investor protections in place and enforce them more effectively would

[30] For private equity, see how property rights affect the type of instrument used to make investments (Lerner and Schoar 2005), in Latin America, see Chong and Lopez-de-Silanes (2007) and Khoury, Junkunc, and Mingo (2015).

experience more external capital flowing into its companies. Otherwise, firms will receive less external investment, and companies will have more concentrated ownership structures.

It would be foolish to try to refute the overall soundness of at least part of this argument. As the Argentinean case illustrates, chronic experiences of expropriation paired with macroeconomic and political instability are definitely not conducive towards financial development (Roe and Siegel 2011). A strong corporate governance framework, transparent accounting rules, and diligent bankruptcy courts are certainly important elements for the development of more complete capital markets. Still, they are not enough. As showed in the introduction, legal rules by themselves have limited explanatory capacity, at least during the last couple of decades. Throughout this dissertation, I propose to shift the focus from the institutional settings of each of the countries I study to the more proximate actors that can drive external equity investments into companies: institutional investors. In particular, I focus on a group of state-owned financial institutions which, together with pension funds, can help create an emerging private capital industry and anchor other domestic and international investors.

The institutionalist literature barely discusses the mechanisms that connect laws with firm-level outcomes. Explanations based on rules are mostly functionalist; their underlying logic implicitly assumes that if rules are in place, actors will then follow. But the origins and investment logic behind the institutional investors who are the cornerstone players of modern capital markets, such as pension funds, does not necessarily follow the mechanisms that underlies institutional arguments. As mentioned, the actors that I identify as some of the key drivers of equity markets—domestic and multilateral development financial institutions together with pension funds—are hardly pure market players. The origin of these actors is definitely not market-based and does not

follow the enactment of investor protection rules. And their operating logics, while in some cases is certainly market-driven, it is also heavily regulated.

Moreover, my specific focus on private equity makes minority shareholders rights arguably less relevant (Pandya and Leblang 2017). Given their concentrated equity stakes, private equity investors have the incentives and the capacity to monitor management and other shareholders, even without having full control, making weak minority protections and pervasive contract incompleteness somewhat less problematic. This does not deny the importance, from the investor's perspective, of governments ensuring the rule of law and securing the enforcement of contracts; rule of law affects all types of investors. PE investors would certainly also favor the strengthening of minority shareholders protections. They often take minority stakes, and at least in emerging economies, private and public markets complement each other. Therefore PE investors are also interested in developing vibrant stock markets that serve as an exit option for their investments.

But, as I show, legal shareholder rights have limited explanatory capacity. We need therefore to think of alternative—probably complementary—hypotheses beyond standard institutional explanations and to keep in mind that by holding concentrated stakes private equity may have the capacity to penetrate more disorganized political economies and adapt to different institutional environments. Again, given its characteristics, private equity seems to be less demanding in terms of the enforcement of "within the firm" property rights, in particular those concerning minority shareholder protections. This makes it an attractive form of external capital well suited to operate in less strongly institutionalized environments as well as investing in smaller and less formalized firms (N. Berger and F. Udell 1998).

While minority shareholder rights may not be the key mechanisms driving private equity, I still engage with more general arguments about the political economy determinants of investor

protections. Here too there is also a clear parallelism with the arguments made in the broader institutional literature on the political origins of inclusive, as opposed to extractive, economic institutions. Historically-minded "deep institutional" arguments can be distinguished from "political economy" explanations for how financial systems develop over time and across countries.

In line with the colonial origins argument (Acemoglu, Johnson, and Robinson 2001; Dell 2010), a prominent literature on financial development highlights the origins of each country's legal system as the key long-term determinant of the depth of its capital market (Aminadav and Papaioannou 2020; La Porta et al. 1998). Other things equal, common law countries, which have a legal tradition more protective of investors, would have stronger financial systems compared to civil law countries which are less protective of external investors. Countries which transplanted their legal framework from the French civil law family exhibit less protective shareholder and creditor rights, and therefore have less external investment and more concentrated ownership structures. In line with the long-term focus of legal origins arguments, other research has focused on country's religious origins (Stulz and Williamson 2003), and more broadly, on cultural factors associated with social capital (Guiso, Sapienza, and Zingales 2004) and family values (Bertrand and Schoar 2006) affecting financial development.

It may be the case that the historical analysis of legal and cultural traditions in Latin America indeed illuminates some long-term trend that jeopardized development (Mahoney 2010). Latin American countries' common Iberian—Spanish and Portuguese—colonization experiences, inaugurated a legal tradition based in French civil law that arguably offered weaker investor protections, therefore possibly undermining the region's overall development of its financial markets. Similarly, its Christian legacy may have also affected creditors protections negatively

(Stulz and Williamson 2003). And Latin America's culture of strong family values may shape the organization of business away from external investors (Bertrand and Schoar 2006). The dissertation's case selection, focused on a region that broadly shares all these structural factors, and its time frame, comparing the paths of Latin America's five largest economies after their liberalization, in the 2000s, does not allow it to provide a thorough assessment of these arguments. Still, within the cases that the dissertation does examine, there is significant variation in the development of private equity markets that can be leveraged. And Chapter 6 explores cases outside Latin America, granting some more external validity to the dissertation's main arguments.

Even though significant path dependence in the development of financial markets could exist, critics of investor protections as an exogenous variable also note that countries experienced extensive legal reforms over time, and law-makers many times purposely borrowed institutions from other legal traditions, such as the American securities law (Coffee 1999). To explain within-country variations in both legal rules and outcomes, it requires to go beyond a quasi-constant such as legal family. Treating investor protections as an endogenous policy choice, scholars then focused on the type of political institutions that drives investor protections, and hence, financial development (Haber, North, and Weingast 2008; Menaldo and Yoo 2015; Musacchio 2009; Rajan and Zingales 2003; Roe and Siegel 2009). And again, in line with broader institutional arguments about development (Acemoglu, Johnson, and Robinson 2005), this literature usually associates inclusive political institutions—basically democracy—with property rights and therefore with financial development. Development is thought as a dispute between entrenched insiders and outsiders. Outsiders favor the broader availability of arms-length capital, while insiders block the development of capital markets in order to maintain their privileges (Li and Resnick 2003; Menaldo and Yoo 2015). Empowering outsiders and restraining insiders, democracy is argued to

be associated with financial development (Girma and Shortland 2007).

More specifically, there are two types of arguments about democracy—and political institutions more generally—and financial development: one centered on constraints on the executive, the other one on the expansion of "vertical" electoral accountability (Cox and Weingast 2018; Simison 2019). Regarding the first one, Haber, North, and Weingast (2008) explain that "unless there are self-enforcing political institutions that limit the government's authority and discretion, it will have strong incentives to govern the financial system as to facilitate its own political survival, at the expense of the development of the securities markets and banking system that can finance the private economy" (p.2). As for the political institutions necessary to constraint public officials' expropriatory temptations that inhibit the development of markets they list "federalism, separation of powers, electoral suffrage and party competition" (p.5).

The second argument highlights democracies enhanced responsiveness to broader publics. The median voter is assumed to be an asset holder—actual or potential—who would induce policymaker's push for the expansion of capital markets, break the elite's privileged access to capital, induce competition and foster economic growth. "As shareholdings by the median voters increase, for instance because of the economic success of the middle class or the emergence of capitalized pension systems, political support should move towards favoring equity markets with riskier corporate strategies" (Perotti and von Thadden 2006, 147).

Beyond sharing a common colonial origin, from a political institutions perspective, all Latin American countries during the time period covered are considered to be full electoral democracies. While they exhibit some differences in their electoral institutions, party systems and Constitutions, institutions that can bias democracies towards elites preferences and therefore undermine financial development (Menaldo and Yoo 2015; Pagano and Volpin 2005), all of them

were ruled by democratically-elected governments during the studied time period. Therefore, my cross-section of cases does not allow to directly evaluate a regime-type hypothesis. Still, Chapter 3 shows that overall differences on executive constraints can hardly explain variation across cases. And Chapter 5 and 6 provide evidence from both Latin America and Europe that indicate relevant regulations are actually—and purposefully—enacted quite far from congress and the electoral debate.[31] Overall, this dissertation findings tends to rebut the mechanisms behind the hypotheses that highlight democracy as a leading force towards the development of financial markets.

Compared with theories about financial development over long periods, this dissertation takes a shorter term approach.[32] It advances an intermediate range argument that spans over the last twenty years in Latin America's largest countries. And instead of focusing on cross-national regressions on a variety of broad indicators (e.g. market capitalization and bank assets as a proportion of GDP), it focuses on a quite narrow—and opaque—asset class through detailed case studies. This approach allows my dissertation to go beyond institutional environments, and to forefront actors. In particular, it focuses on the role of a variety of state-related institutional investors such as development financial institutions and pension funds, to explain changes in corporate governance. The following section discusses arguments about corporate governance reform that are, indeed, more actor-based.

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[31] Using individual-level survey data, Kerner (2018) shows that the expansion of the population who owned corporate securities through pension reforms did not increase support for pro-market reforms in Latin America and "neoliberalism," against one of the mechanisms that could connect democracy and financial reforms.

[32] Given the shorten time span of my analysis, it could be argued some of the reforms still have to mature in order to observe changes in firm-level ownership structures and governance models: if the market is allowed to operate, ownership structures would gradually become more dispersed and institutional. But this is not in line with the evidence. While business groups in Latin America indeed appear to have professionalized their management; their ownership structure has remained mostly unchanged, even when the institutional conditions for change appear to be fulfilled. When looking at large "incumbent" companies in Chile during the last thirty years, Larrain and Urzúa (2016) find that rather than dispersing, owners—typically families—have actually concentrated their ownership stakes through debt financing. More open models of governance appear to come through new companies that have grown with PE financing rather than through the gradual reform of incumbent firms.

2.3 Corporate Governance Reform

In contrast to the literature on financial development, scholarly work on corporate governance reform is indeed more actor-based. As part of the comparative analysis of advanced capitalisms, this literature is also framed in a relatively shorter time period than century-long legal origins hypothesis. Arguments are more mindful of alternative models of organizing financial markets and firm governance. They are mostly focused on, first, explaining the divergence between corporate governance models in liberal and coordinated market economies, and then, on how each model reacted to financial globalization, and the extent to which each country trended towards more active markets for corporate control with a larger role for financial investors external to firms. Still, this literature is rarely focused on development. And while my goal is less about explaining conflict and reform and more about the emergence of an asset class and the creation of a new industry, discussing the role of each of the main actors in these theories will help frame my argument within the broader literature and introduce alternative hypotheses.

Arguments regarding corporate governance reform highlight how different configurations of social actors affect corporate governance outcomes within market-based democracies. In particular, they discuss the role of labor, managers as well as, in some cases, of institutional investors.[33]

2.3.1 Labor

Most political economy arguments on corporate governance reform set apart a protagonic role for labor. Still, the impact of labor's strength is somewhat undetermined. While most of this literature argues about the relationship between strong labor and the persistence of concentrated

[33] For reviews of this literature, see Aguilera and Jackson (2010) and Roe and Vatiero (2015).

ownership structures, others emphasize the role of labor pushing for the extension of financial markets.

Aiming to explain the political origins of the divergence between American widely-held firms and the European block-holding model, Roe (2003) argues that in a social-democracy the cost for owners of managerial autonomy is higher, outweighing the value of diffuse ownership. Social-democracy raises the pressures on managers to abandon the shareholder's side and couple with employees to do what managers want to do all along: expand, and avoid risk and rapid change at the expense of owners. Moreover, social-democracy hinders the mechanisms that could be used by shareholders to control managers such as take-overs and manager's incentive compensation. Considering a strong organized labor as the key pre-requisite for social-democracy, strong labor blocks the path to firms with dispersed shareholders and managerial autonomy. This would be one of the drivers of the post-war difference between the continental and the US corporate governance model, where in the latter, weak labor loosens the agency problem between owners and managers and therefore makes possible the separation between ownership and control. This argument is validated empirically, for example, by the correlation found between labor strength and ownership concentration (Aminadav and Papaioannou 2020; van Essen, van Oosterhout, and Heugens 2013). In a more limited comparison, but showing directionally similar results, Goyer (2011) uses the strength of German labor inside firms to, explain the different—lower—penetration of financial investors—contingent capital—in Germany and France.

In Roe's class-based model of corporate governance outcomes capital and labor cannot be part of the same coalition. Gourevitch and Shinn (2005), instead, propose a cross-class argument. They agree labor strength may have blocked shareholder dispersion in the post-war era, but propose an alternative three-actor coalitional explanation of this outcome in which labor allied

with management in a corporatist agreement, and owners accommodated by maintaining concentrated block-holdings. In line with VOC's argument about electoral systems, this corporatist compromise is facilitated by proportional electoral systems that incentivize coalitions between different parties and actors.[34]

Gourevitch and Shinn's three-actor framework has important consequences when thinking about reform, since it also conceive a cross-class alliance between labor and owners. These coalition will push for reforms that extend the role of financial markets, facilitate the monitoring of management and allow firms to open their capital structure and disperse their ownership. In this line, other scholarly work argues labor-based parties, in particular when workers have their pensions invested in the financial market, can lead a "transparency coalition" that, together with investors, intends to curb managerial opportunism and push for increased investor rights against corporate insiders. For example, Cioffi and Höpner (2006) provide evidence that center-left political parties have pushed for pro-shareholder corporate governance reform in the 1990s and 2000s. Against the conventional wisdom, they show that the pro-business right has generally resisted reform to protect established forms of organized capitalism and concentrated corporate stock ownership, as their interests are mostly aligned with managers. Moreover, Pinto, Weymouth, and Gourevitch (2010) find evidence that left-leaning governments are more likely to be associated with higher stock market capitalizations. And Barker and Rueda (2007) show that the weakening of "insider" labor, and strengthening of outside labor, undermines the corporatist coalition and pushes for reforms in the financial markets as a way to favor new entrants and make markets more competitive.

[34] Pagano and Volpin (2005) also propose a model—and provide evidence—about the relationship between proportional electoral systems, weaker investor protections and more concentrated shareholdings.

At least in Latin America, we do not observe more open corporate governance models in those countries where labor is relatively weaker, for example in Chile, Mexico or Colombia. And labor-based parties, even those more oriented to outsider labor, do not appear to push for "neoliberal" reforms that would extend the scope of financial markets either. Instead, the left is in general skeptical of the expansion of financial market. As the empirical chapters note, I do not find direct evidence about the relevance of labor either facilitating or blocking more open and institutionalized forms of ownership in Latin America, at least through the creation of more active private equity markets. Organized labor indeed participated in designing a pension system during market reforms. For example, as Etchemendy (2011) argues, labor, when strong, usually pressed to obtain compensations that strengthened their organization. Beyond these reforms, in some cases unions have a role in the management of pension systems, particularly in the case of defined benefits plans. The management of individual capitalization plans is usually less related to organized labor.

That organized labor has not actively pushed or hampered the micro-level reforms that promoted more dynamic capital markets does not counter arguments about the valence between labor relations and corporate governance models. Family firms may be better able to cope with conflictive labor and therefore relatively more prevalent in countries with hostile labor relations (Mueller and Philippon 2011), even if they do not actively promote labor conflict. Business across the board does not favor extending labor regulations. But PE's restructuring role may be more easily conducted in contexts with more flexible labor protections. Most interestingly, several interviewees pointed out private equity investors avoid getting involved in sectors with high levels of labor—and tax—informality. Given their more stringent compliance standards related to the institutional origin of their capital, PE investors are arguably more sensible to labor liabilities. And

competition from informal firms prevents them to overcome atomization and foster the consolidation of a sector, a usual investment strategy.[35]

2.3.2 Managers

Other than labor, political economy models of corporate governance also grant managers a pivotal role. In order to protect their positions, and preserve their autonomy, managers can side with either owners or labor. While the relevance of managers may be valid in a context where management already exists as an actor, as it is the case in both coordinated and liberal market economies, this literature is hardly useful in a developing context. Given the prevalence of concentrated ownership and hierarchical governance models (Schneider 2013), there is actually no management as an autonomous group to begin with. Autonomous managers are precisely one of the key outcomes of financial development, therefore hardly its cause. Without external investors that inject professionalism into firms, management typically remains closely subordinated to the firms' owners. As Chapter 5 shows, different public agencies had to aid fund managers' collective action and sponsor their business association, arguably helping them "become an actor" that could then push for reform. Once again, my argument is less about reform and insiders vs. outsiders than about the creation of a new industry through private-public collaboration.

2.3.3 Institutional Investors

Finally, representing "outsider capital" (Barker and Rueda, 2007), institutional investors such as pension funds are portrayed by the literature to be unequivocally called to limit the influence of corporate insiders and block-holders. But after more than 20 years from pension

[35] Beyond just refraining from high-informality industries, a former executive from one of the largest PE funds in Brazil described me how they researched in detail which sectors government was tightening the enforcement of taxation and regulations to then deploy a "buy-and-build" investment strategy.

system reform, in Latin America, pension funds have yet to play that role. With portfolios fully-loaded with public debt and/ or increasingly attracted by global investment strategies free of "headline-risk," their engagement with more activist forms of domestic investing, such as private equity, is far from automatic. Getting access to pension fund resources is one of the key outcomes I analyze throughout the dissertation, and a core goal for both state interventions and private capital industry associations.

While there is some recent political science work on institutional investors in the region (Bril-Mascarenhas 2016; Bril-Mascarenhas and Maillet 2019), I am not aware of any systematic comparative research on the political economy of pension fund investment strategies, and this topic has yet to permeate into the more mainstream literature on financial development (Scharfstein 2018). Engaging with pension funds as corporate governance actors in an emerging context is one of the contributions of this dissertation.

Pension fund's mandate is to generate financial returns to face pensioners' retirements. Developmental "market-making" role is not typically within pension fund's stated goals. PE's role is to enhance traditional stock and bonds portfolios by generating excess returns (i.e. alpha). Long-term private equity commitments match well the distinctively long-term liabilities held by pension funds, and would enable them to obtain a liquidity premium. While there is a debate on the extent of the "alpha" generated by the PE asset class during the recent stock market super-cycle (e.g. Bain & Company 2020), generating financial returns and beating the market is pension funds main goal

when investing in the asset class.[36]

Pension systems are structured in different ways that affect the incentives and goals of pension fund managers. Broadly, there are two different models. On one side, pay-as-you-go systems that are typically managed publicly. Their public sector status creates a tension between maximizing financial returns, the need to attract top financial talent to do so, and pressure from politicians to invest in projects that may not maximize financial returns, but benefit them, electoral or privately. Still, public pension funds are among the most active private equity investors. The most successful of them have resolved this tension granting their managers a substantial degree of autonomy from politicians and bureaucracies; best exemplified by Canadian pension funds (Little 2008; World Bank 2017). As I discuss in Chapter 4, this tension is clearly exemplified in the more politicized Brazilian pension funds.

On the other hand, individual capitalization pension systems accumulate the largest pools of capital and are typically managed by private administrators. By design, they intend to insulate pensioner's savings from political pressure to prevent expropriation. Still, portfolio allocation quotas—as well as other parameters—are heavily regulated. Managers incentives to take risk, compete and differentiate from each other and prioritize longer-term investments over short term securities are not easily generated, as discussed for the Chilean case by Opazo, Raddatz, and Schmukler (2014). And pensioners discretion to re-allocate their individual savings can also bias portfolios towards liquid securities (Da et al. 2018).

[36] As mentioned, the number of listed companies in Latin American stock markets is quite small. Firms typically have a controlling shareholder, dual shares and pyramidal structures. These features generate a gap between political and cash flow rights that incentivizes controllers to expropriate minority shareholders (Dyck and Zingales 2004; Nenova 2003). From this perspective, and notwithstanding the agency problem between PE fund managers and institutional investors, private equity may have an advantage over domestic public equities.

Different systems certainly raise different governance issues, but the overall challenge is similar: to create the channels that connect large pools of capital into long-term projects while generating risk-adjusted market returns, i.e. without expropriating pensioners. And as this dissertations shows, these channels are far from automatic, but the result of extensive public-private collaboration.

2.4 Quiet Politics

As an alternative to macro-societal theories of corporate governance reform, Culpepper (2010) makes a "quiet politics" arguments centered on the preferences of managers rather than on the relative power of social actors. Culpepper points out that it would be a mistake "treating corporate control like any other high-profile battle in democracies, where public opinion and legislative votes are the most valuable currencies" (p.3). In low saliency and technically opaque policy areas, in particular when execution and implementation is more relevant than legal reform, as it would be the case for corporate governance, Culpepper argues that managerial organizations have an advantage. Given their superior knowledge and technical lobbying capacity, outcomes would tend to follow manager's preferences.

However, Culpepper's argument is still based on societal considerations, since managerial preferences are ultimately a function of the strength of within-firms labor organization. So, notwithstanding the level on which each of these arguments identifies the corporate governance policy arena—micro or macro-level—all of the arguments presented are mostly societal, with the role of labor being at the core of most models. They hardly acknowledge any role for public policy besides implementing the winning coalition's preferred position in a rather automatic way. It is not clear from reading the literature what are the mechanism through which these societal actors

operate and how, nor which, policy is implemented. The different arguments are not very explicit on the specific policies driving change, and if any, are mostly centered on legal reforms. For example, are the policies implemented by alternative socio-economic coalitions changes to corporate law, specific pieces of administrative-level regulations or the increased enforcement of existing rules? Or, rather, they push for alternative pension fund regulations, privatizations or a different direction in the strategy of development banks? Diving into detailed case studies allows me to weigh these alternative "mechanisms" to then connect them back to the broader hypotheses in the literature.

My argument is indeed located in the "quiet politics" arena, as an alternative to macro-coalitional theories. While my focus does not allow for the large-n type of evaluation to make a full quantitative assessment, I do not observe the connection between the macro-coalitional politics discussed by the literature and the micro-level topics that I am focusing on. First, as mentioned, labor has not played a relevant—direct—role pushing for financial market reform in Latin America. And second, explanations focused on the role of managers seem hardly relevant for an argument about the development of a new market. Without an autonomous management group to start with, the emergence of a private capital market is less about conflict and reform, and more about the creation of a new industry. Therefore, a macro-societal approach does not appear to be as helpful as in other contexts.

Given the smaller scale of the object of study—private equity in a region where it is yet emerging—and the micro-level and highly technical regulations that affect it, a quiet politics approach seems trivially true. But as Chapter 5 discusses in detail, even for a low-salience topic, the "quiet politics" bureaucratic arena is not always the natural setting for this type of issues.

Actors in the PE industry actively chose to keep their policy working space outside Congress and party politics, even if that means paying a cost in the—second-best—outcomes they may obtain. Moreover, Chapter 6 shows the logic behind PE regulation in more developed markets also follows a similar logic.

Beyond societal arguments on reform, my explanation focuses on the pivotal role of the state for the emergence of a new industry. First, development financial institutions act as investors in this emerging asset class, and try to attract other state-related institutional investors, such as pension funds, into the new industry (Chapter 4). Second, some of these public agencies also foster the industry's collective action by sponsoring business associations that represent fund managers, who in turn, then lobby for a workable regulatory environment (Chapter 5). The policy-making roles played by a variety of—domestic and multilateral—development financial institutions, substantially more active than the one granted by institutionalist arguments, are central to explain the emergence and institutionalization of the private capital industry.

2.5 Update: State and Finance

Beyond a set of market-conforming policies, mainstream institutionalism considers the state not as an enabler but mostly as a barrier to development. This tradition grants business a more functionalist role: firms will germinate and take advantage of market opportunities if the state's expropriation impulses are checked by an institutional framework that protects property rights and allows market competition. Similarly, in the financial sector, capital market development would follow from the rules that protect investors and constraint executives. If the correct institutional environment is in place, investors will emerge in a decentralized way to invest into firms, and owners will open their firm's capital structure to external investors in order to reduce the cost of

capital and to diversify their wealth. The role of the state is limited to the—at all trivial—tasks of enforcing the law and guaranteeing a frictionless regulatory framework. Beyond that, government's role in markets crowds-out private investment.

Oddly, the countries that exhibited the highest growth in capital markets in the last couple of decades exhibit quite a statist political economy, comparatively less constrained executives and a prominent role for government-related investors (OECD 2018). Such is the case in China but also in Singapore, Korea and Malaysia (Gomez et al. 2018; Klingler-Vidra 2018; Yong 2012). State-related actors such as sovereign wealth funds, development banks and publicly-managed pension funds function as cornerstone investors in many of these markets. As Chapter 6 documents, state-related sources of capital funding private equity investments are ubiquitous not just in emerging markets but also in the developed world.

Latin America is a non-obvious choice to advance an argument with state and policy at its core. Not only have Latin America states been historically weaker than their Asian counterparts (Stephan Haggard and Kaufman 2008; Schrank 2007), but also, after extensive liberalization in the 1990s, Latin American political economies are typically thought as less statist than they were in the past. If anything, state presence in the financial sector is mostly restricted to commercial banking (Etchemendy and Puente 2017; Yeyati, Micco, and Panizza 2007). Of course, Brazil is a clear exception with its well-known development bank, BNDES, one of the largest of its kind in the developing world (Hochstetler and Montero 2013; Lazzarini et al. 2015; A. Leslie 2017; Torres and Zeidan 2016). Even though Latin America may be an unexpected region to focus on, it exhibits interesting variation across countries and time that can provide empirical leverage to support my argument. As in many regions in both the developed and developing world, if we analyze the investors behind some of the pioneer private equity funds, even in Latin America, we notice the

presence of state-related financial institutions, both multilateral and domestic.

As an investor, the state can participate in private equity markets in two main different ways: directly and indirectly. First, occasionally, state-related financial institutions can function themselves as private equity investors, and participate in the firm's equity directly as shareholders. This model is well described in Musacchio and Lazzarini's (2014) "Leviathan as a minority shareholder" model, that uses the Brazilian case as an example. In contrast with more traditional state-owned enterprises, in these cases the state usually holds minority, though concentrated, stakes in firms, co-investing alongside a variety of business partners. While state investments generally have an explicit policy purpose, and there might be some guidance and monitoring through participation in the board of directors, companies are mostly managed by the state's business partners (Musacchio, Lazzarini, and Aguilera 2015).

Second, and most interestingly, state-related financial institutions can also function as investors—as limited partners (LPs)—in privately managed private equity funds. These funds pool capital from multiple sources and in turn participate as shareholders—majority or minority—in multiple portfolio companies. This extra layer of intermediation, that outsources ultimate capital allocation decision-making to a third-party fund manager, provides a more detached model of intervention. It allows the limited partners to reach smaller, and a larger number of firms in an arms-length way. Acting as an anchor investor and aiming to crowd-in other domestic and international investors, through PE investments state-related financial institutions also often aims to achieve narrower, sector-specific, policy goals, while imposing themselves some level of market discipline. Chapter 4 discusses different private equity government-sponsored initiatives throughout Latin America.

Policymakers promoting private equity have intertwined goals. More generally, they aim

to develop more complete capital markets and improve firms' access to finance, in particular in the form of equity capital, otherwise notably absent from the financing menu. As just mentioned, access to finance in some cases is combined with sectoral goals; equity funds serve as targeted policy instruments. Development financial institutions in general do not invest alone, but their goal is to anchor resources from other institutional investors. Most importantly, they often intend to leverage pension funds' vast pools of capital.

Beyond these more programmatic goals, and regarding individual-level motivations, some senior public officials at both development banks and regulators most likely consider their career paths that often combine public service with private sector positions. The fund management industry, and the professional services surrounding it, is a common path for senior technocrats to go into business. So gaining expertise, and embedding themselves in the industry networks can help them advance in their careers. This seems to be the case across Latin America, and probably elsewhere, and is most clearly observed in the Mexican case.

Beyond the focus on capital markets, there is, of course, a large literature that addresses the role of the state owning corporate assets, typically focused on the discussion around state-owned enterprises (SOEs). There are compelling arguments both in favor and against market interventions.[37] SOEs indeed appear to face multiple governance issues, as raised by an agency perspective usually skeptical of governments' developmental efforts. Efficiency and profitability may be in tension with the social objectives that motivated state intervention in the first place, and SOEs thus have multiple and potentially contradictory goals. Their managers may lack high-powered incentives that would align their goals with societal goals. The ultimate principals,

[37] For a complete discussion of this debate, see Musacchio and Lazzarini's (2014) Chapter 3. Also see Musacchio, Lazzarini, and Aguilera (2015) and Yeyati, Micco, and Panizza (2007).

politicians, are tempted to use their authority over SOEs for their personal gain and to benefit their cronies. Lack of proper monitoring, either from an independent board of directors or the market, may complicate things further. SOEs can also distort competition and crowd-out other private sector participants. And poorly managed SOE can lead to chronic increases in the fiscal burden. In contrast to a more cautious approach to state intervention, the defenders of an industrial policy view conceive state investment as a way to promote development beyond what is possible under the free market. Governments can help firms develop new capabilities by reducing capital constraints, subsidizing part of the research and development expenses and solving coordination and rent appropriation problems, encouraging firms to pursue new projects with potentially high spillovers.

While co-investing with private sector players and the intermediation of professional managers may ease some concerns, the different policy programs considered in Chapters 4 and 5 certainly suffer from some of the agency challenges and tradeoffs discussed by the literature. But beyond normative arguments, this dissertation suggests that the state has a significant role in the emergence of private equity markets. Without a more active role of the state than the one portrayed by the institutionalist literature, private capital markets can hardly take off. This is not the same as arguing that state intervention is always positive or exempt of rent seeking. The empirical chapters go into the agency challenges of programs specifically aimed at equity markets, and discuss how different organizational designs try to resolve them.

Interestingly, most of the private equity programs established throughout Latin America were built by each country's long-standing state-owned development financial institutions. This is certainly the case of the largest of these programs, such as BNDESPAR, part of BNDES in Brazil, *Fondo de Fondos*, affiliated to Nafinsa in Mexico and Corfo's risk capital program in Chile, and

exemplifies one of the somehow more novel role development financial institutions can have (Griffith-Jones and Ocampo 2018; Lazzarini et al. 2015). The importance of these legacy organizations also signals the high fixed costs of starting these programs (nicely exemplified in the FDN case in Colombia), and therefore, their path-dependent nature. Legacy financial institutions grant government-sponsored investment programs some autonomy from politics and standard bureaucracy, and employ the type of officials—with experience in finance that spans the private and public sector—that typically lead these initiatives.

More generally, by focusing on equity investment rather than on bank loans, this dissertation also contributes to update the state's role in finance. As mentioned, comparative capitalisms literature presented a dichotomy between bank-based and capital market based financial systems. This literature in general also associates state intervention with a bank-based system argument (e.g. industrialization in France and Germany (Gerschenkron's 1962), postwar industrial policy (Zysman 1983) and East Asian development (Woo-Cumings 1991)). Capital markets were portrayed as the reign of more liberal political economies. Characteristically short-sighted, they would be unable to overcome the multiple market failures that plague development. As explained above, this bank vs. capital market dichotomy is at best, outdated. The association between banks and state interventions also seems old-fashioned. While development banks continue to play a significant role through their loan businesses, many of them have adapted to more globalized financial markets and are also active players in capital markets. The sharp dichotomy between bank and capital market-based financial system does not seem to hold. Nor does the exclusive affinity between banks and state intervention.

Favoring a limited role for the state in the economy, mainstream institutionalism is also quite skeptical of close business-government relationships, as opportunities for entrenchment and

rent-seeking would outweigh any potential gains from closer coordination. The role for the state is to serve an arms-length regulator. This includes strengthening regulators' capacity, improving transparency and information flows and reducing overall transaction costs. But beyond these functions, there is a generalized skepticism about close relationships between bureaucrats and their private sector counterparts. As the case of private equity business associations illustrate, the role played by the state in the organizational dimension, again, contrasts with this hands-off approach.

In tandem with its role as an investor, and well beyond state's role as a regulator, we observe in most countries an active participation of a variety of public agencies that, together with multilateral financial institutions, promote the emerging private capital industry's collective action. They help create asset-specific business associations which will then lobby for regulatory reforms. This is in line with arguments about the importance of private-public collaboration for effective productive policymaking. Together with the crucial issue of public sector capabilities, the aspects that determine the success or failure of public-private cooperation appear to be less structural and more practical issues around the collaboration between the private sector and public agencies (Fernández-Arias et al. 2016). And as Fernández-Arias et al. (2016) emphasizes, private sector organizations are a pre-requisite of successful policies, since industry associations are key to fostering cooperation among firms and to allow more stable and legitimate interactions with the government (Schneider 2015). The private capital industry is a clear example where different domestic and multi-lateral public agencies play a more political role facilitating collective action in order to have an organized business counterpart that can aid policy design and implementation (Schneider 2004). Chapter 5 analyzes the origins of each country's business associations and their role behind some key regulatory issues.

Beyond its contribution to the academic literature on financial development and corporate

governance reform, by emphasizing the role of institutional investors, this dissertation can also provide relevant—though still high-level—inputs for policymaking. Mainstream theories of financial development are more detached from policy. They prescribe, if anything, strengthening regulatory agencies and legal reform. While developing competent regulators is certainly crucial, this dissertation studies the role of the state not just as a regulator but as an investor through public and semi-public institutions (e.g. sovereign wealth funds, development banks and pension funds), helping create an institutional framework for capital accumulation and the channels that connect these large capital pools with firms. I also discuss a more "political" role for state agencies: fostering collective action through business associations to establish a more fluid public-private working relationship. These business associations, whose creation is in part supported by the state, in turn advocate for the creation of specific corporate vehicles, push for favorable taxation and lobby for accessing pension fund resources. Acknowledging the role of different actors that participate in the policy making discussion can also contribute to more practical design questions around the trade-offs policy-makers face when trying to foster private equity, and capital markets more generally.

2.6 Conclusion and Roadmap

This chapter explained how from a narrow focus on the development of private equity markets in Latin America I can engage broader questions about financial development and corporate governance reform in an "emerging" context. Other than private equity—that as I discuss, can accommodate different models—there is no clear alternative form of financing that combines three important characteristics: institutional origin, riskiness and patience. In contrast with its role in more developed capital markets, where private equity concentrates ownership as a way to check managers' autonomy, in emerging economies it is an alternative to governance

models organized around families and individuals.

In order to explain the emergence of this new market, I emphasize the role of state-related institutional investors as an alternative to just focusing on institutional environments. Property rights and investor protections are certainly important for development, but they are not enough, at least for the case of equity markets. As the empirical chapters make clear, an exclusive focus on institutions can hardly explain the emergence of private equity markets in Latin America. Instead, in all cases analyzed, I observe a more active role of policymakers than the ones acknowledged by mainstream arguments about financial development. In particular, I distinguish state's role as an investor (Chapter 4), from policymaker's role helping the emerging industry organize into asset-specific business associations (Chapter 5).

Next, Chapter 3 introduces firm-level evidence to supports the arguments on the role of private equity made throughout this chapter. PE investors are behind a majority of stock market listings, crowd-out kinship ties within firms and induce more dispersed ownership structures. It also presents data on the relative penetration of private capital investors in each country, and score cases on a set of alternative hypothesis discussed in this chapter (e.g. investor protections, trade protections, regime type and labor strength), laying-out the stylized facts of the country case studies developed in Chapter 4 and 5.

Chapter 3 - Private Equity and Latin America

This chapter presents data about private equity in Latin America to support both the theoretical arguments from the previous chapter and the case studies developed in Chapters 4 and 5. It makes three main points.

First, it presents firm-level evidence to support the relationship between private equity, financial development and corporate governance reform. In particular, it provides evidence that indicates: (1) PE is an important driver of stock market listings; (2) PE-backed companies exhibit a more dispersed—and more institutional—ownership structure; (3) PE investors crowds-out family members from corporate leadership positions; (4) family ownership, and not private equity, is associated with more leveraged capital structures (i.e. with more intense use of debt financing); and, (5) the mere passage of time, measured as firm's age, does not drive companies to become more institutionalized. This exercise provides an empirical validation to the arguments about private equity made in Chapter 2.

Second, it shows Brazil is, by far, the largest private equity market in the region. This second sections displays fundraising and investment figures gathered by industry associations, and other metrics related to the relative penetration of the asset class by country. Brazil dominates the regional private equity industry, even after normalizing by the size of its economy. Chile, that otherwise has the most developed financial markets in the region, exhibits a relatively lower penetration of PE investors. These figures confirm evidence gathered from the IPOs, and are also consistent with data on the penetration of PE into business elites, as well as with the material gathered through interviews with market participants and other secondary sources.

And third, it shows alternative hypotheses do not reconcile easily with the ordering of the

cases regarding the penetration of PE investors. Latin American countries are benchmarked on a set of indicators that illustrate alternative hypothesis from the literature: investor protections, financial and trade openness, regime type, and labor strength. We would expect the development of private equity markets—as a key component of a more developed financial system—to be related with stronger investor protections, more deregulated financial systems, trade openness, democracy and relatively weaker labor organizations. But Latin American country's relative ordering in these dimensions do not match the development of each country's PE markets. For example, while Brazil is the largest country in the region, its prominence is theoretically unexpected since its scores low on investor protections, it is quite protectionist and has strong organized labor, at least relatively to its Latin American peers. Moreover, I discuss the role of country's size and scale as another possible explanation for the relative penetration of PE in Latin America.

Private equity is, by definition, an opaque industry. Given the private nature of its investments, data is mostly proprietary and not easily available (L. Jeng and Lerner 2016). Moreover, there are significant measurement challenges that make data from different sources hardly comparable (G. W. Brown et al. 2015). For example, it is not always clear what type of investors are considered part of the asset-class (e.g. government-related funds are rarely included), which sectors are covered (e.g. infrastructure or real estate), and how investment figures are calculated (e.g. with or without leverage). Beyond definitional congruence, the information collected by industry associations can also be biased since it is mostly used for promotional purposes. In order to overcome these limitations, and being mindful of the advantages and limitations of different data sources, I triangulate multiple sources of information: firm-level data from stock-market listings, aggregate data from regional industry associations, and individual-

level data from businesspeople. Moreover, the main findings from these different data sources are corroborated with interviews and secondary sources.

Overall, the goal of the chapter is both to present evidence that validates some of the arguments made in the theory chapter, and to introduce the stylized facts of the country case studies that will be developed in subsequent chapters. The first section displays the empirical exercise using firm-level data from all companies that listed in Latin American stock markets since 2002. Private equity investors, indeed, appear to help modernize corporate governance at the firm level. Then, I present different data sources to determine the relative penetration of PE at the country level. Third, I compare these countries on a series of indicators that illustrate alternative hypothesis. Finally, I conclude and introduce the case studies developed in Chapters 4 and 5.

3.1 PE and Stock Markets: Evidence from IPOs in Latin America

To assess the penetration of private equity across different countries, and compare PE-backed[38] with non-PE backed firms, I gathered the prospectus of all companies that listed their shares in Latin American stock markets in the last fifteen years. The sample comprises around 250 companies in six countries—Argentina, Brazil, Chile, Colombia, Mexico and Peru—spanning from 2002 to 2017.[39] A prospectus is a document that companies are required to file in each country securities regulator before their initial public offering. These documents contain detailed information on the firm's ownership structure and board of directors, providing a snapshot of the

[38] A PE-backed IPO is the initial selling to the public of shares in a company that has been previously funded (not necessarily founded) by private equity investors. See, for example, Wilhelmus and Lee (2019) that also compare PE-backed from non-PE backed companies.

[39] Given the relatively shallow capital markets in the region, the number of companies is not large. To identify the companies that listed in Latin American stock markets, many of them later de-listed, I triangulated data from Capital IQ with the information of each country's security regulators. Then, I downloaded the prospectus for each company from either the securities regulator's portal or the company's investor relations site, and codified by hand the different variables.

company before going public, while still privately-held.

It would be extremely hard to obtain equivalent information on a larger sample of private companies. From the prospectus I can identify who are each firm's pre-IPO owners, and gather a battery of firm-level covariates. I classify ownership type into five different categories: family/individuals, multinationals, government, private equity, and shares owned by public investors; and compute this variable before and after the listing. These is not data that is readily available in off-the-shelf sources, but has to be collected manually. Prospectus contain richer and more accurate information than standard sources of firm-level data such as Bureau van Dijk and Capital IQ, but in a raw format.

Figure 8: # IPOs per Country (2002-2017)

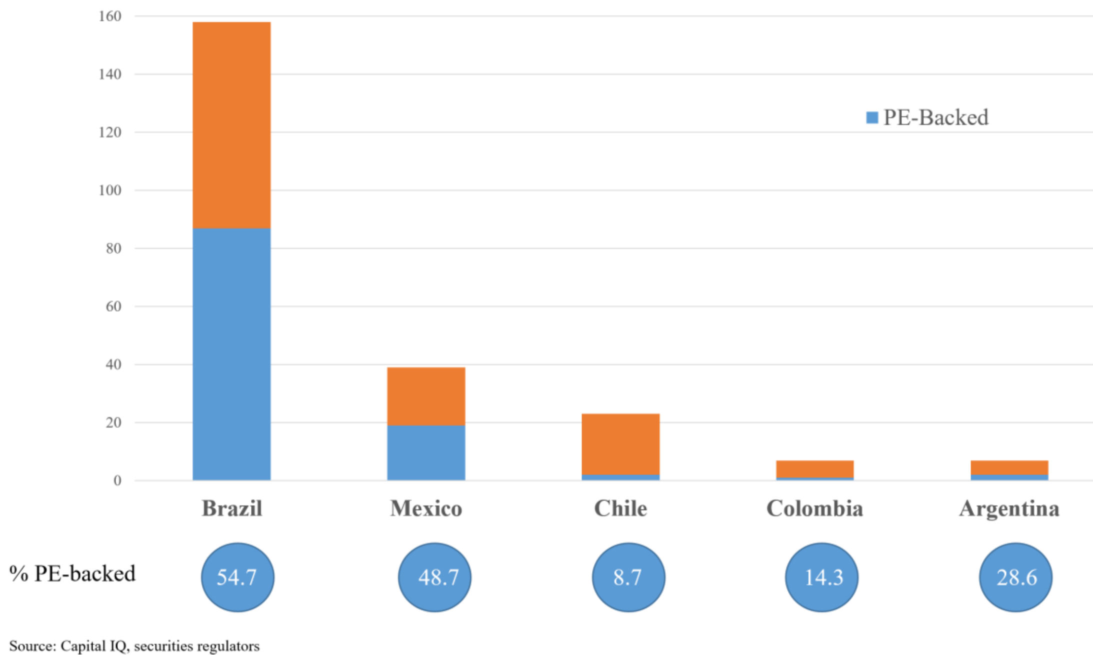

Figure 8 shows the number of listings by country, and distinguish between companies that had PE-backing before the IPO from those that did not. Clearly, private equity is an important

investor in companies that list in the public market. Pooling across all countries, 47% of all the companies that listed had a—broadly defined—private equity investor among its pre-IPO shareholders. This figure is somewhat lower than comparable figures outside the region,[40] but still quite significant. Cross-country differences are noteworthy. Brazil concentrates around two-thirds of the total listings (67%) but more than three-quarters (78%) of all the PE-backed IPOs in the region; more than half (54.7%) of the companies that listed in Brazil throughout the period had PE backing. On the other hand, only two of the 23 companies that listed in Chile (8.7%) had a private equity shareholder when they went public. The country-level average is of 31%. Suggestively, the two countries that concentrate most of the listings, Brazil and Mexico, are also where the proportion of PE-backed companies is higher. These findings are consistent with the complementarity between private and public markets.[41] Private equity investors "feed" stock markets of companies, and stock markets provides PE investors a feasible exit option for their investments.

The evidence in Figure 8 is also in line with arguments gathered during fieldwork. An executive from the Brazil's stock exchange highlighted the importance of private equity investors as a driver of listings:

> *Around 60% of IPOs in the last decade have been PE-backed, and in the last couple of years this figure has been larger, over 70%. PE is the key factor for new listings! This is our working hypothesis.*

Similarly, in Mexico, a former official from the banking and securities regulator explained,

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[40] Relatedly, see Kaplan and Lerner (2010) that find that around 60% of IPOs in the US between 1999 and 2009, were venture-backed.

[41] See, for example, Jeng and Wells (2000) that show IPOs (and not overall market capitalization) are crucial determinants of VC/PE finance.

when discussing the—scant—development of the local stock market:

> *I am not sure how we can accelerate the process, but there is one thing that is very clear: every IPO from the last couple of years was backed by a PE fund. So we don't have to re-invent the wheel, but to promote private capital. We need to feed the stock market of companies. […] They [grupos] don't need to raise money. You need a private equity fund that changes the culture of the company, and then sponsors the IPO. If a company reaches the stock market, it will likely be because it is backed by a PE fund. Achieving a listing without them is very unusual.*

Beyond cross-national differences, this dataset is also useful to compare firm-level characteristics of private equity backed companies at the time of the IPO. In particular, I focus on evaluating ownership concentration, presence of kinship ties and leverage.[42]

First, regression analysis makes clear that private equity backed companies tend to have more dispersed shareholding structures before listing, one of the metrics usually associated with financial development (e.g., in La Porta et al. 1998). The likelihood of having a controlling shareholder (someone who individually controls more than 50% of the voting rights) is significantly lower for PE-backed companies. Using a binary measure for PE, results in Table 2 shows PE-backed companies have a 22.5% lower probability of having majoritarian control before they do the IPO (0.6 of the standard deviation). IPOs, of course, modify firms' ownership structure. Following the IPO, PE-backed companies are also less likely (14.8 percentage points) to have a clear controlling shareholder, even after controlling by the pre-IPO concentration level.[43] Relatedly, PE-backed companies are associated with larger free-floats and more dispersed

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[42] For an analysis of firm and country-level corporate governance features and valuation, see Chong and Lopez-de-Silanes (2007).

[43] All these regression outcomes are from models that include country fixed effects and controls by year and firm's age, industry and size. For the post-IPO models in the second column, they also control for the largest shareholder prior to the IPO.

ownership, as shown in Table 5 in the Appendix of this chapter. These are important results: the empirical literature on finance and development coincides that what is relevant for economic growth, capital accumulation and productivity is market liquidity—related to larger free floats and more dispersed ownership structures—and not market size/ overall market capitalization (Beck and Levine 2004; Levine and Zervos 1998).

Table 2: Private Equity and Majority Control

	Majority Pre-IPO	*Majority Post-IPO*
PE (dummy)	-0.225***	-0.148***
PE (%)	-0.004***	-0.003***

0.01“***” 0.05 “**” 0.1 “*”

Note: Majority is defined as one shareholder having more than 50% of voting rights, not by economic rights. Regression models include country fixed effects and controls by year, assets (ln), sector (infrastructure and financial) and age. Post-IPO regressions in the second column also control by the stake of the largest shareholder before the IPO.

Indeed, it appears PE can introduce some dispersion in otherwise typically highly concentrated ownership structures. Still, it is clear that in Latin America, the end line in terms of ownership concentration is not the Berle and Means model of atomized shareholders. Most companies in Latin America have a clear controlling shareholder (see data in De La Cruz, Medina, and Tang 2019), with a few exceptions mostly in Brazil of companies that had at some point state-related investors among its main shareholders (e.g. Embraer, BRF). Following the IPO, the largest shareholder owns, on average, 56% of the company. There is some variation across countries arguably related to the relative penetration of private equity investors: companies that listed in Brazil and Mexico are somewhat more dispersed compared to the ones that listed in Chile and Colombia. Still, the region’s firms exhibit very concentrated ownership structure relative to

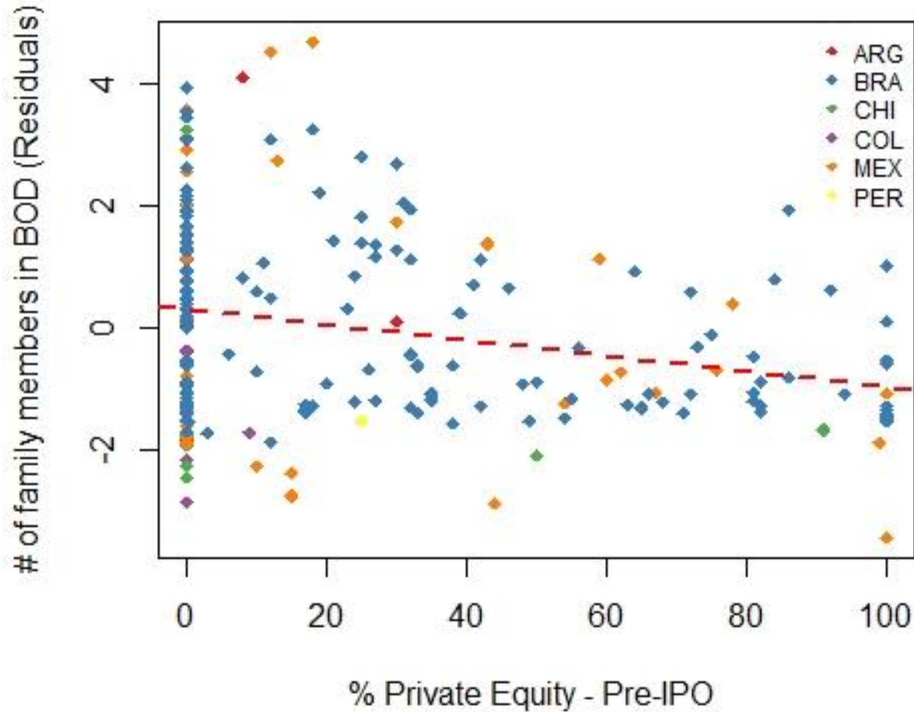
international standards.

Crucially, I find evidence that a higher proportion of—more institutional—private equity investors before the IPO also drives a more "modern" corporate governance, measured by the number of kinship ties in the board.[44] PE-backed companies tend to have fewer family ties among the board of directors. The presence of institutionalized investors is inversely related with the presence of family ties within a firm's board and management. Equity holdings usually grant political rights and give shareholders a say on the appointment of board members and top management. Thus, shareholders can encourage the replacement of family members in leadership positions with professionals. Figure 9 displays a negative relationship between the percentage of private equity ownership prior to the firm's initial public offering (IPO) and the number of family members in the company's board across Latin America.[45] Companies controlled by private equity investors rarely exhibit any family ties within their leadership, in line with the argument that private equity is a driver of firm professionalization.

[44] For an evaluation of the effectiveness of PE/VC funds promoting best practices in corporate governance in SMEs in Brazil, see Latini, Fontes-Filho, and Chambers (2014).

[45] I use the residuals obtained after regressing the number of members with family ties on each company's board of directors on country and year fixed effects, industry indicator (infrastructure and finance), and firm's age and size (log assets).

Figure 9: Private Equity and Corporate Kinship



Note: Each dot the graph represents a firm, color identifies the country of the stock market the firm is listed. Y-axis exhibit the residuals obtained after regressing the number of members with family ties on each company's board of directors on country and year fixed effects, controls for assets (ln), sector (infrastructure and finance) and age (years since its foundation).

To corroborate this relationship statistically, I regress both binary and continuous measures of family ties within a firms' board on a—binary and continuous—measures of PE ownership. Table 3 shows the results from the four resulting models. All models include country fixed effects (that, interestingly, are not significant under most specifications), as well as controls for year, and firm's industry, age and size (measured by both assets and revenues). The presence of family-related individuals within a firm's board is negatively—and highly significantly—correlated with the percentage of shares owned by PE investors. The same results hold true when using a binary indicator of private equity and of family ties. At the time of listings, companies that have a PE

investor have 24 percentage points lower probability of exhibiting kinship ties within their board (around half a standard deviation of the binary metric of kinship ties). Thus, this data supports the claim that institutional forms of ownership and investment such as private equity have the potential to break the kin-based control of firms.[46]

Table 3: Private Equity and Kinship Ties

	Family Ties (#)	*Family Ties (Binary)*
PE (dummy)	-0.653***	-0.242***
PE (%)	-0.014***	-0.004***

0.01"***" 0.05 "**" 0.1 "*"

Note: Regression models include country fixed effects and controls by year, firm's age, assets (ln) and sector (infrastructure and financial).

This dataset also supports the argument made in Chapter 2 regarding capital structures. I regress a measure of firm leverage[47]—or indebtedness—at the time of the IPO on both the percentage of the company owned by private equity investors, and by families or individuals, together with a battery of controls. Results in Table 4 do not show statistically significant evidence of a relationship between private equity ownership and leverage, at least at the moment of listing (see left column). Instead, I do observe a positive relationship between family/individual ownership and leverage, even when including in the regression country fixed effects, and firm age,

[46] With cross-sectional data alone it is not clear if the negative relationship between PE investors and kinship ties comes from the "within firm" effects of PE investors institutionalizing family firms, or just from the composition effect. In order to strengthen the plausibility of a causal connection between ownership structure and kinship ties, in a separate co-authored paper using across-time data from Brazilian listed companies, I find evidence of the former. Exploiting variation in firm ownership over time, the paper tracks the evolution of kinship ties across time (at both the board and top executive levels). Including firm fixed-effects, coefficients are negative and significant at the 5% level. These results give more credence to the argument that as a firm's ownership becomes more institutional through PE investments, it displays fewer family ties. See Puente, Balan, and Dodyk (2019).

[47] I measure leverage as the ratio between total liabilities and total assets (book value).

asset size and industry controls (see right column). One possible explanation is that family members significantly value retaining control over their firm. Thus, they try to avoid diluting their control by selling an equity stake to external investors. Debt can be a way for them to retain control. This correlation is in line with the findings of some applied finance work on Latin America that I discussed in Chapter 2 (Kayo et al. 2018; Larrain and Urzúa I. 2016). Overall, leverage seems to be more associated with family ownership than with private equity, at least in Latin America.

Table 4: Ownership Type and Leverage

	Leverage (%)	*Leverage (%)*
PE (%)	-0.00072	
	(0.0005)	
Family (%)		0.00073*
		(0.004)

0.01"***" 0.05 "**" 0.1 "*"

Note: Regression models include country fixed effects and controls by year, firm's age, assets (ln) and sector (infrastructure and financial).

Finally, I analyze how firms' age impact corporate governance. If change at the firm level is slow, and reforms take time to mature, it could be expected existing firms will gradually drift to a more dispersed shareholding base and slowly professionalize their corporate leadership. But this does not seem to be the case. A firm's age (measured as the number of years since foundation) is not related to ownership dispersion, nor to the professionalization of its leadership. Actually, age is correlated positively both with the size of the stake of the largest shareholder, and with the probability of having kinship ties in the board, even if not consistently statistically significant at conventional levels (again, controlling by a battery of firm level covariates and country fixed effects). Table 6 (in the Appendix to this chapter) shows the results of models using age and age (ln). These results are in line with evidence about the stickiness in the ownership structure of

business groups (Larrain and Urzúa I. 2016), that show a remarkable stability in ownership structure even after going public.

I use this dataset for two different purposes: (1) to evaluate the relative penetration of PE in each market/country and (2) to assess the impact of this type of investor on the firms' ownership structure, governance and leverage. As explained above, this empirical exercise was based on data extracted from IPO prospectus. The richness of this information is, of course, at the expense of only including in the sample companies about to be listed, that "selected" into the capital markets. For the cross-country comparisons (e.g. which country has more PE?) the sampling of this dataset would be problematic if private equity investors in one country are more or less likely to exit their investments through the public markets. I did not find indications to believe so and next section validates this dataset's findings using several other sources.

For the firm-level assessments (e.g. how are PE-backed companies "different"?), this dataset misses the comparison between PE-backed and non-PE backed companies in the private space. But, if one considers that non-PE backed companies that list in the stock market are actually more institutionalized than the ones who do not, then, by focusing the comparison only on companies that go public, we are creating a more stringent test for PE-backed companies. If this is the case, then this sample would underestimates the already quite significant relationship between private equity investors and corporate governance modernization shown in this section.

3.2 PE Investment by Country

Figure 8 presented data about the relative penetration of private equity across multiple Latin American countries. Brazil appears to be, by far, the largest market. As (Leeds 2015) asserts, "even accounting for the country's dominant size (…) its share of total Latin American private

equity has long dwarfed the rest of the Southern Hemisphere" (p.195).

This assessment is consistent with the information gathered from interviews across the region. When asked to rank Latin American countries in terms of their development of private equity markets, interviewees working in the industry unanimously indicated Brazil as the leader in the region (even though interviews occurred during a time when Brazil was pretty much a bad-word in the business community); Mexico and Colombia usually followed.

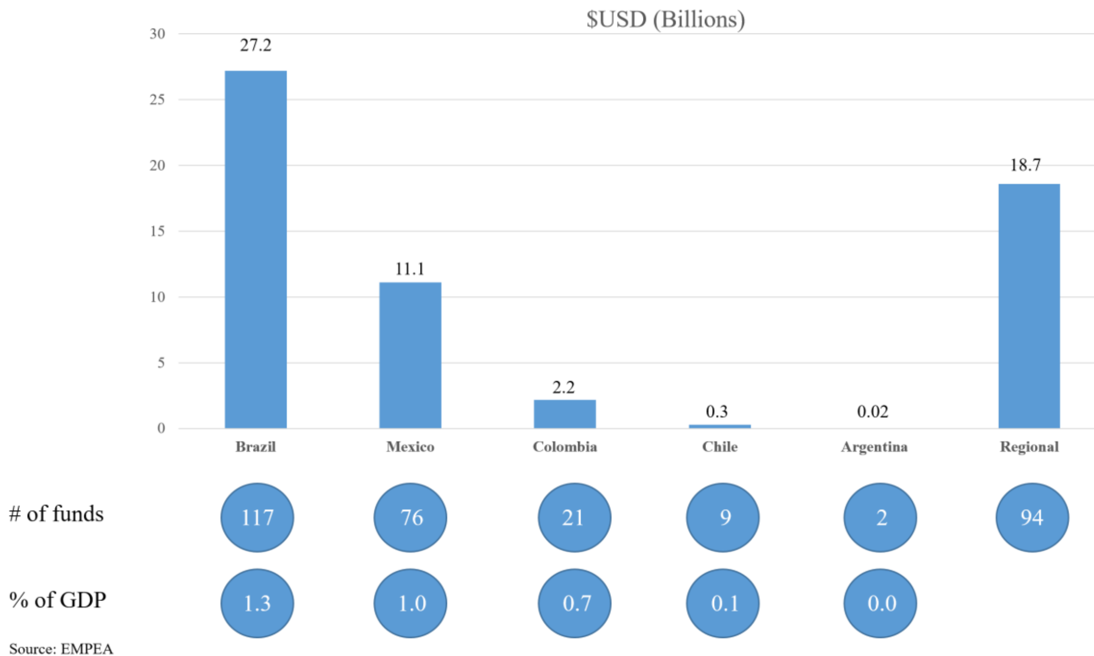
For example, a corporate lawyer working throughout the region, and very involved in the PE/VC business associations, answered "Brazil, then Mexico—we'll see what happens with AMLO—then Colombia, Argentina. And then Chile, they play in a different league." Similarly, a Colombian partner of a fund with operations across the region agreed on Brazil's dominance: *"Brazil is the most developed and institutionalized market in the region, by far!"* These are just a few examples. It is also worth noting that Brazilians do not even benchmark the development of their industry with other countries in the region, but rather with Asia, Europe and the US.

While data from public listings could introduce some biases, the general ordering of cases is also corroborated by data gathered by the two regional industry associations: EMPEA, that brings together fund managers from across all emerging markets, and LAVCA, that focuses on Latin America. Since transaction-level data was not available, I use the aggregates they make available to the public. Moreover, data was not consistently collected during the post-2000 period. Therefore, I do not show time trends by country, but rather average them out. When relevant, the case studies in Chapter 4 leverage the within-country temporal dimension. For example, the timing of the Mexican case very clearly illustrates my main argument about the development of private capital markets: the market only emerges after local pension funds are allowed to invest in private

capital funds in 2009.

Figure 10 presents fundraising values. It aggregates all the capital committed to funds dedicated to each country. Although capital commitments come from both local and international investors, this metric is arguably a good proxy for the development of a domestic private capital industry as it only takes into account funds raised with a mandate to invest in one particular country. It does not include regional or global fund managers conducting "opportunistic" transactions in those countries. Both in terms of total volume and when scaled by GDP, Brazil is the largest market, followed by Mexico and then Colombia. Of course, this metric could be biased against smaller countries such as Chile, as its smaller scale makes it less attractive for dedicated funds. Still, Chile shows low "dedicated" fundraising volumes, only surpassing Argentina's null fundraising activity.

Figure 10: Private Equity Fundraising by Country (2008-2016)



In terms of private equity investment volumes, the data exhibited in Figure 11 corroborates Brazil's lead, followed by Mexico, then Colombia, Argentina and finally Chile. Chile, in turn, appears to receive substantial private capital for infrastructure investments. To facilitate comparability I also present data scaled by the size of the economy (GDP), as well as by the gross capital formation levels in each country. I present figures compiled by LAVCA,[48] the Latin American association that encompasses the whole period of my case studies (2002-2018), a longer period of time that figures computed by EMPEA (2008-2016). While at first sight scaling by GDP seems reasonable, this approach could be questionable at the very early stages of development of the industry (particularly without correcting by other factors (such as GDP per capita) that can also affect the industry from the demand side). Adjusting by gross capital formation levels amplifies Brazil's lead.[49] Chile, the smallest economy, ranks second, arguably driven, at least in part, by a handful of infrastructure investments made by foreign fund managers. Colombia and Mexico follow, and Argentina is—consistently—last.[50] As explained by LAVCA's director, responsible for collecting these numbers:

> *Chile is not the largest market, but is able to attract $100M a year just because it has many natural resources. Once in a while, a foreign fund manager invests $500M in a solar plant or in some other renewable energy. Given the size of the economy, that inflates their investment over GDP ratio.*

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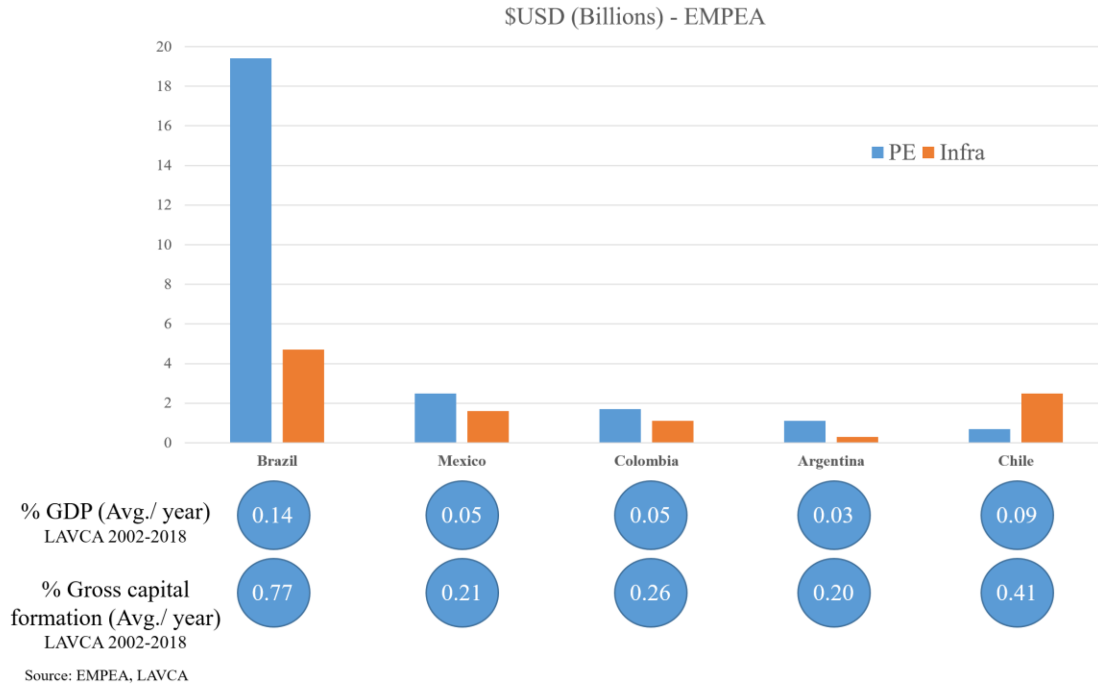
[48] From LAVCA Scorecards. Data on PE/VC stocks in 2006 was distributed across the 6 previous years.

[49] It is important to note these figures do not include BNDESPAR's (BNDES private equity arm) direct private equity investment that as I show in Chapter 4, are quite sizable.

[50] On normalizing by GDP, it is remarkable China, where PE has undoubtedly boomed well beyond Latin America levels (Fuller 2016; Leeds 2015; Yong 2012), would show very similar (in some years lower) by GDP metrics than Brazil/ Chile.

Figure 11: Private Equity Investments by Country (2008-2016)



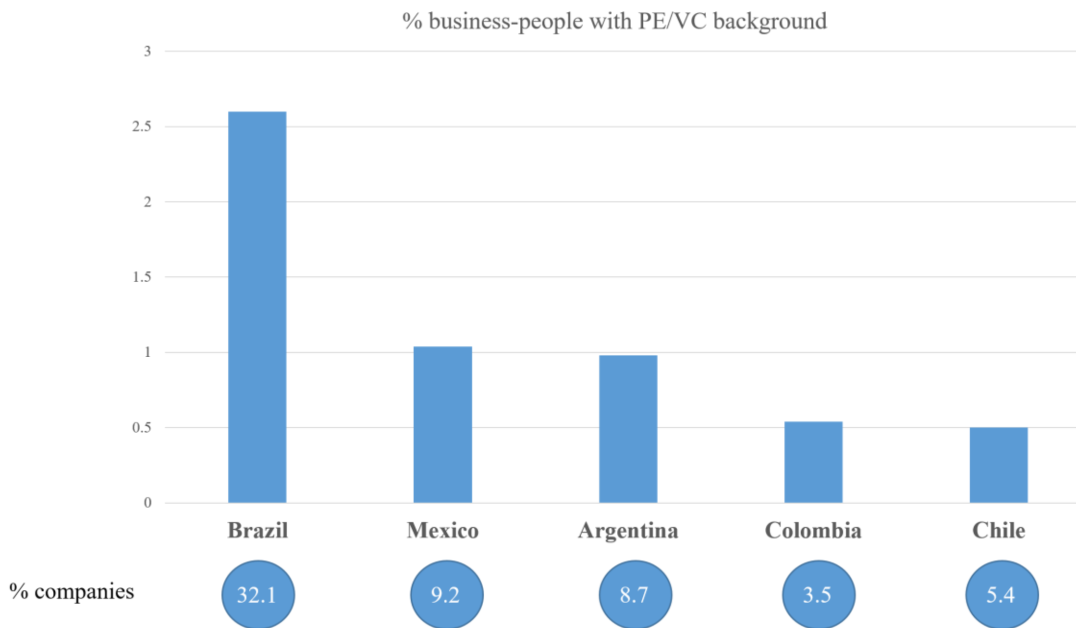
3.2.1 Evidence from Business Elites

In order to provide further evidence on the relative ordering of cases, I analyze the penetration of private equity professional experience in each business community. To do so, I collect the bios of top business executives and board members from all Latin American companies under the supervision of securities regulators (i.e. those that issue stock and/ or debt in public markets), available through Capital IQ. The dataset comprises the bios of 8,020 unique individuals from 946 firms. Arguably, this extensive list is representative of most top businesspeople in each country, with some possible biases driven by the different levels of capital market development across the region. I then count how many unique individuals have experience working in the private equity industry, and normalize this number by the total amount of individuals from each

country included in the dataset.[51] The prevalence of businesspeople with a background in private equity can serve as another good proxy for the relative importance of the private capital industry in each country. The pattern is quite clear and consistent with the figures presented above. Figure 12 shows that Brazil is, by far, the country where the private equity model is most extended among the business community, with a frequency 2.5 times higher than in Mexico and Argentina,[52] and more than five times than Colombia and Chile.[53] Not surprisingly, the same exercise as above but aggregating the data at the company level, find the same pattern. These figures are displayed at the bottom of Figure 12.

[51] I use a very simple text function over the bios of each businessperson, where I search for the words "private equity" and/or "venture capital."
[52] Argentina's relatively high ranking is most probably a legacy of its pioneering role during the 90s, where the PE model was quite extended.
[53] Also, a comparative analysis of each country's corporate networks using board interlocks shows private equity professionals among the top connectors in Brazil (also, see Lazzarini 2010). This contrasts with Chile's interlock network. While Chilean network shows an extremely cohesive business community, the businesspeople that connected where mostly executives from family-owned business groups.

Figure 12: Penetration of PE/VC in business elites



3.3 Alternative Explanations

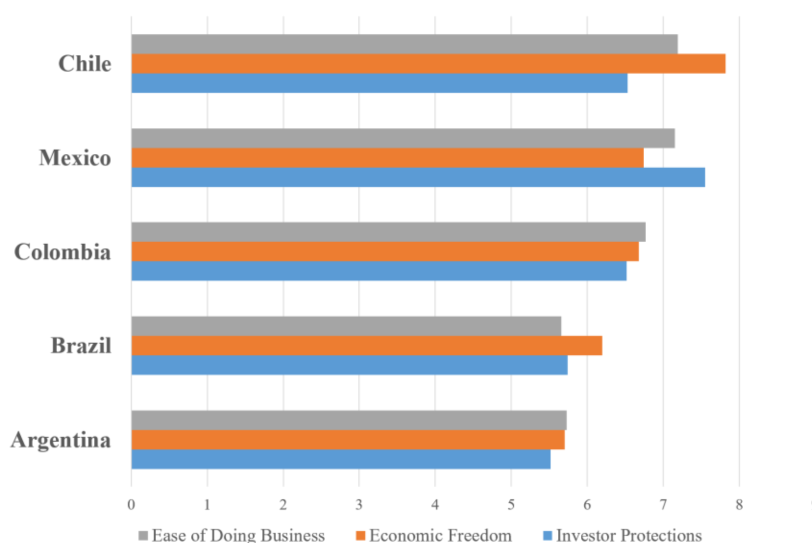
The following section presents country-level data on a set of variables that illustrate alternative hypothesis: countries' institutional environments, their trade openness, regime type and the strength of their labor organizations. This data allows to evaluate some of the hypotheses already introduced in Chapter 2, which discussed the different strands of the literature on financial development and corporate governance reform. It also provides context for the case studies. It is important to highlight that the empirical leverage that supports my findings does not come mostly from this cross-sectional analysis (e.g. Brazil vs. Chile), but from the detailed case studies that, through time, exhibit similar patterns throughout the region. While this exercise does not attempt to substitute a more thorough econometric assessments, it illustrates the ordering of cases in some key dimensions. Still, it shows that the relative penetration of private equity is not in line, and

sometime even at odds, with what would be expected according to alternative hypothesis. Brazil, the Latin American country where private equity is most extended, is also consistently the lowest-ranked in terms of its institutional environment, the least liberalized in terms of trade and capital flows, and where labor is relatively strongly organized.

The analysis beings with a cross-national evaluation of each country's institutional environment. Institutional-based rankings are in line with a country's trade and financial openness. It then turns to political variables, and score the cases on regime type and evaluate the strength of organized labor in each country. Finally, I discuss the role of size and demand side factors.

Figure 13 scores each of the countries in three metrics: World Bank's overall "ease of doing business" score, Fraser's Institute index on economic freedom/ rule of law, and World Bank's score on minority shareholder rights and investor protections—more focused on financial markets. A similar pattern is observed across these three metrics where Chile, together with Mexico and Colombia, score higher than Brazil and Argentina. Beyond the Argentinean case, whose weak investor protections and chronic episodes of expropriations certainly affected all forms of external investment into the country, by themselves, hypotheses only based on property rights and overall investor protections can hardly explain the relative ordering of cases in PE dimensions.

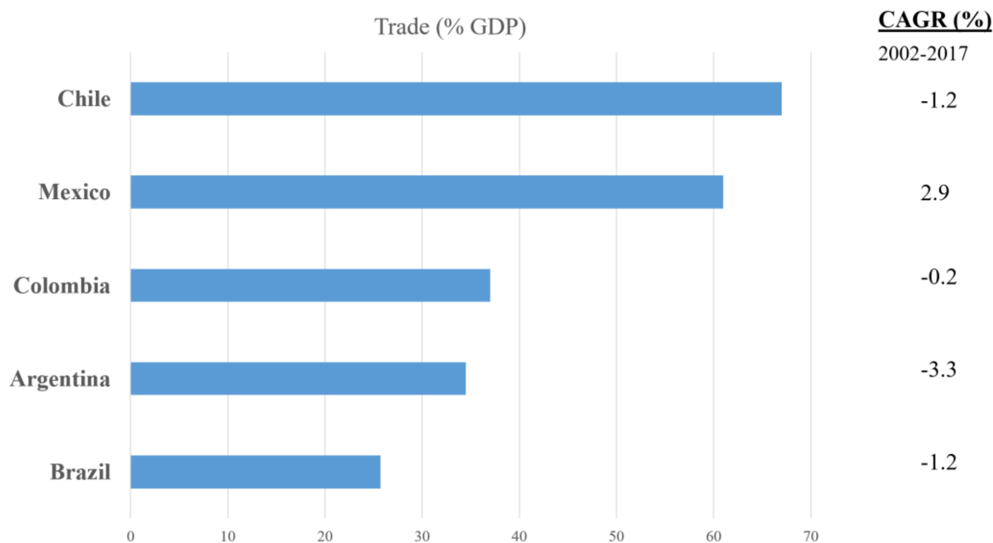
Figure 13: Institutional Environments



Note: Investor Protections (2006-2017), Ease of Doing Business Score (2010-2017), and Economic Freedom Index (2002-2017)
Source: Ease of Doing Business (World Bank); Fraser Institute

Rajan and Zingales's (2003) seminal paper focuses on cross-border capital and trade flows as key elements that drive the extension of arms-length financing (i.e. financial development). The rationale is that liberalization will generate more competition and weaken the incumbents' opposition to capital market development. Data from IMFs financial reform index (Abiad, Detragiache, and Tressel 2010), ranks Mexico, together with Chile and Argentina high, and Brazil low, in addition to showing significant liberalization and "convergence" in the 80s/90s. Data on trade liberalization, as a proxy for the intensity of cross-border competition, is also not consistent with the ordering of my cases. Brazil is by order of magnitude, the most protectionist country in the region and the one that has liberalized the least. Mexico and Chile are more open, as measured by total trade—imports and exports—as a proportion of GDP (and score higher in the financial liberalization index), as shown in Figure 14.

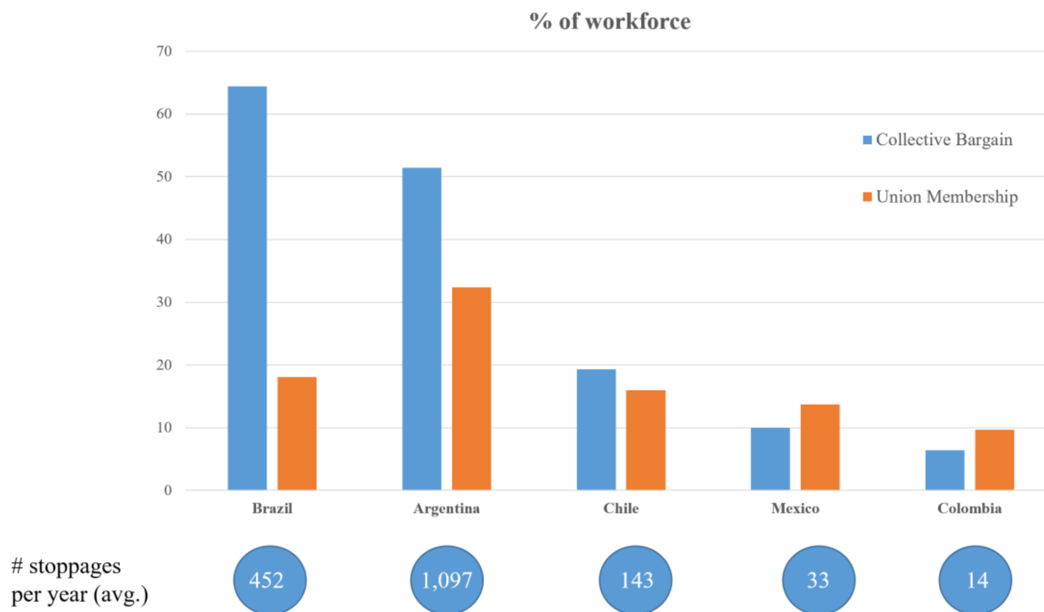
Figure 14: Trade Openness (2002-2017)



As discussed in the theory chapter, political economy arguments about financial development connect inclusive political institutions—democracy—with growth in capital markets. After Fox's 2000 election in Mexico, the five Latin American countries I analyze are classified as democracies, at least when considering binary classifications (Cheibub, Gandhi, and Vreeland 2010). Throughout this period all countries are also above the 0.5 cut-off in the—continuous—polyarchy indicator from V-DEM (Coppedge et al. 2019). In this classification, Chile, together with Argentina and Brazil rank above Mexico and Colombia. Polity IV indicator, more associated with horizontal constraints, grants Chile full scores, followed by Argentina, Brazil, Mexico and Colombia. And if focused just on constraints on the executives rather than on broader dimensions of democracy, again, for most of this period Chile appears to have a slight advantage over its Latin American peers. So overall, and at least by itself, a regime-type hypothesis does not fit well the results. Chapter 5 further engages in the discussion on democracy and its mechanisms.

Beyond regime type, as argued in the theory chapter, Brazil (together with Argentina) seem to have the most powerful labor organizations in the region. This is clear from ILOs data that measures the coverage of collective bargain agreements as well as union membership, shown in Figure 15. Argentina and Brazil appear to have the most conflictive labor relations, as suggested by the higher average number of stoppages per year. Chile, ranks as the intermediate case, and in Colombia and Mexico, organized labor appears to be quite weak. Strong—and conflictive—labor organizations may be somehow related to Argentina's capital market underdevelopment, but does not seem to have prevented the emergence of a PE market in Brazil. And as for the rest of the cases, the strength of organized labor does not seem to be a relevant factor to explain their relative underdevelopment.

Figure 15: Labor Strength



Even though most of the metrics presented are somehow normalized, size seems as a

plausible explanation for relatively more developed equity markets in Brazil, the region's largest economy. Data about the penetration of PE using IPOs is normalized by the total number of companies listed, PE/VC businesspeople data is scaled by the total number of business executives, and fundraising and investment figures are divided by GDP and gross capital formation. Still, there could be some scale effects that could favor the development of capital markets in larger countries (e.g. Panizza and Borensztein, Eduardo Eichengreen 2006). But, as I argue below, this can hardly explain all the variation observed across Latin America.

First, it is worth highlighting some counter-examples. There are numerous countries with very dynamic capital markets that are not large. For example, Singapore, Malaysia and Israel, are relatively small in terms of population and GDP but have quite sizable capital markets. Chapter 6 expands my arguments on cases outside of Latin America, and show evidence that suggest it holds beyond this region.

Even if PE/VC financing is particularly well-suited for small—growing—companies, at least relative to public equity markets, one could argue that smaller countries lack a significant pool of companies large enough to become attractive to external investors. But this does not seem to explain the Chilean case. Notably, even the total number of listed companies in Chile is quite large (and therefore their total stock market capitalization high), especially when normalized by the size of the economy or population. What is most remarkable about the Chilean case is that even though—at least before late 2019's protests—it is the most stable country in the region (and with the larger pension funds), there have been relatively few new listings. And the ownership structure of even those listed companies is significantly concentrated and stable over time.

A related mechanism through which an economy's size could affect the development of

the private equity market would be through its visibility to international investors. Small, peripheral markets could arguably be outside of the radar of large international investors who are certainly important players for the development of PE markets. Again, this does not seem to be Chile's case. For example, the difference between fundraising and investment levels shows that Chile indeed appears to have attracted significant international attention.[54] Local institutional investors are the ones notably absent from domestic private capital markets, and these are arguably less affected by scale/information effects. Overall, even though a sizable internal market may help drive demand for private capital, there is much more than size to the development of capital markets, as the case studies will show.

There could be other "demand side" issues affecting the development of the private equity industry. Generally, growth and income levels of the economy are viewed as proxies for the "demand" of capital. During the commodity boom, all of these countries exhibited significant growth, followed by deceleration, quite pronounced in the case of Brazil and Argentina.[55] Moreover, Chile's higher GDP per capita levels should actually skew demand side explanations in its favor. There are other "demand side" factors that could possibly affect the development of the industry, many of them policy-related (e.g. privatizations, public support for R&D). While these are certainly plausible, they are mostly outside the scope of the dissertation. And at best, could complement my arguments based on the role of institutional investors.

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[54] Beyond PE/VC financing Chile is, by order of magnitude, the country that has received during the last two decades more FDI—as a proportion of GDP—in the region. See World Bank Development Indicators (BX.KLT.DINV.WD.GD.ZS)

[55] Colombia, together with Chile have been the fastest growing economies of this group of countries, averaging between 2002 and 2017 4.1% and 3.9% annual GDP growth rates. This was followed by Argentina (3.0%), and then Brazil (2.5%) and Mexico (2.2%). See World Bank Development Indicators (NY.GDP.MKTP.KD.ZG)

3.4 Conclusion

This chapter's findings support some key arguments about the role of private equity advanced in the theory chapter. First, it provided firm-level evidence that suggests that PE investors are indeed a driver of more modern corporate governance models. PE appears to be a relevant driver of new stock market listings. Moreover, among companies that list in the stock market, those backed by PE investors appear to have a more dispersed shareholder structure and less kinship ties within their leadership positions.

Second, the chapter presented multiple data points about the emergence of PE in Latin America, triangulating between alternative data sources. In terms of penetration, Brazil is clearly the most consolidated market. Mexico and then Colombia appear to follow. Chile receives some sizable international investments, mostly in infrastructure; otherwise, it appears to lag behind. Argentina, where the PE model was early adopted during the 90s, exhibited very limited activity after the 2000s. Contrasting the ordering of cases with data that illustrates the main hypotheses advanced in the literatures on financial development and corporate reform, and uncovers an unexplained gap.

This chapter also introduced the country case studies developed in Chapters 4 and 5. They show how the expansion of this new form of capital is enhanced by a set of policies aimed at promoting it. I distinguish between two policymaking roles. First, Chapter 4 focuses on the more direct role of state-related financial institutions, who promote PE funds by investing in them and encouraging pension funds to follow their lead. Second, and beyond its role as an investor, Chapter 5 shows how state agencies helped the incipient private capital industry organize into asset-specific business associations who then lobby for regulatory—institutional—change.

3.5 Appendix

Table 5: PE and Ownership Concentration

	PE Ownership pre-IPO (%)	*PE Ownership pre-IPO (binary)*
Free float (%)	0.126***	4.025***
	(0.024)	(1.773)
Largest shareholder post IPO (%)	-0.333***	-21.891***
	(0.039)	(2.820)

0.01"***" 0.05 "**" 0.1 "*"

Note: Regression models include country fixed effects and controls by year, firm's age, assets (ln) and sector (infrastructure and financial).

Table 6: Firms age, ownership dispersion and professionalization

	Largest shareholder (%)	*Family Ties (binary)*
Age	0.047	0.002
	(0.056)	(0.001)
Age (ln)	2.703	0.107**
	(1.852)	(0.002)

0.01"***" 0.05 "**" 0.1 "*"

Note: Regression models include country fixed effects and controls by year, firm's assets (ln) and sector (infrastructure and financial).

Chapter 4 - From Institutional Rules to Institutional Investors

The main goal of this chapter is to provide evidence about the role of state-related institutional investors nurturing the incipient private capital industry in Latin America. Going through each of the cases, this chapter characterizes the actor-based approach to financial development advanced throughout the dissertation. In particular, it shows that state-related institutional investors,[56] and not just retail or international players, appear to catalyze the sector's growth. Among institutional investors, I highlight the initial role played by local and multilateral development banks, followed by pension funds.

The chapter provides key support to my second argument from the introduction and show that rather than the overall enforcement of investor's property rights, the role of institutional investors is a more direct factor to explain the emergence of PE investors, and can better explain the variation we observe across cases. These PE investors, in turn, are arguably one of the few drivers of corporate governance reform in the region, as showed in the previous chapter. Mainstream explanations based on rules related to investor protection do not grant much attention to the mechanisms behind their main causal hypothesis that connects legal rules to financial and corporate governance outcomes, and overlook the origin and role played by financial intermediaries. Throughout this chapter, I focus on these two issues, and show that financial intermediaries whose origin do not follow a market logic are key drivers of the development of private capital markets.

It is important to note that my actor-based argument does not contradict some of the lessons we can learn from the institutionalist literature, nor suggest all state interventions will be conducive

[56] By institutional investors I refer to organizations that invest on behalf of its usually large member's base. In this chapter I focus primarily on pension funds, as well as on state-owned investment funds.

to more vibrant equity markets. Needless to say, recurrent state expropriation indeed inhibits financial development; it is enough to look at the Argentinean chronic history of sovereign defaults, the recent nationalization of pension system and to the negligible size of its financial system (Datz 2012). Some degree of macroeconomic stability certainly seems to be a pre-requisite for developing a domestic financial sector, particularly one based on securities denominated in local currency. Fiscally responsible administrations that do not overload local asset manager's portfolios with government bonds (Menaldo 2016), allow them to invest in longer-term riskier private sector securities and a reasonably working corporate governance framework that protects investors external to the firm seem to be a pre-requisite for attracting them. But these conditions are not enough to generate a more active equity-based risk capital market. As the cross-section of country cases together with evidence from their timing will illustrate, these markets have to be incubated by more active public policies.

This chapter is focused on the supply-side of private capital and explore the role in each case of both multilateral and domestic financial institutions. It introduces the main investors in PE funds in each country, and highlight the role of domestic and multilateral state-related investors that promote the emergence of these new funds. Among state-related institutional investors, development financial institutions play an "incubating" role during the early stages of the PE industry, followed by pension funds. This chapter in centered on capital providers; the following one dives into the politics of regulatory change that helped institutionalize the industry, where notably many of the same players that provide capital also played a protagonic role.

It is also important to clarify the development of the industry is not just a function of the supply of capital and its regulatory framework, and that there are certainly important demand side aspects that also drive the overall development of the industry. This is particularly clear, for

example, in the venture capital realm, the target of many government initiatives. The mere availability of funds will hardly generate any amount of innovative projects that require funding. While important, many potential demand-side factors go well beyond the scope of my research, focused on the financial supply side. Acknowledging the issue, my cross-country comparison can roughly control for these factors. As mentioned, these are all countries in the same continent, with comparable macro-trajectories, sizable economies at broadly similar stages of development, and exposed to the same shocks and trends in the international political economy. Moreover, the private capital industry is throughout the region at its early stages of development, way before the overall size of the economy can function as a limiting factor.

My focus is broad enough to potentially include all sectors of the economy. I include into the analysis all the different segments of the private capital industry, including venture capital, private equity and infrastructure-related funds. Aside of their peculiarities—some of them certainly relevant but outside the broader scope of this dissertation—they all fit my "inclusive" definition of the PE: they are financial investors who have a medium to long-term time horizon and an active role in management. They generally use the same investment vehicles from a legal and tax perspective. Regarding their fundraising sources, they all strive to attract institutional capital. Not surprisingly, they are represented in the same business associations, which tend to represent all segments of the private capital industry. Moreover, the governance model they promote is broadly the same, with a protagonist role for external financial investors and professional managers. And notably, the emergence of each of the different segments of the private capital market also follows broadly similar dynamics.

Latin American countries display similar patterns in the emergence of these actors, though their different timing and intensity grant some empirical leverage from where to make inference.

The first "modern" PE funds first appeared in the region during the nineties in Argentina and Brazil, largely related to international flows of capital that followed these countries liberalizations. In most cases they participated in the privatizations of former state-owned enterprises, and started engaging local financial institutions. Even if at that time there were some attempts by domestic actors to engage with PE, I focus most of my analysis on the more institutionalized phase starting in the early 2000s, where PE firms' local footprint is much more important.

As an executive with vast experience in the market acknowledged, the main investors that backed a typical first-time fund were *"always multilateral development banks, the government and maybe some family money and fund-of-funds."* Schematically, I identify two key steps in the emergence and institutionalization of a local market for private equity. In the first one, development financial institutions (DFIs), domestic and multilateral, play a significant incubating role. The next crucial step is the engagement of local pension funds.

I first highlight multilateral development financial institutions, in particular the role of both the World Bank and Inter-American Development Bank's private sector arms, together with some international—mostly European—DFIs. Then, I introduce the main state-related financial institutions in each country that have programs aimed at private equity, describe their main initiatives, compare them, and discuss their main governance challenges. In the Brazilian case, I inquire on the role of its well-known development bank, *BNDES,* as well as of *Finep*, a federal agency devoted to the promotion of science and technology. I then explore the fund of funds model led by *Fondo de Fondos* (FdF), closely related to Mexican development banks, as well as the role of other state-related financial institutions. In Chile, *CORFO,* its long-lasting development agency has been promoting the local venture capital industry since the late 1990s. In Colombia, this role was played in a more limited way by *Bancoldex,* a second-floor (i.e. that operates through

commercial financial intermediaries) policy bank, together with its newly launched infrastructure-oriented development bank, FDN. And finally, Argentina's more recent (2017) *Fondce* can only very timidly substitute for the lack of any active—state or private—domestic institutional investors. Table 7 below provides an overview of the key institutional investors in the region, whose role is addressed throughout the rest of the chapter.

Table 7: Main state-related institutional investors

	Development Banks	Pension-funds
Brazil	• BNDESPAR • FINEP	• Previ • Funcef • Petros, etc.
Mexico	• Fondo de Fondos (NAFIN, Banobras, Bacomext) • FONADIN	• AFORES
Chile	• CORFO	• AFPs
Colombia	• Bancoldex • FDN	• AFPs
Argentina	• FONDCE	• AFJPs (nationalized) • FGS-ANSES
Multilateral DFIs	• IFC • IDB • CAF	
European DFIs	• CDC (UK), • Proparco (France), • FMO (Netherlands), • DEG (Germany), etc.	

Development financial institutions (DFIs) can have direct and indirect investment strategies. By direct strategies I refer to those cases in which they directly participate as shareholders of otherwise privately managed firms, and are not intermediated by a third party fund manager. This is closer to the state-as-a-minority-shareholder model as introduced by Musacchio and Lazzarini (2014). As I show below, Brazil's development bank together with some multilateral institutions, are the only cases in the region in which development financial institutions actively

functioned as a private capital provider directly into companies, at least at a meaningful scale. DFIs can also have indirect strategies, where they invest through third-party fund managers that pool capital from different sources and then acquire equity stakes in companies. This “state as a limited partner” model can be thought as a particular—and outsourced—case of the state-as a minority-investor.[57]

Regarding the question around the goals of these policy interventions, conceptually, I distinguish between two main motivations. First, state-related financial institutions can invest in private equity funds as a way to promote the development of local capital markets in a more direct way. They aim to facilitate firms’ access to risk—equity—capital outside public markets. Doing so, they also intend to nurture the otherwise anemic public equity markets with new companies, beyond what can be achieved just through regulatory reform. With more of a “horizontal” goal these programs tend to invest in generalist PE funds with broad mandates, instead of promoting industry-specific funds or investing directly into companies. Second, policymakers can have sector-specific goals, and use capital investments as a tool to pursue them. These “vertical” policy goals are varied, and range from pushing for new “green” energy sources to tech-related entrepreneurship, including more classic industrial policy areas. Even if the differences are not always as clear in practice, different program designs I found throughout the cases can be classified as more closely aligned to one of these two models.

In addition to the promotional role of state investors, I explore the engagement of pension funds as a key next step in the emergence of a more institutionalized private equity market. This is in line with global trends, where pension funds are usually the cornerstone actors in their local

[57] As a reminder, limited partners (LPs) are those investors of the partnership, that as opposed to the general partners (GPs) who manage the investments, do not usually take part in the fund’s active management.

capital markets. This is even more the case for private capital markets, where the presence of retail investors is quite limited—even through defined-contribution pension plans (e.g. 401(k)). Instead, public and private defined-benefit pension funds, who give no investment decision-making to pensioners, are by far the most important investors (Cornelius 2011, 160). In Latin America, pension funds involvement with the asset class is still quite incipient, in an ongoing process of institutionalization and one of the big challenges it faces. Interestingly, I find that their involvement with private equity does not seem to be only a function of how they are structured. For example, very different types of pension funds, such as the ones in Brazil and Mexico, have channeled more resources to managers investing domestically than those in Chile, otherwise more similar in structure to the Mexican ones.

Going back to the literature discussion, it is important to note that pension funds are not pure market players, even in those cases where they are indeed privately-managed. Their origin and up to certain extent also their operating logic are not purely market-based. Regarding their origin, the source of their resources are mandatory savings. Individuals are compelled to contribute as per government rules; they cannot opt-out from the pension system. And pension funds investment decisions are not completely market-based either, but are usually quite stringently regulated through detailed guidelines that, for example, specify allocation quotas to each asset class in their portfolios. While I explain the involvement of the pension funds in each case, Chapter 5 explores more closely their regulation.

Other than as pensioners, the retail investor capacity to participate in this asset class is limited. Given its illiquidity and riskiness, private equity does not have a good fit with retail investors. This is by no means just a Latin American phenomenon. The investor base of large international private equity is for the most part institutional; composed mainly of pension funds,

endowments, sovereign wealth funds and insurance companies. Outside institutional investors only very wealthy—and well connected—individuals and family offices can access the asset class directly. Even in the most developed financial markets, several attempts to commercialize private capital funds to the retail public have not worked. Actually, most regulators restrict PE firm's ability to fundraise outside accredited investors.

Instead of retail investors, wealthy individuals and families are core actors in the Latin American business scene. Investing through their family offices, they certainly helped mount some PE firms. The policy initiatives I will be describing, also actively aim to channel private non-institutional money into private equity/ venture capital. But in general, family offices conduct investments by themselves and do not delegate on professional managers who pool money from multiple sources, including institutional money; in particular for private equity investments.[58] Instead, even if they hire their own team of professional managers, they prefer to act on their own, and not through an institutional route. And if they invest into the more institutionalized private equity asset class, family offices tend to invest outside their local country in order to diversify their geographic exposure. Still, as already discussed, as part of the consolidation and diffusion of the private equity model, some of these family offices, particularly if they have already exited their core business, are becoming increasingly institutionalized and professionalized, and behave as long-term PE firms.

4.1 Multilateral DFIs

Multilateral development financial institutions (MDFIs) are public institutions, funded and

[58] For an assessment of the—rather limited—role of family offices in Mexican private capital market, see Márquez and Sandoval-Arzaga (2017).

owned by multiple member countries that provide financing to encourage economic development. Most of them are structured as development banks,[59] and concentrate their activities in lending and policy advising. While governments are their main clients (and sponsors), development banks have transitioned to also support the private sector directly. In order to do so they have often created separate subsidiary corporations that offer investment, advisory and asset-management services. Notably, these multilateral investment corporations have actively pushed for the introduction of new organizational forms in emerging economies, pioneering the private equity and venture capital model into new markets (Settel, Chowdhury, and Orr 2009). As I explain below, they did this by investing in PE funds as limited partners, co-investing along them as well as by providing equity finance directly to companies. Beyond just providing capital, they promoted industry best-practices and functioned as a vector for the diffusion of these more novel forms of financial policymaking.

As part of their broader menu of financial products, MDFIs have both direct and indirect equity participations. In all cases, their involvement intends to catalyze further private investments. They aim to function as anchor investors that grant a seal of approval to help mobilize additional capital. When they hold an equity stake in a company directly, even if significant, they are always in non-controlling minority positions. And when they invest indirectly through third-party managed PE funds, their participation is also limited, in general subscribing no more than 20% of fund's committed capital.[60]

Even if most of these institutions have existed for a longer time, they started to more

[59] Even if none of them are banks in the sense of being deposit-taking institution.
[60] They only exceed this limit in the case of funds that invest in countries with very underdeveloped capital markets, or when these funds have a specialized mandate that includes underserved segments, such as early-stage VC or some specific priority sector, when mobilizing a substantial portion of private capital would be very hard.

actively engage in private equity in the late 1980s and beginning of the 1990s (Ibanez 1989) and they functioned as vectors for the diffusion of this new model. As part of the global liberalization trend, MDFIs helped create several private equity funds as a way to support the privatization of state-owned enterprises and the expansion of capital markets in emerging economies, trying to fill a chronic gap in equity financing. Many of these efforts were focused in post-communist Eastern Europe, where the IFC, together with the European Bank for Reconstruction and Development (EBRD) had—and still have—a very active participation funding the transition from planned to market-oriented economies. Latin America was no exception in this global trend. And in this region too, multilateral investors backed private equity initiatives early-on, during the nineties. And still today, we can find this class of investors active in many PE funds in the region. Among them, World Bank's IFC, the Inter-American Development Bank's IIC, and a group of European development institutions are the most prominent.[61] I will briefly introduce each of them and discuss their main initiatives.

The World Bank's private sector arm, the International Financial Corporation (IFC) offers private firms a full menu of financial products ranging from more detached trade finance instruments, to core equity products. Within their equity holdings, most of them are private rather than public equities, being the former more closely aligned with their market-failure-oriented mission. Significantly, the IFC was the pioneer supporter of private equity initiatives across the emerging world, and served as anchor investor for several of the first PE funds that appeared in the region during the nineties (Lavelle 1999; World Bank 1996). It still invests in many of the largest regional funds and directly in companies, and vividly promotes this asset class among policymakers and the general public, for example, through sponsoring specialized publication,

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[61] For a good overview of the equity investment strategies of different DFIs, see Michelitsch et al. (2017)

events and industry associations. In terms of investment, the IFC is involved in the private equity business in at least three different ways, both direct and indirectly.

First, the IFC is organized by industry verticals and as part of their menu of products, they may participate directly in firms within each sector through equity products. For example, through their Oil, Gas & Mining unit the IFC is a minority shareholder in several companies in that sector. Second, the financial services vertical also promotes PE firms, as an alternative type of financial intermediary than for example, banks. Third, and most importantly, through their asset management unit—IFC's Asset Management Company—they leverage the IFC's industry knowledge and relationships and act as a private equity firm themselves, managing third-party resources. They manage 11 funds and fund-of-funds with activity all over the emerging world through which they invest directly into companies and participate as quota-holders in other investment funds. Besides managing the IFC's own resources, each of these funds also fundraise capital from outside investors. Among several global, regional and industry specific funds, they also manage one country-specific fund. The $1.2 billion China-Mexico Fund, whose capital comes from sovereign sources of these two countries,[62] is mandated to make equity and quasi-equity investments in privately held Mexican companies.[63] Instead of channeling these resources directly into companies, governments outsource decision making to the IFC.

The IFCs recruitment profile is similar to standard private financial investment firms. Salaries attempt to match the market, and compensations are tied to performance, although less aggressively than in the private sector. And employees exhibit a higher turnover with the private

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[62] One billion came from Chinese sources (China Investment Corporation and China Development Bank), the rest from the Mexican state-owned financial institutions (Nafinsa and Fonadin-Banobras).

[63] For the moment activity has been quite limited. The fund has investments in the energy and telecom industries, following these sector's recent reforms.

sector than what is the standard for state-related organizations. Yet, the IFC exhibits a more patient behavior than private investors, may accept lower returns, and in each of its transactions aims to provide "additionalities" to its financing. When investing directly into companies, their average holding period is longer than the standard 5/7 years cycle of PE investments. They also exhibit a less aggressive behavior, restricting their participation to minority stakes and having a relatively more passive role in management. Rather than going into the operational details of the companies they invest in, they push for a more general ESG[64] agenda. For example, in terms of governance practices, they push for more open and transparent models; and when able, supports the nomination of independent directors, usually outside experts not related neither to the company nor to the IFC.

The Inter-American Development Bank (IDB), dedicated to the Latin America and the Caribbean region, also played an active role in the emergence of an incipient PE industry, and continues to do so. Similarly structured to the World Bank, but smaller in size and regionally focused, they also have at least three programs through which, independently, promote the private capital model. First, the IDB's department of structured corporate finance makes equity investments, among several other less hands-on type of securities. Second, the IDB's Multilateral Investment Fund (MIF), promoted as an "innovation laboratory" in finance also makes some investments in PE funds while promoting, at least lately, an impact investing model. Beyond financing, they also provide grants to support institutional-building activities. As I show in the next chapter, the MIF actively promoted the organization of business associations that group the private capital industry at the regional and country-level, serving as a vector for the diffusion of a set of policies and regulations that promote this novel form of financing and managing firms. Finally, the Inter-American Investment Corporation (IIC), that in 2016 was rebranded as IDB

[64] Environmental, social and governance.

Invest and consolidated all IDB's private sector operations, also invests through funds. Given its smaller size, it usually makes earlier-stage investments and has a less systematic equity—direct and indirect—program than the IFC, its analog organization at the World Bank after which IDB Invest is modeled.[65]

More recently, *Corporacion Andina de Fomento* (CAF) also started to include some private capital into its portfolio. Given its mandate, it is targeted towards infrastructure-focused private equity funds. Moreover, it supports domestic public sector initiatives to enhance the involvement of the private sector in infrastructure. For example CAF, together with the IFC, is a minority shareholder of Colombia's recently launched development bank, *Financiera de Desarrollo Nacional (FDN),* and has also supported Mexico's government fund-of-funds.

Finally, outside of the multilateral space but still external to host countries, there are also several mostly European DFIs that engage with the private sector in emerging economies mostly through PE funds. The most important of them are British CDC,[66] French Proparco, Dutch FMO, Norwegian Norfund, German KFW DEG, the European Investment Fund (EIF)[67] and US OPIC.[68] Mostly owned by their home-country development financial institutions, in some cases they have participation from the private sector. They replicate in developing countries, especially in some of their former colonies, what they do in their home countries in order to promote the private capital industry. Engaging through PE funds is an easier way to maximize their private-sector

[65] For a comparative study of equity investing strategies of DFIs, see (IDB/IIC 2017).
[66] For example, Actis and Aureos, two of the largest PE firms specialized in emerging markets are actually spin-offs of CDC group, UK Government's development finance institution created in the second post-war to promote private investments in the former British colonies (McWilliam 2001).
[67] European Investment Fund, the investment arm of the European Investment Bank, is the largest provider of capital for risk capital (VC and growth) funds in Europe. See more in the Chapter 6.
[68] OPIC (US Overseas Private Investment Corporation) was revamped in October 2018 by the Build Act. The bill that was approved with bipartisan support capitalized the agency with $60B and grant it with more flexibility, allowing it to take equity stakes in private companies. This reform intended to match its European counterparts and as to counteract Chinese influence in the emerging world.

development impact in emerging economies, without large staff requirements. Even though they are much more active in the MENA region, these development agencies have also been core investors in many of Latin American private equity funds since the introduction of this new business model. Interviewees repeatedly highlighted their role, and stressed their importance, particularly in the case of “first-time” funds. Together with funding, they also help first time funds formalize their practices and improve their reporting and governance standards.

Overall, multilateral development banks, certainly had an important role incubating private equity in Latin America. MDFIs pioneered the asset class, and as repeatedly mentioned in the interviews, function as anchor investors of first-time funds, serve as a vector for the implementation of industry’s best practices and disseminated the policy alternatives national development banks could then implement. While the total allocation of their portfolios to this asset class is not very big since they are mostly concentrated in the loan business, given the absolute lack of other institutional sources of equity financing in most countries in the region, multilaterals are still quite significant. Moreover, as I develop more thoroughly in Chapter 5, the role of some of these multilateral institutions went well beyond that of detached capital providers, and actively supported different promotional and regulatory initiatives together with local bureaucrats and business leaders. Crucially, they fostered private capital’s industry collective action, both at the national and regional level.

While MDFIs “non-private” institutional status fits well with my non-market based explanation of the origin of private capital markets, they are hardly able to explain the cross-country differences I observe. It is clear from the interviews that their role in the different countries is conditional on the support they have from each local government. Ultimately, governments are their shareholders, and usually through their finance ministries the ultimate principals of these

multilateral institutions.[69] Moreover, multilateral's domestic counterparts have established financing programs on their own. For that reason, I turn now to each country's local development financial institutions, and examine their main initiatives with respect to the private capital markets, together with the investment regimes of local pension funds. As I show below, the strategies pushed by MDFIs are many times emulated at the local level, who are used explicitly as models. The rest of the chapter develops brief country case studies where I review the main outcomes of each case, introduce the main institutional investors and describe their most relevant initiatives related to venture capital, private equity and infrastructure financing.

4.2 Country Case-Studies

4.2.1 Brazil

Brazil is by far the most developed and institutionalized private equity market in the region. It is the only country in the region that appears systematically on the radar of global investors; and even after losing its investment grade, suffering its worst recession in history, and going through significant political turmoil, continues leading the region in terms of PE activity. Among industry participants throughout the region, there is no doubt about Brazil's leadership position. Tellingly, Brazilians do not even benchmark themselves with their Latin American peers, but with Europe, the US or Asia. The opposite happens in the other Latin American countries, where Brazil is the standard.

Related to this more institutionalized private equity industry, Brazil's stock market exhibits some greater dynamism in terms of fundraising than its regional peers. And listed companies have

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[69] Country representatives in each of these multilateral organizations monitor very closely the transactions their country's private sector firms are involved in. Moreover, the bylaws that rules both the IFC (Section 3 (ii)) and IDB Invest (Article III - Section 4 (b)) operations grant each country veto powers over any operation within their territory. Ministries of Finance have to be formally informed of all transactions that involve a firm operating in their country and they have the right to object them.

relatively more dispersed shareholders, business executives in both board of directors and top executive positions more frequently have a financial background and less family ties between each other, as Chapter 3 shows. Moreover, Brazil's financial ecosystem appears to be more wide-ranging in terms of the type of players that participate in it. For example, it includes some activist hedge funds, together with several funds specializing in distressed assets, actors completely unheard of in the rest of the region.

In contrast to what it would be expected from the literature, the variables emphasized by institutionalist hypothesis such as indexes of economic freedom, judiciary strength, contract enforcement and ease of doing business systematically rank Brazil in the regional (and even global) lower tier. In terms of its shareholder rights Brazil made progress since the 1990s, particularly after the introduction of the Novo Mercado listing segment in 2003 (Nenova 2006). But it is still not significantly different from other countries in the region that, beyond this particular metric, are well known for being more open to trade, stable and market friendly, in particular those in the Pacific Alliance (Chile, Peru, Colombia and Mexico).

Of course, Brazil is the largest country in the region. Its market size, even if accounted by normalizing figures by GDP, certainly attracts the attention of international investors. Global capital allocators, investing through local PE firms and more recently also directly, have certainly played an important role in the development of the private capital market in this country. But as discussed in previous chapters, demand-side factors hardly drive the whole difference observed in the cross-country regional comparison. Beyond its size, what also distinguishes Brazil from its regional peers is the longstanding state participation as an investor together with—even if quite

erratic—an early involvement of pension funds in private equity markets.[70] As I will discuss below, these institutional investors certainly helped grow the market, but also contributed to generate many of the challenges the sector faces today.

With all its ups and downs, Brazil is the only country in the region that can exhibit a significant number of complete investment cycles: from fundraising, to investment, holding period and exit. The first formal PE funds started during the mid-1990s, in general led by some local bankers, many times in partnerships with international firms. These PE funds participated in some of the privatization processes, and as I mention below, had an early engagement with local state-related financial institutions. But still, this first initial phase certainly had a more international flavor than what we observe after the turn of the century. As a senior businessman, former president of the local business association who started working in the industry during the 1990s describes, *"it was a very US-centered model, based in Miami, with a ton of leverage. Completely different from when it resumed in the mid-2000s, based locally, with no leverage, and local teams."*

Following the devaluation and crisis of the late 90s paired with the dot-com crash, this incipient private equity industry experienced a significant slowdown. Fundraisings were paralyzed, as well as new investments, only to resume a couple of years later, in the mid-2000s. In this new more institutionalized phase, public organizations played a significant role, in particular two of them: Brazil's well know development bank BNDES, through its investment arm, BNDESPAR[71] and FINEP *(Financiadora de Estudos e Projectos)*, a federal level agency under the Ministry of Science and Technology devoted to funding science and technology.

[70] For a great analysis of the ties among BNDES, state-related pension funds and business elites, see (Lazzarini 2010).
[71] *BNDES Participações S.A.* For other academic assessments of the bank, see Gomes Schapiro 2013; Hochstetler and Montero 2013; Lazzarini et al. 2015; Musacchio and Lazzarini 2014; Bril-Mascarenhas 2016.

BNDES's private equity arm, BNDESPAR is structured as a separate entity from the bank core unit that is focused on the lending business. Even if the whole bank works under the same leadership, this internal division arguably enjoys higher status and more qualified professionals. Regarding broadly defined private equity, it displayed two strategies. On one side, it has injected massive amounts of capital directly into companies, mostly in the form of equity and convertible debt. And on the other, it participates as an investor in several independent PE firms who in turn invest in private companies. Of course, these two types of investments are not isolated from each other and sometimes work in tandem. On multiple occasions BNDESPAR participates directly in companies co-investing together with some of the funds they also participate in.

In terms of total amount of funding, BNDESPAR functions mostly as an independent investor, directly sourcing its deals and managing its own portfolio. Even when it operates across the broad spectrum of the private capital market, its direct operations are significantly larger than the ones of average PE funds operating in Brazil. From 2008 to 2016 it had made direct investments for more than $66 billion *reais*.[72] Importantly, when investing directly, BNDESPAR always takes a minority stake. But even without having control, the bank can still have quite significant participations, with up to around 30% of the company's total equity. Through its direct equity investments, the bank channeled a substantial part of the more ambitious industrial policy of PT's administration, that helped consolidate sectors and push for their internationalization, for example

[72] This figure includes 2010's Petrobras massive recapitalization (~$25B *reais*). But even if not taking into consideration this transaction, the figure continues to be very large. Importantly, these figures do not include the larger and more traditional activities of the bank specialized on commercial loans. Not all of these capital injections are made directly in equity; instead a big portion of them go into companies as convertible debt. This is quite standard in the industry (Lerner and Schoar 2005) and is intended to protect the external investor from the downside. If the value of the company goes up, the debt holder can convert its contract into an equity stake, become a standard shareholder and participate in the upside. If the company gets in trouble, convertible debt are more senior creditors than standard equity holders.

in the meat industry (Musacchio and Lazzarini 2014; Sierra 2017).

Through its indirect "funds" strategy, the bank intends to create a more vigorous small and mid-cap growth equity environment, and is able to support smaller companies than what it would be able to achieve through direct investment. Even when the overall value of BNDESPARs indirect investment strategy is overshadowed by its massive direct investments, most primary and secondary sources, even those critical of the more recent role of BNDES, agree that the bank had a catalytic role for the funds industry. BNDES has been promoting the asset class since at least 1990, for example by structuring and investing in the first private capital vehicle, FMIEE[73] (see for example, Viveiros (2017, 55:60)).[74]

In contrast with Mexico, where the state has a minority participation in most of the funds operating in the country, the BNDES has a more selective approach. It periodically makes public calls for fund managers, specifying in advance the fund's term and mandate. These calls result in very competitive public processes. Only between 2008 and 2016, the BNDES supported 50 different funds, all of them managed by Brazilian firms, with around $3.5 B *reais* (around $1.5B) in actual disbursements, and signed capital commitments for larger sums. In all cases, these funds got additional capital from other investors, including local pension funds.

Industry-wise, the allocation of BNDES' investments followed its focus in financing large infrastructure projects together with supporting core sectors of the economy such as large industrial, agribusiness and mining firms. Beyond this more traditional focus, the BNDES has also advanced into earlier-stage funds that target smaller, innovation-oriented projects, as for example

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[73] F*undo Mútuos* de Investimento em *Empresas Emergentes,* a tax-incentivized private vehicle launched in the mid-1990s in order to promote the asset class. Now it is mostly replaced by FIPs.

[74] For a concise story of private equity in Brazil, see Chapter 7 of Leeds (2015) book on private equity in emerging economies, who repeatedly highlights the role of BNDES as a catalyst of the PE industry in Brazil.

they do through the *Criatec* program. The program is composed by a series of VC funds—they are now in their third one—sponsored by BNDES, together with *Banco do Nordeste*, a regional development bank, who outsourced their management to third-party private firms (see Borsato da Silva and Biagini 2016).[75]

Overall, most sources agree that BNDES, through its private equity arm, played a crucial role in the development of the sector (Leeds 2015, 214). Notably, the more vigorous intervention in the region is also the most contested, and interviewees have strong opinions about it. For example, an interviewee who had worked at BNDESPAR, and at the moment was part of a local investment firm managing mostly international money, was very critical about the banks and state-related pension funds when talking about the role of the development bank in the PE market:

> *Indeed, maybe it was the case in the past that BNDES performed an important role to create the market. […] I was working there when BNDESPAR was recreated, and helped it go into private equity. Back then we thought it had an important role to play in private markets, help companies to bridge their financing gap, plus the anchor-funding type of argument. But that role doesn't make sense any more. There are already too many managers and too much money!*

It is important to highlight, beyond its equity arm, BNDES as a whole has far from uniformly supporting of the PE model. First, there is certainly a tension between investing directly into companies and fostering an active market for private equities composed of private—independent—fund managers. And second, and most importantly, BNDES most likely discouraged equity financing through its core loans business with cheap—subsidized—loans

[75] Interestingly, one of this funds is managed by *Bozano Investimentos* (renamed as Crescera), Paulo Guedes', Bolsonaro's finance minister's, investment firm. This investment firm also has BNDES as an investor in another of their PE funds.

targeted towards large "incumbent" SOEs, legacy industries and construction companies that controlled the infrastructure business.[76]

Besides *Criatec*, FINEP is the most relevant public institution in Brazil for the venture capital segment. With a mandate related to science and technology, public initiatives led by FINEP and BNDES to support a nascent VC industry can be traced to at least the 1970's. Still, the VC segment has been a laggard in the industry's development that emerged during the 1990s focused on the more standard private equity type of deals. But as I argued, these categories are sometimes hard to distinguish in practice. Accordingly, beyond supporting this smaller and riskier segment of the market, FINEP played a role for the institutionalization of the domestic industry and got actively involved with the broader PE ecosystem. Central to FINEP's performance was the *Inovar* program, developed with close support from IDB's MIF.[77]

FINEP played a protagonist role promoting this new business model and coordinating the fundraising process among potential investors. It organized forums in which fund managers were connected with potential investors, in particular pension funds, and provided training and education for both prospective managers and investors. Besides contributing with capital to anchor the different funds, FINEP coordinated the fundraising process. FINEP led multiple public calls for funds in which they would function as an anchor investor but also facilitate the engagement of other potential investors by conducting "collective" due diligences. FINEP's screening and selection process provided an informal certification for prospective fund managers that helped them fundraise with pension funds and other potential investors, most of them state-related.

[76] Moreover, investing in both the equity and the debt of a company, as BNDES often does, can create significant conflicts of interests (e.g., Jiang, Li, and Shao 2010).
[77] For a more detailed analysis of INOVAR and its policy lessons, see HBS case (Leamon and Lerner 2012) together with the IADB's reports on the program. I will come back to this program in Chapter 5.

Otherwise, and given the interest rate environment that characterized Brazil at least since the economic stabilization of the mid-1990s, these investors were used to follow quite passive investment strategies that allocated most of their portfolio to fixed income instruments.

The *Inovar* program evolved quite a lot since it was launched in 1999, and among the policy literature on the topic it was considered to be a relatively successful initiative (e.g., Leamon and Lerner 2012); although it has demonstrated it is very hard to get private investors on-board, particularly for the smaller VC segment. Beyond its focus on early-stage innovation-related funds, it also incorporated larger growth-equity type of funds, closer to standard private equity; in which it overlapped—and worked together—with BNDES. And more recently—and quite controversially—it also started to make small direct investment into companies. Besides making capital contributions, it also pushed for a battery of other measures to support the industry. For example, beyond fostering the engagement of institutional money, it provided guarantees to individuals that invested in this asset class. And trying to appeal to corporate money, it was working to give the investment in some of these private funds the same tax benefits than the ones granted to R&D expenses. And, as Chapter 5 discusses more thoroughly, it was as part of *Inovar's* project that FINEP played a leading role in the creation of the local PE/VC association, ABVCAP.

Brazil's pension system is one of the few in the region that was not part of the trend towards individual-capitalization and privately-managed model. Instead it continues to be structured as a multi-tiered system, similar—at least in structure—to the ones found in Canada or in several European countries. Its two tiers are constituted as mandatory pay-as-you-go regimes that provide basic coverage to all formal workers. The first tier is oriented to private sector workers, and the second one is focused on government employees, with over 2,400 specific pension regimes managed by the federal, state and municipal governments. Massively underfunded, this system is

arguably responsible for a significant part of Brazil's chronic fiscal deficits.[78] On top of these two tiers, a third one is composed by closed pension funds that offer individual and occupational plans through private pension entities. These are non-profit organizations that can be established on a single-employer or multi-employer basis and by labor unions and class associations. Their accumulated assets are legally segregated from their sponsoring entities and submitted to specific regulations from PREVIC.[79] Historically, this segment of the pension system grew based on the employees of large state-owned companies, but private enterprises also began to offer benefit plans to its employees.[80] Even if there are over 300 independent funds, the largest ones are related to state-owned enterprises. Previ, Funcef, and Petros, who, respectively represent employees at *Banco do Brasil*, *Caixa Economica Federal*, another state bank, and *Petrobras*, Brazil's national oil company, manage close to half of the total funds of the system.

Consequently, the government has significant leverage over its investment decisions and its management is quite politicized. [81] This is not only because of political appointments from the company's management side, ultimately controlled by government, but also because unions representing workers/ pensioners participate in each foundation's board of directors, with direct authority over the investment officers. In the case of the PT administrations (2002-2016), government had leverage over the management appointments but also over the selection of union's representatives (Dieguez 2009; Musacchio and Lazzarini 2014, Chapter 9).[82] A former director of PREVI, the largest pension fund in the region confirms their close relationship with government:

[78] This tier of the pension system was the object of a long-awaited reform, approved in 2019.
[79] *Superintendência Nacional de Previdência Complementar.*
[80] For a summary of Brazil's pension system, see ABRAPP (2014).
[81] Among the largest funds, the case of Valia, Vale's pension fund, is often highlighted as a somewhat less politicized management.
[82] See Anzia and Moe (2019) for an interesting analysis on the governance of public pension funds in the US. For the relationship between unions and pension funds also in the US, see McCarthy (2014).

We have direct relationship with Casa Civil [chief of staff], also with Fazenda [Treasury]. Ultimately, we depend on them (...) There is always pressure from government, in particular to go into infrastructure projects.

Pension funds participated quite actively in the privatization of state-owned enterprises.[83] They did so directly, and still hold large blocks of former state-owned companies such as Vale and Embraer, companies with a quite dispersed shareholder base, whose stocks are among the most liquid in Brazil's exchange. Indirectly, pension funds were also investors in some funds that participated in privatizations. Among others, some of the larger pension funds were investors in the CVC Opportunity Fund, managed locally by people related to Opportunity Bank, with support from Citicorp.[84] The fund participated in the privatized telecommunications sector. Even if they were the larger investors, pension funds had no control over the fund decision-making. This became highly contentious, and ended up in court, with a long dispute around the governance of the fund and the rights of its investors.[85]As most industry participants mention when asked about the involvement of local pension funds in the PE industry, this experience proved to be quite traumatic for the pension funds. And their reaction shaped the Brazilian private equity market in the following decade.

Once the fundraising market re-opened in the mid-2000s, and arguably as a reaction to the ongoing Opportunity Fund case, pension funds started requesting more governance rights and a tighter control over the investment process of the funds they would invest in. Crucially, they demanded a seat on the fund's investment committees. This is a departure from standard international PE practices, where investment decisions are made exclusively by the funds general

[83] For a history of Brazil's private equity industry before the turn of the century see Monteiro Ramalho (2013).
[84] Citibank's private equity arm
[85] For a nice, journalistic description of the conflict between Opportunity's manager and Previ, see Dieguez (2009).

partners (GPs). Moreover, they pushed for clauses that allowed investors the right to replace the GP under certain conditions and negotiated to pay lower management fees. These more stringent governance clauses were in general supported by the BNDES, who anyway showed some more flexibility.

In part as a consequence of these governance issues, the industry was basically separated in two. On one side, there are funds that fundraise almost exclusively internationally; and in the other, funds whose resources come mostly from Brazilian state-related institutional investors (A. M. A. F. Minardi and Bassani 2016; A. M. A. F. Minardi, Kanitz, and Bassani 2014). There were only a handful of funds that combined local and foreign institutional sources of funding. Doing so is cumbersome. For example, to get local and foreign institutional investors, firms have to necessarily use separate investment vehicles, as it would be hard for any foreign institutional investor to accept participating in a fund where local pension funds have veto power.

Moreover, the regularity of pension funds investment in the asset class has not been as systematic as industry participants would have hoped. Larger pension funds did not develop their own private equity strategies and teams,[86] but tended to invest together with other state-related large funds, and development financial institutions. Moreover, and as a result of these governance demands, pension funds arguably suffered from an adverse selection problem in their allocation of capital to fund managers. More experienced managers, with a more complete investment track-record and who were better connected to international investors were able to avoid fundraising locally and dealing with pension funds, even if they have been in business with them before.

[86] I reviewed the professional profiles of PREVIs executive leadership since the late 1990s. For the most of this period, the president had a union background. Otherwise, chief investment/planning officers came from Banco do Brasil (BB), and showed no asset management experience outside Previ/ BB. This does not appear to be significantly different from the profile of officers in most US public pension funds, but it is in sharp contrast with Canadian pension funds who are able to attract top financial talent (World Bank 2017).

Instead, pension funds invested in funds who did not have an easy access to international money and therefore had no alternative but to rely only on local investors, even if that meant loosing part of their decision-making autonomy. Many of these funds ended up being over-exposed to oil and gas and infrastructure related projects, arguably pushed by government. The end of the commodity boom, paired with the economy's recession, translated into bad financial performance. The downturn in the economic cycle, together with the corruption scandals that affected pension funds,[87] made the pension funds withdraw momentarily from the private capital market.

Still, the market was quite active during the latest recession. The infrastructure sector appeared to be especially attractive. With local construction companies out of the game due to corruption scandals, and the BNDES no longer providing cheap subsidized loans, there were several large infrastructure-related transactions that involved private-equity-like financial investors. Since local fundraising was closed, few companies had "dry powder," i.e. capital available. Therefore, the few firms that could tap international investors were the most benefited. Among them, and notably, some massive foreign institutional investors with a local footprint were sourcing deals directly (e.g. Canadian Pension Plan (CPPIB), Singapore's two sovereign wealth funds, GIC and Temasek, and Brookfield).[88] So, even with a more international flavor given the retreat of local investors, the market showed dynamism during the latest recession.

The corruption scandals and Dilma Roussef's impeachment inaugurated a period of uncertainty. The BNDES is currently revamping its business model. It hired the same large

[87] Some private equity vehicles (FIPs) were part of a judicial (Greenfield) and congressional investigations (see CPI Fundos de Pensao - Relatorio Final 2016). Importantly, the funds under investigation were mostly mono-company vehicles, used just for tax purposes and managed directly by some state-institution (e.g. Caixa), and not standard private equity funds managed by an independent third-party (e.g. managers were not members of the PE/VC association) pooling resources form a broad investor base. See Minardi and Bassani (2016) for a complete inquiry of pension funds' private capital investments.

[88] Also, Chinese investors, and large local groups (e.g. Itausa) were also active in the infrastructure space.

international consulting firm that had previously worked with the German and French development banks, and was arguably trending towards a less interventionist model, closer to the IFC. It has stopped providing massive amounts of cheap subsidized credit to insiders, which would arguably drive the need for more equity investments. Moreover, it is definitively shrinking its balance sheet, is unlikely to continue making significant direct investments and will most likely privatize part of their equity portfolio. Still, it seems it will focus on indirect investments. Even in the midst of all this uncertainty, BNDES participated in some new funds, accepting the more standard governance clauses that give fund managers more autonomy. And it also continues to lead the introduction new financial instruments, for example, it has launched calls for a new series of private-debt funds.

As it was clear in the last couple of years, the Brazilian PE market certainly exhibited a lot of problems. But with all its flaws, from which we can certainly extract some lessons and illustrate some of the trade-offs policymakers face, the Brazilian case is still particularly salient when contrasted with other cases in the region. Through significant state support that began well before the PT administration and an early involvement of pension funds, it exhibits the most dynamic private capital industry in the region. Far from unique given it's distinctly statist model, these two characteristics are in different ways also present in the other cases I explore below.

4.2.2 Mexico

Compared to Argentina and Brazil, where these new financial actors showed an earlier participation during the 90s, Mexico was more of a latecomer to the private equity industry (Charvel and de Yeregui 2002). It had limited activity during the 1990s, more related to international investors. The timing of events of the Mexican case provides crucial support for my hypothesis, and illustrates clearly the two stages in the emergence of a domestic private capital

market. In the first stage, and following a different mode than the Brazilian one, state-related financial institutions also consistently invested in pioneering private equity funds. And following this early incubating phase, the entrance of pension funds was the key step that allowed the industry to take-off.

The first steps of a Mexican proto-private equity industry can be traced back to the late eighties, with the creation of SINCAS.[89] SINCAS were a public investment vehicle that received strong support from *Nacional Financiera (NAFIN*), Mexico's largest development bank, who automatically contributed with a minority portion of the capital of these public investment vehicles.[90] According to early industry participants, SINCAS were expensive vehicles, information requirements were too onerous and, critically, pension funds could not engage with them. But, crucially, it was from the legacy portfolio of SINCAS that in 2006 Nafin, together with other policy banks, created *Fondo de Fondos (FdF)*. Registered as a corporation independent from its shareholders, the sate-owned policy banks, FdF is formally constituted as *Compañía Mexicana de Inversiones de Capital, S.A de CV*.

Led by NAFIN, who holds around 75% of the capital of this new investment company, other state-owned policy banks such as FOCIR, Banobras and Bancomext also participated in this venture from the beginning. NAFIN's strategy is different from BNDES, where the bank invests either directly into companies or indirectly into funds. As the names indicated, Mexico followed a fund-of-funds approach (Lerner 2009, 133). Instead of investing directly into companies, as standard PE funds do, a fund-of-funds adds an additional layer of intermediation, and itself acts as an investor in multiple funds, that then capitalize different companies. Therefore, a fund-of-funds

[89] *Sociedades de Inversión de Capitales.*
[90] SINCAS apparently provided finance to around a dozen companies that were listed in the Mexican stock exchange back in the nineties; other than that, there is not much information about them (EY 2015).

holds a portfolio of quotas of other funds, rather than directly holding its underlying assets, the equity of private firms. This model adds an extra layer of intermediation in the flow of capital from its ultimate investor (e.g. the depositor, pensioner or taxpayer) to its recipient, in this case a privately-held company. And in the case of Mexico, it moves the state policy banks one step up in the financing chain, further away from the ultimate investment decision.

Most distinctively, the FdF is structured as a separate organization from its sponsors and has its own and potentially different pool of investors. At first, its main sponsors and owners were the same as its investors, but then it obtained investments from multilaterals, and later from local pension funds. Another key difference with the Brazilian case where fund managers have to participate in open competitive bid processes in order to receive funding, the FdF is permanently open for new applications. That is, as long as the fund has not run out of capital, a prospective fund manager can show up at any time with its proposed fund plan to be evaluated. Notably, the terms of the investment are negotiated individually and not disclosed. Since its inception the FdF has sponsored most of the funds operating in the country; both local and international. As of the end of 2016 they have participated in 71 funds and have made capital commitments for close to one billion dollars. They report, only through highly-aggregated and hardly-verifiable data, overall quite a reasonable performance, with average annual return in dollars of around 10%.

The FdF also explicitly aims to crowd-in private capital from other sources, and maximize the multiplier effect of its money. For example, as a rule it never invests more than 35% of a fund in a single GP, and their average participation is of around 15%. Their ticket size cannot exceed $30M per fund, nor $75M in a family of funds (i.e. funds operated by the same PE firm). Given these limits, it is certainly a more significant investor for small and mid-sized funds. Even so, it

also participates in large international funds that invest in Mexico as part of their regional focus.[91] Given the importance of exhibiting the commitment of local investors when fundraising internationally, FdF was still considered a valuable resource for these funds according to interviewees. Until pension funds entered the scene this was the only Mexican institutional investor that could possibly contribute resources to the asset class. As an experimented fund manager who launched one of the first funds in Mexico as the local representative of an international firm told me:

> *They are still now the only Mexican institutional investors that invests in PE, besides the AFORES that have to go through CKDs. Before that, they were the only ones. That makes them quite relevant. They participate in most funds, with a relatively small share of the total fund. They know they are the only Mexican investor, and therefore that they have an important catalyzing role […] this is their real value, the catalyzing effect they have by being the only local institutional investor that can go into the asset class.*

Interestingly, the model proved to work quite successfully, and allowed *Fondo de Fondos* to grow and become increasingly sophisticated with time, diversify its holdings and extend its reach. Following the first two "generalist" private equity fund-of-funds, they developed some more targeted initiatives. In order to enhance their venture capital strategy, they partnered with an American VC firm, Sun Mountain, with experience managing state-related fund-of-funds in the US. Also, as a way to support the energy reform, they launched a separate fund dedicated to the

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[91] As many of these larger funds are not country specific, but rather have a regional approach that does not bind them to invest a portion of their capital in a particular country, FdF has an informal agreement in which they require these funds to invest at least double the value of their commitment into Mexican companies. Still, the enforcement of this agreement relies basically on fund manager's trying to maintain their reputation and relationship with FdF, and can only be eventually enforced during the fundraising of subsequent funds by these managers.

energy industry. In terms of products, they diversified into more flexible quasi-equity type of securities such as private debt and mezzanine, as a way to also promote these more novel asset classes. Moreover, moving down the investment chain, they started to co-invest with some of the funds they participate in.

In terms of fundraising, besides obtaining resources from its original state-owned shareholders and multilateral institutions, the FdF has also recently started to raise funds from the local capital markets. They have issued their own vehicles to raise financing from the pension system's resources instead of participating as quota-holders in the vehicles launched by PE firms to raise money from the pension funds. Through a subsidiary, *PMIC Latam*, FdF now manages its own CKDs,[92] through which they raise capital for smaller funds that would otherwise be below the minimum investment size that would be worth the attention of pension funds.

FdF is an example of an organizational model that combines public goals with private expertise, similar to Colombia's FDN case I introduce below. Well known within the small private capital community, FdF is rarely noted outside of it. They function completely under the radar, and try to keep it that way, cultivating explicitly a low profile that helps them function with significant independence. The staff do not recognize themselves as public servants and operate with autonomy from bureaucracy, and therefore are more flexible in their recruitment and compensation policies. Consequently, their office with around 30 people, is in an otherwise standard corporate location, and is staffed with professionals with career paths that interlink the private sector.

[92] *Certificado de Capital de Desarrollo.* A publicly-listed private capital vehicle through which the pension funds are allowed to invest in this asset class. I provide a more thorough discussion of the genesis of this particular kind of security in next chapter.

Given that the FdF is a private corporation separated from its state-owned shareholders and not structured as a bank, they have no requirements to disclose information. They operate similarly to standard private industry players, typically quite secretive and hard to trace.[93] They can invest through offshore vehicles—which allows them to engage with international investors more easily. And can participate in private placements, since they do not have the requirement of investing only in public securities. This is something unthinkable in other contexts where state-sponsored investment funds are restricted to operate through local vehicles or only participate in funds regulated by local authorities. Moreover, the governance of the FdF is also closer to private sector standards. For example, their board of directors is independent from the management of the firm and half of it is composed by private sector businesspeople. Importantly, this external board-members have a veto power in the firm's investment committee.

Although FdF is Mexico's main public initiative to develop the private capital industry, there were other more specific programs aimed to mobilize further private capital funds and help introduce new financial players into different sectors of the Mexican economy. Parallel to the FdF, although sometimes led by its same state-owned bank shareholders, these initiatives are more targeted towards specific sectors.

Banobras also manages *Fondo Nacional de Infraestructura (Fonadin)*, who has its own initiatives to promote private capital investments in infrastructure. Since its inception in 2009, it has invested in 21 privately-managed PE funds that targeted infrastructure, energy, real-estate and tourism projects.[94] For example, it was the cornerstone investor in *Fondo de Infraestructura de Macquarie Mexico* (FIMM), the first peso-denominated fund focused solely on investment

[93] Even for industry insiders their investment portfolio is not that clear.
[94] Among this 21 different funds, 16 were CKDs, 4 private funds and 1 Fibra-E.

opportunities in Mexican infrastructure projects, managed by Macquarie, a large Australian asset manager with extensive expertise in infrastructure finance. It is also the Mexican sponsor of the US$1.2 billion China-Mexico Fund managed by the IFC. Moreover, *Fonadin* also participates, together with local pension funds in a US$2B peso-denominated infrastructure-oriented investment fund with CPDQ, one of the largest Canadian—publicly-managed—pension providers.

The private capital model was also attempted to be introduced to the agricultural sector. *Fondo de Capitalización e Inversión del Sector Rural (FOCIR),* another of *Fondo de Fondos'* shareholders, created a series of smaller private capital initiatives targeted to the agribusiness. Resources were channeled through so called FICA funds, and is also experimenting with agro-related VCs.

Finally, and parallel to all these programs, the more recent *Instituto Nacional del Emprendedor (INADEM)*, was active in the smaller venture capital segment. Created in 2013 during Peña Nieto's administration as an initiative of the *Secretaría de Economía*, it attempted to consolidate different programs scattered throughout the federal government targeting entrepreneurship. It was not conceived strictly as a financial institution, and has a decentralized status that grant it some autonomy. Its activities go beyond providing capital and is mandated to promote the broader entrepreneurial "ecosystem" in Mexico. It sponsored over 40 new VC funds, supports incubators and accelerators, and organizes activities to promote entrepreneurship and innovation.[95]

In addition to these smaller public programs, the key catalytic role in the industry was undoubtedly played by pension system resources, through the entrance of AFORES[96] into the

[95] Mexico's new administration recently announced it will discontinue most programs related to the institute.
[96] *Administradoras de Fondos para el Retiro*

market. AFORES are private companies authorized to manage individual retirement accounts. They were created in 1997, as a result of the pension reform that transformed the retirement system from a from a pay-as-you-go, defined-benefit scheme to a fully-funded, private and mandatory defined-contribution scheme. The reform, as in other emerging economies, followed the Chilean model, and generated a system very different from the Brazilian one, where as described above, the largest pension funds are related to the state-owned enterprises, and therefore have very close ties to government. In Mexico, instead, the individual capitalization accounts are managed by specialized private organizations, in general related to international financial institutions.[97] Importantly, in order to increase the transparency of the system and protect retirees' savings, AFORES are restricted by law to invest only in publicly traded securities. While they started with a portfolio composed almost exclusively by public debt, they became increasingly sophisticated, investing in "structured" alternative assets in 2009 through the introduction of CKDs. As an experienced manager working in the investment team of a pension fund summarized, *"if it wasn't for CKDs, we would still be just trading government bonds."*

Until their entrance into the market, the only domestic institutional investor available to provide capital was the government through the FdF. Beyond these resources, fund managers depended almost exclusively on external sources of capital. The creation of CKDs, an idiosyncratic financial instrument denominated in local currency and listed in the local stock exchange, allowed Afores and other institutional investors to allocate part of their portfolio to private capital projects. Their introduction created an important source of domestic fundraising, and what is clear from both interviews and industry reports, allowed the sector to take-off (see for example, EMPEA

[97] There is still one publicly-managed pension fund, *Pensionissste*, which has around 6% of the market.

2016; Leal and Del Sesto 2013).

As the next chapter explains more thoroughly, peso-denominated CKDs are far from being standard industry investment vehicles, but are the result of a "quiet politics" compromise that even if suboptimal for most players, was successful in channeling pension resources into real assets. Since it is a listed security, CKDs are required to disclose information quarterly and to have a daily price, even though given the limited public that can access it (since they were tailor-made to pension funds), they show no liquidity. Moreover, CKDs are very restrictive in terms of the capital uses of the funds and limited to investments in Mexico. For these reasons, it is usually considered a "necessary evil" and referred to as a "Frankestein." It nevertheless seems to have worked, and since its inception, 86 different CKDs have been issued, amounting to over $22B dollars in capital commitments (see October's 2018 Amexcap's presentation). Not all of these resources are expected to be invested in general purpose corporate private equity, but also fund infrastructure, energy and real estate projects.

Released in 2009, CKDs have been incrementally fine-tuned through regulations and consolidated into legislation. Moreover, to overcome some of their limitations, regulators further experimented with new vehicles such as Fibra's and CERPIS. Anyway, it seems clear that the capital constraint of the incipient local private capital industry was relaxed once it was able to tap into the resources of pension funds. Given Mexican demographic dynamics together with a trend towards increasing formalization, the pension system funds available for "alternative" investments are expected to grow. Interviewees suggested the more pressing bottle-neck was no longer on the funding side but on human capital: there are not enough experienced fund managers with a reputation and track record that are able to absorb all that available liquidity.

Relatedly, the Mexican case is noticeable for the prevalence of fund managers whose

professional careers also includes senior positions at the federal bureaucracy. With technocratic profiles that in most cases include graduate studies in the US, some former officials' path into business includes being part of private capital fund management partnerships. This seems to be more often the case in infrastructure-related funds. Still, this "technocrats into business" dynamic does not appear to be specific of the Mexican case, but it often observed in Brazil, and more generally across the industry.[98] Of course, this may raise concerns about political cronyism in this industry.

Certainly, the Mexican private capital industry is not short of challenges. For example, industry participants repeatedly complain family groups keep the best deals for themselves: *"In Mexico the problem is that PE only gets the bad deals! The good deals, the 6/7 families that control everything keeps them for themselves."* The dominant position exhibited by family-owned diversified business group throughout Latin America, that seems to be particularly salient in the cases of Mexico and Chile, seems to further limit the expansion of private equity investors.

There is also a shortage of professionals within pension funds capable of evaluating and managing this new type of illiquid, long-term private equity investments.[99] Moreover, given the large size of pension funds and their limited staff, there is a scale issue that affects smaller participants: you need to have large (for the region standards) ticket sizes in order to be able to attract pension fund's attention (~$400M according to an interviewer's estimate). This signals the more structural trend, in Mexico and elsewhere, towards a consolidation and subsequent concentration of AFORES, and of pensions fund managers in general. It certainly raises a question

[98] For research about politically connected private equity in the US, see Faccio and Hsu (2017).
[99] It was quite common during my interviews for fund managers to complain about pension funds' investment teams profile, arguing "they are all traders," referring to their preference and knowledge trading short-term liquid assets, mostly public debt, and their lack of experience evaluating/ managing illiquid portfolios.

about the sustainability of a market where there are just a handful of players (five pension funds in Mexico, two in Colombia, etc.), with no incentives to differentiate from each other and pressed to reduce their fees and commissions.

Given the length of investment cycles, it is too soon to make conclusive evaluations of the outcomes. But at least in terms of fundraising, it seems clear that the resources from the pension funds play a decisive role, building on top of pre-existing public resources. Even if far from a financial revolution, it is quite clear, as another fund manager of a leading mid-market PE firm argues, that *"there is now a proven domestic fundraising channel that allowed for the emergence, in each segment of the private capital market, of at least a couple of competing firms."* Interestingly, the Mexican case also illustrates nicely the dynamic of institutional change. The institutional money that flowed into private capital, found a much easier path into new ventures than to the buyout of already existing standard corporate assets. A lot of resources are going into infrastructure, energy and real estate projects rather than into old closely-held family companies.

Not exempt from challenges, the Mexican case shows clearly my two-step argument. First, a state-owned investment corporation anchored both local and international funds that wanted to operate in the country. Mexican *Fondo de Fondos* exemplifies a novel organizational form that combines policy goals with technical expertise and autonomy from formal bureaucracy, and appears well-suited to interact with private capital investors. And second, access to pension fund resources through the issuance of CKDs allowed the industry to consolidate. As the Chilean case develop below will help make clear, state-funding alone is not enough, and engaging pension funds is a key necessary step for the institutionalization of the private capital industry.

4.2.3 Chile

Chile is the richest country in the region. It is also the region's most stable and market-friendly economy. It has maintained investment grade since the early 1990s, and it is usually praised as the poster child of pension reform, that resulted in the largest pension funds in the region, comparable in terms of GDP to those encountered in advanced economies. And indeed, under many metrics Chile is financially—and otherwise—the most developed country in the region. The size of its banking system is large, the market capitalization of firms as a proportion of GDP reaches the level of developed countries and the population's overall access to financial services is broad. Still, Chile's domestic private capital industry is relatively underdeveloped, and relatedly, there is comparatively little institutional equity, scant IPOs, and very few companies that are not tightly controlled by a family or a group of families other than multinationals.

Notably, in contrast to the free-market portrait of Chile's economy, the nascent private capital industry is heavily dependent of state backing. Since the late 1990s there has been a sizable support for private "risk" capital funds by its longstanding development agency, CORFO *(Corporación de Fomento de la Producción)*. Other institutional investors did not consistently followed this early-stage state impulse; and little to none pension fund resources go into the domestic private capital industry. As a result, the industry is composed on one side by a relatively large number of small PE/VC funds highly dependent on public money and on the other, by a few large international investors, that unmediated by local fund managers, have invested mostly in the infrastructure sector.

Of course, if Brazil enjoyed being the largest market in the region, Chile is—even if the wealthier—the smallest among the countries that I focus on. As already discussed, I make three main points to counter the size argument. First, and more generally, there are several examples of

small countries that in the last couple of decades have developed relatively more active equity markets (e.g. Singapore, Malaysia and Israel). Second, it is often argued that Chile's small size makes it an irrelevant market for large international investors; and that is what explains Chile's relative market void. Contrary to the implications of this argument, notwithstanding its size, some of the world's largest global private capital allocators are indeed present in Chile. For example, Canadian pension funds, global leaders in this sector, have several direct investments in the country. Unmediated by local fund managers, they made a couple of buy-hold infrastructure investments. Instead there are few local firms operating in the mid-market private equity that combine foreign and local money. Third, given its size, Chile has a quite significant number of listed companies; still, after more than 30 years of Chile's economic transformation, their shareholding structure is unchanged and still very concentrated (see for example, Larrain and Urzúa I. 2016), and there are very few new listings.

Constituted not formally as a bank, but as an agency dependent of the Ministry of Finance, CORFO had a central role during early import-substitution industrialization periods, adapting its profile to accompany Chile's shifting development model (Musacchio et al. 2017). Regarding private capital, it started promoting the venture capital industry in 1998, with a pioneer program in the region, inspired by the—back then quite recent—Israel's well-renowned Yozma experience.[100] CORFOs funds program has grown and evolved over time, but exhibits quite a remarkable consistency since the early Lagos' administration. There are at least three different overlapping programs that target funds that invest in companies at different stages of development, ranging from seed capital to growth equity strategies. But as a key difference with the Brazil and

[100] A government initiative to attract venture-capital investments in Israel, especially foreign, promising to double any investment with funds from the government. The program is considered to be very successful, triggering the creation of a VC industry in the country (Avnimelech 2009; Lerner 2009).

Mexican cases I layout above, all of these programs promote comparatively "early-stage" funds. The policy is less aimed at the general development of the capital markets and more towards the promotion of entrepreneurship and innovation. Industry-wise, they are not only oriented towards asset-lean tech start-ups but interestingly also include programs specific to sectors they want to promote, including agriculture, biotech and mining.[101] As I will discuss more thoroughly in the next chapter on the politics of reform, CORFO's lack of autonomy limited the size and the type of its investments, and arguably limited the expansion of the asset class in Chile.

CORFO depends directly from the Ministry of Economy. Its risk capital unit is not structured as an independent organization nor has external investors, and therefore CORFO has to get yearly budget approvals for each of its programs. Instead of making regular public calls in which funds have to make competitive bids for a specific investment mandate, such as in the case of Brazil's BNDES and FINEP funds programs, CORFO is permanently open for new applications, similar to the Mexican fund of funds. But in contrast to the Mexican case, the main contractual terms with each fund are fixed by the program and information about their investments transparent to the public. To incentivize the crowding-in of capital from private sources it has a matching funds approach: CORFO's contributions are set to be a fixed multiple of the resources obtained from third party investors, capped at a maximum amount.[102]

In terms of how the support is provided, CORFO's programs are from the fund managers' perspective, extremely beneficial. As Chile's 1980's Constitution limits state's "entrepreneurial"

[101] For a more complete description of the different programs, its characteristics, and recipients, see CORFO (2018) and other similar reports from the same institution.
[102] The public to private ratios are calibrated according to the stage of development of the target firms. The smaller the target companies, the larger the proportion of public money invested in those VC funds, with CORFO to private-money ratios ranging from 1:1 to 3:1.

role,[103] CORFO capacity to make equity investments is quite restricted. Therefore they do not participate in the fund as any other private sponsor, but instead contributes capital through a senior debt contract. CORFO basically gives the fund—not the companies—cheap leverage against no collateral. In a way, this scheme intends to promote risk-taking and benefit fund managers and their other private investors. If the target company fails, everyone loses their investments, including CORFO, who usually then writes-off the debt. But if the funds do well, CORFO's upside is limited and it only gets a small mark-up over a baseline overnight risk-free rate.[104] In terms of governance, CORFO has a somehow more hands-off relationship with fund managers; for example, and contrary to Brazil, they do not get involved in each firm's investment committee, and just demand the compliance of internal protocols. At least from a manager's perspective, some of requirements can be somewhat tedious:

> *I personally raised two funds. Would those two funds have existed without CORFO? We didn't have a chance to raise those funds without CORFO's support […] CORFO gets most of the risk, and if it goes well, we all win. Still, operating with CORFO is a pain, you have to deal with a lot of useless rules made by lawyers that know nothing about our business. You get their money just because you need them […] without them all this industry wouldn't have existed. We suffer them, but we are also very grateful.*

Since 1998 CORFO has made disbursements for over $500M in more than 50 different funds, and still has close to $ 300M in outstanding commitments available for both early-stage and growth equity funds. But after 20 years, the private capital industry in Chile is still completely dependent on the funding by CORFO (ACAFI 2018; CORFO 2018); pioneer funds have had a

[103] See Article 19 Nº 21 of Chile's Constitution: *"El Estado y sus organismos podrán desarrollar actividades empresariales o participar en ellas sólo si una ley de quórum calificado los autoriza."*
[104] In most programs LIBOR +2%.

very hard time scaling beyond the state support phase.

The main problems, according to a fund manager sponsored by CORFO and leader of the new business association are two:

> *First, CORFO requires its money to be only invested in Chile. The Chilean market may be good to do a proof a concept or act as a platform, but it is too small of a market. You need to go out of the country, but it's difficult to do so and comply with CORFOs rules […] And second, and most importantly, there is a lack of financial sources to follow-up CORFO's investments and complete the financial "ladder" [incrementally larger rounds of funding]. Family offices and high net worth individuals are reluctant to invest through unrelated professional asset managers. And crucially, given how they are regulated and absent any initiative such as the Mexican fund-of-funds, it is very hard for fund managers to engage with pension funds and insurance companies. Therefore, different from other markets is which the whole financing chain is much better covered, in Chile there is an absolute lack of funds beyond the $40M size.*

This is quite puzzling, since Chile has served as the poster child of successful pension reforms in the emerging world. By removing social security from the public balance sheet liabilities, the reform certainly helped create a stable macro-economy, in itself a remarkable achievement. And the resulting pension funds are the cornerstone of otherwise quite developed Chile's financial system. In terms of the assets under management of the system, Chile has by far the largest pension funds in the region relative to the size of its economy. Even in absolute terms they are larger than their Mexican peers and close to Brazilian pension funds. Chile's system has served as a model after which the pension regimes in many countries inside and outside the region have been designed (Weyland 2005).

But notably, the pension funds investment strategies are tightly regulated in a quite

conservative way, and fund managers incentive structures are arguably biased towards short term securities (Da et al. 2018; Opazo, Raddatz, and Schmukler 2014). Pension funds have relatively low maximums on the stakes of a company they can own, which limits their influence in listed firm. And regarding private equity, throughout their already quite long history, they have not engaged systematically with local private capital fund managers. Even if they have been increasingly active in the asset class, they are discouraged to go domestic. Instead, they have gained exposure to "alternative" asset classes by investing in large blue-chip international fund managers (e.g. KKR, Blackstone, Carlyle, etc.) that have global strategies and invest mostly in USA, Europe and Asia, and hardly ever focus in Chile. This is in some way the opposite dynamic we observe in the other cases, where before engaging with the asset class internationally, pension funds start locally.

As I explain in more detail in Chapter 5, the regulations around the pension funds investment regime were updated in 2016/7, granting some more flexibility for AFPs to allocate resources into the alternatives asset class. The reform facilitated investment in external PE funds and laid the ground for a more direct role of pension funds in the infrastructure space. But local VC/PE was excluded from the reform, and absent more ambitious initiatives such as the one in Mexico's FdF that blends public resources with pension funds money, industry participants thought it was unlikely that the domestic private capital sector would grow.

In sum, Chile's case illustrates at least two key points. First, and counter-intuitively, well known for its market-oriented political economy, Chile's private capital industry received strong public support that included significant capital contributions to most of the funds operating in the country. But the industry could not engage successfully with pension funds, the largest and more consolidated ones in the region. Arguably as a result of its lack access to institutional sources of

funding, the industry in the more stable and institutionalized country in the region is still small and highly dependent on state-related funding.

4.2.4 Colombia

The Colombian case exhibits a similar trajectory as the one sketched in the introduction to this chapter and observed in other countries, therefore helps confirm my main arguments. A latecomer to the PE industry, the first private capital funds appeared in Colombia in 2005 with initial support from different development financial institutions, local and international. During this period Colombia was able to attract international investors, but also key to the growth of the sector was the involvement of local pension funds. With a pacified and booming economy, the industry experienced significant momentum, even if it has not generated significant exits yet. Following the end of the commodity boom the prospects for the industry, even if now more institutionalized, are less optimistic. Currency depreciation has quite adversely impacted the returns of existing investments, and crucially, the concentration levels of its pension system inhibits the development of the incipient market.

Together with the recurring presence of multilateral and European DFIs as investors in each country's pioneer funds, we also observe in Colombia early government initiatives that helped establish some PE funds. For example, through *Ecopetrol*, Colombia's state-owned oil company, and *Fiduagraria*, a rural-focused DFI, the government anchored a series of funds specialized on the oil and gas and timber sectors, respectively. These were managed by LAEF, one of the pioneer PE firms of the region. Beyond these more targeted early initiatives, Bancoldex was the instrument through which the national government channeled its efforts to promote the sector.

Bancoldex is a second-floor bank, meaning that it does not have direct commercial ties

with companies but operates through financial intermediaries (mainly commercial banks), specialized in financing exports. As a division within the same organization, Bancoldex Capital was created to provide support to the nascent PE industry. Their program combines some funding together with promotional initiatives. In terms of capital provision, Bancoldex interventions were, for the moment, quite limited. The ticket sizes they contributed were small and fund managers complain their investment process is too bureaucratic. It started by investing directly from the bank's balance sheet, with the expectation of then creating a separate fund-of-funds. Modeled after the Mexican fund of funds, it planned to initially invest around $100M from the bank and bring-in some outside investors (see Bancoldex 2015, 2016, 2017). For the moment this initiative didn't really take off and seems to have lost political momentum, although with the 2018's change in government, the initiative has resurfaced. Rather than its role in capital provision, Bancoldex's indirect "table-setting" (Lerner 2009) initiatives appear to be more relevant, as I explain in the next chapter. The bank helped local pension funds connect with PE managers. And in a quite clear case of organizational public-private partnership, they helped set-up Colcapital, the local association that groups industry participants.[105]

It is in infrastructure financing where the Colombian case is particularly interesting. In a first stage, the government promoted the creation of several infrastructure-oriented private equity funds, managed by well-recognized international asset managers such as Ashmore and Brookfield. For example, in 2009 the government—through Bancoldex—pushed for a pioneer infrastructure fund that was managed by Ashmore, and as usual, partnered with multilaterals and pension funds

[105] Colombia has other agencies, federal and regional, to enhance private capital industry, mostly oriented towards smaller VCs (e.g. Impulsa and Ruta N). Besides their promotional role they provide some seed capital. But as it seems to be the case elsewhere in the region, it seems very hard for these small funds to obtain other sizable outside investors beyond the state.

(and Australian Macquaire served as an advisor).

Moreover, as part of the 4G ambitious infrastructure plan of President Santos' administration, the government embarked in a quite impressive institutional building process. On the regulatory side, they centralized all competencies concerning PPP contracts in one agency (ANI), and revamped and professionalized it. But more related to the focus of this chapter, in order to secure the financial viability of these novel forms of private-public partnerships, the government built a new development bank basically from scratch: *Financiera de Desarrollo Nacional* (FDN). Re-launched after 2011, the government sold minority stakes in this new bank to World Bank's IFC, CAF and Japan's Sumitomo. Notably, the FDN is the only case in which these international institutions participate as shareholders in an otherwise state-owned development financial institution. External multilateral and private investors arguably helped secure bank's autonomy from bureaucrats and politicians, and guarantee its "commercial" orientation.

Funded in part by the proceeds obtained by the privatization of *Isagen*, a power generation company acquired by Brookfield (a large Canadian PE investor) FDN redeployed these resources into the 4G highway projects. Together with some direct loans and guarantees, they channeled significant amounts of capital through third-party private asset managers. Given the highly-levered nature of the infrastructure business, the equity part of the projects was already mostly covered prior to the PPP biddings. Instead, the market voids were in the longer-term portion of the debt financing and some mezzanine securities (hybrid debt-equity securities). FDN therefore first promoted the creation of private debt funds,[106] structured similarly to private equity funds. There

[106] Private debt is more similar to private equity, different from a standard commercial loan provided by a bank, or participating in a bond that has liquidity in the secondary market.

are now several of these new type of vehicles, managed by international and local institutions.[107] Together with FDN's money, these funds also pool resources from other investors, mainly pension funds.

More recently, FDN structured a US$1.1B fund, the largest of its kind in the country, targeted towards equity investment in infrastructure projects and companies. Similar to the arrangement in Mexico, half of the capital is contributed by CDQP, Canada's second largest institutional investor, who manages Quebec public employees' pensions. The rest of the capital commitments are granted by FDN as well as local pension funds.[108]

Taking a step back, the Colombian case clearly indicates the key role of local pension funds. They are certainly the main local investor in the asset class, but also the main limitation for the sector's continued growth. During the initial years, they indeed helped foster the market. Together with sizable external investments, the private capital industry grew quite quickly and accumulated a substantial amount of assets. As of 2018, there were around 50 firms managing resources for around $13 billion. In terms of regulation, the environment is quite pro-investor. Different than for example in Mexico, pension funds are allowed to participate directly in private placements, avoiding the need to go through onerous listed investment vehicles (e.g. Mexican CKDs).

As in every other country, the end of the commodity cycle and the consequent depreciation of the exchange rate negatively affected the financial returns of the funds denominated in dollars,

[107] For example, Ashmore, that also manages a pure private equity fund, structured the first of these private debt funds, together with CAF, the multilateral institution. And Blackrock, the world's largest asset manager, started investing locally in Colombia through another of these private capital funds, anchored by FDN. It is important to note, even if part of large international franchises, that these funds are managed locally. Among the Colombian asset managers, Credicorp and Sura also manage one of these funds.

[108] Besides its financing activities, the FDN also provides with advisory and investment banking services to the different levels of government (e.g. it coordinates Electrocaribe's restructuring effort).

therefore limiting the fundraising of subsequent funds. Again, private capital flowed more easily into new companies, real estate and infrastructure investments than to already mature corporate assets, where corporate governance change is slower. Moreover, the problem of pension system concentration observed throughout the region finds in Colombia its maximum expression. There are only four pension funds, and just two (*Porvenir* and *Proteccion*, part of *Grupo Aval* and *Grupo Sura*, respectively) hold close to 90% of the assets. As the managing director of a large international fund with a long history of investments in the region, and former president of the Colombian PE/VC association told me, about the Colombia case, but also more generally about the region:

> *The main barrier for the development of the PE industry is that there are no investors. Each country has four pension funds. I can count institutional investors here in Colombia with only one hand. Pension funds concentration is the most perverse for the funds, and for the capital markets in general. It is really hard to create a market with such a few numbers of players.*

Not optimistic about the fate of the industry, still, this last quote confirms my main argument about the centrality of institutional investors for the sustainability of the private capital industry. With just a few concentrated institutional investors, the development of the industry is jeopardized. And it signals one of the structural limits for the country and region's capital markets growth.

Overall, the Colombian case seems to fit well with my two arguments. We observe a pioneering role of different state agencies in each segment of the private capital industry, PE, VC and infrastructure investment, which helped attract pension funds into the market. The infrastructure segment is especially interesting and exhibits clearly the dynamics I emphasize

throughout the chapter. In order to promote private sector participation in infrastructure financing, Colombia created of a new development bank, FDN. In turn, this bank anchored different private capital funds that attracted external asset managers into the country and catalyzed local and external pension funds participation in the asset class.

4.2.5 Argentina

Argentina was the hottest private equity market in the region during the 1990s. Following macroeconomic stabilization and extensive liberalization, the country attracted considerable amounts of foreign capital. As part of these flows, and as part of the broader restructuring of the economy, Argentina saw the emergence of the first formal private equity firms in the region (Baltin and Bell 2001). Led by local executives managing mostly international funds, these pioneer PE firms emulated the American leveraged buyout model of the eighties. While initially very successful, the virulent economic crisis at the turn of the century, that in Argentina included a massive sovereign default and a substantial devaluation, turned out deadly for the industry.

Following the crisis and the rise of a more leftist government, the sector did not recovered, even if the economy returned to growth quite quickly. Argentina did not take any of the steps towards a more institutionalized private capital market we observe, even if timidly, in all of its regional peers. Fund manager’s attempt to follow the other countries’ path during the early 2000, creating a manager’s association to engage with local pension funds, did not work out. The pro-business government inaugurated in 2015, was urged to mobilize financial capital into the real economy. In order to do so, they embarked in a reformist agenda that included the passage of several pieces of legislation that would encourage this type of investor. But the lack of any local institutional investors arguably limited the impact of this reformist agenda and hindered the flow

of financial capital into the real economy.

As mentioned, the industry had an early start during the nineties, parallel to the process of economic liberalization and market reform. The first private equity funds in Argentina grew by doing a particular type of debt-to-equity deals that involved the government. These firms acquired distressed debt of private companies from the portfolio of the government's development bank that was being liquidated. And then participated in the firms restructuring, swapped their debt contracts for equity participations and took control of the restructured companies (see Naishtat and Maas 2000, 31).

Similar to Brazil, PE during the nineties in Argentina had a much more international flavor than what we observe in the post-2000s, at least regarding the origin of investors. Even if there was some engagement of local business groups as well as some financing from local banks that helped leverage the deals, most money raised by these funds came from institutional sources in the US. Also, similar to Brazil, some funds also participated in the privatizations of state-owned companies, and propped the transformation of the corporate sector that followed the market liberalization. But in contrast with Brazil, local pension funds did not participate actively in the business since they have been only recently created.

Overall, during the decade there were close to twenty PE country-focused funds plus a handful of regional players. They managed a combined asset pool of over $12 billion and funded more than 160 transactions (Pereiro 2001). This are quite impressive numbers, even by today's standards. Success cases of Argentinian start-ups (e.g. Mercado Libre), in general all related to international funding, were part of this boom. The star of the local market was certainly The Exxel Group, whose case is quite illustrative of this decade. Formed by former Citibank executives,

Exxel became the leading and most admired private equity firm in Latin America.[109] Emulating US buyout funds, they were financially and operationally aggressive, which proved to be, at least initially, very successful. They managed to raise six consecutive country-specific funds in less than ten years—a remarkable achievement—and invested close to $5 billion. By the end of the decade they were one of the largest private employers in the country. But the combination of a deep recession followed by a massive devaluation, ended up badly. Companies with revenues in local currency and hard-currency debts soon had no option but to default on their loans. And lenders ended up in control of most of their companies, many of whom were later re-sold to smaller, less institutional, PE funds.

The comparison between Argentina's *Exxel Group* and Brazil's *GP Investimentos* is quite illustrative of the trajectory of the industry in each country. This parallelism was made repeatedly by the business press during the nineties,[110] while these two firms were the unquestionable leaders of their markets; and is now usually raised by most experienced industry participants. The original founders of GP ended up playing in the international "big leagues." After the turn of the century, GP raised several new funds dedicated to Brazil, sponsored several IPOs, and engendered a couple of spin-offs that dispersed their human capital throughout the industry. In contrast, Exxel, who is also often praised by its human capital, disappeared with no legacy besides damaging the local industry's reputation up to today. Its former executives are, if at all, doing small, non-institutional private equity and mostly outside the country. Notably, and as legacy of the first booming decade, there is a handful of Argentinean managers working in the largest regional Latin America funds, but operating mostly outside their home country.

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[109] See, for example, an HBS case about the firm (Lerner and Ballve 2001).
[110] See notes in NY Times and Bloomberg about Exxel Group being the "KKR of Latin America."

Even if the economy recovered quickly following 2002's default and devaluation, Argentina could never re-develop a private capital industry. The government was certainly not market friendly and did not engage extensively with international capital markets. But still, its leftist orientation was not so different from the PT administrations that governed Brazil since 2002 during which the local PE industry experienced major growth. Significantly, Argentina never had any local capital sources available for fundraising. Different from all of its regional peers, it lacked a development bank or any sort of significant state-related financial institutions. Most importantly, pension funds were not allowed to invest in the asset class, and were nationalized in 2008. Consequently, with no possible local institutional fundraising, during the 2003-2015 period there was very little activity, no country-specific funds and investment was limited to a handful of opportunistic transactions.

Following the 2015 election, Macri's market-friendly government (2015-2019) gave Argentina some momentum within the international financial community. Several officers with a career path in finance and private equity were appointed to senior executive branch positions. With this model in mind, the government pushed a reformist agenda. Overly optimistic of international sources of capital, and managing a complex political and economic scenario, this pro-investment agenda has had few tangible results. Still, I find some interesting episodes that overall support the main points of my argument, and would indicate that, beyond basic macroeconomic stability, the lack of any local institutional investors are a fundamental obstacle to the development of the industry.

Macri's government advanced with three key pieces of legislation. First, a new private-public partnerships (PPPs) law was sanctioned in November 2016, aimed at boosting the participation of the private sector in infrastructure. With the help of multilateral institutions, it

incorporated into local legislation international best practices in infrastructure financing. Practitioners agree the law is technically good, in line with international standards, and grants enough flexibility to be used for multiple purposes. Second, a new "Entrepreneurship Law" was passed on April 2017 that introduced a novel "simplified" legal entity and granted it tax incentives.[111] And most importantly it created FONDCE,[112] a *proto* fund of funds through which the state would be able to anchor a group of new private capital funds. Finally, after a rough passage through the legislature, a new capital markets law was sanctioned in May 2018. Among more general issues that for example limited the capacity of the regulator to intervene in listed firms, increased during the Kirchnerist period, it also created an investment vehicle more appropriate for private equity investments and granted it a favorable tax status. But regulatory change, together with former businessmen with extensive career-paths in international finance appointed to top government positions, were not enough to mobilize local capital.

Even if there is a heavy presence of the state in the commercial banking sector,[113]Argentina lacks any kind of significant development financial institution.[114] More importantly, there are virtually no active pension funds—either private or publicly managed. Following the 2008 nationalization, the former private capitalization regime was transformed back into a quasi-universalized pay-as-you-go system financed mostly by payroll taxes. The holdings of the formerly privately managed pension funds (AFJP), were inherited by a so-called sustainability fund—*Fondo de Garantia para la Sustentabilidad (FGS)*. Among other assets,[115] it included minority

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[111] *Ley de Apoyo al Capital Emprendedor N⁰ 27,349*.

[112] *Fondo Fiduciario para el Desarrollo del Capital Emprendedor (FONDCE).*

[113] Even after widespread privatization of banks during the 90s the national government still owns the country's largest bank *(Banco Nacion)*. Buenos Aires' state-government owns another large bank *(Banco Provincia)*.

[114] Macri's administration tried to revamp BICE, a state-owned investment bank.

[115] AFJP's assets were composed mainly by public debt (see Datz 2012)

equity participations in most of the companies listed in the local stock exchange. After the nationalization, the FGS resources were used in a political, non-commercial basis. Besides financing the federal treasury and funding some state-led infrastructure projects in a rather opaque way, it devoted considerable resources to social programs (e.g. conditional cash transfers, one laptop per child program, heavily subsidized mortgage credit). It kept its considerable equity portfolio untouched, and occasionally used the board seats gained through its equity holdings politically to pressure the companies (e.g. *Grupo Clarin*, a media conglomerate or Techint).

Overall, the FGS had no new interactions with the private sector, for example, by providing significant new financing to private companies through the capital markets, either through equity or debt. Intending to change this, the new administration inaugurated in late 2015 appointed a former investment banker with an extensive career path in finance as head of the FGS, with the idea to manage this fund more actively. But after one year in the position, the head of the FGS resigned, without any tangible results in terms of portfolio management. It was administratively very difficult to sell any of the equity stakes in listed companies, inherited from the nationalized private pension funds, in order to invest the resources in other projects. The fund continues to be completely paralyzed and mostly just finances the Treasury.

Illustrating this last point, Macri's government tried to establish an infrastructure-oriented private equity fund, and obtained a sizable capital commitment from Qatar's Investment Authority (Qatar's sovereign wealth fund). Capital was going to be sourced mostly from QIA (~$1 billion) together with ANSES' FGS (~$300 million). And similar to the arrangements observed in other countries (e.g. Colombia and Mexico) the fund was going to be managed by an experienced international GP. But after the memorandum of understanding became public the project was immediately blocked in Congress by the opposition, and sidelined. As I will discuss in more detail

in the next chapter, with a lack of a financial bureaucracy used to interact with the private sector, Congress approval becomes an unsurmountable obstacle for these types of initiatives.

As mentioned, the new "entrepreneurship law" included a chapter focused on capital with the creation of FONDCE. Even if inspired in the Mexican fund of funds model, it was executed in a quite different way. It had the status of a program dependent of an undersecretary (a third-level unit within a ministry), rather than being structured as an independent corporation, or at least as a program dependent of a financial institution. An officer in the undersecretary that led the law and the implementation of the program identified their lack of autonomy and capacity as a key limitation:

> *In an ideal situation we need to have an autonomous agency. We need FONDCE to be outside the bureaucracy of the ministry. You end up fighting all day with the ministry's bureaucracy, from human resources to IT issues. Being inside the ministry is a limitation. It is very difficult to bring people from outside. This sector needs a flexibility and technical expertise that you don't have inside the state, it's a very niche market. Definitely, in the medium term we need to go towards a more independent structure. And the model we are most interested in is the Mexican fund of funds. Still, we would do their inverse path. They started with big funds and then went down to earlier stage, we started small and hopefully we can grow together with the industry.*

FONDCE it is not a source of permanent capital, nor it is committed to have several rounds of funding, it has resources for only one round. It lacks any dedicated personal or professional staff other than those in the undersecretary, and the invested fund managers were selected by an outside

committee composed by industry participants.[116] Together with some accelerators and incubators, it granted capital commitments for $12M to each of the three winning funds. This amount could represent up to 40% of the fund: i.e. the winners had to get at least $18M from other sources. The small size of the program attracted only small funds oriented towards tech start-ups that may expect to get some additional funding from some multilateral institutions, and possibly other public and private sources. Different than in all the other countries, the program is not oriented towards mid-market PE funds that could have a broader sectoral reach. FONDCE's low bureaucratic hierarchy together with its lack of autonomy and dedicated staff hinder the continuity of the program. Talking about this program, an active participant in the local association, who was also involved in its design told me:

> *I would have liked it to be at least 10 times the actual size, so it can really make a difference. This can only work from VC downwards. It is too small for PE, completely out of the range. [...] The law only approved the budget for one round of financing. Once it is invested, it is over, there is no more. You would have to go again and ask for a new item in the budget law.*

Moreover, given the pension funds void, the government pressured to tap on insurance company's balance sheets as a source of institutional capital. In more developed markets insurance companies are certainly a relatively significant source of funds for the private capital industry. But they are always behind pension funds, who have a more natural fit to the asset class given their much longer time horizons. In Argentina, the insurance market is quite small and atomized,

[116] The FONDCE trust is administrated (not managed) by BICE, a publicly-owned second-floor bank focused in financing import-export operations, that the Macri administration was trying to re-haul into a development bank (plans to do something similar to what they did with FDN in Colombia) although for the moment there has been no major changes and its activities are restricted to its more traditional, and quite limited, second-floor lending business.

fragmented between a lot of small—and some of them quite informal—companies. In August 2018, the same unit in government in charge of FONDCE achieved a change in regulation that allowed insurance companies to invest up to 1% of their balance in the tax-incentivized entities introduced in the entrepreneurship law. If fully utilized, this would mount to a maximum of around $100 M, a scant sum, especially in an environment with virtually no other source of domestic institutional capital. As expressed in interviews with people from the industry that were trying to tap this money, these funds can at best be used to support a tax-incentivized corporate venture program targeted towards the insurance industry ("insurtech"), with a strategic (plus marketing and promotional) goal rather than with a stand-alone investment rationale. Furthermore, it is unclear whether this capital could be effectively mobilized, even for this more narrow purpose.

Finally, the fate of PPP projects related to highways through which the government first launched this new contracting model, is also quite telling. Even if they were actively targeted, there was an absolute lack of interest from financial players as sponsors of the projects; instead, winners were closely-held incumbent construction companies that already managed some of those road concessions, most of them involved in the corruption scandals with the previous administration. This, together with the macroeconomic and financial volatility the country experienced since 2018 precluded the project's financial closing (except for the projects that had Chinese support). At last, the government tried to revive the projects by anchoring private investors with further public resources and pushing for heavy multilateral support, and still could not achieve any success.

The Argentinean case certainly seems to be better explained by more standard institutional arguments: chronic experience of expropriation paired with macroeconomic instability are certainly not conducive towards development, financial and more generally. Still, two arguments can be pushed. First, the parallelism with Brazil is quite revealing. Up to the extent that both

countries experienced similar investment trends in the 90s followed by a macroeconomic crisis, and had governments with similar political orientations in the post-crisis, it is not that obvious Argentina's underdevelopment is only a function of its macro political and economic environment. The lack of public support both in terms of investments and regulations, paired with the absence of pension engagement with the very incipient community of fund managers, also seem to be factors that explain the post-2000 divergence. Second, the 2015-2019 pro-business government who prioritized an investment agenda and embarked in institutional reform, still had limited impact. The counterfactual is certainly hard to make, but even before the mid-2018 currency crisis, there were no great results in terms of the participation of new financial players, local or international. Beyond solving its more basic macroeconomic issues, even with the political will to promote the sector, it seems clear that without any active domestic—public or private—institutional investor, it is very hard to expect a more dynamic capital market going forward.

4.3 Discussion

After scratching the surface of each country's private capital environment, it is clear there is no policy-free path towards a more institutionalized private equity market. In each of the case studies presented above, and in addition to multilateral initiatives, there is a set of policy-initiatives specifically aimed at promoting this asset class. Crucially, as part of their role in incubating the emergent industry, these policies include the direct supply of capital from government-related investors to privately-managed funds and companies. This was the focus of this chapter, the next one explains more thoroughly how these same actors pushed for the regulations that institutionalized the sector.

The presence of state-related financial institutions in private equity markets is by no means

a particularity of the Latin American cases. Quite the contrary, in Latin America the role of state-related financial institutions is much more limited when compared to cases in Asia and Europe. As I discuss more thoroughly in Chapter 6 when exploring the validity of my arguments outside Latin America, even if the different programs described above certainly have many limitations, the state's potential counter-productive role can hardly explain the overall region's relative capital market underdevelopment. As Chapter 6 argues, what distinguishes Latin America from other regions is not if they exhibit public support, but its extent and form.

However, it is important to clarify the argument I am making does not assume that state-related financial institutions are always effective, nor that bureaucrats have better capital allocating capabilities than the market. Indeed, these programs certainly face many trade-offs (as I discuss in the brief appendix below) and many of them indeed go wrong and waste taxpayers money (Lerner 2009). Instead, the point is that without public support, it is very hard to come-up with a local private capital industry.

The role of state-related financial institutions pushing for private capital investments is somewhat counterintuitive. As I discussed at length in the theory chapter, the literature on financial development sidelines the role of the state and policy. Mainstream financial development literature does not go very deep into the role of financial intermediaries either, and just focuses on the institutional features that protect external investors from being expropriated, both by the state and corporate insiders. Its policy implications, if any, are related to legal reform. And the older literature on state and finance, connects public interventions in national financial systems to bank-based models, and equates more active equity markets with less interventionist, more liberal political economies. Private equity is often characterized as the ultimate expression of financial capitalism and the hegemony of the shareholder-value model (see for example, Appelbaum and

Batt 2014; Hall and Soskice 2001), at odds with an active role for the state in the economy. Moreover, businesspeople and practitioners, are also many times surprised by these less visible forms of state involvement in the asset class. Still, by simply observing that the state participates as an investor in this emerging sector, even if suggestive and theoretically puzzling, is in not conclusive evidence of a causal connection.

The cross-sectional evidence, even with the limited number of cases I have, is also in line with my main hypothesis that emphasized, first the incubator role of development financial institutions, and then the engagement of local pension funds for developing a local private capital industry. As showed above while reviewing the cases and discussing the role of each institutional investor, in particular those related to the state, the intensity of their engagement with the asset class varies quite a lot. Overall, after examining the trajectories of the main Latin American countries during the last two decades, the cases support the hypothesis that where there was an earlier and more intense involvement of institutional investors in the asset class, the—broadly defined—private equity market is more developed (Brander, Du, and Hellmann 2015). In Brazil, BNDES, together with FINEP and other state-related financial institutions have invested directly and indirectly in private equity for a relative long time. They have participated in every segment of the market, and arguably encouraged the pension funds to join them. And, with all its problems, and now exhibiting a more internationalized profile, Brazil is in this realm by far the most consolidated market. In the opposite side, Argentina, without any significant public or private institutional investor, remains the most underdeveloped market.

This is still not conclusive evidence. Policy may function reactively, and the state could simply bandwagon the emergence of the new actor. But as I tried to make clear in each case, the timing of the cases provides some further support to my institutional investor-based argument. By

process tracing the main milestones in the history of the institutionalization of a domestic private equity industry in each country, the development of the sector appears to follow the policies to promote it. Moreover, it also makes clear that state-money can hardly work alone (Brander, Du, and Hellmann 2015). Creating the channels that connect large pools of capital with real-economy projects in a sustainable way is they key policy challenge. Indeed, the engagement of pension funds seems to be the crucial step to create a local private capital industry. Mexico is the clearest example of the two successive stages, where a state-owned fund of funds paved the way for the entrance of privately-managed pension funds. In Brazil, public-sector investors working in tandem with pension funds also arguably helped the industry grow; even if after the latest political and economic crisis, local investors were replaced by international investors. In Colombia, the industry grew quite quickly with the involvement of the pension funds, although the very limited number of pension fund managers jeopardize the sustainability of the industry. In Chile, despite the quite significant—and somewhat surprising—state support for the emergent industry, the limited engagement of pension funds has crucially limited its scale. And in Argentina, despite recent political will to promote the sector—and notwithstanding its serious institutional handicap that certainly explains a big part of the insignificance of its financial markets—the lack of any active institutional investors also appears to limit the development of the sector quite structurally.

In order to get access to these institutional sources of capital and operate smoothly, the nascent private capital industry also requires to advance with a specific set of regulations that help institutionalize the sector. The key question that remains open is the one about the actors that push for these regulations. The next chapter goes deeper into this discussion, and lay out the politics behind the most important regulations that shaped the sector in each country. Doing so, it emphasize the more political role of a group of asset-specific business associations.

4.3.1 Appendix: Trade-offs

This chapter suggested it is very difficult to develop local private capital markets without the active support of development financial institutions and the engagement of local pension funds. Still, both government investors and pension funds face significant trade-offs when investing in domestic private equity. To encourage disciplined risk-taking for both pension funds and the state while maintaining investment discipline is a non-trivial challenge. Below, I discuss some of them.

When state-related money tries to anchor further external investment in private funds, it is in no way clear that the incentives of both types of investors are aligned. The state is not necessarily—in practice but also theoretical—interested in maximizing profitability but "social returns." The co-existence of commercial and non-commercial priorities can generate multitude of instances of potential conflict of interest between development financial institutions and its private co-investors.[117]

For policy-oriented investors there is also a tension between direct and indirect investment strategies, in particular when the purpose of the intervention is to develop "the market" and not just to incentivize a particular sector. Beyond state's trade-off between good governance and control when deciding to invest directly or indirectly, direct strategies may crowd-out other private managers, in particular if the state invests directly in the same market segment than other private investments firms. Direct PE investment strategies, can hinder the development of private fund managers and, in turn, inhibit the emergence of a more competitive asset manager's landscape. Moreover, if the same institution is providing a company with both equity and debt capital (as, for

[117] An executive from a top Brazilian PE firm that had at some point on his career worked in BNDESPAR explained what he called the catch-22 of development banks: their only point is to make things the market won't do by itself, but then they are evaluated on a market-basis.

example, BNDES often does), the potential for conflict of interests multiply.

The agency problems faced by state agencies investing directly are well known.[118] Some of these issues can possibly be ameliorated when investing through third-party privately-managed fund that pair state-money with outside investors. Still, even when DFIs invest through outsourced managers, the organizational capabilities/ pre-requisites still seem to be significant. Investing through third-party funds still requires selecting the right managers, performing due-diligence of funds, and then monitoring their investments. This arguably requires less capabilities than investing directly and "picking winners," but still requires significant scarce private capital-specific skills. It requires recruiting, promotion and compensation structures that allow bureaucrats to take investment risks but not go rogue. Similar challenge also applies to pension funds when engaging with this new asset class.

The involvement of pension funds and their regulation also faces its own trade-offs. First, and more fundamentally, it is not pension funds main role to develop capital markets, but to secure pensioners the best possible retirement for which most importantly. In order to do so, they have to prevent expropriation from governments. Beyond this more basic issue, pension funds face a trade-off between an inwards-oriented domestic focus, where local investors may have an informational advantage, and diversifying risk by investing internationally. Moreover, conservative regulations that intend to protect pensioner's savings, many times do not generate incentives for differentiation across pension fund managers, limits competition and disincentives risk taking.

Pension funds are under a lot of public pressure to reduce commissions, which affect pensioners' savings in a more direct and immediate way than the potential long-term benefit they

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[118] Brazil could illustrate how through state's involvement as an investor, public resources can be diverted for political benefits and the proliferation of cronies. Even more grotesquely, see the 1Malaysia Development Berhad scandal.

could receive for allocating capital in a more risky—but also higher-fee—assets such as PE funds. Passive "index" investing certainly help economize fees. And pension fund consolidation, aiming to achieve scale economies, is another way to reduce commissions. But the increasing concentration of pension funds in just a few players in each country is certainly very problematic for the development of capital markets. There is no possible market with just a handful of players.

The small size of the local markets, with very few participants, should drive a more integrated regional market. In Latin America there have been attempts in this direction, starting with the integration of formal stock exchanges. Most interestingly, the MILA market intends to integrate stock markets in Chile, Peru, Colombia and Mexico. But integrations efforts for the moment have achieved scant results; it seems to be very difficult to harmonize complex regulations across these countries.

Private equity is by definition a more risky industry and some investments are quite likely to fail. Fund of funds that diversifies across different funds—that in turn diversify across different companies—can arguably help ameliorate risk and obfuscate some of the likely failures. Still, it is very hard for bureaucrats, as well as for pension funds, to stomach losing taxpayers and pensioners' capital, respectively. Headline risk is often mentioned as another important factor limiting risk-taking.

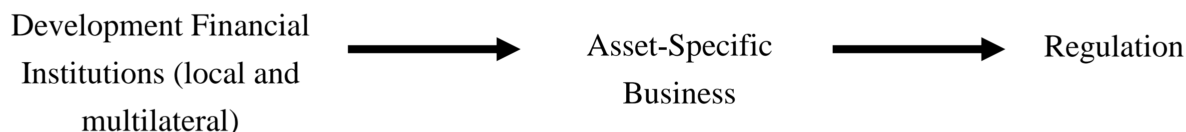
Chapter 5 - Business Association and the Politics of Regulatory Reform

The previous chapter introduced the dissertation's five country case studies from the investors' perspective. It presented the different roles played by state-related institutional investors incubating an emergent private capital industry,[119] highlighting the involvement of domestic and multilateral development financial institutions, who in some cases, were followed by local pension funds. This chapter identifies the actors behind the institutionalization of the industry. To do so, it focus on how the nascent industry organized and pushed for regulations that allowed fund managers to tap into pension fund resources, helped create tax-incentivized investment vehicles, and claimed legitimacy for their investment activities.

Regarding the politics behind the emergence of this new industry, and in contrast to macro-coalitional explanations common to most of the literature on corporate governance reform, I advance a "quiet politics" approach. I emphasize the role of a group of asset-class-specific business associations and make a two-step argument, outlined in the diagram in Figure 16 and developed throughout the chapter. First, I explain how, in most of my cases, these business associations were created through the public-private collaboration between different public agencies, multilateral institutions, and industry participants. And then, I show how these asset-class specific associations lobby for favorable regulations that help institutionalize a domestic private equity industry.

[119] I refer to private capital to include all private capital sub-classes (e.g. VC, PE, infrastructure, private debt, etc.).

Figure 16: Two-Step Argument



Chapter 4 dealt with the policies that addressed directly the supply of capital into funds and companies. This chapter shows how development financial institutions (DFIs) also tried to advance a workable regulatory framework for the industry. Examining the organizational and regulatory side of the emergent private equity industry will make clear that “incubating” policies are not limited to providing capital but also include helping the industry organize and pushing for specific pieces of regulation. In contrast to arguments that forefront rules rather than actors, at least at the micro-level, the regulatory framework appears endogenous to the players, who try to mold the rules under which they play.

This chapter is organized in the following way. First, it briefly recaps the dissertation’s main theoretical contributions regarding the political economy of corporate governance reform in a developing context. It contrast my quiet politics hypothesis with alternative approaches prevalent in the literature, and discuss business associations in finance. Then, it introduces the role of multilaterals and go into each of my five country case studies to provide evidence on the two main empirical steps outlined in Figure 16. The last section of the chapter, discusses my main findings and draw some conclusions.

5.1 Quiet Politics Agenda

In order to explain the regulatory process that enabled the institutionalization of a local private capital industry, I advance a quiet politics approach (Culpepper 2010). In low saliency and technically opaque policy areas, such as those related to corporate governance, Culpepper argues

that managerial organizations, given their superior knowledge and technical lobbying capacity, often have an advantage. Different from more visible policy domains such as taxation or pension system reforms where outcomes are more closely tied to the dynamics of electoral politics, corporate governance issues, while they stay under the public radar, would enjoy some autonomy from the electoral and legislative arenas. Outcomes, therefore, in general would tend to follow managers' preferences. While my findings mostly agree with the description of Culpepper's policy domain, the key protagonists are different.

The main regulatory milestones that enable the institutionalization of a private equity industry indeed appear to follow a quiet politics dynamics. The type of reforms are typically quite technical and remain outside the scrutiny of the larger public. Lobbying is less centered on money than in expertise, and alignments do not appear to be related to big societal coalitions. Regulatory change usually comes through small, incremental, administrative-level reforms across different governments instead of through a salient public milestones, such as a law sanctioned by Congress backed by a well-defined societal or partisan coalition. Congress is purposefully avoided, and is in general an insurmountable obstacle; when regulation goes through Congress, in general they do so as a part of a larger legislative package pushed by the executive.

Culpepper's quiet politics approach, similar to the larger macro-coalitional literature on corporate governance reform, puts managers, together with labor, large shareholders and institutional investors, at the core of the analysis. This could be reasonable to explain reform in already developed economies. In particular, the shift to a more active market for corporate control in advanced countries, for example in continental Europe, where a professional class of managers and powerful external shareholders already existed before the reforms they arguably lead. But, as

I argue, it is less useful when trying to explain the emergence of a new industry. Managers' existence as an autonomous group cannot be taken for granted in the case of emerging economies such as those in Latin America, where firm's typically lack external investors and ownership is mostly concentrated in individuals and their families. There is, therefore, no clear separation between ownership and control, and less space for autonomous management. As discussed in the theory chapter, it is hard to make a theory in which managers are at the same time the main protagonists of reform, and the outcome of this reform.

A common trend across my cases, fund managers' business associations emerge with the strong support from specific public agencies. These private-sector associations, in turn, represent the industry to broader audiences, some of them outside the state, but most importantly, serve as the private-sector counterparts of both their sponsors and other state agencies (e.g. securities and pension system regulators, tax authorities, development banks, etc.) and push for a regulatory framework that allows the industry to develop.

Even taking into consideration the sector's small size and the technical nature of its main regulatory interests, the quiet politics arena is not always its natural setting. This is in many cases an explicit strategy of the actors who actively choose to keep their policy working space "quiet," even at a cost. Going through my country case studies, it is clear that circumventing Congress is in many cases a costly strategy. This is, for example, the case of Mexican CKDs,[120] a publicly-listed private capital vehicle described by many as a "Frankenstein," that nevertheless allowed the industry to fundraise from pension funds without changing the law that regulates the pension

[120] *Certificado de Capital de Desarrollo*

fund's investment regime. Similarly, Brazilian FIPs,[121] that even though having a weak legal standing and loosely-defined liabilities, have been incrementally upgraded through administrative-level regulations, while allowing the industry to avoid getting involved in larger and more partisan politics. These business associations, while more seasoned navigating the narrow technical arenas of financial regulation, have a harder time when addressing larger audiences and trying to go through Congress.

Some level of macroeconomic stability and a government aligned with promoting private initiative and developing capital markets, indeed, appear to be a necessary condition for the development of the industry. Still, as I discus in the theory chapter as well as in Chapter 3, the outcomes I observe do not fit well with a set of alternative explanations that come from the main prevalent hypotheses in the literature about corporate governance reform and financial development. Schematically, I discuss two main strands of arguments, institutional and societal type of hypothesis, developed at length in Chapter 2.

The institutional literature on financial development has, at its core, minority shareholder protections and property rights more generally (La Porta et al. 1998). Regarding the legal origins argument, that highlights the origins of each country's legal system as the key long-term determinant of the depth of its capital market, it is important to recall that given their common colonial past, all these countries share the same legal tradition. Currently, minority shareholders protections are not that different across cases, as shown in Chapter 3. And the most important regulatory instances that helped the industry emerge dealt with issues different than minority shareholder rights. As I advance through the chapter, within certain boundaries, rules appear to be

[121] *Fundos de Investimento em Participações*

malleable and endogenous to the industry's actors. Moreover, and at least for the specifics of the private capital industry, overemphasizing the importance of minority investor's protections seems misplaced. While these provisions are central from the perspective of an atomized and passive investor, they do not seem to be as relevant for private equity investors. Even when private equity investors go into companies by investing in minority stakes (i.e. without complete control, usually the case in VC and growth equity investments), they still acquire concentrated stakes, many times as part of the controlling groups,[122] and have the capacity and the incentives to monitor their portfolio firm's management and other shareholders. Moreover, important contracts between large shareholders are typically made under foreign jurisdiction, and therefore supersede national laws. Regarding property rights and "ease of doing business" more generally, again, they can hardly explain all of the differences across my cases nor their timing. Brazil, who scores low in most of these variables, is where the industry exhibits more dynamism, while in Chile, the more stable and institutionalized country in the region, it shows relatively lower levels of development. And as the Mexican case shows more clearly, the reforms that make the industry to grow are more related to the investment regime of pension funds than to changes in corporate law.

Different governments certainly bring some nuances in their approach to the private capital sector. Still, in most cases, the policies are quite stable through changes in administration. Within my limited sample, I find that variations in government partisanship or big societal interest groups coalitions, the actors behind societal hypotheses, do not have a good explanatory capacity either.

As I show, the regulations and policies important for the private capital industry are quite

[122] In most cases shareholder agreements between different shareholders are enacted under foreign law, therefore enforceable on a foreign jurisdiction with legal systems different from the one in the host country.

far from the electoral arena and tend to remain outside of Congress. This dynamic is therefore hard to reconcile with the mechanisms behind arguments based on electoral rules and median voters (Pagano and Volpin 2005), nor more generally with arguments about the association between democracy and financial development (e.g., Girma and Shortland 2007; Menaldo and Yoo 2015). I could not find evidence on the direct involvement of labor in this type of arena. Even if I do not consider the details of the mechanisms through which these casual hypothesis would work, the configuration of my cases is still not consistent with some of the main hypothesis of the literature. Labor is certainly an important actor within corporations that can limit corporate decision-making and therefore inhibit the entrance of a particular type of external investors into companies. But the relative ordering of the countries I study is at odds with the hypothesis that could be extrapolated from labor-based arguments (Roe 2003). For example, in Brazil, where labor is comparatively stronger, it is where this model has evolved the furthest, at least with respect to its regional peers, with weaker labor. Beyond class-based explanations, coalitional arguments (Gourevitch and Shinn 2005) are also problematic, since the main participants of these coalitions are either weak or inexistent. Labor is rarely aligned with advancing financial markets, nor capital-owning pensioners become "neoliberal" voters (Kerner 2018). As mentioned, managers, the main actor that could be pushing for reform, are, at least at the beginning, basically inexistent as a group. And institutional investors, particularly pension funds, are in several cases the recipients but hardly the initiators of many of these policy initiatives. Overall, as I explain throughout the chapter, the development of the sector appears to be better explained by the actions of bureaucrats and fund managers organized into asset-specific business associations.

5.2 Private Equity Business Associations

Over the last two decades, a group of industry-specific business associations that represent

the nascent private capital industry emerged across Latin America; Table 8 summarizes their main characteristics. The similarity between these associations across the cases is both empirically surprising and theoretically interesting. At first glance, business associations in finance may appear to be an anomaly. Financial investors are expected to have significant structural power, lack a specific sectoral embeddedness and enjoy high mobility. Therefore, they are expected to "exit" more often that exercise their voice options (Campello 2015; Fairfield 2015).

If business associations in finance are in general theoretically unexpected compared to other sectors, they are much more so in the private capital segment. In order to protect retail investors and reduce information asymmetries, public capital markets and banks are much more extensively regulated than private capital market. As a response, we can expect participants in these two segments to develop strong business organizations. As its name indicates, the private capital segment is defined in opposition to public markets, it is outside the reach of retail investors and therefore tends to operate at the margins of regulator's oversight. But even though substantially less regulated than other financial activities, it still requires significant regulatory efforts in the legal corporate structures and tax realms to be able to operate smoothly, as it will be clear throughout the rest of the chapter. For example, and developed with some more detail below, it requires specific types of investment vehicles, friendly liability and tax provisions in line with international standards, and rules granting fund managers access to institutional investor's investment regimes, among others.

For the specific case of private equity in Latin America, a prospective association has to overcome some additional challenges. Even if the sector is small and participants many times know each other (Pandya and Leblang 2017), collective action is not spontaneous nor obvious to emerge.

It is an industry that until recently barely existed, local managers are small and compete for scarce funding sources, and foreign investors, who usually pioneer the industry have little incentives to participate in a local association. As I show throughout this chapter, the emergence of new industry-specific associations of fund managers is better explained as an instance of public- private collaboration. As part of their policies to promote this new financial player, and in order to advance their agendas, government agencies and multilaterals helped business organize.

While insufficient public sector capabilities is certainly a recurring problem in productive policymaking, strong industry associations are usually recognized as key necessary partners to successfully implement sector-specific vertical policies (Fernández-Arias et al. 2016). Organized private counterparts can bring both technical expertise and legitimacy. Though promoting business association organizations is not generally openly recognized as an explicit policy goal, public-private collaboration in productive development policies can also consists of more political and organizational tasks that include solving the industry's collective action problems. This is clear in most of my cases, where the state agencies introduced in Chapter 4, together with IDB's MIF, had a key role helping organize the nascent fund management industry.

State involvement in the private sector's organization clearly resonates with the literature about business association in Latin America, in particular with Schneider (2004). Offering a much broader historical approach, the focus of this book is on large, encompassing business associations that emerged throughout the last century. Crucially, it shows that state actors are the ones who sought to organize business in periods of economic and political crisis. They do it by providing selective benefits to the participants, sometimes in the form of material resources, but usually as privileged access.

While the type of associations I focus on is much narrower—specific to the fund managers of a particular yet-to-be-developed asset class—the evidence is remarkably in line with Schneider's key insight about the role of the state behind business associations. But interestingly, my cases are in sharp contrast with the broader macro-level evidence about business associations' strength in Latin America. For example, while Brazil is characterized as a case where big business is weak, and Chile as a country with powerful and well-organized business, the opposite seems to be true in the industry specific business associations that are the main objects of this chapter. Brazil has the most institutionalized private equity association in the region, while in Chile, the representation of the sector is fragmented and relatively weak.

The main goals of these associations are consistent across my cases. Access to institutional money from both the state and pension funds is typically their number-one priority. Second, these associations lobby for specific pieces of regulation. For example, to introduce investment vehicles appropriate for private-equity investing into local legislation, to make those vehicles tax exempt, and to relieve investors from different types of liabilities (e.g. tax, labor, environmental, etc.). Last but not least, they promote their industry and help legitimize it among the business community and the broader public.

Regarding their operations, these associations typically have a full-time executive director who coordinates the organization's work and manages the relationship with its members and external stakeholders. As it can be observed from Table 8, in some cases executive directors are supported by other staff. They are usually involved in research, PR and communications roles, and among other activities, coordinate events, manage partnerships and generate publications. For more technical work and lobbying activities, associations have different working commissions that

involve the direct participation of the members of the association, both the fund managers and the industry's service providers (e.g. law and accounting firms). Operating under an organizational umbrella grants them access and helps legitimize their interaction with policymakers and regulators.

Table 8: Asset- Specific Private Capital Business Associations

Country	Association	Year Founded	IDB Program	Members (#)	Staff (#)
Brazil	ABVCAP	2000	Yes	150	14
Mexico	AMEXCAP	2003	Yes	110	13
Colombia	COLCAPITAL	2012	Yes	46	6
Argentina	ARCAP	2004/2015	No	27	1
Chile	ACVC	2017	No	14	1
Regional	LAVCA	2002	Yes	150	9

Source: Association's webpages, IDB Lab, interviews; as of 2018.

These associations provide a combination of public goods for the industry (e.g. regulations, fundraising channels, etc.) and private benefits to their more active participants. While there are many reasons why it makes sense for individuals to participate, it is clear that the association allows their participants have a more fluent access to the state agencies that are the gatekeepers of funding sources, the ones described in Chapter 4. Besides facilitating access to capital, being closer to rule-making can also provide additional benefits. While local and smaller investors with less funding alternatives have more incentives to participate, the local management teams of international firms are many times also involved in these associations. There is a lot of turnover of executives between firms, and it is quite frequent that those working for an international firm later join a local firm, or open their own shop. Therefore, staying close to fundraising sources and rule-making can also boost their career paths.

In sum, business associations created through public-private collaboration appear to play an active role in the development of a domestic private equity industry, taking a "quiet politics" approach to regulatory reform. Throughout the rest of the chapter, and relying mostly on my primary research, I providence evidence of the two-step argument focused on the origin and role of these business associations. To do so, I first introduce the role of multilateral development banks. Then, I dive into my five country case studies, explain how the organizational dimension is related to the outcomes described in the previous chapters and discuss how my main hypothesis applies to each of them.

5.3 Multilateral DFIs

Chapter 4 showed how a group of multilateral development financial institutions (MDFIs) contributed to the emergence of private equity across the emerging world, acting as core investors in multiple funds. Some of these multilaterals also played an important institutional-building role. In Latin America, this is particularly the case of IDB's MIF.[123] While its equity investments are small and focused mostly on early-stage funds, it had a very active environment-building role across all segments of the industry. Particularly interesting, MIF sponsored the creation of the regional private capital business association, LAVCA,[124] as well as most of its analogous associations at the national level.[125]

MIF's was created during the 1990s at a time when multilateral financial institutions were

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[123] IDB Multilateral Investment Fund (MIF), renamed as IDB Lab.

[124] Latin American Venture Capital Association, now renamed to the Association for Private Capital Investment in Latin America.

[125] As discussed in Chapter 6, other regional-level associations analogous to LAVCA also appear to have its origin close to multilateral organizations. For example, in Europe (Invest Europe) and in Africa (AVCA). Most importantly, World Bank's IFC together with other multilateral financial institutions sponsored EMPEA, who groups the largest and most prestigious fund managers operating throughout the emerging world. This also suggest a competitive dynamic among multilateral development banks.

active promoting market reforms. In this spirit, MIF aimed to expand access to financial markets. Their pioneering support to private capital ecosystems was framed around broadening access of equity capital to SMEs and promoting entrepreneurship and innovation. As part of their activities to promote the risk capital industry, in several of the countries they got involved, they tried to organize the sector. While MIF's and the association's narrative is more focused on entrepreneurship and innovation, and therefore more related to venture capital, as explained, policy requirements are very similar across the different private capital segments. While associations are usually led by larger PE funds; private equity, venture capital, real estate and even infrastructure funds, while different in their underlying assets, have the same legal architecture and fundraising channels. Therefore their managers share some common policy goals.

The first of several multilateral "institutional-building" programs was in Brazil. As part of the *Inovar* program in the late 1990's, where IDB partnered with FINEP, these two organizations sponsored the creation of ABVCAP, the Brazilian private capital association (Leamon and Lerner 2012; Viveiros 2017). An officer from MIF told me about the rationale behind their support for business associations:

> *When entering a country, as one of the first actions to help develop the local ecosystem, we decided to support the creation of a local association. Our idea is to go in, develop and exit. Our support is transitory, and business associations are important to make the market self-sustainable, they can play a key role in that. For example here in Brazil, ABVCAP was from the beginning thought of as part of our exit strategy; so they could develop the market by themselves. LAVCA was created with the same mindset.*

Even though MIF partnered with the associations by providing funding and advice, they

arguably kept a hands-off approach and did not participate in them directly as members. Instead, they prioritized the protagonism of fund managers, above other industry participants such as service providers or investors. In words of the same MIF official:

> *We don't tell ABVCAP or any other organization we sponsor what they have to do, never. We are not members of the association. Of course we can give some advice on specific topics, but it's an organization of funds managers. That has to be very clear!*

Following the Brazilian experience in the early 2000s, IDB's MIF also sponsored the creation of a regional-level industry organization, LAVCA. Based in New York, its role is less lobbying local regulators directly, and more representing the Latin American PE industry with global institutional investors. In order to do so, for example, they organize several events where they bring together potential investors, fund managers and service providers. They also help with policy advocacy and collaborate with local associations. They generate guidelines and recommendations on a variety of regulatory issues, organize trainings, and consolidate data on the industry. Additionally they offer a number of services to its members for a fee.

While still under the umbrella of IDB's MIF brand, LAVCA has gained considerable autonomy since its founding, when, just to illustrate its closeness with IDB, its flagship annual meeting was part of IDB's annual meeting. LAVCA's most active members are regional funds, and, even if there is a bias towards larger funds, it still has representation of each asset sub-class (e.g. venture capital, growth, real estate, buyout and infrastructure).

The stability of multilateral's staff and programs, less impacted by changes in each country's administration, allows them to function as a more permanent counterpart for the

emerging industry. Its more detached status, arguably made its support for industry's collective action also more legitimate. Multilateral's sponsorship of business associations is quite transparent—even publicized—as opposed to the rather opaque relationship between business associations and domestic public agencies.

Support from IDB's MIF was typically in the form of non-reimbursable grants for technical cooperation under a matching scheme. For each dollar the multilateral fund contributed, the association needed to obtain another dollar from a third-party. As I will show throughout the case studies, these programs' local counterparts were many times public agencies, suggesting that the active backing of governments was a necessary condition for their implementation, this is also clear from my interview with the MIF official:

> *The support of the government to all these programs is key. We can only be successful when they are on board. Their strong support is a necessary condition!*

Therefore, while multilateral development financial institutions were key sponsors of local organizations across the region, there is a lot to be learned from the different country case studies. For each of them, I explain the origin of the local private capital business association, and its main characteristics. Then, I provide evidence about the role played by business associations in pushing for specific pieces of regulation, illustrating the quiet politics dynamics.

5.4 Country Case-Studies

5.4.1 Brazil

Brazil's private equity industry is the oldest and most institutionalized in the region. Beyond the country's more recent economic and political crisis and the controversies around the role of state-related pension funds I discussed in the previous chapter, most actors involved in the

industry agree that the regulatory framework under which they operate works well. This section explains how fund managers organized into an association and advocated for this working regulatory framework.[126]

As I mentioned in Chapter 4, the late nineties' *Inovar* program was central to the institutionalization of Brazil's private equity industry. Lead by FINEP and sponsored by IDB's MIF,[127] the program aimed to develop the risk capital markets in Brazil, to facilitate the access of new firms to equity financing. In order to achieve this goal, "the country needed entrepreneurs who understood how to raise funds and work with equity-owning investment partners, limited partners (LPs) who knew how to evaluate funds and what was involved in such vehicles; and general partners (GPs) who were familiar with selecting and managing companies and funds. In addition, an infrastructure had to be developed that included favorable tax regulations, a national private equity practitioners' organization, information sources on the industry and its performance in Brazil and globally, and a method to establish relationships between Brazilian and international private equity actors" (Leamon and Lerner 2012: 1). Crucially, one of the first "infrastructure-building" projects of the program was supporting the foundation of a local private equity/ venture capital association, ABVCAP.[128]

Founded in June of 2000 by a group of pioneer fund managers of local and international firms together with other public and private entities, ABVCAP was the first association of its kind in the region. It was created even before the regional association, LAVCA, which was actually

[126] Probably as a consequence of its longer existence and its higher level of institutionalization, there are even some secondary data sources available that I used to complement my primary research (e.g. Leamon and Lerner 2012; Viveiros 2017).
[127] Sebrae, a public-private partnership focused on supporting SMEs, and Petros, the pension fund of Petrobras, Brazil's national oil company, also joined the program.
[128] Originally called ABCR - *Associação Brasileira do Capital de Risco*.

modeled after the Brazilian experience. As the most institutionalized private capital association, ABVCAP has served as a model for the rest of the associations in the region, and collaborated with policymakers and fund managers across the region that intended to replicate the experience. It has the most numerous staff and resources, offices in both Rio and São Paulo, gathers proprietary data and organizes the region's largest industry meetings. While it is still related to a group of state agencies (e.g. Bndes, Finep and Apex) who fund major events, it has become increasingly self-sustaining, in particular after the more active involvement in the association of large international firms. Most importantly, as shown below, it has established a close working relationship with the key public agencies of its main areas of interest, in particular with the securities regulator, CVM.[129] And it even holds some self-regulatory capacities, as it is able to enforce governance best practices guidelines among its members.

Managers from global PE firms who source their capital outside the country are logically less interested in participating in business associations. This is also the case for investment firms with a broader focus that also offer asset management services for other asset classes (e.g. hedge funds and mutual funds). Yet, many of them are actively involved in the association and the internal cleavages between VC and PE managers, and international and locals firms are quite clear. The internal equilibrium, reflected for example in the composition of the board, has changed over the years, following the economic and political cycle as well as the availability of local funding. Leadership roles have shifted from managers of smaller local funds to managers of larger foreign firms. Still, the association has been successful in bringing on board all type of investors and has quite effectively bridged the gap that separates the "two worlds" of fund managers (i.e. those who

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129 *Comissão de Valores Mobiliários*, Brazil's equivalent of US's Securities and Exchange Commission (SEC).

fundraise internally and externally) that as Chapter 4 explained, characterize the PE industry in Brazil. As a manager of a smaller fund argued:

Before ABVCAP, private equity and venture capital, as an asset class was only available to the ultra-high net-worth individuals that could take the risks, navigate regulations, now it is a much more institutionalized and democratic industry.

In this line, a former president of the association, now managing partner of an international PE firm with an extensive track record in both local and international funds, confirms ABVCAP's role in institutionalizing the local industry:

It started mostly with smaller GPs that needed local pension funds since they had no access to international investors. They successfully achieved representation with local investors and the CVM. And they created an industry's regulatory framework that actually worked! All the regulation we have is because of ABVCAP: FIPs, tax incentives, capital gains that favor GPs, and many others.

He also describes the changing profile of ABVCAP's leadership:

At first it was mostly about local investors, big international firms didn't clearly see the benefit of participating. There were, of course, some exceptions. For example, Advent [the largest international PE firm in the region] was always active and supportive. […][A former president of the association and manager of a local fund] approached me in 2010, and told me that the large international PE firms needed to speak up and participate more actively. He was right, we were free riding the benefits of the association. For example, there was this big dispute about a 6% IOF [Imposto sobre Operações Financeiras] tax that would have killed the industry: they managed to reverse it very fast and effectively! We started to see the benefits of participating and got more actively involved in the association. And the organization gained sponsors, size, and legitimacy across the whole business community.

ABVCAP fulfils multiple roles, representing the industry with its different stakeholders. It functions both reactively and proactively, lobbies government agencies and leads PR activities. On the reactive side, its role can range from testifying in Congress during an investigation of corruption schemes that involved local pension funds to protect the industry's reputation,[130] to helping spin the interpretation of the tax code in their favor. I will briefly review three other examples where the associations proactively pushed for specific pieces of regulation, clearly illustrating its role in helping institutionalize the industry: the creation of FIPs in 2003, their reform in 2016, and its self-regulatory competences.

The first investment vehicle created specifically to facilitate the development of the private capital industry were the FMIEEs.[131] Pushed by BNDES, they were launched in 1994 through CVM's *Instrução 209*. Aimed at smaller VC funds; they were not useful to structure more standard PE operations through them (Baltin and Bell 2001). Therefore, during its early years, the industry operated through offshore vehicles and/or more "expensive" local holding companies. A key milestone for the industry's development was 2003's *Instrução CVM 391* that created FIPs, *Fundos de Investimento em Participações*. Besides pushing for the creation of this new investment vehicle, several sources agree on ABVCAP's role providing input on the technical details of the regulation was crucial (Viveiros 2017:81).

Among many other provisions,[132] FIPs are fiscally transparent[133] investment vehicles that can be used to acquire a set of eligible securities of companies (e.g. common and preferred shares, convertible debt, etc.), of which they require to participate with effective influence on its decision-

[130] *Comissão Parlamentar de Inquérito (CPI) - Fundos de Pensão*
[131] *Fundos Mútuos de Investimento em Empresas Emergentes.*
[132] For details of the legal framework see for example ABVCAP's and LAVCA's reports on this topic.
[133] Flow-through legal entities; considered "non-entities" for tax purposes.

making process. Restricted to "qualified" investment professionals, they were designed to allow the participation of local institutional investors in the asset class, who were otherwise restricted to invest in listed securities. Moreover, they confer significant tax benefits to investors. While they encourage the participation of foreign investors by also granting them tax benefits, the portion of assets a FIP can have outside of Brazil is restricted to 20%.

FIPs proved to be efficient and flexible investment vehicles to support the expansion of the Brazilian PE industry that began in the mid 2000's.[134] And importantly, and quite differently for example from the Mexican case, it enabled the Brazilian private equity industry to operate mostly through "onshore" vehicles.[135] FIPs are registered and supervised by the CVM, and are required to regularly disclose financial information to the public.

In 2016, the regulation concerning the functioning of FIPs was significantly revamped through *Instrução CVM 578/9* that updated the 2003's rules. Among many changes, these two new administrative rulings clarified the different roles of fund managers and fund administrators, strengthened the corporate governance requirements for invested companies, classified different type of FIPs, defined valuation methods for financial disclosure and arguably discouraged the utilization of FIPs as wealth management trusts.

Beyond its specific content, the process through which change was introduced clearly illustrates ABVCAP's role. The update on FIPs regulation was, again, mainly mobilized by ABVCAP. This is evident from the public hearings documentation available at CVM website[136]

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[134] As of mid-2017, FIP's hold assets with a book-value worth more than $200 billion *reais*.
[135] Even if in many cases an international "offshore" fund functions as a feeder to local FIPs.
[136] See the registries of the public hearings from ICVM 578/9, where it is clear ABVCAP was the main input provider for the change in regulation.

as well as from interviews with people from both the association and the CVM. Recognizing ABVCAP as CVM's private-sector counterpart for the purpose of private investment funds, the regulators' structured investments division manager (who oversees FIPs), told me:

> *ABVCAP is very important for us. They led the initiative to change the regulation and modernize the management of FIPs. Before the public hearings, we had meetings with both ABVCAP and ANBIMA. There were some issues we disagreed on, but they were minor. ABVCAP raised many points in the public hearings, we accepted most of them. You can see the documents they presented, the end document and compare!*

Interestingly, beyond CVM's regulations, ABVCAP, partnering with ANBIMA, has also achieved some self-regulatory powers over its members. ANBIMA is a larger association that reunites all type of asset managers, mostly of liquid securities. Dominated by larger banks, their relationship with ABVCAP swings from competition to cooperation. In this case, they agreed in a set of standards for the industry and incorporated them into a code of "best practices" with which all FIPs managed by members of the associations must comply with. For example, the FIP's prospectus and the disclosure of financial information have to follow a common standard, and fund managers have to abide with certain corporate governance provisions. While adherence to these standards is mandatory only to members of the associations, in practice they impact the whole industry. The code also provides the associations with a supervisory role and the capacity to sanction wrongdoing, and there is some evidence that they actually exercise it. While CVM acknowledges the self-regulatory code, it has not delegated its supervisory authority, therefore in practice they both tend to overlap.

Even if the regulatory framework indeed appears to work, there are clear limits to the type

of reforms that can be introduced through administrative-level rulings or self-regulatory codes that do not require going through Congress. In particular, after nearly two decades of growth, the whole Brazilian private equity and venture capital industry is still basically based in FIPs regulations that have the legal hierarchy of an administrative act. FIPs, in turn, are based on the condominium law. Their structure is hard to interpret by unexperienced judges, and a key question regarding the liabilities investors face when their ventures go under remains unclear. Even if a law would give a much stronger legal sustenance, industry participants agreed that trying to go through Congress was either pointless or too risky. For example, while talking about the big controversy around local pension funds asking for a seat in the fund's investment committees discussed in Chapter 4, FINEP's official in charge of equity investments argued:

> *What would be more important is to pass a law! That would have prevented us from going into all these investment committee issues that damaged the industry. It would clarify who is liable for what. Given funds have no legal status of their own, if the company goes bankrupt, the creditors would try to go after the funds investors. This is why pension funds started to ask to participate in fund's investment committees in the first place. As you know, this became a big problem. I think we should have a law. While it has been in discussion forever, and everyone mostly agrees, it is impossible to pass a law. Not even BNDES can pass a law!*

On the private side, a corporate lawyer, active in the regulatory discussion agreed on the desirability of a law for investment funds:

> *In Brazil we need a law on investment funds, we need a law that gives the industry a more secure standing, now we are based on an administrative ruling!! It is not a very powerful instrument when you go to court. […]*

He also highlighted the risks of trying to push for an investment fund law and the reasons why they are more comfortable working directly with the regulator:

> *The quality of the guys in Congress is a big problem. We are not able to trust the legislative process. Once it starts as a law for investment funds, you don't know when nor where it will end up going. You start the process with a law regulating investment funds and end up declaring some holiday or a national festivity. Therefore from both ABVCAP and ANBIMA we prefer to deal only with the CVM. CVM can amend their own instructions, even if they are slow, it has a better speed. You have public hearings, and CVM is a good competent authority. Actually, CVM is one of the best public authorities we have here in Brazil. It has very good employees, they are very democratic and open. Instead, in Congress we would completely miss it. The level of interests that interfere with this process would be uncontrollable and unpredictable. One single law has the capacity to destroy a market, CVM doesn't. But still, we need a Federal law that states two and only two things: what is the legal nature of investment funds and who answers in each scenario. After having those two things clear, CVM should then take care of all further regulations.*

Interestingly, the CVM official in charge of the division that oversees FIPs also agreed with this perspective:

> *Sure, a law would be more than welcomed. We need funds to have their own legal structure, they can't be based on a condominium. There are lots of things today you can't do with a FIP, questions around liability and governance, many of them key when going into bankruptcy. […] It should be feasible to pass a law, ANBIMA and ABVCAP try to push for it, but it never moves forward. We would help, for sure. But it is way beyond us, this also involves the tax authority [receita federal], and the ministry of finance [fazenda]. I do not expect to see any progress in the medium term.*

As well as showcasing the limits of quiet politics, Brazil's case fits well with this chapter's two main arguments. First, ABVCAP, the region's oldest private capital association, is a good example of how this type of industry-specific business associations were created through close public-private collaboration. FINEP, together with IDB's MIF were key for the organization's foundation, which still keeps ties with several public agencies. Second, the case makes clear how the association pushed for a working regulatory framework that helped institutionalize the industry, even if bounded by the limits of quiet politics. The private capital industry experienced significant changes since the early 2000s, reflected in the changing profiles of the association's leadership, still the association helped bridge the industry's different cleavages and functioned as the private sector counterpart for the industry's different stakeholders.

5.4.2 Mexico

Absent Brazil's strong statist configuration, the role of state-related financial institutions funding private equity in Mexico make the case more interesting. The Mexican case provides some leverage to my argument about the incubating role of the development financial institutions described in Chapter 4. On the regulatory side, it also illustrates my arguments well. As in several of the other cases, we observe the emergence of a specialized business association that groups PE investors, supported by both state-related investors and multilateral institutions. In turn, this association plays an important "quiet politics" role as the private sector counterpart for key regulations that allowed the private capital industry to take off. For example, in the creation and update of CKDs, the instrument that allowed pension funds to allocate capital to private capital funds.

Officially founded in the early 2000s, different sources agree that the Mexican private

capital association, AMEXCAP, took off with the support of *Fondo de Fondos* (FdF), Mexico's fund of funds, owned by several of the country's state-owned financial institutions. While there is no public information about the relationship between FdF and AMEXCAP, since both of them operate as private entities with no disclosure requirements, from the AMEXCAP side they agree that "*as the only institutional investor in Mexico's industry, it was for sure, one of our most important sponsor.*" Another senior interviewee, knowledgeable about the private equity's organizational landscape across the whole region confirms: *"FdF put a ton of money in AMEXCAP."*[137] Besides FdF, AMEXCAP also received multilateral support from IDB's MIF and other state entities such as INADEM.[138]

Starting as a gathering mostly for mid-market PE fund managers, the association has grown together with the industry. It was staffed with around a dozen employees, and organized around the different asset sub-classes (e.g. VC, mezzanine, PE, real estate and infrastructure). Besides organizing events, gathering information and creating promotional materials to socialize the private capital model, AMEXCAP most importantly represents the industry and coordinates its lobbying efforts in front of different governmental authorities. As a senior fund manager while complaining about the regulatory framework, expressed:

> *Amexcap role is to put forward all the frustrations that we have as fund managers to authorities and regulators and push for solutions. So far, even if progress has been slower than I could hope for, it had a positive impact.*

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[137] AMEXCAP started taking care of certain promotional events previously organized by FdF directly. More importantly, it is quite suggestive that FdF and AMEXCAP were, at least as some point, located in the same building, with just one floor of separation between them.

[138] *Instituto Nacional del Emprendedor*, a decentralized agency created in 2013 and dependent on the *Secretaria de Economía*, closed by AMLOs government. Interestingly, the current executive director of AMEXCAP was formerly INADEM's director for VC funding.

The logic behind the introduction of CKDs exemplifies the quiet politics dynamic of financial regulation. As last chapter argued, the introduction of CKDs granted fund managers access to pension system resources, and was repeatedly identified as the industry's key milestone (Leal and Del Sesto 2013). Talking to a senior fund manager, he highlighted the role of the association among the main actors involved in the creation of CKDs:

> *It was a shared effort between AMOFORE [pension funds], CONSAR [the pension system regulator] and the finance ministry, with, of course, lobbying from AMEXCAP.*

Unable to change the law that legislates on the pension system's investment regime, CKDs were first introduced through administrative-level regulations. When discussing with one of the private-practice lawyers who designed this new vehicle, he explained they were an alternative to purposefully by-pass Congress. Himself being a former CNBV[139] official, and very actively involved in AMEXCAP's leadership, he clearly explains the reason for taking the "quiet" path:

> *At first, from AMEXCAP we tried to modify the law so that Afores, as well as the insurance companies could invest in PE funds directly, through a more standard private placement, as it is done everywhere else. But this won't happen, at least for some time. Because the law that regulates Afores, the pension law, is too sensitive politically. Trade union representatives are part of the executive committee of CONSAR, the regulatory body. These are people that don't understand and don't want to understand structured finance, they will turn down everything that is not very conservative. And Congress is even worse, the chance that a law can be modified is close to zero. Therefore, at the time, I recommended we looked for a*

[139] *Comisión Nacional Bancaria y de Valores*, Mexico's banks and securities regulator.

public instrument that could serve as a fundraising vehicle, since that didn't require modifying the law. And then is when we started working towards CKDs.

But circumventing Congress is not free. In the case of CKDs, for example, having to channel investments through a public vehicle, at odds with industry norms, is indeed quite costly and creates a variety of complications when structuring a fund. Besides its listing costs, CKDs have a number of additional troublesome features, some of them adjusted through subsequent regulations. For example, the mechanisms to make capital calls[140] is not straightforward, the governance provisions of a listed vehicle have to be adjusted to the requirements of a closed fund, and the clauses that allow the CKD to co-invest in equal terms in the fund with non-pensioners money have to be carefully designed. As another senior fund manager told me, complaining about the way these investment vehicles are structured:

CKDs were specifically designed for Afores. They are the channel through which they can go into funds as LPs. They are some sort of Frankenstein, a really odd private capital vehicle that is listed in the stock exchange. A public vehicle to invest in private capital. The reason Afores cannot invest directly in a private fund is because they cannot invest in illiquid securities. If private capital investments are not liquid, they have to be structured as a security that looks liquid. But this is complete nonsense, because they don't actually have any liquidity. The fact that there is a daily price for a CKD doesn't mean there is liquidity. At best, companies disclose information quarterly, so they then having a super complicated process to reach a price that makes no sense.

With an active participation of AMEXCAP, regulators successively fine-tuned CKDs to address part of these problems. In 2014, their legal status was upgraded, as they were included as

[140] The process through which investors who have committed money to a fund actually transfer the money to the fund managers, in general before the closing of a transaction.

a small part of a much broader financial reform law. However, for the moment, pension system regulation has remained unchanged. Beyond CKDs, AMEXCAP also functioned as the private-sector counterpart of regulators and advocated for the introduction of further investment vehicles such as CERPIs, that helped attract larger international funds into the country, and FIBRAs, related to infrastructure investing.

Under many important dimensions Mexico and Brazil, Latin America's two largest countries, are significantly different. Mexico had a much more pronounced shift towards a market-based economy that, importantly, included privatizing its pension system. But regarding the development of their private equity industry, they exhibit some striking similarities. As I showed in the last chapter, in both cases, although in different ways, their development banks functioned as pioneer institutional investors in the asset class, followed by their pension funds. With respect to the institutionalization of their private capital industry, Brazil and Mexico also share some key features. The business associations that represented fund managers received extensive support from different state and multilateral entities, both in terms of resources as well as access to policymaking. And, ABVCAP and AMEXCAP, respectively, played an important role pushing for the reforms that allowed the growth and institutionalization of the industry in their respective countries. Importantly, as I show below discussing Chile's case, these two steps are not just the natural unleashing of the industry. Absent direct public support for its organization, the industry remains fragmented and regulations, in particular those governing access to pension funds resources, underdeveloped.

5.4.3 Chile

While Chile's development agency, CORFO, started investing in private "risk" capital

funds in the late 1990s and has continued to do so in a consistent way, the local private capital industry has not really taken off. As discussed in Chapter 4, the sector is still over-reliant on state funding and local funds have a very hard time fundraising with other institutional investors. Crucially, it is extremely hard for them to raise money from pension funds.

While Chile is by far the most stable and institutionalized country in the region with a massive privately-managed pension system, there are multiple factors that explain why the local private capital environment remains weak, as I have already explored in previous chapters. Besides the relatively smaller size of its economy, Chile has a strong liberal tradition. The size and nature of CORFO's investments are quite limited. It is not organized as an agency independent from bureaucracy, and the budget for its investments has to be approved by Congress on a yearly basis. Pension funds, the largest of their kind in the region, are regulated quite conservatively. After some bad experiences during the nineties, they prefer to not get involved with local private capital investors to avoid reputational issues. Still, analyzing the organizational side of the sector can help better explain some of these problems, and introduce an interesting contrast with the others cases in this chapter.

In spite of CORFO's longstanding support of the sector, the industry is weakly organized. Until late 2017 some private capital funds were part of a larger association, ACAFI,[141] who aims to represent the interests of all types of investment funds. ACAFI is dominated by larger asset managers, mostly mutual funds that invest in public securities both in Chile and externally. Similar to Brazil's ANBIMA, ACAFI is dominated by larger financial institutions, whose interests are not

[141] *Asociación Chilena de Administradores de Fondos de Inversión.*

always aligned with those of local private capital managers.[142] Noteworthy, ACAFI is mostly unrelated to the network formed between the PE/VC associations in the other countries such as ABVCAP in Brazil, AMEXCAP in Mexico, ColCapital in Colombia and more recently ARCAP in Argentina.

Talking about the Chilean case with a member of LAVCA's executive team, he mentioned:

> *I do talk with the people from ACAFI, but the focus they have is very different from ours. They have a much more generalist approach, and they are only concerned about the assets under management of their fund managers. Their measure of success is the assets under management, I completely disagree with that. Because it is not necessarily the case that if the Chilean asset manager has $100M to manage that is good for the local private capital industry. Because their managers have their pockets full of money, but all this capital is invested outside of Chile. […] I am not very sure about what happened in Chile, but a group of eight or nine venture capital managers decided to form their own association, my reading is because these managers were not identified with ACAFI.*

Effectively, led by a group of venture capital fund managers, ACVC,[143] a new VC association was founded in late 2017. Until then, Chile was the only country with no business association with the specific mandate of promoting the PE/VC segment of the fund management industry. The president of the newly funded VC association explains the reason they decided to launch a new entity, different from ACAFI:

> *95% or more of ACAFI's members are large mutual funds, debt funds, all of the feeder funds.[144] There is no place for VCs, we were the poor brothers. We used to*

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[142] For example, they were much more focused on *Ley Unica de Fondos* that on the reform that made alternatives assets eligible investments for pension funds.
[143] *Asociación Chilena de Venture Capital.*
[144] Investment vehicles through which the pension funds access large international private equity firms.

participate, and we actually have a pretty good relationship with them, but we decided to spin-off to have just one voice focused on this specific asset class. This is why we founded this new association, to give relevance to this asset class. To engage with more LPs, with CORFO, with potential institutional investors, with other business associations and to go out and connect our industry to the world.

Following the other countries' trajectory, ACVC has been trying to engage with IDB. But as opposed to other experiences, as far as I understand, none of the two business associations in Chile appear to have support from any government agency. Relatedly, ACVC is comparatively weaker, with a less fluid access to regulators or pension funds.

Their limited access to regulators was quite clear during the change in the pension fund's investment regime regulation, in 2017, that followed a 2016 approval of *Ley de Productividad*. This miscellaneous law, which legislated over completely unrelated topics, amended the 1980's law that regulates the pension funds' investment regime (*Decreto Ley Nº 3.500*) to include alternative assets among the eligible securities. This reform again illustrates very well the quiet politics nature of this policy area. The requirement of going through Congress may significantly block reforms. In the cases when the reform finds a window of opportunity to go through Congress, the new legislation mostly ratifies what has been previously agreed among technical regulators and the private sector. Moreover, most of the technical fine-tuning of the regulatory change is made after the law is passed by the same agencies who pushed for the modification of the law. Talking with one of the leaders of the initiative from the pension funds side, he agrees Chilean's pension funds lag behind in terms of investing in alternative assets:

We are laggards. Of course, you have the Canadian pension funds. But also the Mexican and the Colombian examples. Even Brazil, who has a different model than us, but still, they are much more advanced that we are. We are way behind.

In order to explain the situation, he mentions how hard it is to go through Congress. The way the 2016's law was handled also illustrates the quiet dynamics of this type of legislation:

You know, AFP were created in the early 80s by the DL 3,500. This alone explains the whole development of our capital markets. But AFP's investment regime is regulated by DL 3,500, and any change to it has to be necessarily by law. And you know, when you need to go to Congress "es todo una joda" [it's a big deal]. It was only modified in 2002, with the inclusion of multi-funds that allowed AFP's to diversify a little bit more. Between 2002 and 2016 there were no changes to the investment regime at all. It is a long time! This was until 2016, with the introduction of the Productivity Law. The name doesn't make any sense. [...]This was a joint work with the SP [pension regulator]. The strategy was, "we need to have this ready just in case there is a window that opens and we can pass this law." And that was how it was passed. As a completely miscellaneous law. If we had introduced a law just to change the pension's investment regime, there was no chance of getting it through Congress, not even one!

Following the change in law, the pension regulator had a year to fine-tune regulations and implement it. ACVC had a very hard time approaching the pension regulators, and were not even involved in defining new regulations regarding eligible investment instruments. In the end, even if the flexibility of pension funds to invest in alternative assets was significantly enlarged, local private capital funds were excluded from the authorized instruments. As one of the founders and active member of ACVC told me, regarding the law's implementation phase:

We did present a memorandum to the Superintendencia de Pensiones [the pension fund regulator who implemented the law], sharing our point of view. But we were

not considered, we were left out of the new regime. AFPs can now invest directly into a company, directly into foreign funds, but they still cannot invest in FIPs [private local funds].

Given its larger membership base mostly composed by managers who invest through public funds, ACAFI appears to be less focused on this narrow private local funds issues. Still, both associations are mostly aligned in their policy agenda. Tapping into the pension fund's resources is still their top priority, and creating a fund of funds involving CORFO is the way to achieve it. This is clear from ACVC's memo[145] presented to the Capital Markets Commission that interestingly explicitly cites the Mexican *Fondo de Fondos* and CKDs as a model. While both associations, ACAFI and ACVC, have been pushing for the fund of funds proposal for some time, and CORFO is on board with the idea, they have not yet been able to make it happen. As CORFO's official in charge of risk capital investments, who had an extensive prior trajectory is the asset management industry, diagnosed:

The experience from the US and from everywhere is very clear, the [PE/VC] industry will only develop if the pension funds are in. This is our main goal! To lead that process. Clearly, there is a market failure, someone needs to structure the market, it won't happen if pension funds are left by themselves!

This diagnostic coincides with one of the main insights from Chapter 4 regarding the key role of pension funds for the development of the industry and the need to encourage them through public support. And regarding the politics behind these changes, he also points to Congress' as the main bottleneck:

[145] While getting access to pension funds money is the central point of the proposal, they raise other issues. Among others, they request: an increase in the size limits of the companies funds can invest using CORFO's funding, an easier path to write-off of failed investments done with public money, tax benefits and institutional support from other state-related agencies.

There is consensus in the fund industry that we need to have the fund of funds, we know it is the right path, it's very clear from the international experience. But as CORFO would have to participate as an equity investor, not just in the debt trench, we need to go through Congress. We have a law project, it entered Congress in January 2018, but it has lost parliamentary status. It is not that the government don't want to do it, but they need to complement it with other initiatives so it can go through Congress, so we are still waiting.

In the meantime while the pension funds are making the headlines every day and their public scrutiny is high, their priority seems to be avoiding further headline risks. As explained by an executive of the AFP's industry association:

All this external noises around the "No + AFP"[146] *movement go against investing in alternative assets [...] First, you have the regulatory part, that doesn't give fund managers any incentives to deviate from what the other funds are doing. That profitability is measured on a monthly basis, and every month everyone has to know if you are up or down, that doesn't help either for illiquid investments. Even after the commissions question is resolved,* [147] *we'll keep doing international PE, and then we'll see. For AFPs in Chile, today it is much easier to invest outside the country. Given the level of rejection that AFPs have, and how closely we are scrutinized, investing down the capital structure (i.e. equity) and here in Chile is simply too risky.*

While this quote is in line with the quiet dynamic of financial regulation common to all cases, overall, the Chilean case provides some insightful contrast with the rest of the cases. With a hands-off government, the private capital industry representation is weak and fragmented. In turn, they have limited capacity to access regulators and lobby effectively for access to pension

[146] A social movement whose main goal is to nationalize the pension system.
[147] The discussion over who pays (pensioners or AFPs) the commissions charged by third-party fund managers such a PE fund. This was quite a salient issue during the discussions around the pension system reform.

fund's capital. Exhibiting by far the largest privately-managed pension system in the region, it is still very hard for their local private investors to fundraise from them.

5.4.4 Colombia

Colombia exhibits a very similar dynamic than the Brazil and Mexican cases described above and illustrates well this chapter's two main arguments. First, a local development bank had a key role helping the incipient community of fund managers get together, providing another clear example in which the asset-specific industry association is created as an instance of active public-private collaboration. Second, following its creation, the association lobbies for specific pieces of regulation that contribute to further institutionalize the industry.

As I introduce in Chapter 4, Bancoldex, one of Colombia's development banks, had a specialized private capital department. Officially launched in 2009, Bancoldex Capital, Bancoldex's private capital program, had two different roles: one of them financial, and the other one non-financial. On the financial side, as Chapter 4 reviewed briefly, Bancoldex made several capital commitments to different funds (it has $100 M allocated to the program), but had a hard time formalizing a fund of funds. But beyond this financing role, Bancoldex was particularly active in promoting the nascent industry. In collaboration with IDB's MIF, they sponsored industry events, invited external speakers, organized trainings, and other promotional activities targeted mainly towards potential investors. In order to further institutionalize the industry, in 2012 they helped found a local private capital association. Born as a spin-off of Bancoldex private capital department, Colombia Capital (ColCapital) started taking care of all the promotional activities and representing the fund industry before government and the business community more generally.

When asked about the origin of the association, ColCapital's managing director—whose

previous job was, tellingly, in Bancoldex Capital—told me:

> *In 2012, with resources from Bancoldex, ColCapital was launched. We told the fund managers: "Gentlemen, get together and decide what you want to do," and that's how we created this entity. It was then when they called me. We were born as a private association, at first we also had multilateral funding, but today it is mostly self-funded from member fees and events. This is how we were born as an institution.*

Beyond its promotional activities ColCapital's main role is to push for new resources into the industry, enlarging the base of investors. In order to do so, it brokers the industry's relationship with pension funds and regulators to increase the amounts they can allocate to alternative assets and pushes for Bancoldex's fund of funds. In this vein, when asked about the main purpose of the local association, the managing partner of a large international fund and a former president of the association, explained:

> *The main thing we do is to make sure that the AFPs and every state pocket that is around is allowed to invest in private equity. Then you have a regulatory component: that the regulatory authorities don't go crazy with reporting requirements. And third, education, we promote industry best practices, so we can avoid problems such as the one of Abraaj*[148] *is having right now that taints the whole industry.*

Regarding regulation, ColCapital has been the private sector counterpart behind the most recent regulatory reform that helped update the type of investment vehicles and their management. In particular, it regulates a specific vehicle tailor-made for private capital funds (different from

[148] A large Dubai-based emerging markets PE firm that collapsed after being hit by an accounting and governance scandal.

more general-purpose closed investment funds), and clarifies their management role. Interestingly, this new piece of regulation was not passed as a law, but as an executive decree from the *Ministerio de Hacienda*.[149]

While briefer in my analysis, the Colombian case confirms my main arguments: as part of its environment-building agenda, the collaboration from a local development bank was key to form an asset-class specific association. ColCapital is basically a spin-off from Bacoldex's—a state-owned policy banks—private capital unit. Once organized, the association's priorities and main activities are in line with what I found in the other cases.

5.4.5 Argentina

The organization of Argentinean private capital industry tracks quite closely the history of the sector, and provides further evidence supporting two of my main arguments. First, the contrast between the association's failed experience during the early 2000's and the post-2015 re-birth demonstrates the importance of having government support for the organization of the sector; multilateral support is not enough. And second, regarding the priorities of the associations, it is clear from both phases of Argentina's association how central it is for their mission—and more broadly for the fate of the industry—to get access to local institutional funding,.

In contrast to what we observe in Brazil, where the sector began organizing in the late nineties, in Argentina, during its early—and booming—stage the private equity industry was mostly internationally oriented, unorganized, and very thinly regulated. In words of a corporate lawyer active at the time, talking about the novelty of the model and the lack of clear regulation:

[149] *Decreto 1984 - Ministerio de Hacienda y Crédito Público* (October 30th, 2018).

KKR's LBO[150] *model that Navarro*[151] *brought into Argentina didn't have any precedent. There was no experience in the country for this type of operations. Just as an example, it was not even clear something as basic as whether you could deduct from taxes the interest paid to serve the debt used to fund an acquisition. There were no rules, Navarro was trying to make the rules by himself. And when AFIP*[152] *said interest payments weren't deductible from taxes, the liability was huge.*

While recovering from the 2001 crisis that ended with the convertibility system and struck a big hit to most of the funds operating in the country, we observe in Argentina some of the incipient steps we observed in the other cases. With the idea to replicate ABVCAP's—Brazil's pioneer association—model, a group of fund managers founded ARCAP.[153] Their key goal, as in all the other cases, was to tap pension funds' money, at that time privately managed. As stated by one of the founding members of the association:

Everyone agreed the goal was that AFJPs [Argentinean private pension funds] could invest in private equity, and that was the reason the association was founded: to convince the Superintendencia de Pensiones [pension's regulator] that this was the right thing to do.

Some fund managers contributed with resources, and they counted with the initial institutional support from IDB's MIF. But without support from the local government, they had trouble advancing in a more formal program with MIF that would grant them access to funding, as the ones in Brazil, Mexico and Colombia. It was hard for them even to be able to register as a formal civil-society organization. This anecdote shared by an ARCAP's founding member

[150] KKR refers to the US-based PE firm most famous for pioneering the leveraged buyout (LBO) model.
[151] The head of the Exxel Group, the largest PE fund in Argentina during the 1990s.
[152] Argentina's tax agency.
[153] *Asociación Argentina de Capital Privado.*

showcases the association limited access to policymakers:

> *The idea was always to engage with the public sector. It is better that our activity is regulated in the correct way, than in no way or incorrectly. We constantly tried to meet officials, but we were not very successful. It took us more than three years to get access to the finance minister. After Cristina took office,* [154] *we could finally meet Lousteau, who at the moment was the finance minister, at IDB's 2008 annual conference in Miami. He didn't know much about the sector. We had to explain to him that we were not vulture funds;*[155] *that we made long-term genuine investments and brought in external capital into the real economy. We presented our proposal. They told us they had some new ideas regarding the pension system. We thought they were aligned. A couple of weeks later, they nationalized the pension funds.*

ARCAP's demise, following the nationalization of the privately-managed pension funds confirms how central pension funds are for their organizational mission. After the nationalization in late 2008, it made less sense to continue with the association, and it slowly faded away:

> *Following the nationalization, even scheduling internal meetings was much more difficult. There was no interest. Besides, who were you going to talk to in government? In 2011, we finally made the formal decision to keep the association dormant. You have fiduciary rights with your LPs, you can't tell them to put their money in a place where you wouldn't put your own money.*

The association was re-launched at the end of Kirchner's administration in late 2015, discounting that whatever the outcome of the presidential election, the new administration would

[154] Cristina Fernandez de Kirchner, who took office on December 2007 and was President until 2015.
[155] Investors specialized in distressed assets that had an important—and very contentious—role during Argentina's sovereign debt restructuring that followed the 2001/2 default.

be friendlier to business than its predecessors. There was some change in the profile of the association's members, with more active membership from managers closer to the new "entrepreneurial ecosystem" rather than to traditional PE, which certainly helped legitimize their mission. As another member of the association explained:

> *If you need to talk with a government official or a legislator, the message that is always more welcomed is "we are going to create jobs." And from all the type of funds, it is easier to argue that point with venture capital and entrepreneurship. But in the end, the investment mechanism is the same for all funds, you just scale the model.*

Following Macri's victory, the association followed a similar dynamic to the one we also observed in the other country case studies. It was actively supported by some of their peer associations, and established a very fluid working relationship with LAVCA, the regional organization. Most importantly, the "new" association also developed very close ties with the incoming government, in particular with *Secretaría de Emprendedores y PYMES,* an undersecretary part of the Ministry of Production. With government support, even registering as a civil society organization was easier for ARCAP, as one of its board members told me:

> *We started the registration process all over again, basically the same association, but a new filing, it was easier that way. It was registered in 3 months, the same process that before took us 7 years.*

Still, the association is small—they only have one full-time employee—and, given the underdevelopment of the industry in the country, have quite limited resources. At least until the end of 2019 when the national administration changed again, for most of their activities they relied on the support from this government agency, the undersecretary for SMEs and entrepreneurship.

As one officer from this undersecretary described when asked about how they supported the association:

> *We support them with money and with people. For example, we organize together the Foro Argentino de Inversiones [the association's flagship events]. Our relationship is very strong and very good. They are key for what we aim to do.*

ARCAP helped the government agency write the new *Ley de Emprendedores* and cooperated very closely with the government in order to implement the new "fund of funds" the government was trying to launch, as explained in Chapter 4. They are still not satisfied with the legal framework and therefore are working on a broader reform to the capital markets law to address taxing and corporate vehicles issues. As this same government official explains:

> *After the Ley de Emprendedores and FONDCE's first phase, we are now working to farther improve the regulatory framework, always with both ARCAP and LAVCA. The input from the private sector is key for us.*

As elsewhere, in addition to state-funded programs, the association also pushed for more institutional money into the ecosystem. As mentioned in Chapter 4, insurance companies were allowed to invest a small part of their reserves through private capital funds.[156] This change, which did not require an act of Congress but just a modification in an administrative regulation was also promoted by ARCAP through the *Subsecretaria PYME* who brokered the relationship with the *Superintendencia de Seguros* (the insurance regulatory agency):

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[156] Even in the unlikely case they reach the upper threshold allowed by regulation, given the small size of the insurance industry in Argentina, this wouldn't represent much more than $100M.

ARCAP gave us their input, they told us: "if you want to change the market all these guys [referring to insurance companies] have to be in," they presented the need and gave us input. We thought it was going to be really hard, but we could change the Superintendencia's regulation. Now we have to evangelize the insurance industry, it's a really hard task, it will take time.

But regarding the possibility of getting access to Argentina's state-managed pension fund resources (FGS), all actors agreed that, at least for now, this is not an option, and that Congress was the main gatekeeper to the pensioner's resources. For example, a very active person in both phases of the association told me:

Is it possible? Today, politically, it is not. It is not that we don't want to do it. But you would have to go through Congress, and we have no chance. Still, it is really hard to think about the development of a local private capital industry without local institutional investors.

From the government side, they mostly agreed this was not option:

Today, forget about ANSES [social security]. Maybe in a couple more years. They don't even have the money. Still you would have to go through Congress. That's a no go, you would have to face all this discourse about pensioners' money, and you would have to go there and propose investment funds that go through the Cayman Islands? For the moment, we are not even trying.

In sum, analyzing Argentina's case from the organizational and regulatory side supports at least two important points. First, the sharp contrast between the association's lack of access to policymakers during the Kirchner's administration and the relationship it developed with government following the change in administration in 2015, confirms the importance for these associations of partnering with an agency aligned with its policy goals. Second, the Argentinean

case also makes clear that tapping institutional fundraising sources is the key goal behind the industry's organization. The main objective behind the first attempt to form an association in the mid-2000s was accessing pension funds resources; their nationalization made the organization pointless. During Macri's administration (2015-2019), although the results were meagre, most efforts were devoted on the same direction. As argued more extensively in Chapter 4, Argentina's lack of institutional pools of capital—or its inaccessibility—structurally limits the development of the industry.

5.5 Discussion

The private capital industry is by definition one of the most deregulated segments of the capital markets. Composed of sophisticated financial investors, many of them international, these actors are beyond regulator's duties to protect retail investors. Still, as this chapter shows, in order to develop, the industry requires a working regulatory framework. For example, some of the issues central for the development of the asset class are the creation of tax-incentivized investment vehicles and of regular channels to access institutional funding. While these issues are quite technical and rarely salient for the larger public, someone has to push for them.

Throughout the chapter I stressed the role of state agencies and asset-specific business associations in advancing these type of regulations that help institutionalize the industry. I made a two-step argument. First, some public agencies, together with multilateral banks, support the creation of a local private equity association. Second, I relate those associations to specific regulatory outcomes that help formalize the private capital industry.

The origin of these business associations is in itself noteworthy, and clearly exemplifies how a public-private approach to development policymaking can include solving the collective

action problems of the private sector. Fund manager's organizations were nurtured by their close relationship with different state agencies, who at the same time were also acting as investors in the nascent industry. Their support consisted not only of facilitating access to policymakers but also included direct funding. Interestingly, this dynamic is common to all the countries I study, with the notable exception of Chile where the new association appears to have an arms-length relationship with CORFO, and therefore it is arguably also weaker. In Brazil, FINEP supported the creation of ABVCAP, the Mexican association was, apparently, very close to *Fondo de Fondos*; in Colombia the local association was created basically as a spin-off of Bancoldex; and more recently in Argentina, the association was re-founded and developed very close working ties with the government's (2015-2019) undersecretary in charge of promoting SMEs and entrepreneurship. Moreover, these associations are integrated into a regional network that has at its center a regional-level association, LAVCA, also founded with strong multilateral support.

These business associations are at the same time a consequence and an actor pushing for the broader institutionalization of the sector. Within the narrow policy domains, they function as the voice of the industry that pushes for reform. From the public agencies' perspective, having a private sector counterpart provides them with technical input and information, and helps them legitimize their agendas as well as their interactions with the private-sector. Associations generate both some public (club?) goods for the industry and some private benefits for their more active members. Obtaining institutionalized channels of access to capital from both state-related sources and pension funds seems to be their top priority. They also provide a unified private sector voice building the industry's regulatory architecture. They lobby for new pieces of regulation and, through their working relationships with regulators, participate in updating small rules that affect the functioning of the industry.

My claim is not that these associations are distinctly capable or always successful, but more simply, that they contributed to building the rules of the sector. Even if a counterfactual to the role of associations is hard to grasp, given the evidence provided above I expect it would include a less institutionalized private capital industry. Across the different cases, I showed the association's role in providing the inputs for key reforms and actively lobbying for them. I presented clear evidence both in the form of interviews with the actors involved—from the public and private sector—as well as documentation. Moreover, these associations are formed prior to major regulatory milestones as part of a plan to strengthen the sector. The timing of events in each case supports the argument about associations having an important role in reforms. Cross-country comparisons also support this point. Without government support Chile's associations are comparatively weaker. And at least partly related to this, Chile has a thinly developed private capital industry, particularly with respect to the overall large size of its financial markets. Finally, within-country variation in the Argentinean case, where I contrast two different administrations, also shows quite clearly the importance of developing close ties with government agencies for the industry's organization, as well as the role these associations have in pushing for reforms.

As I will discuss more thoroughly in Chapter 6 when testing my arguments beyond Latin America, there is also clear evidence outside the region that provides further external validity to my arguments about the origin and role of asset-specific business associations. The European case, for example, is quite telling. Regarding its origin, Europe's private equity association, formerly known as EVCA[157] and recently rebranded as Invest Europe, was founded in 1983 as an initiative of the European Commission (Ooghe, Bekaert, and Bossche 1989). Based in Brussels, Invest

[157] European Venture Capital Association

Europe groups all sub-classes of private capital fund managers and has pushed for access to state and institutional fundraising sources, lobbied for harmonized regulations across the EU, and introduced corporate governance guidelines for its members. While it now appears to mostly self-finance and therefore it is more detached from the EU, it continues to have a key role as the private sector voice of the industry.

Returning to the larger theoretical discussion regarding corporate governance reform, I argue that investment funds' regulation is a clear example of a topic better understood through the quiet politics lens. Most regulatory initiatives are not involved in larger partisan politics, but restricted to bureaucratic domains. The detailed evidence described throughout this chapter as well as the overall configuration of cases do not seem to follow some of the main hypothesis about corporate governance reform. Explanations based on property rights that focus on minority shareholders protections are not necessarily wrong, but have limited capacity explaining the variation among my cases. And regarding societal arguments, both in its macro and micro-politics versions, the configuration of actors is different in emerging economies from the ones that would lead corporate governance reform according to this literature. As I just showed, managers are an actor that have to be created, rather than the ones initiating reforms. Institutional investors, in particular pension funds, are still quite new to more active forms of investing and accessing their funds is actually the main policy goal. Labor is mostly absent from the discussion, and its strength does not appear to be directly related to the variations I observe across my cases.

In line with a quiet politics approach, associations try to establish fluid working ties with regulators, typically in the executive branch and decentralized agencies. Congress and "big politics" definitely seem to be outside their repertoire, and when possible, purposefully avoided.

These findings, therefore, raise some doubts on the mechanisms through which democracy is a force that promotes the deepening of financial markets. Of course, they also raises normative concerns. That relevant issues are resolved outside of public scrutiny could be problematic from a democratic accountability stand-point. But it also signals the practical limits of quiet politics both as a strategy and as an explanation. To advance broader more structural change requires to go beyond regulators and appeal to larger audiences, pushing the limits of what can be achieved through quiet politics.

Chapter 6 - Beyond Latin America

The core of the evidence presented throughout the dissertation comes from Latin America. Latin America proved to be a good testing ground for my argument, given its common colonial origins, similar democratization and liberalization trends and comparable levels of development. The five cases I analyze exhibit common patterns that support my main arguments. State-related money was channeled into private equity in each of the cases. And PE's interest groups that gave political voice to the industry were organized with significant public support, except in Chile. Cross national evidence also supports my argument over alternative explanations. Institutional variables, on their own, can hardly explain the variation observed across cases. Instead, the extent of public support does a better job. Where there was an earlier and more intense public involvement, private equity markets are also more developed; even after acknowledging for the many flaws government investment programs have. Within-case, across-time evidence provided key support to the argument about the central role pension funds have for the industry, most clearly in the Mexican case. As well as about the importance of government support for business association, evident, for example, in the Argentine case.

Given its comparatively weaker bureaucratic capacities, Latin America can be thought of as a "least likely" region to make a policy-based argument. Still, the region is quite marginal for the global private equity industry, maybe with the exception of Brazil, and its—private and public—capital markets are still at early stages of development. Therefore, it could be argued that when Latin America is compared with other regions, the somewhat more active role of the state has actually hindered private equity investment and undermined overall financial development. Or that some region-specific characteristic (e.g., its colonial origins) made state intervention necessary. In order to rule out these alternative explanations and broaden the scope of my

argument, I explore the US, European and Asian cases, where the PE model is more widely adopted. Through case-specific primary and secondary sources I asses the relevance of state-related investors for the emergence of this new financing actor.

What appears to distinguish Latin America from other regions is not that they exhibit public support, but its extent. Rather than less intervention, every case analyzed outside this region actually shows a larger and more systematic public-sector presence. Latin American more timid and less capable financial bureaucracies, and especially the lack of well-institutionalized channels that connect pension funds and domestic equity markets are arguably more relevant factors to explain the region's overall—financial—underdevelopment than its macro-level political and economic institutional environment.

This brief chapter provides evidence on the relationship between state-related institutional investors, private equity and capital market development beyond Latin America. It adds external validity to my arguments by showing that in various cases outside this region, equity markets also appear to be actively nurtured by the state. The first section shows state-related investors had an active role during the emergence of private capital markets across a variety of contexts. The second section provides further evidence on my argument about the origin and role of private capital business associations, and the quiet politics dynamics behind the industry's regulation.

6.1 The State as an Investor

Outside Latin America, the role of state-related financial institutions "incubating" private equity markets is even clearer. This section begins by briefly reviewing some key historical highlights of the US case, where the private equity model originated and where it is more widely adopted. Then it continues with Europe, and finally addresses some key cases in Asia.

6.1.1 United States

The US is the archetypical liberal market economy with the worlds' most complete capital markets. There is no federal-level development bank, and the state has a hands-off approach to financial markets, except for a few specific markets (e.g. housing). Still, most analyses of the development of US's private capital markets identify two key elements for the growth of private equity that involve the public sector: first, the pioneering role of Small Business Investment Companies (SBICs), and, second, 1979's game-changing clarifications to ERISA's "Prudent Man Rule."

It is widely acknowledged that the creation of the SBICs, as vehicles for small business financing was an important "catalyzing" step in the development of private capital in the US (Lerner 2009). SBICs were created by 1958's Small Business Investment Act. They were independently-owned investment companies funded through privately raised capital together with government funds, and dedicated to investing in small firms. Public funding, through loans, could provide up to three times the amount of capital raised from private sources (i.e. it provided cheap—subsidized—leverage to the private investors). SBICs also received a variety of tax incentives. By mid-1960, 700 SBICs controlled the majority of the venture—risk—capital invested in the US (Gompers 1994). While the program grew quite fast, it received a lot of criticism for its poor financial returns and the mismanagement of funds, and SBICs were gradually replaced by the partnership format without public funding as the main way of organizing private equity firms.[158] Still, these investment firms have repeatedly been recognized as the seed for current private capital (i.e. venture capital and private equity) investment firms (Cendrowski et al. 2011; Gompers 1994;

[158] For an interesting discussion of the competing models of organizing VC investors, see Hsu and Kenney (2005).

Ibanez 1989; Lerner 2009). Some of them financed the leading emerging companies of the day, but, most importantly, SBICs helped develop an emergent ecosystem of independent professional fund managers as well as a network of specialized service providers such as accountants, lawyers, and data providers. Notwithstanding the many critics to the program back in the 70s or the merits for its continuity, the SBIC model influenced several governments around the world who tried to replicate it.

SBICs certainly had an important role for the early PE industry. However, "the single most important factor accounting for the increase in money flowing into the venture capital[159] sector was the change in the 1979 amendment to ERISA's " prudent man rule" (Gompers 1994, 12).[160] Prior to the modification of this rule, pension funds were banned from investing substantial amounts of money in risky ventures. This modification explicitly allowed pension managers to invest in high-risk assets such as PE/VC, and therefore opened the door to massive capital resources for the—broadly defined—private equity asset class. To this day, pension funds—in particular public pension funds—are the single largest institutional investor in private equity funds in terms of their capital commitments, and are therefore key players behind the vitality of private equity markets in the US (Preqin 2017).

The modification to ERISA illustrates that key regulations that unleash private capital markets happen mostly in bureaucratic arenas, quite far, and at times at odds, from Congress and partisan politics. Notably, this game-changing amendment, that generated an "unprecedented increase in money flowing into the private equity sector" (Gompers 1994, 2), and in turn had

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[159] In this context, venture capital includes the three stages of private equity investments: VC, growth equity and buyouts.
[160] Employee Retirement Income Security Act (ERISA) of 1974.

profound consequences on how capitalism is organized in the US (G. F. Davis 2009), was passed as an administrative clarification of a Department of Labor's rule. Even if the change at that time went mostly unnoticed, it was far from unintended. The loosening of ERISA restrictions was the result of active lobbying from the recently formed National Venture Capital Association—NVCA (Avnimelech, Kenney, and Teubal 2004, 25; Pincus 2000, 119). According to Kenney (2011, 1707) "NVCA's first goal was to loosen the ERISA restrictions to increase the flow of capital to the VC partnerships. Through intensive lobbying over the next 5 years, the VC industry convinced the Department of Labor, which was charged with enforcing ERISA, to reinterpret it to allow investment in professionally managed VC funds. The reinterpretation would have a dramatic effect."

Regarding the origin of this association, it was formed in 1973, and represented venture capital fund managers who had developed a separate identity and different regulatory concerns than SBIC operators, who were already organized in the National Association of Small Business Companies (NASBIC). SBICs were not explicitly excluded from NVCA, but only the larger ones were invited to join the new—by invitation only—association (Kenney 2011, 1707). Still, the NVCA was clearly connected with the SBIC experience, showcasing the incubating role of SBICs. Just as an example of these close connections: NVCA's first president and founding member, Ned Helzer, was also on the board of NASBIC, and was a member of the advisory committee of SBA, the federal agency that licensed SBICs.[161] And NVCA's first executive director, Stanley Rubel, was also very much related to the SBA, and had previously worked extensively with SBICs (e.g.

[161] For evidence on this, see, for example, this NASBIC document. Or Helzer's statement in a 1977 Senate Hearings regarding taxation (United States Senate 1977, 75).

Noone 1968).

6.1.2 Europe

In Europe, where the industry emerged later than in the US and following its lead, the role of policy-makers is also clear. Europe's oldest private capital group, 3i (originally called Industrial and Commercial Finance Corporation), was founded by the UK government during the postwar. It pioneered an investment model that deployed long-term capital—often equity-based—to industrial SMEs and operated with substantial autonomy from bureaucracy and politicians. In the 60's, it also pioneered investments in high-technology (Coopey 1994). Beyond its direct impact as a capital provider, it is often highlighted that 3i helped disseminate human capital throughout the UK's emerging private equity industry, similar to the role of SBICs in the US (Ibanez 1989).[162] Similarly, in other European countries, state-related financial institutions also exhibited an active involvement in the setup of pioneering private equity firms. For example, France's first risk capital firm, Soffinova, created in 1972, was backed by state-owned Crédit National, the Ministry of Industry and TA Associates, one of America's pioneer PE firms.[163]

More recently, the European Investment Fund (EIF) appears as a key institution for the development of European risk capital markets.[164] Established in 1994 as a European Union

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[162] 3i floated on the London Stock Market in 1994 and is still a leading mid-market private equity investor with ~ £14.5B in AUM. For a complete history of 3i, see Coopey and Clarke (1995). Interestingly, the origin of Actis Capital, one the largest emerging market private equity funds with more than $15B AUM and a portfolio across Asia, Africa and Latin America is also related to UK government. Actis resulted from the 2004 spinout from the Commonwealth Development Corporation (CDC) Group. For a pre-privatization history of the CDC, see McWilliam (2001).
[163] For the origin of Soffinova, and the introduction of first PE funds in continental Europe, see Brooke and Penrice (2009, 43). Soffinova turned into two sister organizations, Soffinova Ventures and Soffinova Partners, focused in the US and Europe, respectively, that have raised ~$4B since their inception, and invest mostly in the life sciences and technology sectors. Brooke, the founder of Advent, one of the pioneer international PE firms, also highlights the importance of some European families, as sponsors of pioneer PE firms in the region.
[164] The EIF is part of the EIB Group (the European Investment Bank), and is owned 60% by the EIB, 28% by the European Union through the European Commission (EC), and 12% by 30 public and private financial institutions.

decentralized agency, it aims to enhance SMEs access to finance. The EIF does not lend money or invest into companies directly. Instead, it provides finance through a network of intermediaries, among them venture capital and private equity firms. Notably, it became the largest European investor in risk capital funds: it has invested in ~700 funds and has more than €17 billion in private equity assets under management (EIB 2018). In 2018 alone, it committed around €3.5B to fund managers across Europe.[165]

EIF's pan-European approach is complemented by other national-level initiatives that typically combine capital from states, and from other semi-public institutions such as pension funds and European Union's resources. Table 9 provides an overview of some of the current policy programs across Europe that channel public resources into private equity. Organizationally, these national-level programs tend to work with significant autonomy from each country's regular bureaucracy, and are mostly staffed by officers with a private-sector background. And while these programs may exhibit a variety of investment models and target different industries, they all aim to crowd-in private sector investors and in most cases grant capital allocation decision-making to third-party private-sector managers.

These initiatives typically consist of indirect investment, in which the state works as a fund of funds, and makes capital commitments to independent fund managers. For example, Argentum, the leading fund investor in Northern Europe, invests on behalf of the Norwegian state and the country's main—public and private—institutional investors. Dansk Vækstkapital, a joint venture between the Danish state and Danish pension funds, also functions as a funds of funds. Similarly,

[165] See Kraemer-Eis, Signore, and Prencipe (2016) for a summary of EIF role in Europe's risk capital market and its performance. As an FT analysis, it exhibit adequate financial returns in the period between 1997 and 2013, "compared to European private equity generally [that notably include large buy-out funds outside the scope of EIF], this isn't a great performance, but it's not catastrophically bad either."

Spain has arranged a €1.5B public fund-of-funds, FOND-ICO Global, with the goal of promoting the creation of privately-managed growth-oriented PE funds that target Spanish companies at all stages. Interestingly, to close the gap left by the EIF after Brexit, the UK has revamped the British Business Bank. Kfw Capital, a subsidiary of Germany's development bank, was created in 2018 to invest into equity funds investments and promote the industry, taking over two previous state-related programs aimed to promote VC markets.[166] Another example is Tesi, with €1.2 B AUM aimed to develop Finland's venture capital and private equity market.

In some other cases state-related financial institutions participate in the fund management firm (GP), or even make direct private equity investments, but usually co-investing with private sector investors. The French state's investment bank, Bpifrance,[167] has around €30B in private equity assets under management, allocated to companies of all sizes and industries. Two thirds of them are direct equity investments in 142 portfolio companies (in minority positions, generally co-investing with other PE firms). The rest of the capital is invested indirectly through 400 funds, managed by 150 different fund management firms (GPs). And Ireland's Strategic Investment Fund has €4.1B in direct and indirect equity investments "to support economic activity and employment in Ireland."[168] *Fondo Italiano D'Investimento*, majority-owned by *Cassa Depositi e Prestiti*, a state-controlled investment bank, also aims to "combine the objective of economic return and

[166] High-Tech Gründerfonds (JV between KF and large German industrial companies) that had close to 1B in AUM. And Coparion, that co-invested with private funds. Even if KFW Capital plans to make larger investments, its size its smaller than what the local industry association was lobbying for (e.g. see Roland Berger, IEF, and BVK 2018, 33).

[167] *Banque publique d'investissement S.A* is owned by *Caisse des Dépôts et Consignations* and France's Ministry of Economics and Finance. It was founded in 2012, as the result of the merger of several state-related financial institutions: OSEO, *Fonds stratégique d'investissement* and *Caisse des dépôts et consignations's* CDC Entreprises.

[168] ISIF complements the investment programs targeted to private capital funds managed by Enterprise Ireland.

development of the productive system" through direct and indirect equity investments.[169] Overall, it is quite clear that different state-related investors have an important role in sponsoring private capital initiatives throughout Europe.

Table 9: Current European Public Programs to Support VC/PE

Country	Program	Year Created	PE AUM (€, B)	Direct
France	Bpifrance PE	2013	30.0	Yes
Regional	European Investment Fund	1994	17.3	No
Ireland	Ireland Strategic Fund	2014	4.4	Yes
UK	British Patient Capital	2017	2.5	No
Italy	Fondo Italiano D'Investimento	2010	2.3	Yes
Norway	Argentum	2001	1.5	No
Spain	Fond-ICO Global	2013	1.2	No
Finland	Tesi	1995	1.2	No
Denmark	Dansk Vækstkapital	2011	1.0	No
Germany	Kfw Capital	2018	0.6	No

Central and Eastern European countries (CEE) are closer in terms of development levels to Latin America. And the emergence of private equity markets in CEE countries was also heavily sponsored by state-related investors. Earlier, during the transition from planned economies to a free-market system, these countries counted with vigorous support by a series of multilateral organizations (Klonowski 2006). Going forward, some countries developed their own national-

[169] There are several other examples of public initiatives that channel state-related funds through privately managed PE funds. For example, in the infrastructure sector, Marguerite manages two PE funds that target brownfield and greenfield projects in in Europe and is sponsored by the EIB together with public financial institutions from Poland, France, Italy, France, Spain and Germany.

level programs. And when joining the EU, PE funds operating in the region also received substantial support from the Union's financial institutions (Invest Europe 2018; Karsai 2018).

For example, the case of Poland, with the most developed PE market and largest stock exchange in the CEE region, appears to confirm the hypothesis of the market's policy-led origin. "In order to develop, the Polish private equity industry needed two critical components: a supply of viable investments projects and capital. Two igniting forces helped to spur this development: the privatization program and financial assistance from major international financial institutions and government agencies (both Western and local). It would be these forces that would ultimately transform the struggling capital market in Poland" (Klonowski 2011a, 109). In terms of funding, the European Bank for Reconstruction and Development (ERBD) together with World Bank's IFC and direct support from the US acted as the cornerstone investors of pioneer PE funds, who later attracted further private-sector investments.[170] Multilateral support was followed by continuous support from the Polish government. For example, there are "about 16 major programs operated by the Polish government," (Klonowski 2011b) and the state-owned Polish Development Fund manages the largest fund of funds in the CEE region.

6.1.3 Asia

In the last couple of decades, Asia had the fastest growing capital markets. And Asian companies are now the largest users of public equity financing globally, at odds with their prior bank-centric characterization (e.g. Woo-Cumings 1991). Notably, in several of these countries (e.g. China, Hong Kong, Malaysia and Viet Nam), the government is a significant shareholder of

[170] The most noted case is Enterprise Investors. Active since 1990, it has raised nine funds with total capital exceeding €2.5B, invested in 144 companies, and among its exits, it sponsored 35 IPOs.

public companies: in some of these countries the state holds, through multiple investment vehicles, close to half of the market (Carney and Child 2013; OECD 2018). In line with the overall development of Asian capital markets, private equity markets have also grown considerably, now occupying a major role in the global alternative assets industry (Preqin 2018). In PE markets, state-related investors also appear to play a key role, probably even larger than in Europe.[171]

China is by far Asia's largest private capital market (Preqin 2018). While the distinction between state and non-state capital in China is blurry (Fuller 2016), state-related money is ubiquitous throughout its financial market, and secondary sources agree on attributing the growth of the PE industry to government policy (as well as many of its perils, e.g. Fuller (2016)).[172] "The first international venture capital firms entered China in the early 1980s. The impetus for the development of the Chinese venture capital industry was government policy. Government encouraged and sponsored PE funds to invest in SOE to bring them up to world standard in terms of productivity and quality" (Ahlstrom, Bruton, and Yeh 2007, 250). National, provincial and city governments established joint ventures with large international PE houses. But, as Leeds (2015) argues, "perhaps nothing has been more transformative in the Chinese private equity industry compared to other emerging markets countries than the 2008 decision by the National State Council to permit a select number of large, reputable state-owned saving institutions such as the National Social Security Fund (NSSF) and the Chinese Development Bank to allocate up to 10% of their assets for investments as LPs in local currency private equity funds" (p. 179).

[171] For an analysis of the state-sponsored emergence of venture capital markets in East-Asia that goes beyond the focus on investors, see Klingler-Vidra (2018).

[172] There are certainly many nuances to "private equity with Chinese characteristics" (Leeds 2015, Chap. 6) I do not address in this brief paragraph. For a more complete discussion on the history and evolution of private equity in China, see Yong (2012) and EMPEA (2012). For the role of China Development Bank, see Sanderson and Forsythe (2012).

More recently, the growth in the industry was explained mostly by the rapid increase in local currency (RMB) funds (PWC 2017), sponsored by state-related financial institutions and by "guidance funds" from different government levels (i.e. city, provincial and national).[173] These funds are deployed through various models: special investment vehicles, co-investments alongside professional private equity groups, and as funds of funds. They target the tech sector, but also more traditional industries. The claim that guidance funds have $1.8T to deploy—a value equal to one-third of the total assets of the global private equity market—is considered an overstatement. Still, there is little doubt that the Chinese state is channeling massive amounts of financial resources into companies through private capital funds.[174]

The Korean government has also made considerable efforts to develop a more vigorous private capital industry. State-related investors play an important role in the fundraising process by making significant capital commitments to PE; through different channels the state is still the country's largest investor in the asset class. Government also established the KOSDAQ stock market in 1996, which provided venture-capital-backed companies with the possibility of an IPO, facilitating the exit of PE investments. And indeed, listing in KOSDAQ appears to be one of the most usual forms of exit for Korean investors. In terms of the regulatory framework, the industry grew rapidly since 2004, when the government introduced regulations to foster the creation of local funds industry (see, for example, Ko and Shin 1999; Lee 2008).

The Korean Development Bank (KDB) is among the largest direct PE investors (GPs) in

[173] See China' Money Network ranking of China's government fund ranking.
[174] International oriented Chinese PE/VC funding has raised increased scrutiny in the US following the concern Chinese venture-capital investment in American companies intends to give China an edge in technologies for commercial and military use (e.g. Brown and Singh 2018). While certainly important, the strategic dimension of outward-oriented state-sponsored private equity is outside the scope of this dissertation.

the country. Indirectly (as an LP), it accounts for a sizable amount of all the investments in privately-managed domestic PE and VC funds (KDB 2016, 2018). It also partners with international funds investing in Korea. Moreover, state-owned Korea Venture Investment Corporation (KVIC) was formed in 2005 as Korea's fund of funds, investing in typically smaller venture-oriented funds. The National Pension Service, a public pension fund, is the other key investor who leads the Korean LP landscape, together with other government-linked pension funds (Invest Korea 2015). Acknowledging the role of the state in funding new companies, a McKinsey (2015) report on Korea states: "our in-depth conversations with more than 30 leading Korean entrepreneurs, venture capitalists and small business experts found that, within Korea's startup community, there is broad agreement that, thanks to new government policies, there is more funding available to new Korean ventures than was the case even five years ago."

Malaysia and Singapore are also cases worth mentioning. In addition to their "common law" legal origins, analysts grant state-related investors a larger role in the expansion of their—private and public—capital markets.[175] In Malaysia, Gomez et al. (2018), attributes to government-linked companies the ownership of around 50% of the capital markets, for example through Khazanah Nasional, the country's SWF. Khazanah Nasional functioned mostly as a direct private equity type of investor, and had a strategic focus and active involvement in its portfolio companies, at least until reforms following the 1MDB scandal (that, by the way, also illustrates in a quite grotesque way the corruption risks related to state-funded investment funds).[176] The Employee Provident Fund, that manages the compulsory savings and retirement plans for private sector

[175] For an early analysis of the PE/VC markets in Singapore, and comparison with Malaysia and Hong Kong cases, see (Koh and Koh 2002).
[176] See for example, this Reuter's article about Khazanah's change in strategy.

workers in Malaysia, has been recognized for its role anchoring the development of Malayan capital market (Price et al. 2018). Moreover, there are other initiatives, such as Ekuinas, a government owned PE fund with around $1B in AUM, that deploys private equity capital both directly into companies and indirectly into funds. Together with fostering PE investments in the country, this initiative aims to promote Bumiputera's—indigenous Malays—economic participation.

The role of state-related investors was key for Singapore to become a global financial center. According to another McKinsey report on how to deepen capital markets in emerging markets (Jain et al. 2017), the government used many government-related investment funds, most notably the Central Provident Fund (CPF), to allocate capital to external managers across different investment types, among them private equity, transforming the local fund management industry. It is also worth noting that Singapore's two mammoth SWF are key players in the global private equity markets. Outwards oriented, GIC is the third largest private equity allocator (LP) globally, after the Canadian Pension Plan Investment Board and Abu Dhabi's Investment Authority (Preqin 2017). And Temasek is a cornerstone investor in the largest companies of the country, and continues to pursue Singapore's developmental goal, through—direct and indirect—private equity investments both inside and outside the island.

Apart from the well-known cases of GIC and Temasek, Singapore has several other government-related investment arms that, in different ways, provide equity capital to firms, usually tied to government's developmental plans (i.e. becoming a biotech and IT global hub). Temasek's

venture capital arm, Vertex, has developed a proprietary global network of fund managers[177] that, as of 2020, mange assets worth over $3 billion and has equity stakes in more than 170 companies. Singapore's Economic Development Board (EDB) has its own private equity and venture capital arm, EDB Investments. With a broad scope across sectors and sizes, and in line with the EDB's priorities, it has focused on healthcare, information and communication technologies. Similarly, Infocomm Investments is an accelerator and the venture capital arm of Singapore Infocomm Media Development Authority, and is focused on digital investments. As part of the Startup SG Equity program, the government also co-invests with independent, third party investors into startups. These co-investment funds are managed by SEEDS Capital and SGInnovate. Finally, Singapore's National Research Foundation also provides capital to startups, and a majority of their portfolio is in IT. While it is clear that the state is present in all stages of Singapore's dynamic venture capital ecosystem, it is also important to note that these different investment programs work in tandem with other policy instruments such as R&D subsidies, grants and tax incentives to attract multinationals, and the provision of specialized infrastructure (e.g. laboratories).

Overall, even if this has not been an exhaustive compilation, it shows that state-related financing for private—and public—equity investment funds is ubiquitous (Brander, Du, and Hellmann 2015).[178] Through primary and secondary sources, it is quite clear that state-related financial institutions played a role in the emergence of private capital markets throughout different regions and over time, in otherwise quite different financial systems. Moreover, programs channeling capital through private equity funds do not appear to fade out after their initial

[177] Vertex Ventures China, Vertex Ventures Israel, Vertex Ventures SEA & India, Vertex Ventures US, Vertex Ventures HC and Vertex Growth.

[178] Israel's Yozma program is often mentioned as a successful example of a government initiative that helped build a domestic venture capital market, see, for example, Avnimelech (2009).

incubating role, but continue to flourish. For example, the South Korean government has recently launched a $9B "start-up" investment fund. France's government has announced a €5B initiative to be channeled through French asset managers to finance late stage-investments, and aims to mobilize further resources from other local institutional investors. And Europe, launched what appears to be a new fund of funds, in addition to the regular activity of the EIF.

6.2 Business Associations and Regulatory Co-Production

There is little doubt about the active role of state-related investors such as development banks and pension funds in nurturing private equity markets. The argument about the regulatory politics is harder to assess through shadow cases. Still, I was able to gather primary and secondary sources of data to evaluate some key points. It is quite clear that Latin American public agencies were not innovating when "seeding" fund managers' organizations, but rather following the European and Asian experiences. Outside of Latin America, private equity associations were also created with active public support. Moreover, the politics behind the creation of European private equity's regulatory frameworks, as described by the few secondary sources on the topic, aligns well with my quiet politics argument.

The institutional process underlying the emergence of the—more mature—European private capital markets exhibits a similar dynamic to the one described in Chapter 5 regarding PE in Latin America. First, a regional industry association was created with active sponsorship of public authorities, in this case of the European Commission. In turn, this association played a key role "co-producing" the regulatory framework that would allow the industry to function, following a "quiet" politics approach.

In 1983, the European Commission created the Brussels-based European Venture Capital

Association (EVCA, now renamed Invest Europe). As Ooghe, Bekaert, and Bossche (1989, 40) describe, "from 1980 on, the European Community organized a yearly symposium concerning innovation in which one of the mains themes was venture capital. A next initiative was the creation of the European Venture Capital Association (EVCA) in November 1983. The intention of EVCA is the stimulation and coordination of the development of venture capital in an international context. EVCA received financial support and active cooperation from the European Community."[179]

On its research on the origin of new stock markets in Europe, Posner (2005, 23) argues that the actions of Brussels officials were the most important cause in a complex process of institutional change that occurred in Europe's capital market.[180] Regarding EVCA, he highlights how officials from the European Commission, through "seemingly innocuous interventions that drew little attention and no opposition, helped to create and then finance this political voice and interest group for European venture capitalists." In turn, he argues, the association was key to push for "seemingly small and unremarkable bureaucratic interventions accumulated over a fifteen-year period to forge new interests, catalyze coalitions, stretch interpretations of EC laws, and frame debates" Posner (2005, 4).[181]

The association indeed represents most of the European private equity industry and appears to be central to promote its growth. Its role is quite similar to the one I described in Chapter 5 for the Latin American associations, albeit in a more institutionalized way. It has lobbied to create

[179] For the primary documents that show the role of the European Commission founding EVCA, see European Commission's Bulletins of the European Communities: 12-1981 2.1.18, 11-1982 2.1.24, and 6-1983 2.1.46. I obtained the reference for this primary sources from Posner (2005).
[180] For the role of the European Commission driving corporate governance reform, also see Overbeek, Van Apeldoorn, and Nölke (2007).
[181] For the book version of this argument, see Posner (2009).

new types of investment vehicles, to obtain tax incentives for the activity, and most importantly, to open new fundraising sources.[182] Moreover, it has developed industry standards that its members have to follow. Given its European scope, it worked to harmonize regulations across countries and tried to connect national markets. And it has also served to promote and legitimize the asset class with the broader public. EVCA has also served as an umbrella institution to support national-level private capital associations.

At the national level, the institutionalization of French private equity industry, as analyzed by Benquet and Bourgeron (2020),[183] is also informative of the political dynamic behind the origin of private equity markets. The first pioneer funds were developed in the 1970's at the initiative of senior civil servants, working in public or semi-public financial institutions. Some of these managers founded a national-level private equity association—AFIC,[184] later renamed as France Invest—around the same time EVCA was founded. With leadership roles occupied by former civil servants with well-established connections with government, AFIC, in turn, played a central role in the public-private co-production of the institutional framework behind the growth of the industry. Key regulatory domains paralleled the ones analyzed in Chapter 5 for the Latin American cases: the creation of vehicles (e.g. *Fonds Communs de Placements à Risques*) and an advantageous tax framework for the industry and investors. Moreover, the article shows the PE industry grew by the opportunities opened by successive waves of privatizations. And argues private equity investments, in particular through Bpifrance, became the preferred instrument of policymakers to support growth after privatizations and the decline of more traditional industrial

[182] See, for example, its 2014-2019 EVCA's "key policy achievements."
[183] I am grateful to Isadora Araujo Cruxên for pointing out this article.
[184] *Association Française des Investisseurs pour la Croissance* (AFIC).

planning programs.

Moreover, in their analysis of the institutionalization of the PE industry in France, Benquet and Bourgeron (2020) emphasize the close similarities between left and right wing government policies directed to the sector. Using Culpepper's (2010) framework, they describe how sporadically the "private equity sector, which had built its institutional arrangement on quiet politics for three decades, briefly became an object of 'high political salience'" (p.12). However, "only a small part of the criticism was translated into legislation," partly due to the protection from supranational legislation, but also due to the lobbying and a legitimizing campaign conducted by AFIC.

Overall, the European case appears to be in line with the arguments made in Chapter 5 about the institutionalization of private equity markets. The creation of business associations that represent the private equity industry was actively promoted by public agencies. In turn, these associations functioned as a policy instrument to "co-produce" the industry's regulatory framework. Most of these regulatory initiatives are restricted to bureaucratic domains, outside partisan politics and legislatures. Congress and "large" salient politics, when present, appear to have a reactive role. The game-changing modification of the ERISA rule in the US case discussed above, appears to follow the same logic.

Outside these cases, the secondary evidence on the political dynamics behind the emergence of PE is more limited. Still, it is quite clear business associations emerged with support from governments, as part of programs to promote the asset class, except in the US. Eastern European associations, under the umbrella of the European Commission-sponsored EVCA, were founded together with the first PE firms in the region that managed mostly state-related—

international—funds. In Asia, the Korean Venture Capital Association (KVCA) was established in 1989 as a "government-led" association to facilitate the development of the Korean venture capital industry, as acknowledged in this interview with its Chairman. And similarly, the Singapore Venture Capital & Private Equity Association (SVCA) was formed in 1992 under the patronage of the Economic Development Board to promote and foster growth in this sector.

6.3 Discussion

There is a great deal of state-related resources behind capital markets outside of Latin America. These resources are deployed following different models. Equity capital is in most cases invested indirectly, through third-party fund managers. But government funds are also channeled directly into companies. Domestic fund managers are typically prioritized, but some programs also engage international fund managers who invest in their home countries as well as abroad.[185] Moreover, policy initiatives are sometimes targeted at particular industries, while in other cases they are sector-agnostic, and aim to develop the PE market more generally. We can observe these differences across countries, but also across different programs in one particular country. Going forward, a more systematic approach may serve to evaluate the effectiveness of the different policy programs (Colombo, Cumming, and Vismara 2016; Da Rin, Nicodano, and Sembenelli 2006). For example, by relating PE investments with IPOs, the role of privatizations in the growth of PE, or assessing how different governance and investment models of public financing crowds-in, or not, further private investments. And beyond the role of policy programs in the development of markets, the penetration of PE could also be related to different country-level societal

[185] Government-sponsored but externally-oriented private equity programs that are not just a function of portfolio diversification but have "developmental goals" are in themselves an interesting topic. They are much more frequent in Asia (e.g. Singapore, China and Korea). In Latin America I do not observe any such program.

characteristics, such as investor protections and labor rights (e.g. Bedu and Montalban 2014).

More interestingly, it may also be worth understanding better the origins and the politics behind these programs. While the political logic behind the emergence of private equity markets certainly merits more research, the evidence presented above suggests the "quiet politics" dynamic followed in Latin America, as described in Chapter 5, is not just a function of the low level of development of the private equity industry in this region. In most of the cases analyzed, maybe with the exception of the US, business associations were created through active sponsorship of the government, and as part of a broader initiative to promote private equity and venture capital markets. The European case, as described by Posner (2005) and Benquet and Bourgeron (2020), suggests that these business associations had an important role helping write the regulations that institutionalized private equity markets. They also show that in Europe most of the politics behind these regulations also remain at the margins of partisan politics and Congress. Going back to the Latin American cases, these findings suggest that the political dynamics described in Chapter 5 are not just a function of the region's legislatures dysfunctional policymaking capabilities, driven by the deficient technical capacities of legislative bodies, paired with weakly institutionalized party systems (Cox and Morgenstern 2001). Instead, the "quiet politics" dynamics behind private equity regulations seems to be a more common trend across political systems with different levels of institutionalization.

Beyond normative issues, these findings have theoretical implications. If the development of private equity markets is, as I argue, one of the components of "financial development" (i.e. external—institutional—equity capital into firms), these findings cast some doubts on the mechanisms through which democracy is a force that promotes the deepening of financial markets.

And it indicates, more broadly, the need to re-think the relationship between regime type, policymaking and financial development.

Chapter 7 - Conclusions

Thirty years ago, the idea of external financial investors buying into private companies was foreign to Latin America. This is no longer the case. A financial approach to ownership and corporate governance as the one advanced by private equity investors has become part of the business landscape. Institutional change was certainly slow and non-linear. The private equity model will continue to evolve and adapt to local and global market conditions and policies. Hopefully this evolution will be towards longer-term partnerships between—local and international—institutional investors, fund managers and entrepreneurs to finance firm's growth and value creation through very much needed productivity-enhancing initiatives.

This agency-based dissertation can help bridge context-free policy models with theories that highlight the historical and structural political economy pre-conditions for financial development. From a practical perspective, my actor-based argument provides more clarity on the organizational pre-requisites of policies aimed at fostering the deployment of long-term capital and connecting domestic savings pools with the real economy. This dissertation brings finance back into productive development policymaking and introduces financial bureaucracies to the state capacities discussion.

This dissertation has descriptive value. It contributes to updating the typology of business actors in emerging economies by introducing a new "hybrid" type of investor that blends international finance with local management, helps deepen capital markets and drives corporate governance modernization, as argued in Chapters 2 and 3.

But—hopefully—my contribution goes beyond just describing this new corporate actor and also helps explain the emergence of private equity markets, underscoring the role of the state

in market expansion. In particular, this dissertation emphasizes the role of the state sponsoring—incubating—this business model both by investing in private equity (developed in Chapter 4) and helping the industry organize into business associations (developed in Chapter 5).

I identify three main contributions. The dissertation: (1) introduces private equity into the development debate; (2) prompts a shift in the discussion on financial development from institutional explanations focused only on rules—democracy and investor protections—to an actor-based argument centered on the role of institutional investors; and (3) characterizes a novel model of financial industrial policymaking that forefronts financial bureaucracies and pension funds. In this final chapter, I discuss each of these three topics, explore their implications, and suggest ideas for further research.

7.1 Private Equity and Development

This dissertation is in line with a recent wave of research in political science that argues for paying more attention to business and private sector characteristics when explaining developmental outcomes (Puente and Schneider 2020). While introducing private equity, it highlights firm ownership structure and corporate governance as consequential firm-level dimensions, and emphasizes the overall centrality of finance for development.

Private equity provides firms with a distinctive source of financing that is otherwise elusive in the developing world. PE combines three characteristics: it is *risky, institutional* and—at least relative to other financial investors—*patient*. Private equity investors help finance firms by investing in the more risky tranches of the firm's capital structure, which usually grants them an ownership stake. PE firms channel institutional capital into firms, and therefore function as an alternative to more informal individual and family-related sources of capital. And PE exhibit

longer holding periods than those of traditional asset managers focused on public securities, given the illiquidity of their holdings.

PE also appears at odds with prevalent corporate governance models in Latin America. Private equity investors can be described as hybrid actors in at least two ways. First, private equity firms broker domestic and international arenas by combining local embeddedness with connections to international markets. While prioritizing local management and operations, PE investors also participate in international networks of finance, technology, and management. Second, PE funds manage capital from third-party investors but act as owners. Even though they are financial investors, their role goes beyond solving capital constraints to include an active involvement in firm governance and management. Crucially, PE can introduce autonomous professional management in a context where otherwise "hierarchical" models of governance prevail.

A key assertion of this dissertation is the connection between private equity and (financial) development. For some readers this argument may appear controversial, even provocative. The PE model is often portrayed as just a financial engineering exercise, more frequently characterized as value extraction than value creation. Critics argue that the heavy use of debt and high dividend payouts, combined with aggressive restructuring plans that often involve layoffs basically entail a transfer of value from firm's workers and other stakeholders to PE investors.

PE fund managers invest in behalf of a broad base of—mostly institutional—investors. While there is certainly an agency issue between managers and investors that can have large distributive implications, ultimately the returns of PE are also the returns of their investors, among them, millions of pensioners. Instead of justifying PE's excesses, the institutional origin of its

capital should point out the levers for their increased accountability.

Moreover, at least as I defined it, private equity is a broad term that groups different "alternative assets" outside public markets. It includes buyouts, growth equity, venture capital and infrastructure-oriented investments, among others.

Most of the criticisms are specific to—typically leveraged—buyout investors. Still, there is solid empirical evidence that shows private equity investors—including buyouts—help allocate capital more efficiently, improve management practices, drive growth and boost productivity (e.g. Bloom, Sadun, and Van Reenen 2015; S. J. Davis et al. 2014, 2019; Lerner, Sorensen, and Strömberg 2011). Concerning the effect of private equity on employment, results indicate substantial differences across asset sub-classes. In the US, evidence indicates that "take-private" buyouts indeed have negative effects over employment rates. When PE firms acquire a listed company, they often play a restructuring role that often include substantial layoffs. Outside of these public-to-private transactions, private-to-private buyouts appear to expand employment relative to control firms (S. J. Davis et al. 2019). Beyond buyouts, the role of venture capital and growth equity investors is less disputed. These investors often enjoy a better reputation and are mostly seen as drivers of value creation, as they provide funding for firm development, growth and innovation (Rin, Hellmann, and Puri 2013).

Some of the critiques to private equity certainly travel to economies with less developed financial markets, like those in Latin America. In this context, PE also entails the extension of markets and a finance-oriented approach to governance. However, most of the criticisms are less applicable in under-developed financial systems. Whatever their merits, in Latin America there are no large buyouts. Most transactions are in the equivalent of growth-oriented mid-and small-

cap categories in the US. Moreover, highly-leveraged strategies are not common. As I show in Chapter 3, leverage is actually more associated with family control than with private equity ownership. More generally, and notwithstanding the importance of reforms to discourage value extraction, in Latin America the low levels of external finance are arguably a preceding—and more fundamental—problem than its possible excesses.

In Latin America, beyond a few business groups and multinationals, firms are typically small, have concentrated ownership and are governed through traditional structures. External sources of capital are scant, and there is no active market for corporate control. In more developed capital markets, private equity concentrates ownership as a way to discipline managers. In contrast, in Latin America, private equity is an alternative to governance models organized around families and individuals. In a context where stock markets with dispersed ownership and unchecked managers are notably absent, PE plays a different—and arguably more developmental—role. It helps expand capital markets, modernizes firm ownership and professionalizes corporate governance.

Moreover, in the path towards a more complete financial system there is no clear alternative for an active equity market. The traditional dichotomy in comparative political economy between capital-markets and bank-based financial systems does not seem applicable. Bank loans are less of a substitute and more of a complement to equity financing. In any case, banks in the region are hardly a reliable source of patient capital since they are mostly oriented towards short-term consumer lending. In environments with developed stock markets, PE indeed competes with public equity markets. In contrast, in emerging economies PE is arguably a necessary condition for their expansion. As I show, PE is one of the main drivers of stock market listings. And among the

companies that list in the stock market, those backed by PE investors have a more dispersed shareholder structure and less kinship ties within their leadership positions, illustrating how PE drives business modernization.

Overall, this dissertation contributes to a business-centered approach to development by characterizing a distinctive actor: private equity. By doing so, it forefronts finance and corporate governance as key dimensions in the development debate. Going forward with this agenda calls for further evaluations of the implications of alternative ownership and governance models such as PE. While there is a growing empirical literature on the economic effects of PE, it is mostly focused on developed countries. And open questions remain around how PE engages politics.

7.2 Institutions: Rules vs. Investors

That finance is an important driver of economic development is hardly controversial. There is solid evidence that shows the development of a country's financial markets is causally associated with the long-term economic growth and the material well-being of its population. This dissertation argues that the development of private equity markets, as a key source of arms-length equity financing, is an important component of a developed financial system. And regarding the political economy behind the development of financial markets, it proposes an actor-based explanation as an alternative argument that can complement longer-term rules-based hypothesis focused on economic and political institutions.

This dissertation takes a more concrete approach and focuses directly on the role of investors. An institutional environment that guarantees adequate investor protections does not appear to be enough to unleash equity markets. Instead, my comparative case studies indicate that state-related institutional investors, in particular development banks and pension funds, are

actually key drivers of private equity markets. Domestic and multilateral development financial institutions appear to have an "incubating" role during the early stages of the industry, followed by pension funds. While shareholder legal rights are certainly relevant for development, they are insufficient to explain the path towards more complete equity markets. These have to be actively nurtured by state-related investors.

Focusing on specific economic institutions, PE is arguably less sensible to within-firm minority shareholder rights. Given their concentrated stakes, PE investors have the incentives and the capacity to monitor management and other shareholders. Thus, they may be better able to operate in less institutionalized environments, where agency costs make stock markets unfeasible. Moreover, the industry's regulatory framework appears to be endogenous to the emergence of its players, who help shape their rules.

The institutionalization of the private capital industry seems to follow a "quiet politics" dynamics. The regulatory reforms that enable the industry to operate more smoothly (e.g. the creation of new investment vehicles and the rules that grant access to pension fund resources) are made mostly outside of Congress and partisan politics. Asset-specific business associations that push for these reforms purposefully avoid these traditional "democratic" domains and act in less salient bureaucratic arenas. This dynamic is not specific to Latin America. Cases outside of the region appear to follow a similar logic, reinforcing the evidence from my case studies. This finding suggests that the quiet politics dynamics is not just a function of Latin America's underdeveloped PE markets or less institutionalized parties and legislatures, but a more general characteristic of financial regulation.

Consequently, this dissertation calls into question the literature's macro-level relationship

between political institutions and the development of financial markets. The reforms that foster private capital markets do not seem to follow the mechanisms implicit in arguments that relate democracy with financial development. Equity markets do not simply unleash with more constrained executive powers. And reforms do not appear to be pushed by popular support. The case of private capital markets suggests a review of the specific mechanisms through which democracy drives financial development. And more broadly, encourages a deeper assessment of the channels through which political regimes affect policymaking in different areas (Simison 2019), especially in those related to the expansion of markets.

From an organizational perspective, it is clear public agencies—both multilateral and domestic—help industry participants organize. The public sponsorship of business associations is surprisingly consistent across Latin America as well as in other regions. Public agencies promote business collective action, who then help "co-produce" the industry's regulatory framework. For those with an interest on interest group politics, this example of "micro-level corporatism" is in itself intriguing. And suggests possible inquiries into other industries and policy areas.

The quiet politics logic underlying the emergence of the private capital industry certainly raises a normative concern about democratic accountability. It also signals the practical limits of quiet politics as a strategy to promote the industry. While this approach may be successful at the micro-level, broader structural change probably requires appealing to larger audiences beyond regulators and financial bureaucracies, limiting the feasibility of a quiet politics strategy.

The quiet politics explanation also exposes the scope of the arguments advanced by this dissertation. The evidence from the empirical cases suggests some skepticism towards the rather linear relationship between democratic political institutions, property rights and the expansion of

markets, as portrayed in the literature. This dissertation directs the attention to the role of state-related investors, whose origin is hardly market based and therefore not just intermediate steps in a longer causal chain that connect institutions and financial outcomes. Still, it leaves mostly unanswered the deeper question about the political economy origins of capable state-related institutional investors and their push for business modernization.

7.3 Financial Industrial Policymaking: the State and Pension Funds

This dissertation also characterizes a novel model of "financial" industrial policymaking. And as part of its actor-based approach, it emphasizes a specific type of financial bureaucracies as well as the fundamental role of pension funds in developing more complete equity markets.

This dissertation has documented the extensive use of private equity as a policy instrument, even in otherwise market-oriented economies. States promote private equity with the "horizontal" purpose of building more robust capital markets and increasing firm's access to equity capital, otherwise elusive. Even when horizontal, it is clear development-oriented policymaking is not limited to cost-reducing "passive" initiatives. Many initiatives also channel public resources through privately-managed equity funds in a more targeted way, with a focus on specific sectors. This novel policymaking model seems to be part of a paradigm shift in way states intervene in markets: it has finance at its core and prioritizes the private sector as the driver of development.

New industrial policy models have focused on policies promoting cost discovery activities and facilitating coordination among firms, centered on sectors with a—latent—comparative advantage (e.g. Hausmann and Rodrik 2003; Rodrik 2004; Sabel et al. 2012). For the most part, they overlooked the financial side of new ventures, as well as its corporate governance. This dissertation can help complement this literature. I call this model "financial" industrial policy

making because it has finance at its core and privileges the investment channel above other policy instruments (e.g. trade regulations, R&D subsidies, local content requirements, etc.). Through these policy initiatives the state intends to "crowd-in" private investors. To do so, it often outsources capital allocation decisions to private fund managers. By acting as intermediaries between governments and target companies, PE firms can help relax some major agency issues. At the expense of losing some control, policymakers can expect to achieve better governance schemes, improve screening and monitoring capacities. And by maintaining an arms-length relationship with firms, the state can discourage rent-seeking behavior.

The cases of states investing in private equity and "outsourcing" policymaking through private fund managers have multiplied across the globe, particularly in Asia and Europe, as well as in Latin America. Similar policy designs diffused across regions, as policymakers learned from the experiences of other countries. Multilateral development institutions appear to be one of the key vectors for the diffusion of these policies. They not only participate as investors, but also promote and advise in the design of policy interventions. This diffusion effect is noteworthy, for example, in the promotion of asset-specific business associations as well as in the creation of government-sponsored fund of funds.

Diffusion dynamics also appear to be behind arguably misplaced policies that reproduce a "Silicon Valley Consensus" (Armstrong 2016; Piore 2017). These policies, for example, promote venture capital investments in high-tech digital innovation without much consideration towards the suitability of this model with local realities. They are probably as ineffective, and certainly more expensive, as sanctioning laws protecting minority shareholder rights and waiting for capital markets to emerge. Policies that work have to adapt the model to make it "contextually rational"

(Klingler-Vidra 2018). The capacity to overcome blunt isomorphism is, ultimately, one of the key indicators of state capacities (Guillén and Capron 2016).

Regarding state capacities, this dissertation emphasizes the role of government-affiliated investors who exhibit autonomy from politicians and bureaucracies and have extensive linkages to the private sector, in line with the idea of embedded autonomy (Evans 1995). This novel type of financial bureaucracies are typically structured as separate entities from the rest of the state administration. In many cases, they also operate with some independence from the development institutions they are part of; some of them even have private shareholders. This enhanced autonomy enables them to operate with similar standards to those of the private sector, pay competitive salaries and build a reputation that allows them to attract talent. And arguably, it also gives these financial bureaucracies the flexibility to better interact with the private sector.

Close interaction with the private sector appears as necessary condition for the successful implementation of government-sponsored investment programs: the key challenge is to attract and partner with external investors. In terms of outcomes, the "sweet spot" of government-funded private capital initiatives appears to be when government funds are paired with third-party sources of capital, and the state is able to effectively crowd-in other local and international investors (Brander, Du, and Hellmann 2015; Fuller 2016; Lerner 2009). The obstacles to this close interaction are not just technical, but also political. Particularly in contexts where business legitimacy is low, combining public and private money is politically challenging (Di Tella, Dubra, and Lagomarsino 2016).

My analysis suggests the participation of local pension funds is a key step towards the viability of private capital markets. Government programs that invest in private equity usually

intend to leverage pension funds. Gaining access to pension fund resources is also the number one priority in the agenda of private capital industry associations. The main policy challenge is to create the channels that connect large pools of institutional capital—such as resources from pension funds—with long-term productive investments. And doing it in a way that prevents expropriations and does not jeopardize the sustainability of the pension system. As this dissertation has made clear, the creation of these "channels" is not automatic. It requires specific pieces of regulation, as well as the emergence of multiple specialized intermediaries including asset-specific fund managers and various service providers. Ultimately, the creation of these channels derives from extensive public and private collaboration.

Beyond its focus on private equity, this dissertation raises the awareness of the role of pension funds in financial markets. As part of an actor-centered approach to financial development, my findings suggest a broader political economy agenda around the role of pension funds in capital markets.

Pension funds accumulate massive amounts of long-term capital as a result of compulsory saving schemes. The way these funds are invested has major political economy implications and significant potential to affect firm ownership structures and corporate governance practices. Through its narrow focus on private equity, this dissertation only began to explore this extensive topic.

There is significant variation in how pension funds are structured and regulated across the world. While defined contribution plans gained popularity in the last couple of decades, defined-benefit plans are still very common. Publicly-run schemes co-exist with privately managed

systems. There is also a great deal of variation in how pension funds allocate their capital.[186] Beyond the exposure to "alternative" assets like private equity, there are significant differences in the composition of their investment portfolios across multiple dimensions. For example, the extent to which pension funds are used as captive investors to finance the public sector, how much of the capital is invested outside domestic markets, the proportion of equity vs. bonds, or whether they outsource to third party asset managers or invest in-house. And even more broadly, the extent to which pension funds play an activist corporate role as investors, and make use of their "voice" on issues as varied as gender relations in the workplace, environmental sustainability, executive pay and share buy-backs (e.g., Henderson et al. 2020). Variation observed across countries does not appear to reconcile with traditional political economy frameworks, such as varieties of capitalism, and has not been explored through a development lens. A systematic understanding of the causes and consequences of these variations is an exciting—and ambitious—research agenda.

Going back to Latin America, this agenda has substantial practical implications. Latin America's asset management industry is set to double its size by 2025, mostly driven by the rapid growth of pension savings (PWC 2019). The ultimate question is whether countries will be able to capitalize on this expanding pool of capital in a way that protects pensioners and at the same time drives much-needed investments, productivity and growth.

[186] For a description of how pension funds are organized across different countries, and the extent to which their regulatory framework as well as their portfolio allocations varies, see PWC (2020) report.

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