On behalf of the Public Affairs Executive of the EUROPEAN PRIVATE EQUITY AND VENTURE CAPITAL INDUSTRY

Position Paper

Review of the EuVECA Regulation

September 2016

Invest Europe’s key points

1. Support the new definition of eligible portfolio companies (Article 3d(i))

The SME definition used in the original EuVECA Regulation prevented too many managers from applying for the passport. The proposal to allow fund managers to invest in slightly larger companies provides them with the flexibility they need to offer both start-up and growth-stage financing to entrepreneurs and businesses in Europe.

2. Support the proposed improvements to the registration process (Articles 14 and 16)

Changes made in the text - and in particular the prohibition of fees charged by national authorities - will encourage fund managers to operate across borders and remove unjustified restrictions.

3. Clarify that larger VC managers can market EuVECA funds (Articles 2.2 and 14a)

Fund managers with assets under management above €500 million should be able to market their funds as EuVECA - provided they are still compliant with the AIFMD regime. This change will allow them to market those qualifying funds to sophisticated investors (as defined in Article 6.1 of the Regulation) - in addition to professional investors - and may increase the visibility of the regime as a whole.

4. Ensure appropriate own funds requirements (Article 10.3)

Given the nature of venture capital investing it is questionable whether any own funds requirements should be mandated. But if the co-legislators feel the Regulation needs to provide harmonisation in this area, any requirements must be appropriate and proportionate, and not create another barrier to participation in the EuVECA regime.
Introductory comments

Venture capital funds play a key role in providing finance to innovative, small but growing businesses, connecting sophisticated market participants with capital, with those entrepreneurs and business owners who need investment. Last year alone, European venture capital funds invested €3.8 billion into almost 3,000 companies.

Through active ownership of the companies in which they invest, venture capitalists work with entrepreneurs and management to develop the business (for example by improving its governance or by connecting it with new networks of suppliers) to achieve higher levels of growth, profitability and employment. As a result, many of the most successful and innovative new businesses of the last 20 years - in Europe and across the world - have received venture capital backing at a key stage of their development.

To make this contribution, venture capital managers need to raise funds from investors such as insurance companies, pension funds, family offices and foundations. In Europe too many venture capital funds are reliant on domestic investors: the benefits of a Capital Markets Union are not being realised if institutional capital does not flow from an investor in one Member State to venture capital funds in another. Action is needed to break down the barriers that keep capital locked up behind national borders and a workable EU-level marketing passport for these managers would make a major contribution to the goals of the CMU.

With the introduction of the Alternative Investment Fund Managers Directive (AIFMD) - which is for managers of all types of alternative investment funds with assets above €500 million - quite a few Member States switched off their national private placement regimes. This denied many venture capitalists - most of whose funds are too small for the AIFMD to apply to them and have a risk profile that makes it inappropriate - the opportunity to raise capital across borders in other Member States.

The voluntary EuVECA regime was therefore put in place in 2013 to counter this, providing those smaller funds that support Europe’s innovative and growing companies with a cross-border marketing passport appropriate to their needs, characteristics and circumstances.

The core features of the EuVECA regime (such as its voluntary nature and its exclusion of retail investors) do not need to change. But experience over the first three years of operations has identified certain amendments that are needed to improve its uptake and effectiveness.

If these changes are made more EU managers will be able to use the EuVECA label to market their funds to investors in other Member States, delivering on a key component of the CMU and facilitating the flow of investment into innovative and growing European businesses.
Points of discussion

I. Eligible portfolio companies *(Article 3(d)(i))*

Many EU-based venture capital funds are effectively excluded from the current EuVECA Regulation given the restrictions it imposes on the size of company into which they can invest.

The use of the existing EU SME definition as the basis for EuVECA eligibility discourages fund managers from providing finance to those fast growing businesses that have now developed beyond the (essentially arbitrary) criteria of 250 employees, €43 million balance sheet, and €50 million annual turnover. It also fails to provide fund managers with sufficient flexibility in the management of funds to support more effectively the growth and development of SMEs in which they do invest.

Although most of the firms that venture capital fund managers back do meet the SME definition, many venture capitalists also want the freedom to invest in slightly larger companies. Most venture capital fund managers tend to invest in specific sectors or areas of the economy where they have particular domain expertise. This makes for better and more effective investment and support to companies. A venture capitalist specialising in medical technology, for example, is likely to invest in companies of different sizes in that sector, not all of which will meet the SME definition. (It is also worth remembering that that definition is unlikely to have any particular meaning for an investor: a threshold of 250 employees is unlikely to be relevant to a venture capitalist). Many emerging and quickly growing companies are also increasingly active in the services sectors, which have labour intensive characteristics.

Venture capital fund managers are not only active at the very beginning of the life of a company, but provide investment and input to the development of the business over a number of years, so that even at the later stage of their growth and development, many small and medium sized businesses still need the support and investment from such a manager. But a fund that wants to continue to support such companies, risks being ineligible for EuVECA. Annex I provides an example of how in practice a fund might primarily be backing companies that meet the EU definition of an SME but could still end up ineligible for EuVECA simply by making a small number of investments into those slightly larger companies. Annex II shows why investments into larger companies should not be discouraged.

This is exacerbated by the fact that, at the point at which it starts to market the fund, and at which it therefore applies to be an EuVECA, a fund manager may not be able to guarantee that 70% of its capital will be invested into companies that meet the SME definition. A typical venture capital fund will run for at least 10 years and even if its focus is SMEs, a prudent fund manager may want to ensure that there is flexibility over the fund’s life to be able to back an attractive company that needs capital and support even though it does not meet that formal EU definition. For more details on why this happens, please see Annex III.

Venture capital managers, therefore, support the proposal to amend Article 3(d)(i) extending the range of portfolio companies from SMEs to also include small mid-caps.

It is important to remember, however, that venture capital fund managers need a maximum amount of flexibility to choose their investments. Additional flexibility on the eligibility criteria, including the percentage threshold for qualifying investments, might help to increase the take-up of the EuVECA regime.
II. Follow-on investments (*Article 3(d)(i)*)

Given their commitment to investing for the long term and to helping companies to develop, venture capital funds will often make a series of investments in a company, spread over a number of years and at different stages of the company’s development. Seed funding will help the company to develop its initial concept; early-stage funding will then help it to bring its product to market; and late-stage and growth funding will help it to expand into new markets or segments.

The proposal to state explicitly that follow-on investments into a business or undertaking are not considered towards the qualifying threshold (i.e. that the criteria for qualifying investments only apply at the time of a fund’s first investment in a company) is welcome. It will allow funds to continue investing into successful, growing companies.

Otherwise the Regulation would penalise success: a venture capital fund would risk losing its EuVECA status simply because it had achieved the very goals of the programme. This welcome flexibility in the Commission proposal is an important reform and provides valuable certainty to managers.

III. Administrative burden and fees/charges (*Articles 14 and 16)*

Although EuVECA is a Regulation and therefore directly applicable, its day-to-day operation depends on Member State authorities. While in some Member States the registration requirements are reasonable, in others the costs – both financial and in terms of the time and administrative burden required – are excessive and act as a disincentive for venture capital funds to seek the EuVECA designation.

We therefore fully support the proposed changes to streamline the registration process as they provide much needed legal certainty for fund managers seeking to adopt the voluntary EuVECA passport. This includes:

- amendments covering the registration procedure, including the timetable by which a competent authority is required to respond (*Article 14.3a*); and

- the equivalence of the EuVECA registration with the AIFMD one (*Article 14.3b*).

In a Capital Markets Union a fund manager that is fully compliant with the relevant EU law (and particularly with a Regulation that has direct effect) and that is in possession of a valid passport should be free to market across the EU without any further administrative requirements being imposed by the ‘host’ jurisdiction, including fees and charges. Such charges are an unwarranted barrier to the single market and to cross-border marketing. The cumulative cost to a venture capital manager can amount to tens of thousands of euros, which acts as a disincentive for a manager to consider fundraising in another Member State.

The explicit prohibition of such fees and changes via the provision of Article 16.2 (which states that no requirements and administrative procedures other than those set out in the Regulation are permissible) is particularly welcome.
IV. Allowing AIFMD fund managers to market EuVECA labelled funds (Articles 2.2 and 14a)

In its Guidance on the existing EuVECA Regulation ESMA has explicitly recognised that fund managers with assets under management above the threshold of Article 3(2)(b) of the AIFMD (€500 million) can nonetheless manage and market funds using the EuVECA label.

ESMA states that: “While the Regulation limits the benefit of the ‘light touch’ passporting regime to sub-threshold managers, the use of the EuVECA and EuSEF designation is not exclusive to these managers. [...] EuVECA managers that subsequently exceed the threshold in Article 3(2)(b) of the AIFMD, and therefore have to seek authorisation in accordance with the AIFMD, are entitled to market and manage EuSEF and EuVECA in accordance with the Regulations.”

ESMA also stresses that this carries no prudential concerns as these larger managers continue to operate under the requirements of the AIFMD and in addition will need to comply with certain EuVECA requirements.

The Commission’s proposal therefore clarifies ESMA’s existing interpretation, which is to be welcomed. A fund manager whose investment strategy is consistent with the objectives of EuVECA should be permitted to market its fund using this designation.

This will:

- increase visibility of the EuVECA label; and
- ensure that successful fund managers whose assets grow beyond the €500 million threshold are not prevented from continuing to market as an EuVECA.

As ESMA notes this would have no impact on investor protection as:

(i) fund managers with more than €500 million of assets under management will continue to comply with the AIFMD; and

(ii) Member States would retain control over whether marketing to retail investors should be permitted.

V. Own funds requirements (Article 10.3)

It is not clear that the Regulation needs to set any own funds requirements for the small, venture capital fund managers for whom EuVECA is designed. Investors in venture capital are typically sophisticated, professional investors who understand the risks and play an active role in negotiating the legal terms of the fund including arrangements for aligning the interests of fund managers and investors. They can accept losses and lock-up their money for several years.

The venture capital model is based on strict separation between the fund (which owns the underlying assets) and the fund manager (who carries out the business of investing into and developing those assets). This means that even if the manager ceases to do business the real assets are fully protected and the investors will simply appoint another manager to operate them. High capital requirements on the fund manager therefore add no protection for the investor, nor for the underlying entrepreneurs or companies
being backed. Nor would there be any financial stability concerns should a small venture capital manager be unable to continue to operate.

If the co-legislators nonetheless feel that the Regulation needs to impose own funds requirements, there is merit in having more uniformity than we have right now.

Experience with implementation of the current EuVECA Regulation has demonstrated that national competent authorities have taken quite different approaches to the determination of the level of ‘own funds’ that a fund manager must have in place. While there may be some national specificities that should be taken into account, we believe that an EU-level passporting regime that is based on a Regulation that has direct effect should be based on a greater level of convergence.

There are different ways to achieve such harmonisation but however it is done it should be acknowledged that excessive capital requirements will simply act as another barrier to venture capital managers’ participation in the EuVECA regime. Venture capital managers are typically requested to invest in parallel with their investors, to ensure alignment of interests. They will have already made a sizeable commitment to the fund and it will be difficult for them to come up with significant additional own funds.

Furthermore, these own funds will only serve to reduce the capital the venture capitalist has available to invest in companies and entrepreneurs. The more capital that the venture capitalist is required to lock-up in the fund management entity the less will be available to back companies.

A potential solution could be found in CRD IV (Article 31.1), which imposes an initial capital requirement of EUR 50,000 on investment firms who provide no MiFID investment services other than: (a) reception and transmission of orders; and (b) investment advice, and who in particular do not hold client assets or client money. This requirement was originally proposed as part of the MiFID framework in 2004.

We are confident that venture capital managers (even those that are newly established) ought to be able to cope with EUR 50,000, provided this is only a capital / balance sheet test. It must not be a requirement for cash or other liquid assets as this will only lock-up more capital that cannot be used productively.

Another way to achieve harmonisation is, as the European Commission proposes, through the development of Regulatory Technical Standards (RTS). Such RTS need to give a clear steer that the own funds requirements for EuVECA managers should be much lower than for other AIFMs, in recognition of the characteristics and risk profile (i.e. low level of risk) of the fund managers in question.

The European Commission rightly acknowledges this in its proposal, explicitly asking for such RTS to take account of the size and internal organisation of EuVECA labelled funds and their managers (many venture capital fund managers are themselves small businesses, employing no more than 10 or so people) and to ensure that the amounts constituting sufficient own funds under EuVECA do not exceed the amounts laid down in the AIFMD.

VI. Third country tax treaties (Article 3 (d)(iv))

The current Regulation requires that eligible portfolio companies are based in third countries which are fully compliant with the standards laid down in Article 26 of the OECD Model Tax Convention on Income and on Capital and have in place effective exchange of tax information measures.
It can be a very difficult task for an EuVECA fund manager – who will most likely be a small operation with limited staff resources – to assess and determine whether any third country in which a potential investment is located is compliant with the Article 26 standards and has signed relevant tax information exchange agreements with both the manager’s home Member State and with all other Member States in which the fund will be marketed.

The cost and complexity of this requirement acts as a further disincentive for managers to opt-in to this voluntary regime.

In order to make it easier for the fund manager to comply with this requirement a central database should be created listing:

- third countries that are compliant (with the standards of Article 26 of the OECD Model Tax Convention and with the FATF requirements); and
- the EU Member States with which they have signed relevant tax information exchange agreements.

Such centralised information could then be consulted by EuVECA fund managers, providing them with ready access to the information that they need to comply with the Regulation.

We believe that such a database could be maintained by ESMA, as there is precedent for it playing such a role. ESMA did this for the Memoranda of Understanding that needed to be negotiated between EU Member State competent authorities and non-EU countries under AIFMD. This matrix is updated on a regular basis (for the last time in September 2015 - available here) and a similar service here would be of meaningful benefit.

VII. EuVECA as a management passport (Article 1.1)

In a Capital Markets Union venture capital fund managers should be permitted both to market their funds in other Member States and to manage funds located in another Member State through a passport. There are no grounds for requiring a manager to be located in the same Member State as the EuVECA fund.

In its Q&A on the current EuVECA Regulation ESMA has already stated that:

“EuSEF and EuVECA managers can manage and market AIFs, since this is not prohibited by the Regulations”

The new Regulation should be explicit on this point through an amendment to the text:

Proposed amendment to Article 1.1

This Regulation lays down uniform requirements and conditions for managers of collective investment undertakings that wish to use the designation ‘EuVECA’ in relation to the marketing and management of qualifying venture capital funds in the Union, thereby contributing to the smooth functioning of the internal market.
About the PAE

The Public Affairs Executive (PAE) consists of representatives from the venture capital, mid-market and large buyout parts of the private equity industry, as well as institutional investors and representatives of national private equity associations (NVCAs). The PAE represents the views of this industry in EU-level public affairs and aims to improve the understanding of its activities and its importance for the European economy.

About Invest Europe

Invest Europe is the association representing Europe’s private equity, venture capital and infrastructure sectors, as well as their investors.

Our members take a long-term approach to investing in privately held companies, from start-ups to established firms. They inject not only capital but dynamism, innovation and expertise. This commitment helps deliver strong and sustainable growth, resulting in healthy returns for Europe’s leading pension funds and insurers, to the benefit of the millions of European citizens who depend on them.

Invest Europe aims to make a constructive contribution to policy affecting private capital investment in Europe. We provide information to the public on our members’ role in the economy. Our research provides the most authoritative source of data on trends and developments in our industry.

Invest Europe is the guardian of the industry’s professional standards, demanding accountability, good governance and transparency from our members.

Invest Europe is a non-profit organisation with 25 employees in Brussels, Belgium.

For more information please visit www.investeurope.eu

Contact

Thank you in advance for taking our comments into account as part of the negotiation process. We would be more than happy to further discuss any of the comments made in this paper.

For further information, please contact Michael Collins (michael.collins@investeurope.eu) at Invest Europe.
ANNEX I - Expanding the Definition of Qualifying Portfolio Company - Why it is needed

Practical example:

Fund X is a fund with a broad range of investments in the biotech sector covering both small start-ups and more established companies.

Fund X is run by a manager based in the Netherlands. It has a small team of 10 people, some of whom are investment specialists and others medical Phds with expertise in the sector.

Fund X has made 8 investments into biotech companies. Its investor base is wide and international, and comprises both professional investors (pension funds) and sophisticated investors (successful entrepreneurs in the field, university endowments, family offices). These investors are based in the Netherlands, Belgium and the United Kingdom.

Here is an overview of the 8 investments of Fund X:
Companies A, B, C, D and E are recently created start-ups requiring seed and start-up financing of respectively €200,000, €400,000, €1 million and €2 million.
Companies F and G are established SMEs which require late-stage venture financing (€2.5 million each).
Company H is a successful company in the field of biotech which wants to internationalise. Company H requires €5 million of funding and has 270 employees.

Despite the vast majority of its investments being in SMEs and all of its investments being in growing companies, Fund X would fail to meet the existing EuVECA requirements due to its investment in Company H.

By the value of its investments only 63% of Fund X’s capital will be deemed to have gone into SMEs (as per the EU definition), falling below the 70% qualifying investments requirement and thereby rendering the fund ineligible for EuVECA, despite the fact that 87% of the companies it has backed (by number) are SMEs.

Under the revised EuVECA Regulation, which proposes to expand the range of qualifying portfolio companies (Article 3 (d) (i)), Fund X would be eligible for EuVECA and would be able to meet the 70% qualifying investments requirement.
ANNEX II: Why should the European Union encourage venture capital funds to continue to invest into companies as they grow and through different investment cycles?

Venture capital funds invest across a wide range of stages of investment from seed investment for an initial concept through the funding of start-ups and on to providing development capital and later stage growth equity.

European venture capital is largely succeeding to provide seed investment for entrepreneurs and businesses at the start of their development. As the graph below demonstrates, in Europe those venture capital funds that support the very smallest companies at their earliest development stage are comparable in size to those in the US.

But the data also show that European funds have less capital to support companies as they grow. As entrepreneurs and growing businesses develop, they need further rounds of financing (characterised ‘A’ to ‘E’), to develop new products or expand into new markets for example.

In Europe those funds that are supporting companies in the later rounds of financing tend to be significantly smaller than in the US - only having around half the capital to invest. The companies being backed during financing rounds A - E are not big, established companies that have access to a wide range of sources of finance. They are those that have overcome the initial hurdles of getting a business off the launch pad but that are still comparatively new and need significant support to be able to scale up their activities, perhaps investing in new machinery to increase production; or starting to sell into new markets (a next step that is often particularly important for entrepreneurs in those Member States with comparatively small domestic markets).

If European venture capital funds are unable to back them then these companies either risk being unable to grow further or they look outside Europe for their investment (which runs the risk that the intellectual capital and perhaps the entire company leaves the EU).
The EU therefore needs to encourage the growth of venture capital funds that are able and willing to support new companies not just at seed and start-up phase, but also as they grow and expand. This is why it is so important that the EuVECA regime does not act as a further block to the capacity and willingness of EU venture capital funds to grow in size and to (continue to) back these growing, successful portfolio companies.

If EuVECA does not allow venture capital funds to (continue to) invest in high-potential companies at different stages of their growth but only to back those that meet the strict SME definition the development of a vital source of finance for those entrepreneurs that have enjoyed initial success will be impeded.
Annex III: Why are funds that meet the EuVECA criteria not marketed as such?

No manager wants to run the risk of marketing a fund as a ‘EuVECA’ only to fail to comply with its requirements for legitimate reasons of portfolio selection.

At the start of the fundraising process – when the manager is considering an application to become a EuVECA - the manager may not be confident that it can guarantee finding sufficient companies that meet the strict EU definition of an SME to ensure the funds stays within the investment threshold limit during its entire life.

The EuVECA manager faces a dilemma - either risk having to decline an opportunity to invest in a company simply because it does not meet the strict SME definition (which may not be in the interests of the fund’s investors or of the company needing finance); or risk breaching the terms of the EuVECA Regulation and risk the legal consequences of this (whether from the competent authority or from investors).

As these risks are unlikely to be attractive many managers have simply declined to opt-in to the EuVECA regime. This denies venture capitalists the opportunity to seek backing from a wider range of investors and limits the opportunities for investors who will get less access to fund managers from other Member States.

Even where a fund has consistently invested only in SMEs that meet the EU definition, one investment into a slightly larger company is potentially enough for it to breach the threshold.