

What lies ahead



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Giancarlo Capolino-Perlingieri and Dante Leone explore the highly regulated Italian private equity fund market and, in the process, offer a possible glimpse of the future for private equity generally

These days, private equity is under intense scrutiny. Well-informed public opinion has conclusively established that a significant part of the fault for the recent sub-prime crisis and unprecedented market meltdown lies with hedge fund managers.

The jury is still out on the collective culpability of private equity professionals. But it is safe to assume that regulations will come. They will not be painless. And they will be mostly indiscriminate.

While waiting for new regulations, we would like to offer Italy as a good example of a jurisdiction where, long ago, private equity professionals had to learn to stop worrying and love indiscriminate regulations.

A wide spectrum of levels of regulation...

Italian private equity funds are generally organised as closed-end funds – or *fondi chiusi* – which may be set up only after prior authorisation by the Bank of Italy, upon request by an authorised and regulated management company - or *società di gestione del risparmio*. In fact, Italian private equity funds are but a sub-category of a larger regulatory family of investment funds, comprising all retail and institutional open- and closed-end investment vehicles pursuing real estate, public equity, private equity and hedge fund strategies.

Comprehensive capital requirements, limitations on investable assets and strategies, leverage caps, conflicts of interest policies and reporting obligations are established as a set of general rules that are applicable to all authorised management companies and funds.

There are a few variations in regulatory levels. Many layers of these regulations are peeled back for non-retail products, based on the minimum amount committed by a single investor, the types and overall number of eligible investors and the strategy pursued by the management company.

As an example, diversification thresholds and limitations on investments in limited partnership-type interests may be overcome by closed-end funds reserved for qualifying institutional investors. Prohibitions to deal with affiliates do not apply to real estate funds,

subject to certain conditions. All non-retail funds may observe less demanding reporting obligations.

...organised around a small group of fundamental principles...

Notwithstanding this very moderate differentiation of levels of regulation, a substantial number of core rules apply across the spectrum of all authorised Italian management companies.

For instance, a private equity-style management company, managing only institutional money organised into a single private equity-style fund, must nonetheless comply with minimum capital requirements. In practice, this leads to the continuous verification that the net equity of the management company has not decreased below a certain minimum threshold based on total fund commitments and past operating expenses and, if necessary, to the replenishment of the equity by the shareholders of the management company.

Similarly, all management companies, including of pure private equity funds, must ensure appropriate risk management control, which typically entails the identification of a professional other than the members of the investment team, who is at least partly dedicated to carry out this key function, and participates in investment committee meetings in order to assess the risk profile of each prospective deal.

All management companies are subject to substantially similar standards for the management of internal conflicts of interest, investment in securities by management or employees and the processing of complaints by fund investors.

Along the same lines, members of the board of directors and chief operating officers of all management companies are subject to stringent personal and professional requirements, which must be verified prior to their appointment (for instance, the chairman of the board, the chief executive officer and the chief operating officer must have a minimum of five years' experience in the industry).

The assets held by any Italian fund must be left with a licensed bank acting in its official capacity as custodian. Among the duties of a custodian is the verification that each investment and each movement of fund assets complies with the rules for the management of the fund and other applicable regulations.

Likewise, the transfer of any portion in excess of 5 percent of the share capital of any management company is subject to prior authorisation by the Bank of Italy, based on the assessment of the characters of the prospective shareholders and the resulting governance of the management company. The authorisation process may take up to 90 days.

Breaches of, or lack of full compliance with, any of the core regulatory principles may give rise to the imposition of steep fines by the Bank of Italy, including – in certain instances – personal fines to private equity professionals involved in management or controlling activities. Random on-site inspections and off-site requests by the Bank of Italy are frequent, as is the imposition of monetary fines on management companies, members of the board, chief operating officers, statutory auditors and authorised outsourcers.

From a purely regulatory standpoint, one could question this very moderate differentiation of levels of regulation. While most Italian asset managers operate under the regulatory category of a licensed management company, one would expect that the organisational and compliance rules applicable to a manager of retail open-end long-short public equities funds would be dramatically different from those applicable to a manager of a single closed-end fund reserved for sophisticated institutional investors and dedicated to investments in private equity.

Most of these requirements, policies and rules have recently been brought into line with corresponding EU-wide standards, as a result of successive acts of implementation of UCITS (Undertakings for the Collective Investment in Transferable Securities) and MiFID (Markets in Financial Instruments Directive) regulations issued at the European Union level.

...serves the purpose of affecting the composition of the Italian private equity scene...

There are some positive effects of the comprehensive Italian regulations covering investment funds – including private equity funds – and licensed management companies.

First, barriers to entry into the world of management of private equity funds are remarkably high. The length and complexity of the process for the authorisation of a management company (first) and a private equity fund (second), which may well take more than a year, require considerable patience and financial resources. It is safe to say that most would-be private equity managers embark on a venture of this kind only if sponsored by a deep-pocketed affiliate (such as a banking or industrial group) or after being reasonably certain of securing a minimum commitment to their fund by third-party investors.

This is partly why, even in boom years, relatively few new independent Italian fund managers succeeded in raising capital, compared to similar jurisdictions. And why, we believe, the current decrease in valuation multiples and consequent crisis of fund returns will result in the demise of proportionally fewer fund private equity managers in Italy than in other jurisdictions.

Second, turning significant profits from the management of an Italian private equity fund calls for successful investment strategies.

Italian management companies are elaborate organisations, in light of the number of separate functional roles mandated by applicable regulations, which emphasise controlling and risk management, as well as several checks and balances.

Running an Italian management company is extremely expensive: management fees cover little more than general operating expenses and outsourcing fees. They are never sufficient to provide top private equity professionals with their target financial returns.

As a result, carried interest – which, in Italian funds, is typically paid to principals only after the restitution to investors of all drawn-down capital plus a preferred return – still retains its original purpose and significance.

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...albeit with a number of drawbacks

Of course, the Italian system is far from perfect.

The requirement that the rules of every private equity fund conform to certain basic features set out by stiff Bank of Italy regulations (which, as explained above, are meant to cover a wide range of financial products) often collides with the commercial necessity that the same fund rules satisfy the exacting standards and customs of international private equity fundraising.

For instance, the commitment by investors to an Italian fund must be structured through the subscription of standard classes of units issued by the fund. This makes it exceptionally hard to consider the status and capital account of each investor on an individual basis, as would be typical in a fund organised as a common law-style limited partnership. With the result that counsel must necessarily devise ingenious mechanisms in order to accommodate the excusal of an investor based on its specific investment prohibitions or other mandate limitations, and in order to deal with the subsequent adjustment of distributions, which, by default, would have to reflect standard unit-based capital accounts.

In addition, there are general restrictions that remain valid for private equity fund managers, and yet run contrary to the typical way of conducting private equity business.

As an example, Italian regulators have recently enacted blanket limitations to the receipt by management companies of fees from underlying portfolio companies. These limitations were originally conceived as a way to constrain the payment of inducement fees to retail asset managers focused on public equities. But the same limitations may also apply to private equity funds, irrespective of whether there are hard-negotiated agreements already in place between the management company and the sophisticated fund investors, which would generally call for the management company charging portfolio companies with advisory or transaction fees to give part of the stream of such fee income back to investors, through a reduction of future installments of the management fee or otherwise.

As another example, there is a prohibition on holding subsequent closings of a *fondo chiuso* more than 18 months after the initial date of authorisation of the fund by the Bank of Italy. While this provision ensures that fund managers do not spend a disproportionate amount of time raising (as opposed to managing) their fund, it may prevent managers from achieving an optimal fund size, especially in challenging fundraising cycles such as the current one.

Moreover, regulators, which are supposed to investigate possible instances of negligence by management companies, do not necessarily possess the specific experience and expertise to judge in all circumstances the soundness of strategies and control measures of private equity fund managers, such as when they need to address the suitability of a risk manager's assessment of a proposed turnaround investment in a troubled company.

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Which is part of the reason why Italian private equity sometimes takes different forms

The extent to which Bank of Italy regulations affect the formation and running of a fondo chiuso may be appraised through the observation of how in Italy, perhaps more than elsewhere, private equity investing is often carried out in forms other than a proper closed-end fund. The use of these other forms aims at reflecting in substance the typical management and economic construction of a private equity fund, while demanding a lower level of financial and administrative resources than a fondo chiuso.

In particular, in recent years, the passing of new legal provisions allowing more flexibility in the fine-tuning of the rights and obligations attaching to different classes of stock issued by Italian corporations has led to the proliferation of investment

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vehicles set up as a company limited by shares – or società per azioni – subject to less stringent regulations by the Bank of Italy. Nevertheless, società per azioni, as well as other types of alternative structures, do not allow a full replication of the governance and management fee arrangements typical of a private equity fund, and are not generally tax-efficient for foreign investors, thus being ideally suited only for single ventures or very tightly wound groups of investors.

Our conclusion

Italy is a case in point of a market where overreaching regulations have directly stifled the growth of the private equity market. At the same time, it is also an example of how excellent private equity professionals can not only succeed notwithstanding rigid regulations, but assert that they are the product of a rigorous process of breed selection.

In brief, it is a case study for regulators worldwide when, in the near future, they will be considering how to cast the die on the private equity world. ■

For a brief analysis of other types of structures used by private equity professionals in Italy, and their typical disadvantages, see our commentary in the Private Equity International Fund Structures 2008 edition, p. 14.

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