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Private equity in Italy: market and regulatory overview

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MARKET OVERVIEW

1. How do private equity funds typically obtain their funding?

Private equity funds continued to have a diverse investor base in 2015. Although with a significant decrease from the 2014 figure of 68%, about 48% of the capital raised in 2015 was sourced abroad (*Il mercato italiano del Private Equity, Venture Capital e Private Debt nel 2015, Italian Private Equity and Venture Capital Association (AIFI)*).

In 2015, the main sources of funding were:

- Funds of funds: 9.7%.
- Pension and social security funds: 18.6%.
- Banks: 15.3%.
- Insurance companies: 11.7%.
- Public sector: 16.2%.
- Individuals and family office: 19.3%.
- Foundations: 2.4%.
- Corporations: 2.3%.
- Others: 0.9%.

See box, Private equity/venture capital association.

2. What are the current major trends in the private equity market?

2015 confirms the positive trend in the market of private equity and venture capital in Italy. Market fundraising has increased by 92% with about EUR2.9 billion compared to the EUR1.5 billion of 2014. Individual investors and family offices have been the main source with 19.3% of the aggregate amount of capital raised, followed by pension and social security funds (18.6%) and public sector funds (16.2%).

In 2015, 342 new transactions have been carried out, involving 272 companies, for an overall amount of approximately EUR4.7 billion, with an increase of 31% *vis-à-vis* 2014. The number of transactions increased by 10% if compared to 2014.

Buy-out transactions continued to represent the core sector, with approximately EUR3.3 billion invested, followed by replacement transactions, with approximately EUR900 million and expansion transactions, with approximately EUR340 million.

In terms of numbers of transactions, early stage transactions ranked first, with 122 investments, followed by buy-out investments (101) and expansion stage investments (81).

Considering the market segments, early stage (seed and start-up) increased in respect of both the number of transactions, with 122 transactions vis-à-vis the 106 transactions in 2014, and the invested amount, which increased from EUR43 million in 2014 to EUR74 million in 2015. In the expansion segment, approximately EUR335 million were invested, distributed on 81 transactions, with a decrease of 20% in terms of number of transactions and 72% in terms of invested amount.

Considering the nature of the investors, asset management companies (SGR) carried out the greater number of investments (35%), followed by regional and public players (33%) and by investment companies (22%).

Turnaround transactions were four, with a decrease from the 2014 figure of eight, also considering the invested amount, which decreased from EUR97 million to EUR64 million.

In 2015, the invested amount in replacement transactions was approximately equal to EUR900 million, with a significant increase from the 2014 figure of 28.

In 2015, the average size of the invested amount per single transaction was equal to EUR13.5 million, with an increase from the 2014 figure of EUR11.3 million.

In relation to the geographical areas where the investments took place:

- 71% of the total investments were carried out in the north of Italy (an increase of 14% compared to 2014).
- 16% in the centre (an increase of 4% compared to 2014).
- 9% in the south (an increase of 3% compared to 2014).

3. What has been the level of private equity activity in recent years?

Fundraising

In 2015, funds raised were for the following type of funds:

- Buy out (56%).
- Expansion (23%).
- Early stage high tech (1%).
- Infrastructures/others (20%).

Investment

The main sectors targeted by private equity investments in 2015 were:

- Financial services: 23 transactions.
- Non-financial services: 35 transactions.

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- Industrial products and services: 34 transactions.
- Computing: 29 transactions.
- Media and entertainment: 21 transactions.
- Energy and utilities: 11 transactions.
- Medical: 28 transactions.
- Manufacturing: 39 transactions.
- Biotechnology: 11 transactions.
- Food: 22 transactions.
- Luxury: 12 transactions.
- Transportation: 4 transactions.
- Retail: 12 transactions.
- Chemicals: 11 transactions.
- Industrial automation: 5 transactions.
- Electronics: 2 transactions.
- Agriculture: 2 transactions.
- Telecommunications: 4 transactions.
- Consumer goods: transactions.
- Other: 5 transactions.

Transactions

The investment amounts by stage in 2015 were:

- Seed or start up: 122 transactions totalling EUR74 million.
- Expansion: 81 transactions totalling EUR333 billion.
- Turnaround: 4 transactions totalling EUR64 million.
- Replacement: 34 transactions totalling EUR894 million.
- Buyout: 101 transactions totalling EUR3.255 billion, of which:
  - 66% were small;
  - 28% were medium; and
  - 6% were in the large and mega buyout classes.

Exits

In 2015, exits accounted for EUR2.903 billion, compared to EUR2.632 billion recorded in 2014. The distribution of exits (by value) was as follows:

- Trade sales: 23%.
- Sales to other financial investors: 48%.
- Public offerings: 22%.
- Write-off: 2%.
- Buyback or other: 5%.

The distribution of exits (by category of investor) was as follows:

- Early stage players: 1%.
- Banks: 13%.
- Investment firms: 12%.
- International players: 12%.
- Public or regional players: 17%.
- SGR (*società di gestione del risparmio*): 45%.

(*Il mercato italiano del private equity, venture capital e private debt nel 2015, Italian Private Equity and Venture Capital Association (AIFI)*).

REFORM

4. What recent reforms or proposals for reform affect private equity in your jurisdiction?

Status of the AIFMD implementation

Directive 2011/61/UE on alternative investment fund managers (AIFMD) introduced a harmonised regulatory framework on the rules applicable to alternative investment fund managers (AIFMs) of alternative investment funds (AIFs), including private equity funds.

The AIFMD applies to the following managers:

- EU alternative investment fund managers who manage EU or non-EU AIFs (regardless of whether or not they market them in the EU).
- Non-EU AIFs managers who manage EU AIFs.
- Non-EU AIFs managers who market their AIFs in the EU (*Article 2(1), AIFMD*).

The AIFMD expressly excludes from the scope of application of its provisions managers of private equity funds that qualify as "small AIFMs" for the purposes of the AIFMD, that is:

- Managers with assets under management of less than EUR500 million that manage unleveraged closed-end funds with no redemption rights within five years.
- Managers with assets under management of less than EUR100 million.

The AIFMD also sets out asset-stripping limitations in the case of acquisition of control stakes in listed and non-listed companies.

Broadly speaking, the asset-stripping rules apply to the following categories of private equity managers:

- Italian or other EU AIFMs.
- Non-EU AIFMs managing EU AIFs.
- Non-EU AIFMs that commercialise their funds to investors based in Italy (or another EU member state).

Accordingly, non-EU AIFMs established outside of the EU, which are not marketed to EU-based investors, are not affected by the AIFMD.

The implementation process was completed on 19 March 2015. The main steps of the implementation process were as follows:

- Legislative Decree No. 44 of 4 March 2014, implementing the AIFMD (AIFMD Decree) entered into force on 9 April 2014. The AIFMD Decree amended the relevant provisions of the Legislative Decree No. 58 of 24 February 1998 (Consolidated Law on Financial Intermediation) and detailed the transitional regime applicable until the entry into force of the implementing regulations of the Ministry of Economy and Finance (MEF), the Bank of Italy and the Italian Securities and Exchange Commission (*Commissione Nazionale per le Società e la Borsa*) (CONSOB).
- Resolution No. 19094 dated 8 January 2015, where CONSOB adopted the above implementing regulations by amending both the CONSOB Regulation No. 11971/1999 containing the implementation rules of the Consolidated Law on Financial Intermediation relating to issuers (Issuers Regulation) and the CONSOB Regulation No. 16190/2007 containing the implementing rules of the Consolidated Law on Financial Intermediation relating to intermediaries (Intermediaries Regulation).

With regard to the new Issuers Regulation, some amendments have been introduced with a view to:

- Defining the pathway that Italian and foreign managers must follow in order to market AIFs both nationally and internationally, in respect of either institutional or retail investors.
- Numbering the information obligations towards the investors. In this respect, with regard to institutional investors, annex 1-*bis* to the Issuers Regulation sets out the minimum set of information to be given before

the investment is completed. In relation to retail investors, with subscriptions of open AIFs, prior provisions are confirmed with regard to the duty to provide the document with key information for the investors and the prospectus. For closed AIFs, provisions implementing EU Prospectus Directive (2003/71/EC) apply.

- Implementing the new provisions set out in the Consolidated Law on Financial Intermediation concerning the duties imposed on the AIFs managers that acquire relevant and controlling equity interests in both listed and unlisted companies.

With Intermediaries Regulation, the principal amendments concern:

- Managers' conduct.
- Incentives.
- Best executions duties.
- Rules regarding reporting and registration activities.

In particular:

- In relation to managers' conduct, some exceptions to the ordinary regime are provided in favour of reserved AIFs' managers.
- For incentives, specific duties to communicate the incentives have been introduced (*Article 24, EU Regulation No. 231/2013*).
- With reporting and registration activities, Article 74 of the Intermediaries Regulation expressly recalls Article 26 of EU Regulation No. 231/2013 by imposing on managers of undertakings of collective investment in transferable securities (UCITS) tighter rules in relation to orders execution confirmations.
- Article 76 of EU Regulation No. 231/2013 extended the rules concerning the marketing of quotas or shares of UCITS also to AIFs' managers.

Another step is by means of regulation dated 19 January 2015 where the Bank of Italy has implemented some modifications to the Italian regulation dated 8 May 2012 concerning the collective investment in transferable securities (UCITS Regulation). In particular:

- Under the new Title II, SGRs (*società di gestione del risparmio*) must have a minimum share capital equal to EUR1 million, fully paid-up. Such amount is reduced to EUR500,000 for SGRs managing exclusively reserved closed-end AIFs. The same provisions also apply for variable-capital investment companies (*società di investimento a capitale variabile*) (SICAV) and fixed-capital investment companies (*società di investimento a capitale fisso*) (SICAF).
- Under the new Title III, new rules have been introduced for SICAFs and under-threshold managers' authorisation process.
- Under the new Title V, some limitations are provided for the use of leverage by AIFs' managers, while non-reserved open AIFs have been granted the ability to invest until 100% of their assets in some kinds of reserved AIFs.
- New Title V provides for some specific independence requirements with regard to subjects required to carry out approvals concerning UCITS assets and net asset value (NAV).
- Additionally, certain new provisions have been introduced for depositaries, with particular regard to the:
  - procedure relating to the granting of the mandate;
  - relationships between the manager and the depository;
  - depository's professional liability.

Another step is by means of the resolution dated 19 January 2015 under which CONSOB and the Bank of Italy have implemented some amendments to the joint regulation under Article 6, paragraph 2-*bis* of the Consolidated Law on Financial Intermediation (Joint Regulation). In this respect, some simplifications have been introduced, including for under-threshold managers, by providing a graduation of the applicable requirements considered the:

- Size of the manager.
- Broadness of its business.

Additionally, to implement the provisions regarding remunerations set out in the AIFMD, certain provisions have been introduced in order to comply with European rules and standards, namely the AIFMD and the European Securities and Markets Authority (ESMA) Guidelines No. 232/2013 concerning remuneration policies of AIFs managers.

The step from 19 March 2015. The new Ministerial Decree adopted by the Ministry of Economics (New Ministerial Decree) was published in the *Official Gazette*. The New Ministerial Decree implements Article 39 of the Consolidated Law on Financial Intermediation and defines the main rules applicable to the functioning and structure of Italian collective investment undertakings, including Italian AIFs. It replaces the Ministerial Decree No. 228/1999. According to the New Ministerial Decree, which entered into force on 3 April 2015, the following provisions have been adopted:

- The obligation that requires the listing of closed-end funds whose minimum subscription amount is lower than EUR25,000 was cancelled (*Article 5, New Ministerial Decree*).
- Open AIFs can invest until 20% of the portfolio in unlisted financial instruments (*Article 8, New Ministerial Decree*).
- Yearly calculation of the value of the units or shares of open AIFs (*Article 9, New Ministerial Decree*).
- AIFs investing in assets characterised by a lower degree of liquidity must be set up in closed-end form. If investments are made in unlisted financial instruments, other than units or shares of open UCITS, in a measure exceeding 20% of the fund's assets, the closed-end form is mandatory (*Article 10, New Ministerial Decree*).
- The regime applicable to real estate AIFs was introduced (*Article 12, New Ministerial Decree*).
- A manager that provides reserved AIFs can also have participations by non-professional investors, provided that the minimum subscription amount is not lower than EUR500,000 (*Article 14, New Ministerial Decree*).
- There is the possibility for reserved real estate AIFs to be marketed to public subjects, where these public entities invest through the direct contribution of real estate or real estate rights in connection with transactions aimed at appraising public assets under Article 33 of Law Decree no. 98/2011, converted into Law No. 111/2011 (*Article 14(3), New Ministerial Decree*).

Impact of the AIFMD

The implementation of the AIFMD affects a number of aspects relating to the management and operation of AIFs. With particular reference to the activities performed by private equity funds:

- The AIFMD Decree introduced certain provisions aimed at regulating the acquisition of control or significant shareholdings in target companies by AIFs managed by AIFMs (*Articles 26 to 29, AIFMD*).
- The rules on the marketing of Italian and foreign AIFs (among other things) have been amended to introduce the passport regime provided under the AIFMD. This means that the restrictions that previously applied to the marketing in Italy of foreign AIFs have been relaxed. This is particularly true for marketing activities carried out by AIFMs in relation to Markets in Financial Instruments Directive 2004/39/EC (MiFID) professional investors and other categories of investors that may purchase units or shares of Italian reserved AIFs (*FIA italiani riservati*) under applicable regulations.
- The regulatory regime applicable to AIFMs before the implementation of the AIFMD has been significantly reviewed. The review examines the rules on:
  - risk and liquidity management;

- valuation;
- delegation of functions;
- depositary;
- internal organisation and controls;
- conflict of interests;
- initial capital and own funds;
- reporting to competent authorities.

Additional requirements have been introduced in a number of areas that were not previously covered in detail by applicable laws and regulations. This includes leverage, coverage of professional liability risks and disclosure to investors.

- The AIFMD Decree introduced a new set of provisions on SICAF. This is a new form of AIFs that can also be used to set up private equity investment vehicles.

Other reforms

Other recent reforms and legislative proposals that may affect collective investment undertakings are detailed below.

The AIFMD introduced certain provisions aimed at defining the competent authorities and identifying the relevant authorisation and marketing procedures for the purpose of EU Regulation No. 345/2013 on European Venture Capital Funds (EuVECA) and EU Regulations No. 346/2013 European Social Entrepreneurship Funds (EuSEF).

CONSOB adopted certain new provisions applicable to the distribution of complex financial products to retail clients (*Communication No. 0097996 dated 22 December 2014*). In particular, the communication:

- Discourages intermediaries from offering to clients certain complex financial products, including, among other things, asset-backed securities, contingent convertible notes, credit linked products and credit derivatives.
- Underlines intermediaries' duty to tailor the quality of the offered products on the basis of the different clients' profile.
- Stresses the importance of preventing possible conflicts of interest that may arise in the distribution of products aimed at boosting the financial solidity of the intermediary itself, also by way of elimination of the inducements granted to the intermediary's employees.
- Promotes the recourse to risk assessment and management techniques and also in the selection of the information to be given to the clients, with particular regard to information concerning credit, market and liquidity risks, as well as any other risk relating to the specific investment carried out by the relevant client.

However, CONSOB recommends that products such as the following are neither proposed nor distributed directly to retail clients:

- Asset-backed securities.
- Contingent convertible notes.
- Credit-linked products.
- Derivatives instruments under Article 1(2)(d) to (j) of the Consolidated Law on Financial Intermediation that are negotiated outside trading venues without hedging scopes.
- Certain structured financial products with no guarantee for reimbursement of the principal invested.

If the intermediary deems, on completion of proper evaluations made under to paragraph 14 of ESMA Opinion "*MiFID practices for firms selling complex product*", that the relevant product can be distributed, then certain precautionary measures must be adopted, including the adoption of a specific and motivated resolution by the intermediary's internal bodies concerning the distribution of such products. In order for such a resolution to be adopted, specific limits must be defined, with regard, among other things, to:

- Socio-economic features of the potential client.
- Quantitative investment thresholds.
- The modalities through which products are offered.

Intermediaries must take measures concerning the areas referred to above by 30 June 2015, informing CONSOB of the policies, the protections and the results of the control activities carried out.

On 22 July 2013, the Bank of Italy issued a communication on the adequacy of the procedures for the assessment of credit risk and the use of ratings in the context of collective asset management activities.

Other possible changes to the regulatory framework may derive from the implementation of the Regulation on European Long-term Investment Funds (ELTIFs) that was adopted on 29 April 2015 (ELTIFs Regulation) as well as from the implementation of the UCITS V Directive.

In particular, the ELTIFs Regulation, which is strictly connected to the AIFMD, and which applies to all EU member states effective from 9 December 2015, aims, on one side, to impose to the ELTIFs managers, whose quotas or shares will be distributed to retail investors, the duty to adopt and implement a specific internal evaluation procedure aimed at assessing whether the product is suitable in order to be commercialized to such investors; from the other side, the ELTIFs Regulation aims to impose certain safeguard measures in favour of the investors, especially in terms of consultancy services to be provided in favour of the same. In fact, in the event the financial portfolio of the client does not exceed EUR500,000 a minimum initial investment not lower than EUR10,000 is required. Moreover, specific concentration limits are provided, according to which the investment shall not exceed 10% of the overall value of the portfolio. With regard to the investment policies of the ELTIFs, certain activities shall be considered as permitted investment activities, including investments in:

- Equity or quasi-equity instruments issued by a permitted portfolio company.
- Debt instruments issued by a permitted portfolio company.
- Loans granted by the ELTIF in favour of a permitted portfolio company, having an expiration not exceeding the life of the ELTIF.
- Shares or quotas of other ELTIFs, EuVECA and EuSEF, provided that such ELTIFs, EuVECA and EuSEF have not invested more than 10% of their capital in another ELTIF.

In order for a company to be qualified as a permitted portfolio company, the following requirements, among others, must be satisfied:

- The company must not be qualified as a financial company (as defined pursuant to the ELTIFs Regulation).
- The company must be incorporated in a member state or in another third country, provided that such third country meets certain requirements, including compliance with the requirements imposed by the Financial Action Task Force (*Ecco come funzioneranno gli ELTIF*, *www.assogestioni.it*).

Certain new provisions were introduced through Law Decree no. 145/2013 (amended to Law No. 9 of 21 February 2014). The new provisions clarified a number of aspects relating to securitisation transactions carried out through investment funds (*fondi comuni di investimento*). They extend the possibility for insurance undertakings to invest in units of investment funds that are mainly invested in bonds or similar instruments issued by non-listed companies (mini-bonds) to cover their technical provisions. The rules applicable in relation to any such investments made by insurance undertakings have been further specified in the IVASS Communication dated 23 January 2014 (IVASS Communication). The IVASS Communication clarified that the units or shares of EU AIFs that are marketed in Italy under the AIFMD passport regime are included in the list of eligible assets for the investments made by insurance undertakings to cover their technical provisions. This must be in accordance with the limits specified under the applicable regulations. Accordingly, the IVASS Communication has removed

certain restrictions that were previously applicable to these kinds of investments, therefore facilitating the investments made by insurance undertakings in EU AIFs marketed under the AIFMD passport regime.

Tax reforms and recent developments

During 2015 and early 2016, some relevant tax reforms and official positions from the Italian Tax Authority were issued.

Those which may affect collective investment undertakings are detailed below.

- **2016 Budget Law**
  - Starting from 2017, Corporate Income Tax (IRES) ordinary rate will be reduced to 24% (from 27.5%).
  - As a consequence, starting from 2017 the EU withholding tax will be reduced to 1.20% from 1.375%, as well as the effective tax rate on dividends received by Italian resident companies and the effective tax rate on capital gains benefiting from the participation exemption rule.
  - Any goodwill or trademark arising from a tax neutral transaction (for instance, contribution, merger and spin-off) is generally disregarded for tax purposes unless a substitutive tax is paid. In this case the amortisation period, previously ten years, is accelerated to five years for transactions occurring from 1 January 2016.
  - Reduced municipal taxes on PV (photovoltaic) plants.
- **GAAR and Internationalization Decree**
  - Effective as of 1 October 2015, the Italian GAAR (General Anti Avoidance Rule) was revised. According to the new Italian GAAR, an abuse of law exists when a transaction "lacks any economic substance and, while formally consistent with tax law, is aimed at obtaining undue tax saving".
  - Starting from 2015, sister companies controlled by the same EU resident entity may form a tax group, subject to certain conditions.
  - Starting from 2015, EBITDA of foreign entities cannot be included into the earning stripping rule calculation for the deductibility of interest.
- **LBO Circular Letter.** The Italian Tax Authority provided some clarifications on the tax treatment of leveraged buyouts via a Circular Letter.
  - Management fees and other similar expenses paid by the BidCo / Target to private equity sponsors are deductible only to the extent they have a business purpose.
  - Interest expenses incurred by an Italian *bidco* on loans obtained to fund the LBO should be considered, in principle, as having business purpose and therefore tax deductible. Abusive transactions are still subject to tax authority reviews.
  - Shareholder loans granted in the context of a LBO can be recast as equity based on a substance over form approach. Typical subordination, maturity and rating terms should be considered in that respect.
  - The Circular emphasizes that "substance" is essential to obtain Treaty Benefits and/or access to EU Directives on exit. A foreign resident holding company can be respected as such only to the extent it is a "genuine set up" and not "artificial structures".
  - An artificial structure would be denied Treaty Benefits and would be subject to the general anti abuse rules provided by EU Parent Subsidiary Directive.
  - The Circular indicates that in case a Foreign Holding company is disregarded for Treaty purposes, it should be possible to apply to its shareholders the same Double Tax Treaty Regime that would be applicable had they invested directly.
- **BEPS Final reports.** The OECD released the final reports of BEPS launched in July 2013, which address several issues relevant for the private equity industry. Most of BEPS which can have an impact on the private equity industry in Italy (for instance, treaty access and substance requirements) have not yet been implemented.

TAX INCENTIVE SCHEMES

5. What tax incentive or other schemes exist to encourage investment in unlisted companies? At whom are the incentives or schemes directed? What conditions must be met?

The European Commission has issued guidelines in *Communication Europe 2020* to facilitate access to venture capital and support the growth of new enterprises, using investment funds. According to these guidelines, any income from capital arising from participation in funds for venture capital (FVC) will not be subject to income tax. The FVC and the target companies of FVC investments must meet certain conditions to qualify for the tax exemption. A decree of the Minister of Economy and Finance for applying these provisions and implementing the guidelines has recently been enacted.

To facilitate sustainable growth, economic development and young entrepreneur initiatives, additional tax incentives are provided for individuals and companies who invest in innovative start-up companies. For the purpose of such tax incentives, an innovative start-up company is a company resident in Italy or in a EEA country (with a permanent establishment in Italy) that has been established for longer than 60 months and whose exclusive or main object is the development, production and commercialisation of innovative goods or services of high technological value.

Such incentives consist of a percentage deduction of the investment made in the tax periods 2013, 2014, 2015 and 2016. In order to benefit from such tax incentives, the investment can be carried out directly or indirectly through participation in an investment fund whose assets comprise at least 70% by investments in innovative start-up companies.

The main tax incentives mentioned before have been extended to "innovative" small and medium enterprises (SMEs), namely companies whose shares are not listed and whose last financial statements have been audited. There are no restrictions concerning the main object of the activity provided that two out of the three following requirements are met:

- Research and development (R&D) expenses must be at least equal to 15% of the highest between cost of goods sold (COGS) and revenues.
- One-third of the employees hold a PhD or one-third holds an MSc.
- The SMEs must hold industrial patents or patented software.

FUND STRUCTURING

6. What legal structure(s) are most commonly used as a vehicle for private equity funds in your jurisdiction?

SGR

The most common legal structure used by Italian-based private equity funds is the closed-end investment fund (*fondo comune di investimento chiuso*) managed by an Italian SGR. The structure is well adapted to the process of selection, managing, monitoring and divestment of investments in the private equity industry, because:

- The separation between the fund and the management company allows the management team to choose investment opportunities autonomously and rapidly.
- The fund's duration allows the investors to achieve the result of their investments within certain period of time.
- The fund's closed-end term allows the investors to exit from the fund at predefined and specific times. This allows the management company to have a capital reserve available that remains relatively stable over time.

Investment funds set up by SGRs are similar to limited partnerships organised under English law, with dissociation between managers, fund sponsors and third party investors. However, SGRs are more strictly regulated (to provide protection to retail investors) than limited partnerships and therefore there is less room for contractual autonomy.

SICAF

As anticipated, the Legislative Decree No. 44 of 4 March 2014, implementing the AIFMD (AIFMD Decree) introduced a new form of collective investment undertaking, the fixed-capital investment companies (*società di investimento a capitale fisso*) (SICAF), which may be used also for the purpose of setting up private equity investment vehicles.

A SICAF is a closed-end investment company organised in the form of a joint-stock company (*società per azioni*) that is subject to the same provisions applicable under the law on closed-end investment funds. It can be managed by a board of directors or by an external management company (such as an SGR).

According to the new provisions included in the Consolidated Law on Financial Intermediation:

- A SICAF must be established in the form of a joint-stock company.
- The corporate purpose of the SICAF must be limited to the collective investment of the capital collected through the issue of shares or participating financial instruments (*strumenti finanziari partecipativi*).
- The registered and administrative office of the SICAF must be in Italy.
- The SICAF must have a share capital, fully paid-in, at least equal to EUR1 million. This threshold is reduced to EUR500,000 for SICAFs reserved to professional investors.
- The directors, statutory auditors and senior managers of the SICAF must satisfy certain reputational, professional and independence requirements.
- The relevant shareholders of the SICAF must possess certain good standing requirements.

Other structures

Other legal structures that can potentially be used in the context of private equity transactions include:

- Joint stock companies (*società per azioni*) (SPA).
- Limited liability companies (*società a responsabilità limitata*) (SRL).
- Partnerships limited by shares (*società in accomandita per azioni*) (SAPA).
- Co-operative and mutual insurance companies (*società cooperative e mutue assicuratrici*).
- European companies (*societá europee*).
- European co-operative companies (*societá cooperative europee*).
- Special purpose acquisition companies (SPAC).

The above legal structures cannot be used to set up private equity funds vehicles, in case they fall within the scope of the definition of collective investment undertaking introduced through the AIFMD Decree.

Foreign legal structures commonly used to invest include:

- Luxembourg holding and financing company scheme (*société de participation financière*) (SOPARFI).
- Luxembourg venture capital investment vehicle (*société d'investissement en capital à risque*) (SICAR).
- UK limited partnership (LP) or general partnership (GP), usually investing through a Luxembourg special purpose vehicle.

7. Are these structures subject to entity level taxation, tax exempt or tax transparent (flow through structures) for domestic and foreign investors?

OICR

Italian investment funds (OICR) are not subject to income tax. Interest income, dividends and capital gains are received by the fund gross of withholding taxes (with some exceptions), and contribute to the year-end operating result of the fund.

Investor income is taxed as income or capital gains. The tax treatment depends on the investor's tax residency.

Italian tax residents. Investor income includes:

- Income received by investors on the distribution of earnings by the fund.
- A positive difference between the value of units on redemption and their value on subscription or purchase.

Investor income is taxed as follows:

- Individuals and non-commercial entities (for example, banking foundations) are subject to a 26% final withholding tax.
- Individual entrepreneurs' investors are subject to a 26% withholding tax. The income received is qualified as business income and is included in their taxable income subject to progressive individual income tax rates. Withholding tax can be treated as a tax credit. Corporate entities' investors' income is subject to a 26% withholding tax. Income is taxed at the ordinary 27.5% (24% starting from 2017) corporate income tax rate. Withholding tax can be treated as a tax credit.

Capital gains realised through the sale of units are taxed as follows:

- Individuals and non-commercial entities are subject to a 26% capital gains tax.
- Individual entrepreneurs' investors' income is subject to a 26% withholding tax. The income received qualifies as a business income, and is included in their taxable income subject to progressive individual income tax rates. Withholding tax can be treated as a tax credit.
- Corporate entities' income is subject to a 26% withholding tax. The income is taxed at the ordinary 27.5% (24% starting from 2017) corporate income tax rate. Withholding tax can be treated as a tax credit.

Capital loss relief may be available.

Non-Italian residents. Non-residents' investor income and capital gains from the sale of units are subject to a 26% final withholding tax. An exemption on interest income from long term corporate debt) applies to a non-Italian resident investor that is any of the following:

- A resident, for tax purposes, in a country that allows for a satisfactory exchange of information with the tax authorities (a country on the white list).
- An international body or entity set up under international agreements in force in Italy.
- A central bank or other entity authorised to manage the official reserves of a state.
- Subject to certain conditions, an EU AIF that invests directly in long term corporate debt.
- Subject to certain exceptions, an institutional investor established in a white-listed country, even if it is not a taxpayer in its country of establishment.

In addition, non-resident investors that do not qualify for this exemption may be exempt from tax under an applicable double tax treaty.

Other structures

Joint stock companies, limited liability companies, partnerships limited by shares and co-operative and mutual insurance companies that are tax resident in Italy (*see Question 6*) are subject to corporate income tax on their worldwide income. The ordinary corporate income tax rate is equal to 27.5% (24% starting from 2017).

Dividends received by a company from participation held in a company resident in a white list country (with the exclusion of partnerships) are 95% exempt, for an effective tax rate of 1.375% (1.20% starting from 2017) on the dividends. This exemption does not require a minimum holding percentage or minimum holding periods. The same exemption (Participation Exemption) is available, under certain conditions, for capital gains realised by a company from the disposal of shares or quotas in both Italian companies and non-resident companies that are not resident in a tax haven and that are engaged in an active trade or business.

A 26% final withholding tax is levied on dividends paid to both non-resident companies and individuals. For certain EU-resident companies, the final withholding tax rate for dividends is of 1.375% (1.20% starting from 2017). These withholding taxes may be reduced or eliminated under an applicable double tax treaty or pursuant to the provisions of the Directive 90/435/EEC on the taxation of parent companies and subsidiaries (Parent-Subsidiary Directive).

Partnerships are tax transparent entities and are not subject to corporate income tax. Their partners are directly taxed on their share of the partnership's profits.

8. What (if any) structures commonly used for private equity funds in other jurisdictions are regarded in your jurisdiction as being tax inefficient (whether by not being recognised as tax transparent or otherwise)? What alternative structures are typically used in these circumstances?

Generally, non-resident companies are regarded as opaque entities. Their use of intermediate holding structure can be considered, subject to substance and anti-abuse provisions.

FUND DURATION AND INVESTMENT OBJECTIVES

9. What is the average duration of a private equity fund? What are the most common investment objectives of private equity funds?

Duration

Investment funds have a duration which usually ranges between eight to ten years. Such period can be divided into two different sub-periods:

- The investment period, which ranges from a minimum of three years to a maximum of seven years (generally five years).
- The disinvestment period, during which the fund proceeds with the gradual reimbursement of the quotas subscribed by the investors.
- However, a grace period of usually two to three years may be implemented in the event that the disinvestment process has not been completed yet and the majority of the investors agree with such extension. (*Alcune domande e risposte sul come e perché investire in fondi di Private Equity, 2008, Italian Private Equity and Venture Capital Association (AIFI)*).

Investment objectives

Private equity funds typically seek to achieve medium-term capital gains on their investments, which are usually measured in terms of internal rate of return (IRR) and money multiples. Historically, private equity funds have targeted annual IRR of 20% and above.

The average term of a private equity fund ranges from three to five years. During the investment and commitment period, the fund manager can require the investors to draw down new investments, while the remainder of this period is used by the manager to increase the value of the portfolio investments and seek profitable exit opportunities.

FUND REGULATION AND LICENSING

10. Do a private equity fund's promoter, principals and manager require authorisation or other licences?

SGRs (*società di gestione del risparmio*) are treated as financial intermediaries, which must be authorised by the Bank of Italy to provide collective portfolio management services. SGRs must be set up as joint stock companies and have a minimum share capital of EUR1 million. SGRs' directors, auditors and general managers must satisfy certain reputational, professional and independence requirements. SGR shareholders must satisfy certain reputational requirements. An SGR's authorisation is subject to assessment by the Bank of Italy of the SGR's activity programme and organisational structure.

An SGR that manages private equity funds typically consists of:

- A board of directors, which has final responsibility for decisions relating to the fund's investments and exits.
- An executive committee, consisting of certain members of the board of directors, which assesses proposals presented to the board of directors.
- One or more managing directors, who co-ordinate the SGR's activity.
- A management team composed of top managers, which represents the company's operational engine, selecting the options for the fund's investments and exits.

If SGRs lack the capabilities to manage a business or investment internally, they can delegate the management of one or more stages of the investment activity to third party advisers but cannot avoid responsibility for the activities carried out by them.

11. Are private equity funds regulated as investment companies or otherwise and, if so, what are the consequences? Are there any exemptions?

Regulation

Private equity funds are normally set up as investment funds (*fondi comuni di investimento*) and, together with other forms of investment, are considered to be collective investment undertakings.

A public offering of private equity fund units requires prior approval by Italian Securities and Exchange Commission (*Commissione Nazionale per le Società e la Borsa*) (CONSOB) and the publication of a prospectus. Certain exemptions may be available.

An SGR (*società di gestione del risparmio*) can market the fund units directly, at its offices through distance marketing techniques or tied agents (*promotori finanziari*) or indirectly through one or more placement agents.

The same provisions specified above also apply to the marketing of private equity funds that have been set up in the form of a fixed-capital investment companies (*società di investimento a capitale fisso*) (SICAF) in accordance with the new provisions introduced by the Legislative Decree No. 44 of 4 March 2014, implementing the AIFMD (AIFMD Decree).

Exemptions

A public offering of private equity fund units does not require publication of a prospectus and prior approval by CONSOB if certain exceptions, including any of the following exemptions, apply:

- An offer of units addressed to no more than 150 potential investors in Italy (other than Markets in Financial Instruments Directive (MiFID) professional investors).

- An offer addressed to MiFID professional investors.
- An offer of units totalling less than EUR5 million calculated over a period of 12 months.
- An offer involving securities for a total consideration of at least EUR100,000 per investor in each separate offer.

12. Are there any restrictions on investors in private equity funds?

Generally, no nationality or number restrictions are imposed on investors in private equity funds.

Under the current framework, the units of private equity funds established in the form of Italian "reserved" alternative investment fund (AIFs) (as it normally is the case in Italy) can only be marketed to qualified investors falling within one of the following categories:

- Investment companies, banks, exchange agents, SGRs, variable-capital investment companies (*società di investimento a capitale variabile*) (SICAV) (that is, a common type of open-ended collective investment scheme), pension funds, insurance companies, finance companies that are parent companies of banking groups and other financial entities.
- Authorised foreign entities that engage in the same investment activities as those referred to above.
- Bank foundations.
- Natural and legal persons and other entities with specific knowledge and experience in securities transactions.

Also, according to the 19 March 2015, the new Ministerial Decree adopted by the Ministry of Economics (New Ministerial Decree), the units or shares of Italian reserved AIFs may be marketed also to non-professional investors, provided that some investment threshold requirements are met (*see Question 4*).

13. Are there any statutory or other maximum or minimum investment periods, amounts or transfers of investments in private equity funds?

There are no statutory limits on investment periods in private equity funds, except that the maximum duration of a common fund cannot exceed 50 years.

For some specific funds, investors may be required to subscribe for minimum quotas.

For funds that are restricted to qualified investors, units can only be transferred to persons and entities included within specific categories (*see Question 12*).

The fund rules can contain other restrictions.

INVESTOR PROTECTION

14. How is the relationship between the investor and the fund governed? What protections do investors in the fund typically seek?

The relationship between investors and the private equity fund is governed by the fund rules. Approval of the fund's rules by the Bank of Italy is not required for funds reserved to particular categories of investors or for speculative funds. Also, under the new regime introduced with the implementation of the Directive 2011/61/EU on alternative investment fund managers (AIFMD), no such approval is required in relation to Italian reserved alternative investment funds (AIFs).

Typical protection terms that investors seek in the fund rules include:

- Certain governance powers, such as the power to appoint the members of the fund's advisory committee, as these powers can express binding opinions on conflict of interest transactions and non-binding opinions on certain other matters.
- The right to request, under certain circumstances, the suspension of the investment period or the early winding-up of the fund.
- Information and reporting duties for the fund's managers.

Provisions regulating the meeting of participants of closed-end funds were issued in 2010. The rules of a closed-end fund reserved to qualified investor can identify some issues that require authorisation by a resolution of a meeting. In any case, a meeting of the investors must be called to vote on:

- A replacement of the SGR (*società di gestione del risparmio*).
- An admission to listing (where this is not provided for).
- Changes to the investment policy.

It is common for a newly established fund to adopt rules aimed at facilitating fundraising on both domestic and international markets in line with international best practices.

INTERESTS IN PORTFOLIO COMPANIES

15. What forms of equity and debt interest are commonly taken by a private equity fund in a portfolio company? Are there any restrictions on the issue or transfer of shares by law? Do any withholding taxes or capital gains taxes apply?

Common forms

In a typical buyout, a company is acquired by the private equity fund, using equity and bank loans. Equity is provided by the private equity fund, the target company's management (either incumbent or new) and, occasionally, the seller.

A typical equity package comprises both:

- True equity, in the form of ordinary shares or preference shares (whether convertible or not) or a combination of these.
- Quasi-equity, usually in the form of a subordinated shareholder loan or convertible bonds or warrants.

Generally, management equity consists of ordinary shares only.

A preference share is a form of hybrid security. Preference shares differ from ordinary shares in that they generally have a preferential right to receive dividends and participate in any distribution on liquidation of the company. A convertible preference share, in addition to the traditional preference share rights, entitles the holder to convert it at some future point into another security, such as an ordinary share.

Investor loans are often used to extract cash in a tax efficient way. Typically, they have a long maturity and interest payment is capitalised due to restrictions on dividends and other payments under the acquisition finance package. They are generally treated as if they were equity by acquisition finance providers because of these characteristics.

For an overview of the main forms of debt financing, see *Question 23*.

Advantages and disadvantages

See above, *Common forms*.

Restrictions

The issuance and transfer of shares in a company are not themselves subject to any legal restrictions. However, the company's bye-laws or the shareholders' agreement generally include restrictions on the transfer of shares, such as lock-ups, tag-along, drag-along rights and similar provisions, which allow the fund to force the other shareholders (and give them the right) to sell their shares on exit. The duration of shareholders' agreements entered

into in respect of joint stock companies cannot exceed five years (*Article 2341-bis, Italian Civil Code*).

The management team is typically prohibited from transferring their shares until exit and is subject to good and bad leaver provisions under their service agreements. Also, the acquisition of shares of joint-stock companies (S.p.A) is generally subject to financial transaction tax equal to 0.2% on purchase price. Capital gain taxes may apply, as well as participation exemptions, subject to certain conditions.

BUYOUTS

16. Is it common for buyouts of private companies to take place by auction? If so, which legislation and rules apply?

In the last few years auctions have become fairly standard for buyouts of private companies. Although there are no specific laws or rules governing auctions, these procedures generally follow a specific path. First, a limited number of potential buyers are contacted by the seller's financial advisers. After signing a non-disclosure agreement, interested buyers receive an information memorandum with information on the target company and its business. Buyers are then invited to submit indicative, non-binding offers, following which a limited number of them are invited to conduct due diligence (with documents normally posted in a virtual or physical data room) and attend management presentations. Vendor due diligence reports are fairly standard. Generally, during this phase, buyers receive a first draft of the purchase agreement prepared by seller's counsel. At the end of this phase buyers submit their bid, together with a mark-up of the purchase agreement and other related documents. One buyer is then selected to conduct final negotiations with the seller and finally sign the definitive agreement.

Occasionally, businesses are sold in private transactions. This is much preferred by private equity houses because of the lack of competition and because of the higher level of information that they typically receive from sellers. Sellers have been willing to follow this path (instead of an auction) where there is a very committed buyer who could offer certainty of closing within a relatively short time frame.

17. Are buyouts of listed companies (public-to-private transactions) common? If so, which legislation and rules apply?

Public-to-private transactions are not uncommon but are more complex to execute compared to transactions involving private companies.

Public-to-private transactions are regulated by the Consolidated Law on Financial Intermediation and numerous Italian Securities and Exchange Commission (*Commissione Nazionale per le Società e la Borsa*) (CONSOB) regulations. These transactions are generally structured as multi-step acquisitions in which the buyer:

- First acquires all of the shares of the target company owned by one or more sellers owning a controlling block of shares.
- Then commences a mandatory tender offer seeking to acquire all of the target company's outstanding voting shares.

To take the target company private, the offer is generally followed by a mandatory buyout of the remaining shares if the buyer is able to acquire 90% or more of the voting shares (and the subsequent exercise of a squeeze-out right over the minority shareholders of the target company if the buyer acquires 95% or more of the target shares).

Alternatively, assuming the buyer then holds a sufficient number of target company voting shares to approve it, the second end of the transaction can be structured as a forward merger of the target company with, and into, the buyer, with the latter remaining as the surviving entity. A merger triggers withdrawal rights for the target company's dissenting shareholders.

Principal documentation

18. What are the principal documents produced in a buyout?

The principal document between the seller and the buyer is typically the sale and purchase agreement. In a cross-border transaction the parties usually have a master purchase agreement and local transfer instruments that are designed to make the transfer effective in each local jurisdiction in accordance with applicable legal requirements.

The buyer and the incumbent management team, in connection with the funding of the acquisition entity, usually enter into:

- Investment agreements.
- Shareholders' agreements.
- Directorship and employment agreements.

Depending on the structure of the financing, the buyer can also be required to grant the acquisition entity one or more loans in addition to equity capital contributions.

Private equity firms usually provide the seller with an equity commitment letter, under which the fund commits to provide the equity capital to the acquisition entity, subject to certain conditions in the acquisition agreement. It is not uncommon for the seller to seek the status of a third party beneficiary under the equity commitment letter, to have a right against the fund if the fund fails to provide the equity capital at closing. However, the parties enjoy broad powers to shape the rights of recourse against the fund in favour of the seller.

Bank financing is almost invariably present in any private equity transaction (*see Question 23*).

Buyer protection

19. What forms of contractual buyer protection do private equity funds commonly request from sellers and/or management? Are these contractual protections different for buyouts of listed companies (public-to-private transactions)?

In the highly competitive pre-financial crisis environment and also remaining in the current market environment for highly contested target companies, the offering of very limited contractual protection to buyers was, and is, still common. This requires buyers to conduct deeper due diligence to compensate for low contractual protection, which often did not extend beyond:

- Title and other very basic warranties.
- Restrictive covenants to maintain the status of the target as of the reference accounts date by preventing cash leakage (such as a locked-box mechanism).

Payment mechanisms

Locked-box mechanisms involve both:

- A fixed equity price for the target company agreed between the parties based on pre-signing accounts (generally audited).
- A warranty from the seller (with corresponding indemnity) that no leakage has occurred or will occur from the date of accounts and completion. Leakage is broadly defined to include dividends, distributions, management fees and other charges paid to the sellers, for example, the repayment of shareholder debts. Exceptions include payments made in the ordinary course of business.

Locked-box mechanisms are still widely used in secondary buyouts and are favoured by sellers as they provide price certainty.

An alternative to a locked-box mechanism is an estimated equity price and post-closing price adjustment. Typical price adjustment factors include net financial debt and net working capital. This is generally used in a corporate carve out or similar transactions, in which stand-alone accounts are missing. Purchase price adjustment clauses are usually heavily negotiated between the parties.

Buyers can also use vendor financing and contingent purchase price payments (earn-outs or similar mechanisms) to bridge the gap between the seller's price expectations and the buyer's available resources or business valuation.

Key contract terms relating to deal certainty, such as financing conditions and other customary conditions precedent, material adverse change provisions and reverse break-up fees, receive significant attention.

Representations and warranties

Buyers usually expect to receive a full range of representations and warranties covering all matters regarding the target company. However, in the secondary buyout market, private equity funds generally limit the representations and warranties they give to title and the seller's ability to complete the transaction. Similarly, in public-to-private transactions, bidders proceed with a transaction based only on due diligence without warranty or indemnity protection (other than those that may be given by controlling selling shareholders).

If sellers are not willing to give representations and warranties concerning the target business, buyers generally look for warranties from selling managers. Although these warranties have financial and practical limitations, they are generally sought to get disclosure of information.

The warrantor's liability for breach of warranties is usually subject to a number of limitations, which are usually heavily negotiated. Key limitations are:

- Time limitation.
- Financial limitations, such as:
  - an overall cap on the aggregate maximum liability;
  - a minimum level for individual claims;
  - basket limits (a minimum amount of claims before liability kicks-in).
- Whether the buyer has knowledge (actual or presumptive, according to a standard of due care to be agreed on) of the relevant matter.
- Whether other sources of redress (that is, third-party claims or insurance) have been exhausted.

Specific known issues (for example, pre-closing tax or contingent environmental liabilities) are sometimes dealt with through specific indemnities.

Part of the consideration can be put in escrow to cover risks under warranty claims or other specific liabilities.

Other buyer protection

Other forms of buyer's protection include:

- Bank guarantees (instead of escrows).
- A mergers and acquisitions (M&A) insurance policy for the benefit of the acquirer.
- Interim covenants, which limit the seller's actions between signing and closing without the buyer's consent. Key areas are the buyer's control over debt, working capital, capital expenditure, litigation, personnel and M&A transactions involving the target company.

These contractual protections normally do not apply in buyouts of listed companies. However, if there is a multi-step acquisition in which the buyer first acquires a controlling block of shares, some of the above contractual protections may apply (*see Question 17*).

20. What non-contractual duties do the portfolio company managers owe and to whom?

Managers of a portfolio company that take a position as director owe fiduciary duties to the company. Generally, directors must act in the best interests of the company. The interests of the company are normally aligned with the long-term interests of its shareholders.

While the law does not prohibit directors from being involved in or soliciting a management buy-out (MBO), they must act in good faith and in a manner that avoids conflicts of interests or misuse of fiduciary powers. Directors have a statutory duty to declare at a board of directors' meeting the nature of any interest that they may have in any contract, or proposed contract, with the company. If they are executive directors of a joint stock company, they should even abstain from voting on the relevant matter. Therefore, directors must inform the competent body of the company when they expect to approach potential investors in relation to an MBO.

21. What terms of employment are typically imposed on management by the private equity investor in an MBO?

Typical terms of employment in individual service contracts and the shareholders' agreement include:

- Restrictive covenants under which managers are prevented from taking various actions.
- Non-compete obligations under which managers assume obligations not to compete with its employer for a specified period of time, which must be specifically remunerated in order to be enforceable.
- Non-solicitation obligations, under which managers are prevented from soliciting:
  - another employee to leave the company;
  - customers to do business with another company.
- Confidentiality obligations under which managers are prevented from using or disclosing any of the company's confidential information.

Managers are commonly incentivised in their capacity as shareholders (by good leaver or bad leaver provisions) or other employment instruments giving share options or other incentive securities. The bye-laws or the shareholders' agreement may give additional protection to the investor by:

- Allowing the company to redeem management shares.
- Granting to other shareholders an option to purchase management shares, when the holders leave the company.
- Prohibiting transfer of management shares without the prior consent of the private equity investor.

22. What measures are commonly used to give a private equity fund a level of management control over the activities of the portfolio company? Are such protections more likely to be given in the shareholders' agreement or company governance documents?

A private equity fund controls the majority of the acquisition vehicle's equity in a typical single sponsor transaction. Therefore, private equity funds secure rights to nominate and elect directors and they do so with a view to protecting their interest in both the acquisition vehicle and the target company.

However, once appointed, the nominee is legally required to ignore the underlying rationale for the appointment and to promote the company's

interests at the expense of those of the fund. The private equity fund can remove directors at any time, although if the removal is without cause, then directors are entitled to recover damages, which are usually determined as an amount equal to the remaining compensation that they would have received if they had held the office until its natural expiration.

It is common for the private equity fund and the other equity holders (including managers) to enter into a shareholders' agreement giving the fund a right to nominate a majority of the company's directors and appropriate voting provisions to ensure that the sponsor controls a board majority. If the sponsor invites minority investors to participate in the transaction, shareholders' agreements can offer the minority shareholders exit rights and veto rights over certain key matters. However, the sponsor typically exercises control over exit transactions by reserving drag-along rights, rights to request an initial public offering (IPO) of the shares of the company and other similar rights.

DEBT FINANCING

23. What percentage of finance is typically provided by debt and what form does that debt financing usually take?

The principal form of debt finance continues to be senior debt, which is provided by banks and institutional lenders. Senior debt is generally guaranteed by all companies of the group (including the target company) and is secured over all of their assets, subject to certain limitations. Senior debt has a shorter maturity compared to the other debt finance and is typically amortising. The facilities generally provided in a senior finance package include a:

- Term facility that is used to fund the acquisition.
- Capital expenditures facility.
- Revolving credit facility (working capital facility).

The senior loan facility agreement typically contains detailed provisions designed to protect the lenders' investment (*see Question 24*).

Junior debt is used, particularly in larger transactions, to increase the total amount of debt available and to bridge the gap with the equity package. Junior debt generally takes the form of:

- Second lien debt.
- Mezzanine debt.
- Payment in kind (PIK) loans.

All junior debt ranks behind the senior debt in terms of priority of repayment.

The seller can also provide a source of finance, typically in the form of deferred consideration or an earn-out.

Typically, acquisition finance is funded by a bridge facility provided by the senior lenders, which is taken out sometime after the funding of the senior term facility following a merger of the acquisition vehicle with the target (which then becomes the borrower) or through a refinancing (debt pushdown). Most often, the senior debt is made available to the acquisition vehicle (in the form of a bridge loan) to finance the acquisition, and to the target company to refinance its existing debt and for working capital purposes.

Mezzanine debt ranks behind senior debt and, as a result, has a higher interest rate. Typically, there is just one borrower, the acquisition vehicle, but sometimes senior lenders require junior debt to be structurally subordinated (*see Question 24, Contractual and structural mechanisms*). It generally matures later than the last tranche of the senior debt and is repayable in one bullet instalment. The margin generally includes a PIK element in addition to a cash element. Financial covenants are present but typically contain more headroom. It is fairly common for warrants giving the right to subscribe for shares in the borrower at a predetermined price to be issued to the mezzanine lender as part of the package.

Law Decree No. 83/2012 introduced urgent measures for growth (Decree for Growth), as implemented into law by Law No. 134/2012 (Act of Conversion). It has introduced significant regulatory changes to expand opportunities for non-listed companies to access the capital market. It removes fiscal and corporate limitations that penalised such companies in comparison to equivalent companies in other European countries. In particular, in relation to:

- Abolishing the obligation of non-listed companies to meet certain conditions to issue bonds.
- The duration of, and conditions for the issue of, finance bills.
- The tasks assigned to the sponsor.

The tax regime applicable to such securities has been aligned to the more favourable tax regime for securities issued by larger issuers (that is, banks and listed companies). In particular, in relation to the following:

- Exemption from withholding tax.
- Deductibility of interest expenses.
- Deductibility of expenses of the issue.
- Exemption from stamp duty.

The Act of Conversion confirms that the quantitative limits on the issue of bonds set out in the Civil Code should not apply to securities, to the extent that the bonds are intended to be traded on regulated markets or multilateral trading facilities, if certain conditions are met.

Based on Law Decree No. 91 of 24 June 2014, as converted into Law No. 116 of 11 August 2014, interest on bonds and similar securities issued by non-listed companies that are not traded on regulated markets or multilateral trading facilities, can be exempt from withholding taxes provided that such securities are held by one or more "qualified investors" as defined by Article 100 of the Consolidated Law on Financial Intermediation. Qualified investors are the entities that are required to be authorised or regulated to operate in the financial markets, resulting in the list below:

- Credit institutions.
- Investment firms.
- Other authorised or regulated financial institutions.
- Insurance companies.
- Collective investment schemes and management companies of such schemes.
- Pension funds and management companies of such funds.
- Commodity and commodity derivatives dealers.
- "Locals".
- Other institutional investors.
- Large undertakings that meet two of the following size requirements on a company basis are deemed to be a professional:
  - balance sheet total of EUR20 million;
  - net turnover of EUR40 million;
  - own funds of EUR2 million.
- National and regional governments, public bodies that manage public debt, Central Banks, International and Supranational institutions such as the World Bank, the IMF, the ECB, the EIB and other similar international organisations.
- Other institutional investors, whose main activity is to invest in financial instruments, including entities dedicated to the securitisation of assets or other financing transactions are deemed to be professionals.

(*Il mercato italiano del Private Equity e del Venture Capital nel 2010, Italian Private Equity and Venture Capital Association (AIFI) and Private Equity Monitor Italia 2010, (PEM) Observatory*).

Lender protection

24. What forms of protection do debt providers typically use to protect their investments?

Security

Bridge acquisition facilities are usually secured by either or both of:

- A pledge over the shares of the acquisition vehicle and the shares of the target group.
- An assignment by way of security or a pledge of the receivables arising under the acquisition documents or under any shareholder loan documents.

Following the debt pushdown, the senior debt security package typically includes full asset security from each company in the target group (including the acquisition vehicle), sometimes subject to a materiality threshold. Although Legislative Decree No. 142/2008 has introduced the possibility to give financial assistance (subject to certain limitations and compliance with certain requirements (*see Question 25*), significant legal and tax constraints still apply to the giving of upstream or cross guarantees and related security.

Contractual and structural mechanisms

Typically, structural subordination is effected by using more than one special purpose vehicle.

Senior debt is typically at the top of the capital structure and is not subordinated to any other type of finance. The acquisition facility is first borrowed directly by the acquisition vehicle and then pushed down to the level of the target company after the acquisition. Other senior facilities are generally made available to the target company after the acquisition.

Typically, senior creditors are party to an inter-creditor agreement with the other finance providers. This agreement governs matters such as:

- Subordination.
- Permitted payments.
- Acceleration and enforcement rights.
- Incurrence of additional indebtedness.
- Release of security and guarantees.

The senior loan facility agreement typically contains detailed provisions designed to protect the lenders' investment. These mechanisms are generally determined on a case-by-case basis but such provisions almost invariably include:

- Voluntary and mandatory prepayments.
- Extensive representations and warranties.
- Information, business and financial covenants.
- Events of default.
- Milestones to be complied with to continue to use the financing.
- Subordination of any other ways of financing to the senior loan.

Financial assistance

25. Are there rules preventing a company from giving financial assistance for the purpose of assisting a purchase of shares in the company? If so, how does this affect the ability of a target company in a buyout to give security to lenders? Are there exemptions and, if so, which are most commonly used in the context of private equity transactions?

Rules

The giving of financial assistance by a company, through either granting of loans or providing securities or guarantees, for the purposes of the acquisition or subscription of shares in itself is prohibited. A company is also prevented from accepting its own shares as security or guarantee, even through the recourse to a fiduciary or any other entity.

Exemptions

The Civil Code now permits the giving of financial assistance when it has been approved by special resolution of the extraordinary shareholders' meeting of the company. There are two limitations on this to protect the interests of creditors:

- The assistance must be provided out of distributable profits and available reserves as reflected in the latest approved accounts.
- There must be a statutory declaration of solvency by the directors of the company.

Other exemptions exist that are intended to allow companies to support employees' share schemes and other share acquisitions by employees.

In a leveraged buyout (LBO) before completion, the directors of the acquisition vehicle and target must consider the financial resources that are necessary to repay the debt incurred due to the acquisition, and there are specified procedural requirements for this. However, this does not exclude the financial assistance rules.

Insolvent liquidation

26. What is the order of priority on insolvent liquidation?

The order of priority on insolvent liquidation is regulated by the Bankruptcy Act. Creditors have priority over equity holders, which are regarded by law as residual claimants. This can apply to shareholders' loans, which may be subject to equitable subordination.

Generally, secured creditors holding valid fixed charges over specific assets of a company are satisfied to the exclusion of all other creditors, including secured creditors of a lower rank (for example, first degree mortgage over second degree mortgage).

Certain other creditors enjoy the status of preferred creditors (such as employees with outstanding wages). The Civil Code gives very detailed rules regulating priority conflicts between secured and preferred creditors.

Creditors can agree to contractual subordination by signing subordination or other inter-creditor agreements. Inter-creditor agreements also typically prohibit any payments to shareholders by way of dividends or through redemption of shares until full repayment of senior creditors.

Equity appreciation

27. Can a debt holder achieve equity appreciation through conversion features such as rights, warrants or options?

Debt holders can achieve equity appreciation through conversion features on terms that provide for the investor to be able to convert its debt security into a share in the borrower at a later date.

A debt instrument with an attached warrant is similar to a convertible bond. The warrant gives the holder the option to subscribe to shares. The debt-plus-warrant structure differs from convertible bonds in that exercise of the warrant does not bring the debt instrument to an end, whereas the debt instrument disappears when a conversion right is exercised.

The characteristic shared by convertible bonds and warrants, and which makes them both hybrid securities, is that they offer their holder the opportunity to participate in capital growth, therefore requiring the portfolio company to set aside a portion of its share capital to service such holders.

A debt holder can receive newly issued shares of the company in exchange for a waiver of its outstanding claim against the company, subject to passing a specific resolution of the extraordinary shareholders' meeting, and other procedural requirements. The terms of this transaction can be part of investment agreements and in many cases are conditional on various circumstances.

PORTFOLIO COMPANY MANAGEMENT

28. What management incentives are most commonly used to encourage portfolio company management to produce healthy income returns and facilitate a successful exit from a private equity transaction?

Common management incentives, which may be combined, include:

- **Compensation plan based on performance.** Individual service agreements can provide for a variable compensation scheme based on the performance of either the portfolio company or the individual. Payments are usually related to key metrics reflecting the performance of the portfolio company, such as EBITDA (earnings before interest, taxes, depreciation, and amortisation), sales or net income. Compensation plans are allocated to have minimal effect on reported earnings. Payments are treated as employment income for tax purposes and are fully subject to personal income tax (at a maximum 43% rate) in the hands of the recipient. In some cases, a tax efficient structuring of such schemes may be based on the issuance of equity-like securities.
- **Stock options.** Managers can be granted options structured as a right for an individual manager, or group, to buy shares of the portfolio company at a fixed or formula price (subject to adjustments) over a stated period of time. The option is usually issued by the company itself, to be satisfied by newly issued shares, but this is not necessarily the case. The use of stock options is less common than in other jurisdictions due to an unfavourable tax regime. There is no exemption from personal income tax on the increase in value between the grant and the exercise of the options. Under certain circumstances, some forms of phantom stock plans can prove to be more tax efficient.
- **Equity interests.** Managers may be granted direct or indirect (*strumenti finanziari partecipativi*) equity participations in their portfolio company, which can enhance their attractiveness by issuing securities at a discount.
- **Golden parachutes.** Employment contracts can provide for parachute payments to managers, contingent on a change in ownership or control of a portfolio company or its assets. Their value usually does not exceed the individual's average annual compensation for two fiscal years.

29. Are any tax reliefs or incentives available to portfolio company managers investing in their company?

There are no specific tax reliefs or incentives available to portfolio company managers investing in their company.

30. Are there any restrictions on dividends, interest payments and other payments by a portfolio company to its investors?

There are no restrictions other than those provided for in the fund rules.

31. What anti-corruption/anti-bribery protections are typically included in investment documents? What local law penalties apply to fund executives who are directors if the portfolio company or its agents are found guilty under applicable anti-corruption or anti-bribery laws?

Compliance with anti-corruption laws is typically included in the representations and warranties of the sale and purchase agreement. It is also fairly common to include specific anti-bribery or anti-corruption policies in the shareholders' agreement with the management.

Violations of anti-corruption or anti-bribery laws by directors can give rise to civil liability for breach of fiduciary duties. Criminal sanctions can also apply, with monetary fines or imprisonment depending on the specific factual circumstances. In certain cases, a company whose directors are found guilty of violations of anti-corruption or anti-bribery laws can be sanctioned with monetary fines or interdiction orders (*Legislative Decree No. 231/2001*).

EXIT STRATEGIES

32. What forms of exit are typically used to realise a private equity fund's investment in a successful company? What are the relative advantages and disadvantages of each?

Forms of exit

Initial public offerings (IPOs), sale (trade sale or secondary buyout) and recapitalisations are all typical forms of a successful exit.

Advantages and disadvantages

IPO. Historically, the IPO has been a successful form of exit for private equity funds. The major benefit of an IPO is that the private equity fund does not need to subscribe to burdensome warranties or absorb price contingencies, which can happen in a trade sale. Other advantages can include a higher valuation (depending on the market), prestige and access to more capital and liquidity for the longer-term shareholders (including managers). The downside is that the process is longer, relatively costly and may not allow a full exit by the private equity house. The exit through an IPO is typically delayed by lock-up periods, usually ranging from six to 12 months for financial selling shareholders.

Trade sale. Trade sales, either to a trade buyer or to another private equity house (usually with the management reinvesting), are generally structured as a sale of 100% of the shares of the acquisition holding company. Trade sales usually offer the advantages of deal speed and closing certainty while minimising continuing exposure to liability. Sales by private equity houses generally take the form of an auction.

Dual tracking. Sometimes, especially for larger companies with well-recognised brands and strong management teams, private equity houses pursue an exit through an IPO in parallel with a trade sale until they choose which route will achieve the highest value.

Recapitalisations. Typically, in a leveraged recapitalisation the portfolio company borrows debt and uses the proceeds to pay a special dividend to the private equity house. Financial assistance issues need to be carefully addressed in this type of transaction (*see Question 25*).

33. What forms of exit are typically used to end the private equity fund's investment in an unsuccessful/distressed company? What are the relative advantages and disadvantages of each?

Private equity sponsors typically exit from an unsuccessful portfolio company due to financial distress, unless the management is willing to try to acquire the company and attempt a turnaround. Private equity sponsors usually enter into negotiations with financial investors specialising in turnaround situations and restructurings.

Other techniques used by private equity funds to avoid the costs and value loss of bankruptcy are the restructuring plans provided for by the Bankruptcy Act and other forms of compositions with creditors.

PRIVATE EQUITY/VENTURE CAPITAL ASSOCIATION

Italian Private Equity and Venture Capital Association (*Associazione Italiana del Private Equity e Venture Capital*) (AIFI)

W www.aifi.it

Status. AIFI is a non-governmental organisation and a non-profit association.

Membership. AIFI has 123 full members and 119 associate members.

Principal activities. AIFI's main activities are:

- Supporting and facilitating the development of private equity and venture capital activity in Italy and abroad.
- Representing its members.
- Increasing awareness and understanding of the private equity and venture capital industry.
- Conducting research and publishing reports and working papers.
- Collecting and presenting information about the industry.
- Organising educational programmes.

ONLINE RESOURCES

Italian Tax Authority (*Agenzia delle Entrate*)

W http://def.finanze.it/DocTribFrontend/RS1_HomePage.jsp (only in Italian)

Description. This is the official website of the Italian tax authority.

National Commission for Companies and the Stock Exchange (*Commissione Nazionale per le Società e la Borsa*) (CONSOB)

W www.consob.it

Description. This is the official website of CONSOB, the public authority responsible for regulating the Italian securities market. In the legal framework section, there is the updated text of Legislative Decree 58 of 24 February 1998 (Consolidated Law on Financial Intermediation), including an English version (only the Italian version is authentic).

National Central Bank: Italy

W www.bancaditalia.it

Description. This is the official website of the Bank of Italy. In the legal framework section, there is the text of Legislative Decree 385 of 1 September 1993 (Consolidated Law on Banking) but only in Italian.

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