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New Rules Open Bond Markets to Italian Non-Listed Companies – Open Season for High-Yield Offerings?

As part of a package of measures to boost the economy, increase competitiveness of the Italian corporate system and facilitate access to alternative forms of financing by non-listed companies, on June 22, 2012 the Italian government issued the final version of Law Decree No. 83 (first approved on June 15, 2012) introducing rules eliminating size restrictions and decreasing the tax cost of bond issuances, bringing the Italian system substantially in line with other European jurisdictions.

In the last few months, the Italian government passed various new laws for the purpose of improving and increasing the efficiency of our corporate system while concurrently boosting economic growth. As part of this plan, the Italian government issued Law Decree No. 83 dated June 22, 2012 (the “Decree”),¹ introducing a set of new rules intended to allow access to bond financing by non-listed companies by extending the application of certain favorable provisions originally applicable only to listed companies. While the Decree contains various new provisions, including a new regime for the issuance of commercial paper by mid sized companies, changes to bankruptcy law and civil procedure and other specific technical changes, this client memo will focus only on the key changes introduced with respect to the issuance of bonds by non-listed companies.

Open Season for High-Yield Offerings?

The Decree eases restrictions on the issuance of bonds by non-listed companies by removing many of the obstacles normally viewed by the markets as hampering the growth and development of a solid Italian corporate bond market for these types of issuers.

Under the previous regime, non-listed companies were at a disadvantage as compared to listed companies, both with respect to:

- the size of the offering, which, pursuant to Article 2412, could not exceed twice the amount of the share capital, statutory reserves and distributable reserves of the issuer; and

¹ Under Italian law, a law decree is adopted by the Italian Government and has the force of law. However, it lapses unless it is ratified by the Italian Parliament within 60 days. The Parliament may also introduce amendments in the process of conversion of the law decree into law.

- taxation, since, unlike for listed companies, interest payments were deductible with severe limitations and were subject to 20% withholding tax.

This restrictive regime was originally intended to curb certain abusive conduct by shareholders of non-listed companies, which basically kept their companies undercapitalized and financed them through the subscription of bonds, which created tax efficiencies at company level, allowed extraction of profits in the form of interest payments on bonds and were generally subject to a lower rate of withholding tax. The regime, however, ultimately resulted to be too restrictive, as it essentially made the issuance of bonds by non-listed companies difficult and economically unattractive to both issuers and the investors.²

The table below summarizes the main obstacles and how they have been solved by the new rules introduced by the Decree:

OLD ISSUE	PROBLEM SOLVED
Size restriction – Must be a listed company and list bonds on a regulated market to be exempt from applicable size restrictions.	No size restriction – Non-listed companies no longer subject to size restriction, provided that the bonds are listed on a regulated market or multilateral trading facility. ³ Any issuance of convertible or exchangeable bonds is also exempt from restrictions, regardless of whether the bonds are listed or not.
Limited deductibility of interest – Must be a listed company to deduct interest payments without incurring in a specific interest deduction limitation for interest payments on bonds issued.	Deductibility of interest – The regime applicable to listed companies has been extended to non-listed companies as well, provided that the investors are “qualified investors” ⁴ and are not (either directly or indirectly) shareholders of the issuer.
20% withholding tax – Must be a listed company to be exempt from the application of a 20% withholding tax.	No withholding tax – The exemption applicable to listed companies has been extended to non-listed companies as well, provided the bonds are listed on a regulated market or multilateral trading facility.

² The Italian government made a first step to facilitate the access to bond financing by introducing in August 2011 (Law Decree No. 98 of July 6, 2011) a new set of rules allowing the application of a 5% withholding tax – irrespective of the beneficial ownership test – on interest payments made by an Italian company to a foreign non-resident entity (in which the intragroup borrower holds at least a 25% stake) in connection with an inter-company loan to on-lend funds deriving from the issuance of corporate bonds, provided that certain conditions were met (including, among others, that the bonds are listed on an EU or EEA regulated market).

³ Since the list of European multilateral trading facilities available on the website of the *Commissione Nazionale per le Società e la Borsa* (the Italian securities exchange commission – see <http://www.consob.it/main/mercati/sistemi/comunitari.html>, containing a link to the MIFID database on the ESMA website) currently includes both the Luxembourg Euro MTF and the Irish Global Exchange Market, a listing of bonds on either of these “multilateral trading facilities” would appear sufficient to satisfy the “listing” requirements set forth in the new rules.

⁴ Pursuant to Article 34-ter(b) of *Commissione Nazionale per le Società e la Borsa* (“CONSOB”, the Italian securities exchange commission) Regulation No. 11971 of May 14, 1999, as amended, implementing Article 100 of Legislative Decree No. 58 dated February 24, 1998, a “qualified investor” is any “professional client” as defined under Article 26(1)(d) of CONSOB Regulation No. 16190 of October 29, 2007, as amended, which include, *inter alia*, “private professional clients” such as (i) professional clients by default, i.e. persons authorized or admitted to operate in the financial markets, including: banks, investment firms, other authorized and regulated financial institutions, insurance companies, collective investment undertakings, investment management companies, pension funds and management companies for such funds, financial intermediaries acting for their own account on commodities and commodity-based derivatives, persons whose exclusive activity involves trading on their own account on financial markets with indirect membership of clearing and settlement services and the local compensatory and guarantee system, other institutional investors, stockbrokers, large-sized companies meeting certain asset/revenue requirements, institutional investors whose principal activity is investing in securities, including companies dedicated to the securitization of assets and other financial transactions; and (ii) professional clients upon request, which include, *inter alia*, wealthy individuals meeting certain experience and asset requirements.

OLD ISSUE	PROBLEM SOLVED
Usury law issue – Interest rate exceeding usury law thresholds may be invalid.	Issue still open – The new rules specifically address usury law matters only with respect to subordinated and/or participating bonds, whereby the Decree clarifies that the variable part of the interest remuneration tied to the profits of the issuer are not subject to usury law restrictions.

The New Regime

Bond Issuance Size Restrictions No Longer Apply

The Italian Civil Code allowed only listed companies to issue bonds without any size restriction.

The Decree replaces the existing paragraph (5) of Article 2412 with a new provision pursuant to which the size restrictions as described above do not apply to:

- issuance of bonds that will be listed on a regulated market or in multilateral trading facilities; or
- issuance of bonds granting the right to acquire or subscribe shares,⁵

in each case, regardless of whether the issuer is listed or not.

New and More Favorable Tax Treatment

The Decree also introduces significant improvements in the applicable tax regime, bringing it substantially in line with the regime applicable to listed companies. In particular:

- interest payments are now deductible without incurring in a specific interest deduction limitation for interest payments on bonds issued (subject to certain restrictions),⁶ provided that the bonds are subscribed by “qualified investors”⁷ that are not, either directly or indirectly, including by means of a fiduciary company or third-party representative, shareholders of the issuer;

⁵ As currently drafted, issuance of convertible or exchangeable bonds would not be subject to any size restriction, regardless of whether the bonds are listed on a regulated market or on a multilateral trading system.

⁶ Under the previous regime (Article 3, paragraph 115 of Law No. 549 dated December 28, 1995) the deductibility of interest payments by non-listed companies was limited only to interest payments not exceeding (i) twice the official reference interest rate (*tasso ufficiale di riferimento*, as set by the European Central Bank) if the bonds were listed or offered to the public or (ii) the official reference interest rate increased by 2/3 for all other types of bonds or similar financial instruments. Since the official reference interest rate can be significantly lower than market rates (especially for non-listed borrowers and in high-yield offerings), the limited deductible portion of interest payments made the instruments unattractive. As a result of the new regime introduced by the Decree, like for listed companies, interest payments on bonds issued by non-listed companies (subject to the requirements described above) are now deductible with the only limitation provided generally for any interest payments depending on the activity carried out by the company (i.e., (i) up to 96% of the interest accrued for banks and other financial entities; or (ii) up to the amount of interest income and other similar proceeds, and any excess is deductible up to an amount not to exceed 30% of the gross operating result (*risultato operativo lordo*).

⁷ See Note 4 above.

- the 20% withholding tax on interest payments will no longer apply. Provided the bonds are listed on an EU or EEA regulated market or multilateral trading facility,⁸ interest payments fall under the scope of application of Legislative Decree 239/96 which generally provides for a 20% substitutive tax except when the bonds are held by (i) certain institutional investors or (ii) beneficial owners of the income received that are established or resident in a jurisdiction with which Italy has concluded a double tax treaty containing an exchange of information clause (so called “white list” jurisdiction);⁹
- in addition, the transaction costs incurred in connection with the bond issuance will be fully deductible in the financial year in which they have been incurred.

Subordinated and Participating Bonds

The Decree also provides that the companies falling within the scope of application of the new rules, as described below, may issue bonds incorporating the right to participate in the profits of the issuer (participation clause), and/or a subordination provision (subordination to all other creditors, but senior to the shareholders of the issuer), provided that, however, such bonds have an initial maturity equal to or in excess of 60 months (or 5 years). These provisions do not apply to bonds that are offered to the public and listed on a regulated market or multilateral trading facility.

The issuance of subordinated participating bonds will have to comply also with specific requirements, including minimum fixed interest rate component (which may not be lower than the applicable official reference interest rate (*tasso ufficiale di riferimento*)), payment of the variable interest rate component to occur no later than 30 days after approval of the financial statements and specific rules on the determination of the criteria for the calculation of the variable interest rate component.¹⁰

The Decree also clarifies that the variable component of the bond remuneration will not be subject to the “usury law” provisions set forth under Law 108/1996 and that the issuance of subordinated and/or participating bonds will be subject to the general restrictions applicable to any regular bond issuance as set forth under applicable Italian law.

Tax Treatment of Participating Bonds

The Decree provides for a specific tax treatment of participating bonds. In particular, if participating bonds also include a subordination provision and provide for a restrictive covenant preventing equity distributions, other than distribution of dividends out of net profits:

- the variable interest rate component tied to the profits of the issuer must be accounted for in the income statement as a cost (provision for costs);

⁸ In connection with the issuance of bonds that are not listed on a regulated market, the issuer must notify to the Italian tax authority (*Agenzia delle Entrate*) any data relating to the issuance within 30 days. Additional requirements may be requested in the future by resolution of the competent authority.

⁹ This is the same favorable tax treatment provided for bonds issued by so called Italian “large issuers”, i.e., Italian banks and listed companies.

¹⁰ The criteria for the calculation of the variable component must be determined at the time of the bond issuance and may not be modified for the whole term of the issuance. Such criteria must be objective and may not depend on corporate resolutions adopted each financial year.

- the net profits of the issuer are therefore netted of any such amount;
- the amount of the variable interest (as well as the fixed component) is deductible in determining the taxable income of the issuer.

Scope of Application and Issuer's Requirements for Bond Issuances

The new rules apply to all non-listed companies (i.e., any company that does not have financial instruments listed on a regulated market or on a multilateral trading facility) other than banks and “micro” enterprises (or enterprises that employ less than 10 persons and have total annual revenues and/or an annual balance sheet not exceeding €2 million).¹¹

Pursuant to the Decree, non-listed companies may issue bonds under the new, more favorable regime if they comply with the following key requirements:

- the issuer must be assisted by a Sponsor (which must comply with the specific obligations described in greater detail below);
- the most recent financial statements of the issuer must be audited by a certified auditor or certified auditing company;
- the issuance of the bonds must be reserved exclusively to “qualified investors”;¹²
- purchasers of the bonds must not be shareholders of the issuer, either directly or indirectly, including by means of a fiduciary company or third-party representative;
- bonds may only circulate among “qualified investors.”

Large-sized non-listed companies¹³ are exempt from the requirement of appointing a Sponsor or may exempt the Sponsor from compliance with the requirements and obligations described below. In addition, these requirements, including the presence of a Sponsor, do not apply to bonds that are offered to the public and listed on a regulated market or multilateral trading facility.

The Sponsor's Role

Who Can Act as Sponsor

The role of Sponsor in the issuance of bonds may be carried out only by authorized financial institutions, including: banks, foreign banks (including non-EU banks) to the extent authorized to carry out their services in Italy, investment companies, management companies of investment funds (*Società di Gestione del Risparmio*) and other authorized financial intermediaries.

¹¹ See EU Commission Recommendation 2003/361/EU dated May 6, 2003.

¹² See Note 4 above.

¹³ Large-sized companies are companies meeting or exceeding at least two of the following thresholds: (i) 250 employees; (ii) annual revenues in excess of €50 million; or (iii) annual balance sheet in excess of €43 million.

Sponsor's Responsibilities

Besides providing assistance and support to the issuer in connection with the issuance and placement of the bonds, the Decree attributes to the Sponsor several ongoing tasks and responsibilities, including:

- entering into specific undertakings with the issuer to ensure minimum liquidity of the market for the instruments;
- investing and keeping in its portfolio, until maturity, a portion of the bonds issued, in an amount equal to (i) at least 5% of the aggregate value of the bonds issued, if the overall issuance does not exceed €5 million; (ii) an additional stake equal to 3% of the issuance value in excess of €5 million, up to €10 million; and (iii) an additional stake equal to 2% of the issuance value in excess of €10 million;
- carrying out periodically and at least every six months an evaluation of the market value of the bonds outstanding;
- carrying out periodically and at least every six months (and in any event upon the occurrence of any extraordinary event having an impact on the evaluation) creditworthiness valuations of the issuer and classifying it within specific risk categories taking as reference the EU Commission Communication 2008/C 14/02, as amended, regarding the revision of the methodology for the determination of reference and discount rates.¹⁴

Preliminary Considerations

Article 32 of the Decree introduces numerous welcome, long-awaited changes to the Italian regime and represents a significant step forward to allow non-listed companies to more easily tap the bond market. The removal of size restrictions on the issuance of bonds (to the extent the bonds are listed), coupled with a more favorable tax regime, applicable to all companies, listed and non-listed, finally aligns the Italian system with other dynamic European regimes. These new rules should unlock new resources for non-listed companies, which have historically been dependent on bank financing to fund their growth and expansion, and afford a broader variety of acquisition financing structures, including based on bond/high-yield financing.

The new rules also appear to allow much more flexibility in the capital structure of Italian companies, in particular with reference to subordinated and/or participating bonds: through the creation of debt instruments with various degrees of remuneration and risk exposure, non-listed companies will be able to offer a wider spectrum of investment opportunities to a greater variety of potential investors.

While it is quite early to properly assess the impact of the new provisions, which, incidentally, are also subject to possible further changes during the process of conversion of the Decree into final law, the following preliminary considerations can be made:

- while large-sized non-listed companies will essentially benefit from full flexibility without having to appoint a Sponsor, the impact of the Sponsor's costs (considering its investment and liquidity obligations) will have to be assessed in all other instances;
- in addition, since the size restrictions regarding the issuance of bonds (other than convertible or exchangeable bonds) and the 20% withholding tax on interest payments do not apply only to the extent the bonds are listed on a regulated

¹⁴ The Sponsor will have to classify the issuer in one of the following five categories: (i) strong, (ii) good, (iii) satisfactory, (iv) weak, (v) bad, and, if the issuance is guaranteed, coordinate the rating of the issuer with that of the guarantee ((i) high, (ii) normal or (iii) low). The Sponsor will have to publish the background for the ratings and update it as necessary.

market or on a multilateral trading facility, pure private placements that do not contemplate a listing (such as certain US Section 4(2) private placements) would not benefit in full from the new regime, and would continue to be subject to current restrictions.

It is difficult to anticipate whether the changes described above will in fact render the Italian corporate bond and high yield market more active, but they openly address the perceived shortcomings of the prior regime. The new rules do open a door in that direction, a welcome development at a time when bank financing is rarefied. Certainly, there are also critical cultural issues that will have to be overcome before a solid bond market can establish, including: (i) preference of entrepreneurs for personal relationships with local bankers, rather than an undefined group of institutional investors; (ii) language barriers; (iii) transaction costs, which are seen still as quite high.

It will also be interesting to see whether the changes that will be introduced by the Italian Parliament in the process of conversion of the Decree into final law will aim at further increasing the system flexibility or, on the contrary, will reintroduce previous restrictions or introduce new ones.

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

If you wish to receive more information on the topics covered in this publication, you may contact your regular Shearman & Sterling contact person or any of the following:

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