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THE CONSTITUTION OF A *VENTURE CAPITAL* COMPANY: THE CASE OF ITALIAN CLOSED-END FUNDS

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1. Introduction

The objective of the present work is to perform a detailed exploration of the different models in which it is possible to carry out institutional *venture capital* activity in Italy, i.e. the investment by qualified financial intermediaries in the risk capital of non-financial companies. This investment, in line with the terminology used in economic literature and professional practice, must also show significant growth prospects and be in the initial stages of thei company's development process.[1]

Vice versa, the term *private equity* is used to describe the investment activity performed in the target company's life cycle after the initial stage; e.g. shareholdings acquired with the main objective of facilitating the resolution of a problem of generational change or, *buy-out/in* operations (so-called *leveraged acquisitions*), which refer to different companies in relation to size, maturity, control and financial fundamentals.[2]

In particular, the subject examined in this paragraphconcerns the constitution process of the intermediary wishing to operate in the *venture capital* business in the Italian financial market; moreover, the analysis will also include the operating models with which the *venture capitalists* raise capital for their core activity (*fundraising*), select projects/companies deserving a financing (*investment process*), and finally, proceed to exiting from the shareholdings acquired (*way-out*).

However, the main element of the contribution is represented by the centrality of the closed-end investment funds in the national *venture capital industry*. As a matter of fact, this intermediary is particularly suited for providing a balanced stream of financial resources to non-quoted companies, characterized with high growth and profit potential, but that do not have the necessary financial resources to support them. The international experience underlines both the importance of this category of intermediary, and the benefits in terms of allocation efficiency that can derive from this financial system. The Italy closed-end funds, although rather recent, after an initial period of stagnation have started to develop and realize their productive activity on a professional basis, following the "fundraising of capital-investment-monitoring-exiting-distribution to subscribers" scheme.

[1] *Cfr* Sahlman W.A., "The structure and governance of venture-capital organizations", *The Journal of Financial Economics*, vol. 27, 1990; Gompers P.A., "Optimal Investment, Monitoring and the Staging of Venture Capital", *The Journal of Finance*, vol. 50, 1995; ABBOT S., HAY M., *Investing for the Future*, Ft Pitman Publishing, London, 1995; GOMPERS P.A., LERNER J., *What drives venture capital fundraising?*, w.p. 6906, NBER Series, Cambridge, MA, 1999; GERVASONI A., SATTIN F.L., *Private equity and venture capital. Investment manual of risk capital*, Guerini e Associati, Milan, 2000.

[2] In some recent definitions both *venture capital* and *private equity*, apart from the company's life cycle phase, refer to *merchant banking*, i.e. the division institutionally appointed to the direct undertaking of shareholdings in non-financial companies. *Cfr*. Caselli S., Gatti S. (2000).

In fact, since the first regulation establishing the Italian closed-end funds (Legislative Decree 344/93) has been revised and homogenized with the disciplines in force in other countries, where the *venture capital* sector is more developed, the risk capital market and its actors have increased significantly.

For this reason, the Italian experience is very interesting as useful lessons may be obtained on designing an intermediary system and financial instruments that will allow an efficient flow of capital from the parties with positive financial balances to those in deficit of financial resources who, by their nature, do not have an immediate and direct access to the stock markets.

The rest of chapter is structured as follows: in paragraph 2 a close examination of the *venture capital* and *private equity* market in Italy is performed, in order to highlight the trend of investments made in the last years and their division by typology, size of the target company and sector of activity. Paragraph 3 focuses on the main operators in the national risk capital market, clarifying the actual and prospective role of the Italian closed-end funds. These intermediaries are the subject of specific examination in the second part of the work, from paragraph 4 on, where the institutional, regulatory, organisational, and managerial specificities of the Italian closed-end funds are examined, with special reference to the cases in which for some time the *closed-end* funds perform their activities. In particular, we will stress the most critical aspects of the legislation measures that in 1993 established them in Italy and show how the successive measures enacted by the national legislator modified and improved the present situation. Finally, in paragraph 5, we analyse a series of observations emerging from the Italian experience of closed-end funds and supply some points for consideration by the *policymakers*.

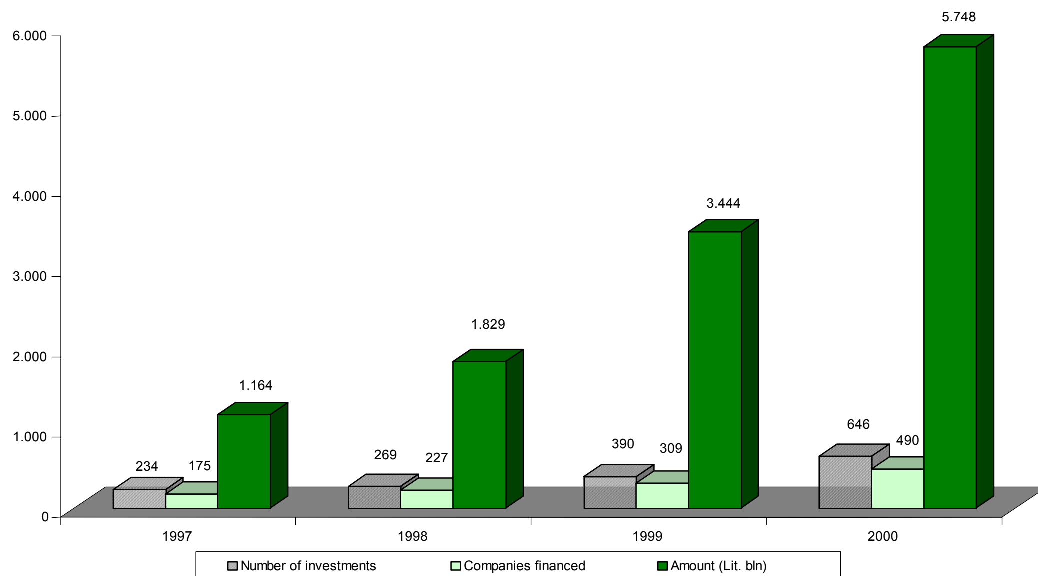
2. The *venture capital* market in Italy

From the beginning of the ‘90 and, in particular, in the last five years, the *venture capital* and *private equity* market has seen, in Italy, an uninterrupted growth, in terms of the total value of investments made, the actual number of operations and, finally, the number of companies financed (see figure 1).

In fact, at the end of 2000, the total value of risk capital investments in non-financial companies reached 5,750 billion Lire, showing a 67%increase compared with the approximate 3,444 billion in the previous year and a 450% increase compared with 1997 (a little more than Lire 1,164 billion). The number of companies financed was 490 in 2000, largely superior to the 309 ones in 1999 and 175 in 1997.

Figure 1

The Italian venture capital and private equity market: growth trend in the 1997-2000 period

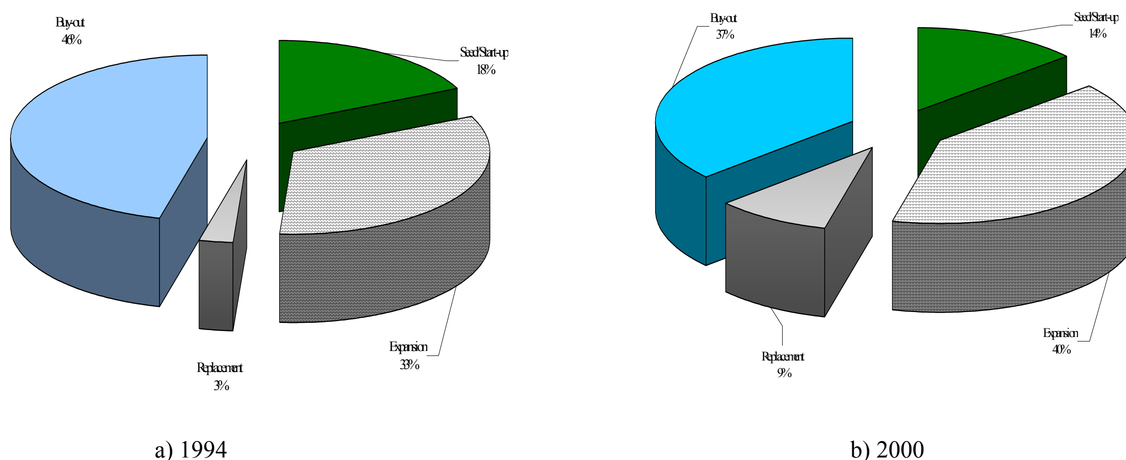


It is worth underlying again that the *venture capital* term used hare refers to risk capital investment in companies that are in the initial phase of their life cycle (so-called *early-stage investments*); this means either the investor's intervention in the experimentation phase, where the technical validity of the product/service has still to be demonstrated (*seed financing*), or in the commencement phase of the production activity, where the commercial validity of the product/service is not yet known (*start-up financing*). However, the investments made in order to accelerate the companies' development (*expansion financing*), favour a restructuring of the shareholding base (*replacement capital financing*), and permit the company's acquisition by a new entrepreneurial group (*leveraged/management buy-out financing*)[3] belong to the *private equity* category.

[3]The definition of *venture capital* in economic literature is not unequivocal; for example, some authors also include *expansion financing* investments (*cfr*. JENG L.A., WELLS P.C., "The determinants of venture capital funding: evidence across countries", *The Journal of Finance*, n. 6, 2000). Moreover, the term *venture capital* is frequently used in professional practice as a synonymous for *private equity*, therefore including all the typologies of investments listed above. The terminological solution adopted in the present contribution is coherent with the definitions chosen by the main official sources of data and information (NVCA; EVCA; AIFI).

Figure 2

Distribution of the amount of investments in venture capital and private equity by typology



a) 1994 b) 2000

If we then adopt a disaggregated vision of the *venture capital* and *private equity* market (figure 2) it is possible to understand how, in the 1994-2000 period, the segment with the largest growth rate relates to the *seed/start-up* investments (+ 32.7%), followed by the *buy-out* operations (+ 25.0%), while the risk capital investments in *expansion* and *replacement capital financing* show a reduction. However, in terms of the number (and not the value, in billion Lire) of investments, table 1 shows how, in 2000, over half of the total investments made related to "pure *venture capital*" (*seed/start-up*): comparing the result with the three previous years, the growth in this segment of the market appears truly considerable.

Table 1

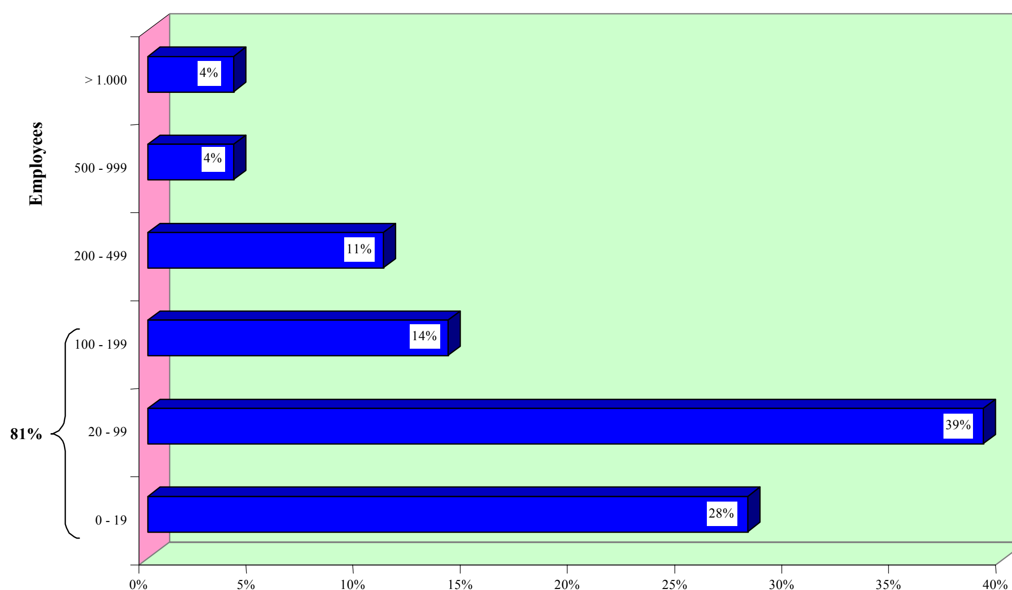
Percentage distribution of the investments in venture capital and private equity in 2000

	Seed/Start-up		**Expansion**		**Replacement**		**Buy-out**		**Total**	
	1997	2000	1997	2000	1997	2000	1997	2000	1997	2000
Number	**40%**	**53%**	35%	36%	14%	3%	11%	8%	100%	100%
Value	**12%**	**18%**	27%	33%	29%	3%	32%	46%	100%	100%

Source: AIFI (2001)

Figure 3

Percentage distribution of the number of venture capital and private equity investments by size of the target company



In addition, these investments, apart from the typology adopted, are particularly suitable for developing small and medium sized companies, that can count on alternative financial (and often managerial and industrial) resources compared to bank financing. Data from the Italian Association of Institutional Investors in risk capital (A.I.F.I.) shows how, in 2000, most *venture capital* and *private equity* investments (over 81%) addressed companies with less than 200 employees; 28% of the investments financed companies belonging to the minimum sized category, i.e. less than 20 employees (figure 3). Although lacking precise details on the typology of investments, it is likely that all - or most – pure *venture capital* investments (*seed/start-up*) related to smaller sized companies. It is the case of the Italian industry, world-wide known for the preponderance of small and medium sized companies.[4]

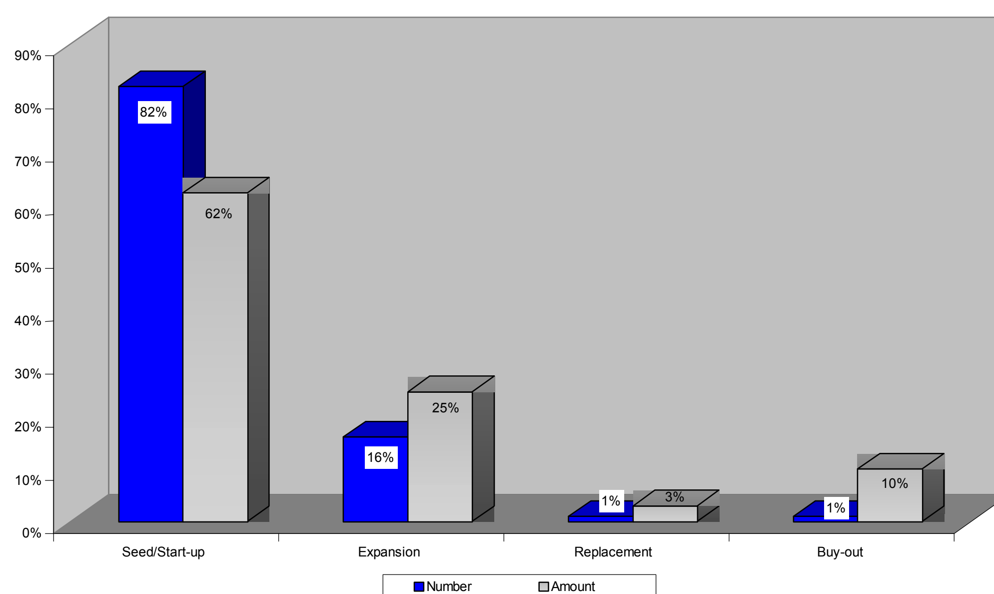
Finally, analysing the destination of the investment flows realised by operators in the domestic equity capital market, the typologies of economic activity preferred by the *venture capitalist* are characterised by *capital intensive* production processes, not much standardised and with high technological content; e.g. the *internet-related businesses*, telecommunications, information science and technology, automation, electronics, biotechnology and medical equipment industries. In particular, empirical evidence relating to the national *venture capital industry* shows how *seed/start-up financing* investments represent 62% of the value (in billions

[4] The statistics elaborated by AIFI not always permit the *breakdown* by typology of investment (*seed*, *start-up*, *expansion*, *replacement*, *buy-out*).

Lire) and, in fact, 82% of the total number of *venture capital and private equity* investments are related to *high-tech* companies (figure 4).

Figure 4

Percentage distribution of the investments in high-tech companies by typology (2000)



3. The main actors in the national *venture capital industry*

A review of the main actors in this market is useful in order to have a precise picture of the operating – current and prospective – possibilities for the different typologies of professional risk capital investors in non-financial companies.

Even today, the general denomination of institutional investors in risk capital describes operators, with different profiles and organisations, belonging to the following categories:

A) *Banks*. Since a few years, following the Consolidation Act related to the banking and credit legislation (Legislative Decree 385/93), the national banks, respecting pre-determined quantitative limits, are allowed to acquire risk capital in non-financial companies.[5] However, a lot of banks were already operating in the *venture capital and private equity* market – through their own *merchant banks* – before the application of this regulatory

[5] In relation to this, the Consolidation Act identifies a *total* limit (relationship between the total of non-financial shareholdings held and the equity for Bank of Italy purposes), a *concentration* limit (relationship between the size of the individual non-financial shareholdings and the equity for Bank of Italy purposes) and a *separation* limit (relationship between the size of individual shareholdings and the net equity of the company invested in); these limits, however, assume different values in function of belonging to a data bank of one of three typologies specifically identified in the regulation: ordinary banks, qualified banks and specialised banks. For more detailed information, *cfr*. Forestieri G., Mottura P., (2000).

measure, and internally possessed the appropriate expertise and professional skills for operating in the risk capital market. As the *venture capital* activity implies the possibility of becoming a company's shareholder, and not just a creditor, requires a clear separation within the bank between the units in charge of the *lending* and investment activities, whose production processes and economic-financial profiles of the services provided are very different.

B) *Merchant banks and holding companies*. They are typically national banking operators, that, in line with the Anglo-Saxon model of *merchant banks*, professionally perform risk capital interventions, as well as intermediary and consultancy activities in the *corporate finance*, *asset management* and *risk management* segments. Mediobanca is the Italian main intermediary for tradition and volumes traded (within this category).

C) *Industrial operators and holdings of industrial groups*, i.e. holding companies held – singularly or in *joint ventures* – by industrial operators with the objective of investing in young companies, generally with a high growth potential. The larger company succeeds in financing innovative technology and defending its original *business* from the threat of substitute products, without internalising risky investments, therefore not compatible with the managerial policies agreed with its financiars and market. In Italy, the presence of *corporate venture capitalists* is of little significance, i.e. large industrial groups directly operating in the risk capital market.

D) *Public operators*, that supply financial risk capital to companies promoting and developing specific economic activities or geographic areas, especially on the employment side. Therefore, although operating in the *venture capital* and *private equity* market, their objectives are partially different from the other operators', and significantly influence the selection of companies to invest in, the investment duration (often a long-term one) and the strategies for investment monitoring.

E) *Regional financial companies*. Constituted towards the end of the '70s as agencies for development and regional programming instruments, they have gradually undertaken an important role in financing the growth of small and medium sized companies. Their main areas of activity relates to financial services, industries and territory interventions. With reference to the *venture capital* market, the regional financial companies grant medium and long term financing, actively provide subsidized financing and acquire minority shareholdings. In general, they do not have the necessary expertise in order to intervene actively in the management of the participated company and operate in the most important sectors for the development of a particular geographical area.

F) *Operators originated from cooperative companies*. The cooperation too, through special financial companies, are active in the risk capital market, and intervene in order to stimulate the promotion and creation of new entrepreneurial cooperative enterprises, without assuming any control. As in the case of public operators, the objectives pursued with the risk capital intervention are partially different from the traditional value maximization seeked by the other intermediaries. As a matter of fact, the initiatives financed relate prevalently to innovative technological programmes, occupational increases and development of particular geographic areas.

G) *Private operators*. This category includes the so-called *business angels*, i.e. private and "informal" investors (generally entrepreneurs, ex consultants or ex managers) with financial means and a good network of contacts and managerial skills, in order to invest in new entrepreneurial initiatives. Moreover, important operators are the *incubators of*

companies, who supply resources to young companies, helping them to survive and grow when they are most vulnerable, i.e. during the *seed* and *start-up* phases. Apart from supplying financial and managerial resources, as the *venture capitalists*, the incubators rpovide office, machinery and equipment services, and also large amounts of space for carrying out the production activity.

H) *Italian closed-end funds*: financial intermediaries who raise capital mostly from institutional investors or private individuals with considerable personal wealth. They aim at investing, in the medium-long term period, in low liquidity and high risk companies, e.g. non-quoted ones. We will examine the institutional and operating characteristics of these intermediaries in the following paragraphs, with particular reference to the Italian case.

I) *Foreign banks, investment banks and closed-end funds*. Finally, the foreign intermediaries have been operating in Italy for many years: Anglo-Saxon/US *investment banks*; subsidiaries of foreign banks through related companies; foreign closed-end funds, managed singularly or in collaboration with Italian partners. These operators, due to their greater experience in the risk capital business and the different regulatory environments in which they carry out their institutional activities, are the most active players in the market, in terms of numbers of operations concluded and value of capital paid (figures 5 and 6).

With reference to the Italian *venture capital market*, several operators are excluded, as they in fact play a significant role in other countries: e.g. *pension funds,* which have not yet completely taken off in Italy due to the structural deficiencies which have historically troubled the national social security system. However, pension fund are likely to become more important in the coming years within the national financial system, therefore contributing to the strengthening of the *venture capital* and *private equity* market.

Figure 5

Venture capital and private equity market by investor category (2000)

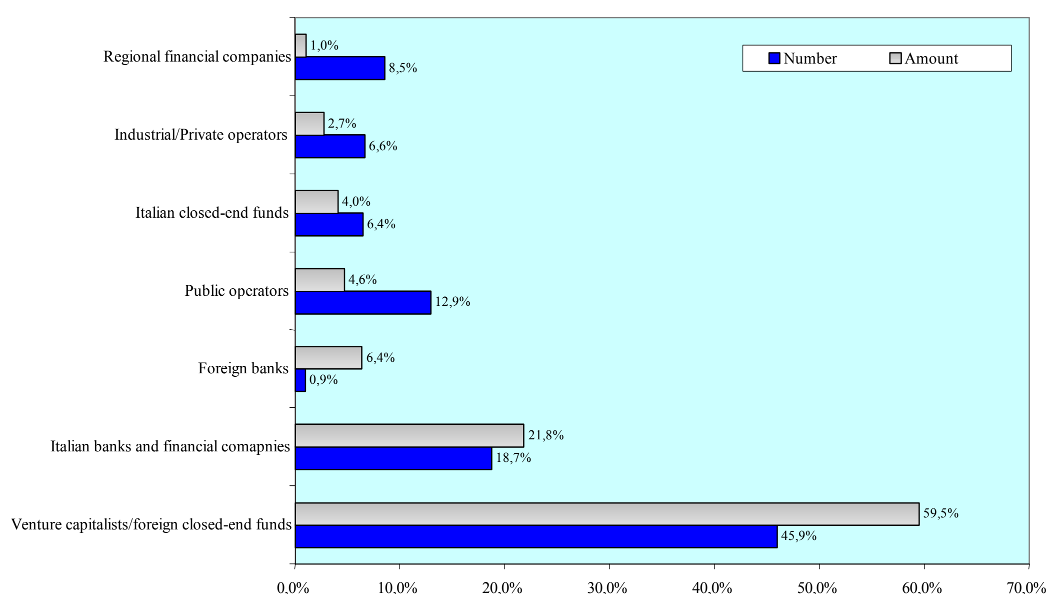


Figure 6

Venture capital and private equity market by investor category (1996)

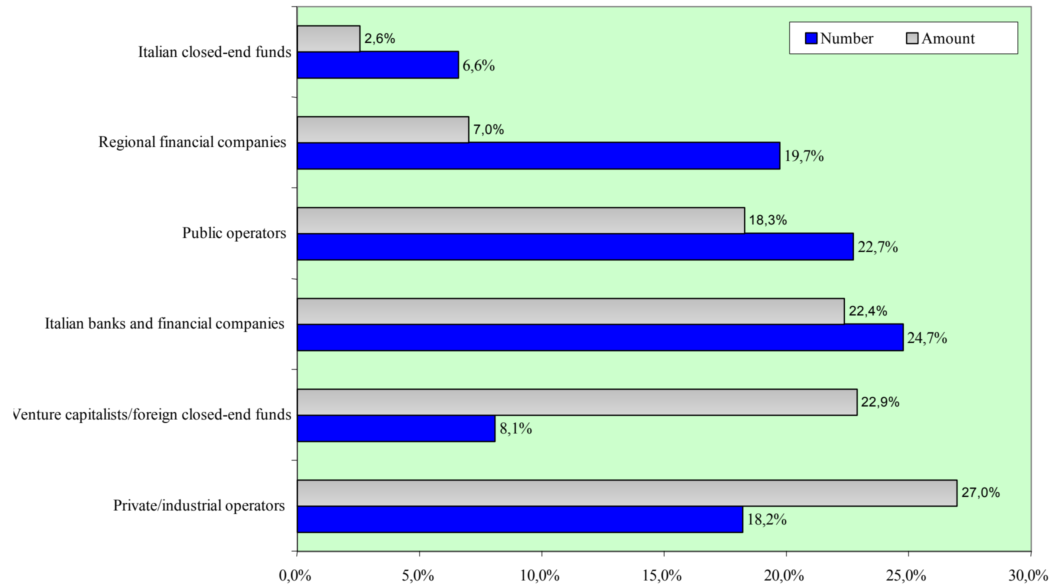
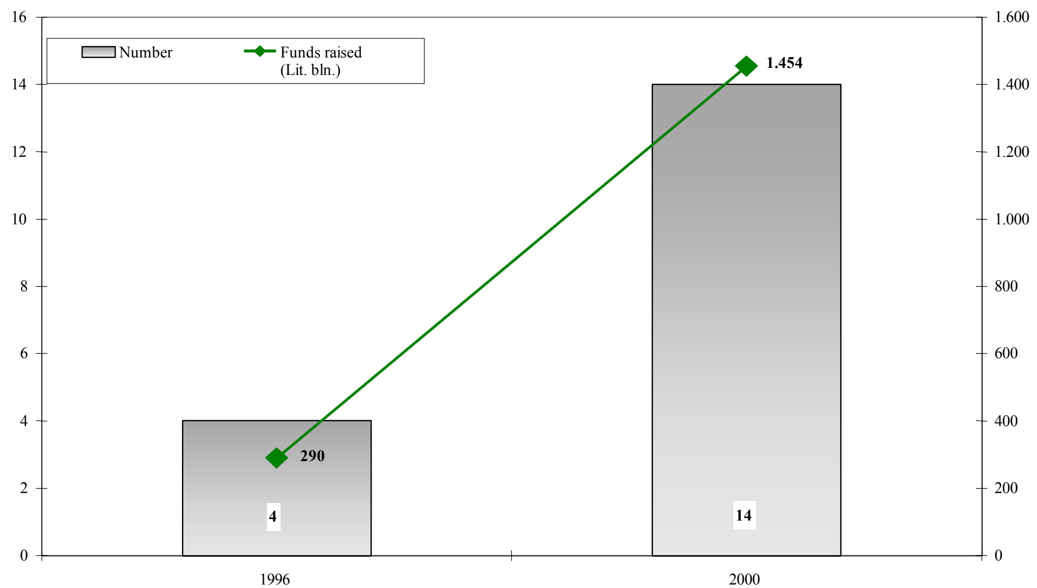


Figure 7

Italian closed-end funds during the 1996 – 2000 period



In the Italian market, several tendencies have contributed to bring the national *venture capital industry* closer to the more developed indirect risk capital markets, where the financing opportunities are greater for the small and medium sized companies with high growth potential. In particular, they refer to the following structural changes:

- the weight of public operators, regional financiers and companies originated from cooperatives has decreased significantly, as proven by the fact that these operators' professional and operating characteristics and expertise is not the engine of a developed and efficient risk capital market;
- the Italian closed-end funds have increased significantly – by number and amount of funds raised – in particular since the regulations on the subject were modified (figure 7). As a matter of fact, in the perod from Sept. 1999 to Sept. 2000, 5 new closed-end funds were established, while from Sept. 1995 to Sept. 1999 nine new nes were added;
- the strong growth in foreign closed-end funds, also managed by *venture capitalists*: this trend suggests greater competitiveness compared to national closed-end funds, that in part seem to have diminished from the previous year.

As in the other contries, also in Italy the closed-end investment funds represent a significant option for performing the *venture capital* activity, and it is destined to assume higher importance over the next years.

4. Italian closed-end funds

4.1. Mutual investment funds and closed-end funds: a summary

The closed-end investment funds represent worldwide - and now also in Italy - one of the main operators capable of performing professional *venture capital* and *private equity* activity.

Mutual investment funds, together with the investment companies with variable (marked to market) net worth (in Italy so-called SICAV) are the alternative solutions for offering the management of collective savings in Italy.[6] This service is disciplined by the Consolidation Act related to financial intermediaries (Legislative Decree of February 24, 1998, n. 58). They are autonomous equities divided into quotas, belonging to a number of participants and managed by a *management savings company* (hereafter Sgr), authorised by the supervision authority to manage collective savings. Legally and substatially, the term "mutual" indicates that the equity raised through the transfer of different participations is an undivided joint estate of assets, and each investor is co-owner of the quotas paid in. Other peculiar elements to this financial intermediary are:

a) the fund equity is distinct from the Sgr's (or *management company's*), and from the participants to the fund itself;

b) all the fund's quotas have equal values and rights, and are represented by registered or bearer certificates;

c) the subscribers to the fund's quotas cannot influence its management activities;

[6] *Cfr*. Forestieri G., Mottura P.(2000).

d) the fund's quotas – also called "liability to market" as they are calculated at market value and not book value – are not liabilities of the Sgr.

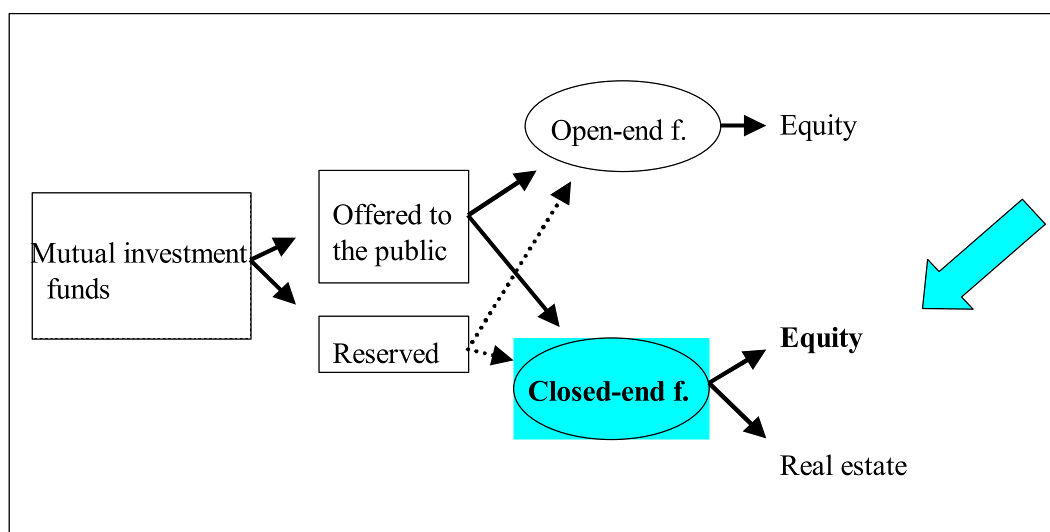
The mutual investment funds are different from the target market for their method of operating and the typology of assets subject to the collective investment (figure 8).

First, it is possible to distinguish between the funds *offered to the public* (*retail*), destined to all the potential savers, and the *reserved* funds, focused on the "qualified investors", i.e. professional investors that, for expertise and volumes, institutionally perform intermediary activity and individual savings management and are particularly suited for subscribing fund's quotas[7] for participating in non-quoted financial instruments – e.g. the *venture capital* funds. These operators generally are:[8]

- investment companies, banks, exchange agents, Sgr, SICAV, pension funds, insurance companies, financial companies belonging to banking groups and parties registered in the lists as mentioned in art. 106, 107 and 113 of the Banking Consolidation Act (Legislative Decree 385/93);
- foreign parties authorised by the regulations of their own country to carry out the same activities as in the previous point;
- banking foundations;
- individuals (or bodies) with the specific skills and experience in financial instrument operations, as expressly declared in writing by the individual or his legal representative.

Figure 8

Typology of mutual investment funds



[7] Reference is made to the chapter by Geranio M., in this volume.

[8] This list is held in the Bank of Italy Regulations of September 20, 1999 (Section I – *Measures of a general character*) as stated by art. 6, 34, 36, 38 and 50 of the Legislative Decree of February 24, 1998, n. 58 (Finance Consolidation Act).

With reference to the operational method, we must distinguish between "open-end" and "closed-end" funds. A fund is defined as "open-end" if the participant-subscriber has, at any time, the faculty to invest in (thus acquiring newly issued quotas at current prices) or exit from the fund (exercising the redemption of the quota and timely obtaining the monetary equivalent at current prices). In a "closed-end" fund, instead, the subscribers' right to the reimbursement of the quota is only recognised at a pre-determined expiry date, as stated in the information prospectus. Thus, closed-end funds do not provide the participants the possibility to subscribe new quotas and "exit" from the fund at any moment. This is why it is particularly suited to allocating financial resources to small and medium sized companies: mainly non-quoted; with high growth potential; in need of "patient" capital, stably available to *management* and that does not oblige from the beginning – when the absorption of cash required for the investments is high – periodic payments of pre-determined cash flows to repay the financing.

Therefore, the typical subscriber of a closed-end fund is an investor – either individual or institutional – capable of assuming a rather high level of risk, in expectation of a similarly high return to be realised in the medium-long term. Hence, the fund manager has stable resources and invests them in low liquidity assets.

However, if internationally the subscription by institutional investors is prevalent (on average private investors contribute fro only 10-15% to the funds raised), the Italian closed-end fund regulation (law n. 344/93) penalises the institutional fundraising, that is therefore strongly focused on *private individuals*. On the other hand, the funds raised from institutional investors for the *venture capital* and *private equity* activities privileges the foreign closed-end funds. The main consequence is that the capital raised prevalently from private individuals does not possess the same characteristics, in terms of stability, risk/return/liquidity and investment philosophy, of corresponding financial resources raised largely from institutional investors.

Finally, with reference to the type of asset subject to investment, both open-end and closed-end funds may invest in liquid assets, even if the latter had better invest – once the relevant authorisation has been received from the Supervision authority – in financial instruments characterised by reduced liquidity and a greater risk profile, e.g. by risk capital in non-quoted companies. The closed-end funds, in addition, are the only vehicles permitted by the law, within the management of collective saving services, to invest in property and real estate[9] activities, which show interesting development potential, as at the end of 2000, the 6 closed-end real estate funds operating in Italy managed resources above Lire 3,100 billion.

4.2. The structure of Italian closed-end funds

Different solutions permit to carry out institutional *venture capital* activity through the creation of a "vehicle" in order to raise financial resources from investors and channel them, under the form of participations, towards companies presenting, in virtue of a product or innovative technology, a high growth potential. In particular, the markets where the *venture capital* is more developed historically and by size, present the following legal structures:[10]

a) *partnership*: the shareholders are responsible for the management or agree to delegate the collective management of the funds raised to external professionals (*management*

[9] *Ibidem*.
[10] *Cfr*. EVCA, *Private Equity Fund Structures in Europe*, Internal publication, Zaventem, 1999. GERVASONI A., *I fondi mobiliari chiusi*, Il Sole 24 Ore S.p.A., Milan, 2000.

company). In any case, the total sharefolders' and fund's reserves are equal, and the fund itself does not have an autonomous legal form;

b) *limited partnership*: a scheme similar to the previous one, that provides the presence of two clearly defined categories of shareholders. In fact, the *limited partners*, i.e. subscribers to the fund's quotas, have a limited responsibility in the fund's management and investment decisions; the *general partners*, apart from transferring capital, are responsible for organising the *fundraising*, managing the funds raised and proceeding, at the expiry date, to the reimbursement of the quotas to the subscribers.

c) *corporation*: a company whose shareholders are the investors. The main disadvantage with respect of the revious organisational froms is due to the fact that the *corporation* is subjected to taxation on the *capital gains* realised (and not distributed), whereas the *partnership* and *limited partnership* are characterised by full "fiscal transparency". They are therefore typically constituted when the law does not permit certain parties to operate through *partnership* or *limited partnership*;[11]

d) *closed-end fund*:[12] an autonomous legal body independent from both the subscribers and the company that manages the resources. The subscribers, however, do not have the possibility to intervene in the management or investment choice, which exclusively concerns the management company, assisted on specific aspects if necessary by one or more *advisory companies*. This is the legal solution envisaged by the Italian regulations to carry on in a professional manner the activity of managing collective savings with reference to non-quoted companies.[13]

However, it is worth underlining how, setting aside the particular legal structure chosen, there are common characteristics that distinguish a *venture capital fund* compared to the other financial intermediaries presented in paragraph 3:

1. *limited life*: the fund has a pre-established expiry date, at the end of which the exiting and redemption of the quotas subscribed are returned to the investors. This characteristic, apart from minimizing the risks of differences between *venture capitalists* and investors on the *timing* and methods of redistributing the funds invested, is a powerful incentive for optimising the efficiency of the *management company*'s investment policies, that, in case of worse results than expected, will seriously compromise its ability to raise funds in the future;

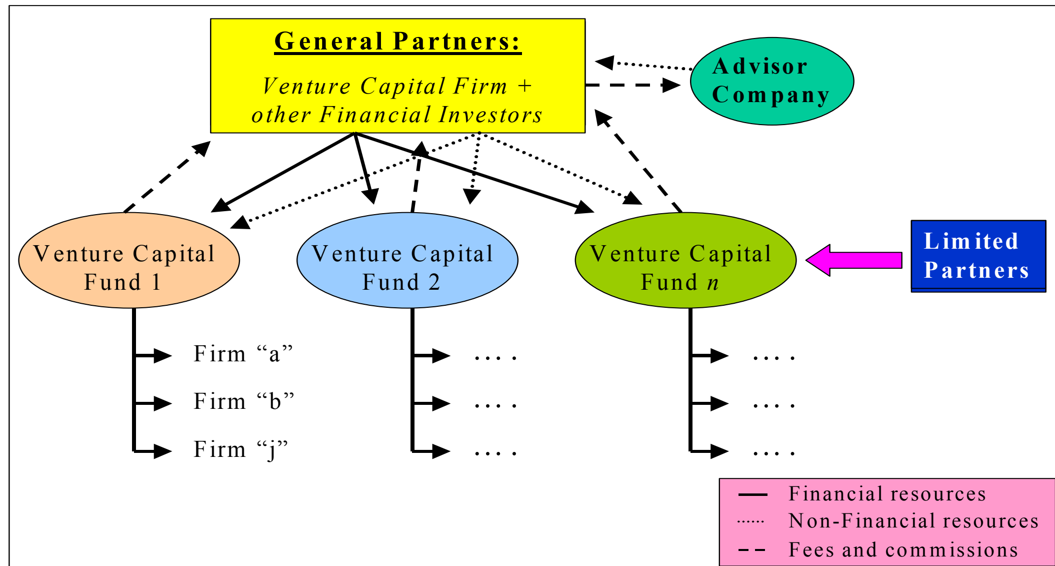
[11] In the United States, for example, the banks cannot maintain holdings in *limited partnerships*: the only possibility they have to create a closed-end fund is through a *corporate entity*.

[12] This term refers to the legal structures operating in the United States; similar to *closed-end fund* are, in Great Britain, the *venture capital trusts*; in France, the *fonds communs de placement à risque*; in Germany the *unternehmensbeteiligungsgesellschaft*; in Spain, the *fondos de capital-riesgo*.

[13] The Finance Consolidation Act (Legislative Decree 58/98) also provides, in the management of collective savings, the *investment in the variable capital of a company* (sicav) solution, whose share capital represents the assets that must be invested and managed. The same normative *corpus*, however, assimilates the assets of the sicav to the open-end mutual investment funds, thus imposing the same limits to the concentration of risks for the latter, the most important of which prevents them from making investments for more than 20% in non-quoted financial instruments from the same issuer. This prevents to consider the sicav as a professional operator in the *venture capital* market.

Figure 9

The typical structure of a limited partnership



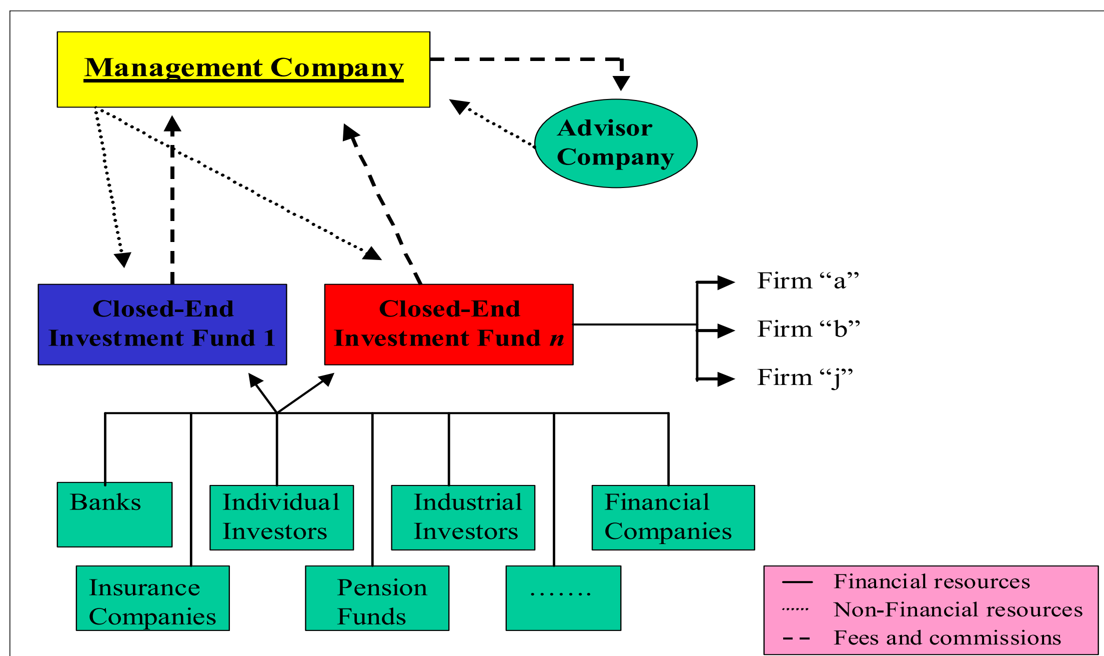
2. *flexibility*. The *management company* can launch several funds simultaneously, each one characterised with a distinctive duration, capital and investment philosophy; therefore, it is possible to satisfy a variety of investor categories, each with a specific risk/return/liquidity profile, widening the depth of the risk capital market. This flexibility, in addition, allows the manager to delegate to other parties (*advisor companies*) some of their institutional activity (fundraising, identification of the *target* companies, investment selection and/or monitoring, analysis of the exit opportunities). He is therefore always able to supply the clientele with highly specialised and sophisticated products, without necessarily possessing internally a wide and specialised expertise;

3. *remuneration mechanisms*. The parties appointed to the fund management receive, first of all, a fixed *management fee*, generally varying between 2% and 3% of the total capital raised; in addition, the *management company* also participates in the final result of the fund, through the *carried interest* mechanism, that allows it to receive a certain percentage (usually 20%) of the total *capital gains* realised in the exit phase. Hence, the *venture capitalists* are more responsible in the investment selection and management activities, as these affect an important part of their own remuneration.[14]

[14] For further details on the typical incentive and remuneration mechanisms in the *venture capital industry*, *cfr*. LIAW K.T., *The Business of Investment Banking*, John Wiley & Sons, New York, 1999.

Figure 10

The typical structure of a closed-end fund



We will now examine the major differences between the structure of the *limited partnership*, widespread in the Anglo-Saxon world due to its advantageous fiscal asymmetry, and the *closed-end fund*, that represents the only option allowed by the Italian legislator (figure 9 and 10).

First, the *venture capital* funds constituted through *limited partnerships* provide the existence of two distinct investment categories – *general partners* and *limited partners* – with involvement and responsibility levels differentiated in the management of the capital raised. This separation does not occur, but it is typical in the closed-end funds, between the reserves of the *venture capital fund* and of the fund managers – the *general partners*: it allows the *management team* to act autonomously in the selection of the best investment opportunities, accelerating the decision-making process relative to the preparation and conclusion of the investments.

In order to avoid the emergence of opportunistic behaviour by the *general partners*, they are explicitly prohibited to perform trading operations on their own behalf (*self-dealing*), which, for example, could allow them to receive benefits not available to the *limited partners*.

Second, in contrast to the *closed-end funds*, the subscribers can exit their investment before the end of the fund's life, i.e. the *limited partners* can ask at any moment for the reimbursement of the quota subscribed. It is thus possible that, against the *limited partners*' request of exiting, there might arise liquidity risks within the *limited partnership*, which could jeopardize the stability of the financial resources given to the companies financed.[15]

[15] In practice, however, the Anglo-Saxon experience shows how the *limited partners*' request for an anticipated exit of the investment is extremely infrequent, as in the case of scarce satisfaction for the

Finally, a further element of differentiation relates to the legal nature of the *limited partnership*: as it is not a company with share capital, it is not eligible, in the countries whose legal regulations provide for such a company structure, to be admitted for quotation on the official stock markets.

The quotas of a closed-fund, on the other hand, can be traded on a regulatory market, and in addition, as stated in the Italian regulations, in case of quotation it is possible to subdivide the quotas, with the aim of permitting greater marketability of the certificates representing them and increasing the liquidity profile.

In the countries where it is possible to constitute a *limited partnership*, the largest part of its success is due to the favourable fiscal regimes, differing from the ones applicable to the other intermediaries operating in the *venture capital* market, e.g. the *closed-end fund*.[16]

4.3. The evolution of the applicable legislation

This paragraph focuses on the most critical aspects characterising the legislative measure (law 344/93) that, for the first time, established in Italy this typology of financial intermediary and that has significantly affected the operation and diffusion on a vast scale.[17] Moreover, we will analyse how the following measures enacted by the national legislator were able to intervene in the problems highlighted. In the final paragraph, we will make a final evaluation and stress the questions not yet solved.

The constant reference point will be the regulatory solutions adopted in those countries where the *closed-end funds* have operated most and have been able to fully perform their potentiality.

In particular, the greatest weakness relating to the characteristics of the legislation of the Italian closed-end funds – only recently modified – can be summarised in the following points:

- legislation related to the fund raising;
- limits to the holding of voting rights;
- limits to the fund duration;
- fiscal regime applicable.

4.3.1. Legislation in relation to the fund raising

The legislation for closed-end funds, which did not distinguish between *retail* and reserved funds, establishes that the fund's reserves must be raised through one single emission of quotas, equal in unitary values. These quotas, as later on specified by the Treasury Ministerial Decree

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general partners' management activities, thay will not participate in the latter's future initiates; *cfr*. JENG L.A., WELLS P.C., "The determinants of venture capital funding: evidence across countries", *The Journal of Finance*, n. 6, 2000.

[16] In the United States, in fact, if at the beginning of the eighties less than 40% of the *venture capital funds* were structured as *limited partnerships*, this percentage was over 80% in the middle of the nineties; *cfr*. GOMPERS P.A., LERNER J., *What drives venture capital fundraising?*, w.p. 6906, NBER Series, Cambridge, MA, 1999.

[17] For a systematic discussion on the discipline currently in force, *cfr*. GERVASONI A., *I fondi mobiliari chiusi*, Il Sole 24 Ore S.p.A., Milan, 2000..

n.228 of May 24, 1999 (hereafter D.M. 228/99), must be subscribed within 18 months from the Consob's approval of the fund's information prospectus. The payments of the quotas subscribed must be made in one unique step, within the terms provided in the fund's regulations.

The problem emerging from such a legislative provision arises from the fact that the *management company* may have to manage considerable amounts of liquidity for a non-negligible period before the fund's resources can be actually invested. However, the investment in non-quoted companies, which often have an extremely limited *track record*, presupposes a *screening* and analysis activity that is *time consuming*. All this could result in the significant reduction of annual percentage returns of the investment guaranteed to the subscriber after the reimbursement of the quota, with consequential detriment to the manager's reputation.

To solve this problem, the D.M. 228/99, after having allowed the possibility of establishing funds, beside the *retail* ones, whose participation are reserved exclusively to qualified investors – as listed in paragraph 4.1. – provides the *draw down* mechanism, i.e. the payments of the quotas can be made in different occasions, following the subscriber's commitment to pay on the management company's request and based on the effective investments decided each time.

In addition, law 344/93 also establishes that the management company must invest its own reserves in quotas of funds managed, within a minimum of 5% and a maximum of 10% of the value of each fund. This limit was, first, lowered to 2% by the Regulations of the Bank of Italy of July 1, 1998 and, afterwards, eliminated in relation to reserved funds by the D.M. 228/99. In fact, in the case of retail funds the subscription of at least 2% of the reserves of each fund aims at transmitting a strong signal to the average investor, in order underline that the *management company*, before carrying out solicitation activity of savings to the public, firmly believes in the success of the initiative. In the case of reserved funds, however, it is legitimate to presume other and more sophisticated parameters for the professional investor to take into consideration in evaluating the profile of the investment's expected profitability.

4.3.2. Limits to holding voting rights

The Treasury Ministerial Decree n. 228 of May 24, 1999 and the successive Regulation of the Bank of Italy of September 20, 1999, implemented by article 6 of the Finance Consolidation Act (Legislative Decree 58/98), radically changed the operating possibilities of closed-end funds, removing those pre-existing restraints to investments, that limited the effectiveness and diffusion of the national *venture capital industry*.

In particular, law 344/93 states special limits on the risk concentration and holding of voting rights, so that the fund's reserves could not be invested:

1) for more than 80% in non-quoted shares (with a minimum limit, however, of 40%);
2) for more than 20% in Italian or foreign government securities;
3) for more than 20% in shares, or quotas with voting rights, in quoted companies;
4) in liquid assets sold to another fund of the same group;
5) in shares or quotas of companies if, as a whole, 51% of the capital is owned by less than three companies managing mutual funds (open and closed), belonging to different groups;
6) in shares, or quotas with voting rights, issued by the same company for a value superior than 5% of all the shares issued by the company, if quoted;

7) in shares, or quotas with voting rights, issued by the same company for a value superior than 30% of all the shares issued by the company, if not quoted.

The Regulation of the Bank of Italy of 1999 substantially revised and modified the above-mentioned limits, benefiting closed-end *retail* funds, and allowed the reserved funds a broad faculty to deviate from the aforesaid norms of risk hedging and subdivision, thus widening the investment possibilities.

The current regulations provide only for a minimum investment limit in financial instruments of *retail* funds in non-quoted companies – 10% of the fund's reserves. However, there are not any maximum limits, and as a consequence there is nothing to prevent these funds to invest the entire capital raised in a non-quoted company. In compliance with the diversification principle, the reserves of the fund cannot be invested:

1) for more than 20% in non-quoted financial instruments by the same issuer;
2) for more than 15% in quoted financial instruments by the same issuer;
3) for more than 30% in financial instruments issued by several companies belonging to the same group (limit reduced to 20% when the group belongs to the Sgr);

In relation to the reserved funds, the regulation of the Bank of Italy of September 20, 1999 establishes that "in the fund regulations different norms from the general ones can be prudentially fixed", thus leaving significant faculty in separating from each of the above concentration limits.

However, the aspect of greatest significance and originality of the new regulations related to the holding of voting rights is the fact that closed-end funds – both offered to the public and reserved – can acquire majority shareholdings in the risk capital of non-quoted companies, ususally object of the *venture capital* and *private equity* activity. With reference to *retail* funds, there is only the limit, and for quoted companies only, to hold a maximum of 10% of the quotas with voting rights from the same issuer. The reserved funds for professional investors can, instead, also depart from this regulation. Law n. 344/93 excluded in all cases the possibility to hold controlling shareholdings, even if not meeting the limits above.

The removal of the prohibition for Italian closed-end funds to hold controlling interests in non-quoted companies represents a real point of discontinuity from the past, as it eliminates the most critical element encounted by the intermediaries in performing their institutional activity in the risk capital market, especially considering that the prohibition was obviously not applicable to operators subject to other regulations.

First, greater weight is attributed to the closed-end fund within the *corporate governance* of the companies financed, as the financial intermediary "counts" more on the board of directors and no longer finds himself in a position of inferiority compared to the majority shareholder. A similar condition should benefit the company financed, as the transfer of industrial experience and skills is easier. Moreover, the assistance supplied to the entrepreneur is more effective in relation to formulating and implementing the company's competitive strategies and adaptating the structural layout to the changes required by the choice of particularly rapid growth paths.

Second, a more equilibrated division of the voting rights, where the entrepreneur does not maintain the majority of his own company even after the entry of the closed-end fund in the risk capital, allows to perform remuneration and incentive mechanisms in order to induce the fund to

avoid opportunistic behaviour and to concentrate on the company's growth.[18] The entry of the *venture capitalist* in a company is preceded by rather elaborate contractual negotiations, in which, typically, a series of appropriate criteria and mechanisms are fixed to allow the entrepreneur to increase, over time, the quota of risk capital held, in order to reach particular growth objectives; therefore, forms of *equity-based* remuneration, share *buy-back* programmes and the issue of convertible shares are some of the possible mechanisms permitting the entrepreneur and the majority shareholder to align their objectives.

Third, as shown by empirical experience, a greater level of involvement in the investment outcome gives the *venture capitalist* greater incentives and better operative possibilities in monitoring the entrepreneur's behaviour; this is a very important aspect in a market where *moral hazard* represents the principal factor of imperfection in trading.[19] Moreover, the typical *target* of the closed-end funds' activity, i.e. small and medium sized non-quoted companies with high ownership concentration, is characterised by a high level of "information opacity"; it is therefore important to benefit from privileged observation points, in order to gain full access to the information sources of the business.

Fourth, the possession of a majority interest is often an essential requisite in managing the exit (*way-out*) coherently with the timing and profitability objectives of the closed-end fund. If the financial investor does not have full discretionary powers in exiting the investment through trade sales operations or mergers with other companies, and the recourse to the stock market is not practicable, the only alternative available is the participation's sale to the majority shareholder (or to the company's *management*), which are a possible detriment to the investor's economic returns. In fact, at the end of the programmed investment period of the closed-end fund, the company might not yet be ready for quotation on an official regulatory market, which however, in the Italian case, does not present the efficiency and liquidity typical of the Anglo-Saxon stock markets. On the other hand, the shareholding's sale on the private market of ownership reallocation makes the requisite of the company's control particularly stringent, in order to manage the private sale (and thus the choice of the buyer, the determination of the operation's *timing*, sales price and method of payment). Moreover, it is desirable to avoid the application of a "minority discount" to the share value.[20]

Finally, the possibilities to assume majority shareholdings in the risk capital of non-financial companies, increasing the investment's control and effectiveness, ends up by increasing the broadness and flexibility of the options available to the *management company*, and thus favours the development of the national *venture capital industry*, in line with the experience of other financial systems.

4.3.3. Limits to the fund's duration

Law n. 344/93 states that the fund's duration could not be less tham five or more than ten years, except for a possible "grace period" of three years at the end of the fund's duration, expressly authorised by the Bank of Italy in order to allow the investment exit.

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[18] *Cfr*. SAHLMAN W.A., "The structure and governance of venture-capital organizations", *The Journal of Financial Economics*, vol. 27, 1990. GOMPERS P.A., "Optimal Investment, Monitoring and the Staging of Venture Capital", *The Journal of Finance*, vol. 50, 1995.
[19] *Cfr*. JENG L.A., WELLS P.C., "The determinants of venture capital funding: evidence across countries", *The Journal of Finance*, n. 6, 2000.
[20] *Cfr.* Capizzi V. (2000).

The D.M. 228/99 extended to all closed-end funds – *retail* and reserved – the maximum duration limit from ten to thirty years (plus the three grace years that mighy be requested to the Bank of Italy to allow the exit from the investment).

Such a modification to the regulations concerning the fund's duration further increases the flexibility of the investment choices, as in the absence of stringent expiry dates, the exit process of the investment can be postponed to a moment when greater value has been acquired.

Therefore, a longer duration is more coherent with the nature of the *venture capital* activity. Differing from the *private equity* investments, addressed towards companies that have already undergone the commencement and development phases and are often ready for quotation on the stock exchange, the path that the *venture capitalist* must take together with the company in the *start-up* phase is long and difficult. In fact, in some cases, ten years cannot be considered as a sufficient time horizon to permit the company to overcome the initial phases of its development (*early-stage*), characterised by the structural incapacity to product cash flows which are positive or, however, superior to the cost of financial resources obtained from debt securities: e.g. the high capital intensive *businesses*, biotechnologies, telecommunications, some segments of the pharmaceutical industry.

Other than reducing the possibility of behaviour oriented towards the short term (*short-termism*), aimed at searching those investment opportunities capable to produce high *capital gains* in a "reasonable" time period – and, therefore, not necessarily compatible with the *seed/start-up financing* – lengthening the maximum duration period of the closed-end funds is more coherent with the investment time horizons of institutional investors such as pension funds, whose weight in the Italian financial system is bound to increase in the coming years.

4.3.4. Fiscal regime applicable to closed-end funds

The fiscal regime of closed-end funds, as disciplined by law 344/93, art. 11, valid until the entry in force on July 1, 1998 of art. 8, paragraph 3 of the Legislative Decree 461/97, stated the tax exemption on the income of corporates, individuals and on the local income tax. A single tax was established equal to 0.25% of the fund's net value, with a reduction to 0.10% where the fund had invested no less than 50% of its own reserves in shares or equivalent securities issued by non-quoted Italian companies considered as "small" in compliance with law n. 317/91, i.e.:

- industrial companies with no more than 200 employees and a capital invested not higher than Lire 20 billion;
- commercial and service companies with no more than 75 employees and a capital invested not higher than Lire 7.5 billion.

The gains of the fund, in addition, did not contribute to the formation of the assessable income of the receivers with the exclusion of those exercising commercial activities; however, in this case, if the fund's quotas were held for a minimum period of three years, a tax credit was established equal to 25% of the gains. This regime was only applicable to those parties who held a quota of the fund inferior to 2%, and then increased to 10% with a special Treasury Ministerial Decree for each of the categories of institutional investors.[21]

[21] Article 3 of the Treasury ministerial decree of February 9, 1994 identifies as "institutional investors" the following categories: *a)* obligatory pension schemes; *b)* insurance companies; *c)* banks; *d)* holding companies; *e)* management companies of closed-end funds; *f)* equipollent foreign organisations.

The ordinary taxation regime for corporate entities did not provide, however, any allowments for the *capital gains*, which entered in the company's normal income. This regulation significantly penalised the national *venture capitalists*, at least with reference to the regimes in place simultaneously in other European countries (such as France, Belgium, Holland, Denmark). The dividends distributed by the fund entered within the company's normal income and were not subject to ILOR. In case they were originated from a foreign resident company, with a holding greater than 20% (10% if quoted), the dividends contributed to assessable income only for 40% of their value. There is clearly, therefore, a fiscal asymmetry in favour of *management companies* resident outside the national boundaries, that benefit from a much better treatment than the Italian closed-end funds.

The new fiscal regime currently in place, that acknowledges the regulations of the Legislative Decree of November 21, 1997, n. 461 and of the Legislative Decree of December 23, 1999, n. 505, stands within a more general revision of the taxation system of mutual investment funds.

In particular, in relation to the fiscal regime applicable the fund's gains, as in the previous regime, the funds are not subject to tax on income of corporates, individuals and to the local income tax (now substituted by the regional tax on production); the withholdings on the income of capital, in addition, are only a lump sum.

The Legislative Decree n.505 of December 23, 1999 stated that on the management result matured each year, and relevant to the qualified participations held by the collective investment organisms (disciplined by article 8 of the n. 461 of November 21, 1997), a substitute tax is applicable, i.e. 27% rather than 12.5%. This measure, however, considers qualified all participations in capital or reserves with a voting right in the company or body higher than 10% for the participations traded on regulatory markets, or 50% for the other ones.

Compared to the previous regime, the tax credit applied on the gains from participations in collective investment organisms, undertaken in the same year by commercial companies and related to the management result subject to the substitute tax of 27%, is 36.98% of the total amount. The fiscal treatment of the closed-end funds has been equalized to that of the open-end mutual investment funds. The measures contained in the legislative decree are applicable to the collective investment organisms with at least 500 participants, starting from January 1, 2000.

In relation to the fiscal regime applicable to the Italian participants in the fund, the gains distributed are not part of the assessable income, with the exception of the participations in the fund undertaken in the same year by commercial companies. The gains deriving from these shareholdings affect the income only in the year in which they are received. The gains received are subject to a tax credit equal to 15% of the amount.

The corporate bodies cannot, by express regulatory exclusion, opt for the substitute tax regime for the capital gains (that establishes a minimum 12.5% and a maximum 27% rate), in case these derive from participations in investment funds.

The fiscal regime applicable to the foreign participants of the fund, depends on two categories:

- resident in countries in the *white list*;[22]
- resident in other countries.

[22] The *white list* includes all the countries with an agreement guaranteeing the exchange of information, e.g. USA pension funds, Dutch holding companies, Luxembourg soparfi and Madeira companies; otherwise – e.g. "fiscal heavens" – they are included in the *black list*: Swiss and Luxembourg holdings, English pension funds, Anglo-Saxon *limited partnerships*.

The first list benefit from a few advantages: where non residents have received gains paid by collective management organisms subject to substitute tax, they have the right to the reimbursement of the tax paid by the fund (equal to 15% of the gains paid). In the Italian collective investment organisms whose quotas or shares are subscribed exclusively by non-resident parties, the organisms are exempt from paying the substitute tax on the management result.

The residents of countries on the so-called *black list* are applied, instead, a 12.5% taxation.

Table 2

Principal legislative measures related to closed-end funds

- ***Legislation August 14, 1993, n. 344***
- ***Legislative Decree November 21, 1997, n. 461***
- ***Legislative Decree February 24, 1998, n. 58 (Finance Consolidation Act)***
- ***Regulation of the Bank of Italy July 1, 1998***
- ***Treasury Ministry Decree May 24, 1999, n. 228***
- ***Regulation of the Bank of Italy September 20, 1999***
- ***Legislative Decree December 23, 1999, n. 505***
- ***Bank of Italy regulation December 24, 1999.***

5. Final considerations: open problems and *policy* indications

We have attempted to critically analyse the main factors that hindered the diffusion of closed-end funds in the Italian market, i.e. the category of intermediaries most suitable, by nature, to perform a professional *venture capital* activity.

The mechanism used at a regulatory level in attempting to solve most of these problems consisted in the identification of two distinct categories of closed-end funds: offered to the public (*retail*) and reserved. The latter includes the funds destined to institutional investors, and a series of exemptions are applicable to the limits that conditioned the Italian *closed-end fund*, especially if compared to the other countries, both European and non.

Table 2 shows chronologically the principal legislative measures that have from time to time modified the discipline of closed-end funds, starting from the institutive law (law n. 344/93).

In particular, the main lessons that can be taken from the Italian experience of closed-end funds can be summarised as follows:

1) It is necessary to provide closed-end funds with a certain amount of flexibility in relation to the methodology of raising funds from the investors, in order to avoid problems related to managing considerable amounts of excess financial resources for a non-negligible period of time;

2) In order for these intermediaries to contribute strongly to the development of a broad and efficient *venture capital* market, they must be also provided with the possibility to acquire majority interests in the risk capital of the companies financed. This is often the only way to be able to manage with maximum discretionary powers the exit phase (*way out*) and monitor effectively the behaviour of the entrepreneur financed;

3) The fund's duration must be compatible with the financial requirements and the growth path of the companies financed, that often need significant periods of time to be able to overcome the *seed* and *start-up* phases, and thus begin to free financial resources for their investors. Lengthening of the fund's duration from 10 to 30 years guarantees a more stable flow of resources to the company financed and, in addition, makes possible a future participation in this market by the pension fund operators, that have a medium-long term investment time horizon;

4) The returns received by the investors should be considered from the fiscal point of view as those deriving from other stock market investments, and in particular should not be penalised compared to the results of the activity carried out by similar types of financial intermediaries with reference to the other countries.

Finally, there remain certain elements of weakness characterising the discipline and operation of Italian closed-end funds not explicitly analysed in this paper, as they are not the subject of legislative modifications planned in relation to this category of operators.

Reference is made, first, to the problem of admission and trading on the official regulatory markets of the closed-end funds' participation quotas. The current discipline does not place a real and proper quotation obligation on Italian closed-end funds – as envisaged in law 344/93 – , therefore transferring the choice of requesting the quotation to the discretion of the Sgr, that must decide when the fund is created.

The experience of other countries indicates that most operating closed-end funds are regularly quoted on official stock markets;[23] the suggestion that can be derived is to institutionalize and quicken the quotation procedures of the closed-end funds' quotas, in order to achieve significant benefits in terms of liquidity and accessibility of the investment for the potential subscribers.[24]

A further aspect not examined in this paper relates to the potential problem of a single banking or financial institution conditioning the *management company* in performing its institutional activity. This is the case of the "*captive*" funds, different from the "independent" ones as their sources of supply are exclusively or prevalently parent companies or other related companies, and thus do not turn directly to the capital markets for raising their financial resources. The reduced operating autonomy of the *captive* funds - widespread in Italy – could significantly affect the investment policies of the closed-end fund's management company and reduce the weight of the non-financial resources transferred from the fund to the companies financed (mainly *business* expertise and managerial resources).

The international experience underlines how:

[23] *Cfr*. EVCA (various years).

[24] The regulations for the placing and quotation of the closed-end funds' quotas are stated in the issuer's regulations, enacted by Consob – in implementation of the Legislative Decree 58/98 – with resolution n. 11971 of May 14, 1999.

a) Mostly independent funds perform a more evident role of *active investor* towards the companies financed;[25]

b) In the Anglo-Saxon markets the independent operators are prevalent compared to the *captive* ones.

It should be therefore considered if it is not approprioate to adopt some measure that stimulates the constitution of independent management companies, capable of operating autonomously with the rules and judgement of the market and of realising fundraising /commitment/management investment policies fully coherent with the expectations of the subscribers and receivers of the financial resources intermediated.

The first Italian closed-end funds constituted according to the new discipline have only started recently. In a few years, when some of these funds end their fundraising-investment-exiting cycle, it will be possible to verify the real potential of this typology of intermediaries within the Italian economic and financial context and, consequently, to know if also in Italy the closed-end funds can really become the main operator in the *venture capital industry*.

[25] *Cfr*. AIFI (various years).

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