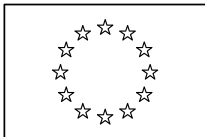

EUROPEAN COMMISSION

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**COMMISSION STAFF WORKING PAPER**

# IMPACT ASSESSMENT

*Accompanying the document*

# Proposal for a REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL

# on European Venture Capital Funds

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*This report commits only the Commission's services involved in its preparation and does not prejudge the final form of any decision to be taken by the Commission.*

# 1 INTRODUCTION

Venture capital funds are operators that provide mostly equity finance[1] to companies that are generally very small, in the initial stages of their corporate development, but often innovative and demonstrating a strong potential for growth and expansion. In the EU, venture capital funding displays high potential benefits for the development of small- and medium-sized enterprises (SMEs)[2]. As this impact assesment will demonstrate[3], SMEs that rely on venture capital financing fare better than those that receive no venture capital backing. Venture capital financing, coupled with a stable legal environment seems a recipe conducive to boosting growth, jobs and innovation.

Moreover, SMEs backed by venture capital can create high-quality jobs, as venture capital supports the creation of innovative businesses whose growth exceeds growth in more traditional sectors. According to recent research, an increase in venture capital investments is associated with an increase in GDP, and the impact of early-stage funding of SMEs has an even more pronounced impact.[4] Supporting venture capital can thereby drive the real economy.

Today, raising funds for venture capital finance remains at sub-optimal levels. This lack of size has negative repercussions on the optimal allocation of resources. The relatively small sizes of European venture capital funds prevents the emergence of economies of scale. These economies are, in turn, a prerequsite for the specialisation necessary to operate a successful venture capital fund[5] .

In order to remedy the lack of venture capital funding in Europe, the Commission has consistently pursued policy measures to build a more integrated and effective European market for venture capital[6]. Success so far has been limited.[7]

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[1] See Annex I: Definitions

[2] SMEs are defined in the Commission Recommendation of 6 May 2003 concerning the definition of micro, small and medium-sized enterprises (OJ L 124/36, 20.5.2003)

[3] The impact of venture capital financing on innovation and the growth of firms is documented in a series of academic papers that are described in Annex XII.

[4] Th. MEYER, "Venture Capital Adds Economic Spice", D*eutsche Bank Research,* September 14, 2010

[5] Communication from the Commission on *Removing obstacles to cross-border investments by venture capital funds* COM(2007) 853 final, 21.12.2007)

[6] Commission summary report 2009: Cross-border venture capital in the European Union: http://ec.europa.eu/enterprise/newsroom/cf/itemlongdetail.cfm?item_id=4053&tpa_id=127&lang=en

[7] See Annex II: Overview of past actions and initiatives in relation to SME access to finance and venture capital funds.

The Europe 2020 Strategy[8] and the Innovation Union[9] brought new impetus to efforts at consolidating Europe's venture capital industry. Supported by the European Council of February 2011 which called for removing the remaining regulatory obstacles to cross border venture capital, the Commission committed itself, in the Single Market Act[10] (SMA), to ensure that by 2012 venture capital funds legally established in any Member State should be able to raise capital from eligible investors throughout the EU. In addition, Member States were invited to ensure that inconcistencies in tax treatment [of venture capital investments] do not lead to double taxation which would hamper cross-border venture capital investments.[11]

The focus of this impact assessment is on the appropriate regulatory measures that could be adopted to create a bigger role for Europe's venture capital operators, provide deeper capital pools for venture capital funds, allow venture capital funds to expand assets under management and thus make such funds into a more important financing tool for innovative start-up companies. In pursuing this aim, this impact assessment will focus on rules govering the 'private placement' of funds to potential investors. In line with the approach adopted in the Small Business Act, issues related to the taxation of venture capital investments will have to be addressed separately.

## 2 PROCEDURAL ISSUES AND CONSULTATION OF INTERESTED PARTIES

This impact assessment draws on the results of a series of previous work relating to the fragmentation of markets for venture capital funds and the lack of equity finance for European SMEs. The key elements of this previous work are briefly summarised in this chapter.

The 1998 Commission Communication on a Risk Capital Action Plan (RCAP) recognised the importance of creating a European risk capital market.[12] Venture capital was seen as an essential part of this endeavour. The final 2003 report on RCAP indicated areas of further improvement.[13] In 2007, the Commission encouraged Member States to ensure the mutual recognition of their existing national frameworks governing the marketing of venture capital funds and create a common understanding of what constitutes a venture capital funds and who should be the investors eligible to invest in such funds.[14]. As will be explained below, in Member States that have not adopted specific rules on venture capital funds, fundraising for such ventures is governed by rules

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[8] http://ec.europa.eu/europe2020/index_en.htm, 3 March 2010

[9] http://ec.europa.eu/research/innovation-union/index_en.cfm?pg=keydocs 6 October 2010

[10] http://ec.europa.eu/internal_market/smact/docs/20110413-communication_en.pdf 13 April 2011

[11] See Review of the "Small Business Act" Europe, p.11 http://ec.europa.eu/enterprise/policies/sme/small-business-act/files/sba_review_en.pdf, 23 February 2011 and also Annex III: Summary of cross-border tax problems of venture capital funds

[12] Risk capital cover three types of financing: (i) informal investment by business angels, (ii) venture capital and (iii) stock markets specialized in SMEs and high growth companies.

[13] RCAP Final report 2003: http://ec.europa.eu/internal_market/securities/riskcapital/index_en.htm

[14] Commission Communication December 2007, Removing obstacles to cross-border investments by VC funds : http://ec.europa.eu/enterprise/newsroom/cf/itemlongdetail.cfm?item_id=2033

on 'private placement'. However, when assessing the situation three years on, the Commission found that Member States had made very little progress.[15] The approach based on mutual recognition of heterogeneous national rules covering the marketing of venture capital funds did not produce a uniform approach to the fundraising of venture capital operators.

In parallel, an impact assessment on 'private placement' rules[16] examined regulatory barriers that impeded cross-border fundraising operations of venture capital funds[17]. The impact assessment report concluded that there was a *prima facie* case for action at EU level and these conclusions subsequently fed into the Commission proposal of April 2009 for a Directive on Alternative Investment Fund Managers (AIFMD).[18]

The AIFMD, adopted by the co-legislators in July 2011, covers all types of alternative investment funds, a notion which also covers venture capital funds. However the AIFMD distinguishes between managers with assets below and above a €500 million threshold. Managers whose aggregate assets under management are above €500 million are subject to the stringent reporting and operational requirements set out in the AIFMD. In exchange for compliance, these managers benefit from a European passport that ensures they can market and manage funds on cross-border basis.

Managers below this threshold are subject to only a set of minimum rules but also do not benefit from the passport, unless they opt-in to the more stringent set of rules governing activities above the threshold. According to the latest estimates of the European Private Equity and Venture Capital Association (EVCA), in 2011, 98% of European venture capital fund managers manage a portfolio of funds that would be beneath the € 500 million threshold set out in the AIFMD[19].

### 2.1 **Related initiatives**[20]

The European Union supports risk financing (including via venture capital) of SME. This includes commitments to financing through public venture capital facilities (under the Competitiveness and Innovation Framework Programme 2007-2013, its successor the Business Competitiveness and SME Programme 2014-2020 as well as forthcoming Horizon 2020), and the development of 'fund-of-funds' structures by the EIB. This type of public financing is meant to provide an incentive to private investors to finance projects along with public contributions in firms and in areas that have been proven to suffer from a market failure.

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[15] Summary report December 2009: Cross-border venture capital in the European Union

http://ec.europa.eu/enterprise/newsroom/cf/itemlongdetail.cfm?item_id=4053&tpa_id=127&lang=en

[16] Annex IV: Summary of the impact assessment on Private Placement

[17] Prior to 2009, non-uniform funds was a group of investment funds like hedge funds, private equity, real estate funds etc. that were not subjected to any European investment fund regulatory framework, unlike the so called UCITS funds that are covered by the European regulatory framework since 1985.

[18] The AIFMD was formally adopted in June 2011 (2011/61/EU).

[19] Source: European Private Equity and Venture Capital Association (EVCA) estimates 2011

[20] See Annex V: Related initiatives: (i) Risk Capital Guidelines, (ii) Financial instruments and (iii) Action plan for SMEs access to finance

These financing structures, be they established at EU or national level need to comply with rules on State Aid. To guide Member States in the best way on how to make use of such financing structures and how to grant support to innovative SMEs in the early stages of development, the Commission, in 2006[21], adopted State Aid Guidelines on Risk Capital. These Guidelines were amended in 2010[22].

A further commitment to establish an deeper EU market for venture capital came with the Commission adoption of the Europe 2020 Strategy. This strategy restated the need to engage in targeted regulatory action to improve SMEs' access to financing, in particular by addressing barriers that hinder the flow of venture capital financing by means of dedicated investment funds. The February 2011 European Council endorsed this approach calling for the removal of remaining regulatory obstacles to cross border flows of venture capital. As a result, the Commission's Single Market Act (SMA) announced an initiative to ensure that venture capital funds established in any Member State can raise capital throughout the European Union.

The development of an EU venture capital fund framework is therefore an essential element for the success of any public financing. Its existence would directly be able to leverage the public financing structures - gearing up the impact of public money. Recent study findings suggest that: "*the impact of governmental VC appeared to be positive for the early stage firms. This finding is in line with the pattern of specialization of public sector VCs and suggests that, if public-sector VCs are to make direct investments in investee firms, these investments are more effective if they focus on very young entrepreneurial firms. It is in this stage that the firms have difficulties in finding alternative sources of financing for their (innovative) projects, and public sector VC seems to be alleviating their financing constraints".*[23]

Moreover, Commission is at the same time putting forward SME Financing Action Plan to address SMEs' problems in access to finance. This action plan will be adopted by the Commission on 7 December 2011 and its aim is to address a variety of problems that SMEs face when accessing finance. In particular it identifies opportunities to continue work to build on the venture capital fund framework and explore further with Member States solutions to the tax problems which may hinder the cross-border investments of such funds.

Other regulatory steps are envisaged to ease burdens on SMEs and to facilitate their access to investment markets: ensuring proportionality in transparency, reporting and listing requirements, and raising the visibility of SMEs on exchanges. Other steps being examined include facilitating access to loans. All these steps can be expected to complement the proposals for a new VC fund framework, by ensuring a rich balance of financing sources and easier transitions for SMEs between financing sources as they grow.

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[21] http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:52006XC0818(01):EN:NOT

[22] http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:52010XC1207(02):EN:NOT

[23] Venture capital: policy lessons from the VICO project, September 30, 2011, www.vicoproject.org

## 2.2 Wider context

This initiative aims to form an integral part of "Europe 2020 Strategy" (including its more focused Flagship Initiative on the Innovation Union, see box below). With this Strategy the Commission committed itself to: "*Making an efficient European venture capital market a reality, thereby greatly facilitating direct business access to capital markets and exploring incentives for private sector funds that make financing available for start-up companies, and for innovative SMEs"* in order to focus on delivering Europe 2020's objectives[24].

Box 1: Related initiatives in the Europe 2020 Strategy

Flagship Initiative: "Innovation Union" : To improve framework conditions for business to innovate (i.e. create the single EU Patent and a specialised Patent Court, modernise the framework of copyright and trademarks, improve access of SMEs to Intellectual Property Protection, speed up setting of interoperable standards; improve access to capital and make full use of demand side policies, e.g. through public procurement and smart regulation);

Flagship Initiative: "An industrial policy for the globalisation era": To improve the business environment, especially for SMEs, including through reducing the transaction costs of doing business in Europe, the promotion of clusters and improving affordable access to finance;

## 2.3 Consultation of interested parties

On 15 June 2011, the Commission services launched a public consultation[25] on the core elements of a possible European framework for venture capital funds. The consultation closed on 10 August 2011. Forty eight answers have been received: 38 from organisations, including representative bodies from across the banking and securities sectors, asset managers and investors' representatives, two from citizens and eight from public authorities. All contributions can be consulted on the following website: http://ec.europa.eu/internal_market/consultations/2011/venture_capital_en.htm. The replies received in this consultation are reflected in the content of this report.[26]

Box 2: Brief summary of replies to the public consultation on European venture capital framework

The large majority of respondents believe that European rules governing the fundraising of venture capital funds would facilitate the cross border activities of these funds. Respondents favour rules on fundraising across national borders that are flexible and avoid, to the extent possible, any additional burden to the managers of venture capital funds, potential investors or target companies of venture capital investment.

Respondents believe that the new rules should be voluntary and open to all fund operators that want to raise capital in their country of establishment and in other Member States. A preference was expressed for a simple system based on prior registration in the Member State where the fund is established. Venture capital fund managers shall be free to decide, depending on their fundraising strategy, whether to use the EU rules on cross-border fundraising or whether they wanted to raise funds domestically in compliance

[24] Europe 2020 strategy objectives: (i) Smart growth – developing an economy based on knowledge and innovation (ii) Sustainable growth – promoting a more resource efficient, greener and more competitive economy and (iii) Inclusive growth – fostering a high-employment economy delivering economic, social and territorial cohesion.

[25] http://ec.europa.eu/internal_market/investment/venture_capital_en.htm

[26] See Annex VI: Feedback statement: Summary of responses to the European Commission public consultation on the European venture capital framework

with their national private placement rules. Respondents pleaded in favour of a registration process and reporting requirements would be simple, relevant and not create any substantial administrative cost.

As regards their form of incorporation, venture capital funds should be allowed to adopt any of the legal forms traditionally used in the Member States.

The new EU rules should specify minimum requirements on operating conditions (organisational requirements / rules of conducts) for venture capital managers. However, most respondents highlight that these requirements should be principle-based and proportionate to the venture capital fund size and human and infrastructure resources.

Many categories of venture capital fund investors (business angels, family offices and wealthy individuals) fall outside of the MIFID definition of professional investor. Most respondents favour that the new EU rules would include these investors into the scope of eligible investors.

Venture capital funds need flexibility regarding the forms of financing that venture capital managers may use. However, in order to fully meet the intended policy goals, venture capital fund managers should be obliged to invest a significant proportion of the capital received from investors into SMEs. Respondents therefore favour a compulsory minimum investment percentage threshold (more than 50%) that should be invested in SMEs.

The majority of respondents believe that new European rules for venture capital should be introduced in the form of a stand-alone legislative initiative. Most respondents disagree with creation a 'lighter' EU marketing passport for venture capital fund managers within the AIFM Directive itself.

### 2.4 Impact Assessment Steering Group and IAB

An Impact Assessment Steering Group was established in May 2011. Colleagues from Directorates General Competition, Economic and Financial Affairs, Enterprise and Industry, Health and Consumer Protection, Internal Market and Services, Research and Development, Taxation and Customs Union, the Secretariat General and the Legal Service participated in the discussions. The Group met three times ahead of the finalisation of this report. The group met on 11 May 2011, 18 July 2011, and 16 September 2011. Minutes of the last meeting of the IASG that took place on 16 September 2011 are attached.

### 2.5 The IAB meeting and follow-up measures

The IAB meeting took place on 19 October 2011 and the IAB issued its opinion on 21 October 2011. Significant changes were made subsequent to this opinion and the report was resubmitted to the IAB on 31 October 2011. To take account of the IAB's opinion, the new version of this impact assessment introduces:

– more evidence on regulatory fragmentation as a driver for the comparatively small size of the average European venture capital fund;

– an overview of various regulatory and compliance costs associated with this fragmentation;

– an overview of how new EU rules would impact the eight Member States that have introduced rules on venture capital, as compared to the 21 Member States that have no such rules;

– more information on the wider ecosystem in which venture capital funds operate, as well as risks and synergies that result from related regulatory initiatives;

- an in-depth analysis of two sets of three substantive options (on venture capital investment portfolios and on eligible investors);
- a separate analysis of three procedural options on how to implement the chosen approach;
- a separate analysis of two other procedural options which do not necessarily base themselves on the chosen approach (e.g., lowering of AIFMD thresholds or an approach based solely on mutual recognition can be achieved without a common regulatory approach to venture capital funds);
- an overall view of how substantive and procedural options are combined to justify the chosen approach, and
- more detailed analysis of the risks for the chosen approach that result from the parallel evolution of the regulatory framework in other fields (prudential supervision);
- More details on the methodology on how the success of the chosen approach will be monitored and evaluated.

The IAB issued its final opinion on 11 November 2011 which contained additional suggestions to improve the impact assessment report. Changes following these suggestions were introduced in the final impact assessment report and include:

**Analysis and problems:** (i) Box 3, section 5.1.1 contains a brief description of process involved when a venture capital fund wants to raise capital in several Member States (ii) Section 5.1.6 contains further explanations on why regulatory fragmentation causes low levels of funds raised by venture capital funds in the EU.

**Intervention logic and stakeholders' views:** (i) Sections 7.4, 7.8, 7.12 and 8.3 links the discussion of options back to specific problems, (ii) Box 4, Section 8.5 introduces a clear description of the features of preferred option followed, in Section 8.5.& by an outline of the enforcement approach , (iii) stakeholders' views have been integrated, especially those of Member States' authorities, in sections 7.4.1, 7.8.3, 7.12.2 and 8.7.

**Assessment of impacts**: (i) Box 4 in Section 8.6 contains explanations as to the coherence of the proposed measures with other measures to promote SMEs and, in Section 5.1.6 addresses linkages to issues of taxation, (ii) Section 8.4 contains a summary table specifying costs and benefits associated with the short-listed options and (iii) Sections 8.7 and 8.8 provide more information on compliance costs and administrative burdens associated with the preferred option. .

**Monitoring and compliance:** (i) More info on how cross-border cooperation will be implemented and how the regulation will be enforced, (ii) clarification as to whether indicators could be the sources of administrative burden and (iii) clarification of arrangements for evaluation and its timing in accordance with future decision making process have all been incorporated in section 9.

## 3 KEY CHARACTERISTICS OF THE EUROPEAN SME SECTOR

Today, there are 23 million SMEs in the European Union. SMEs are seen as the key drivers for economic growth and the creation of jobs in the European Union. SMEs

account for nearly 99% of all European businesses. SMEs provide around 90 million jobs (2/3 of all private sector jobs) and contribute to entrepreneurship and innovation. SMEs are critical to the development of the European economy. However, as the Innovation Union Flagship Initiative [citation] stresses, one of the most serious impediments preventing SMEs from deploying their full innovation and growth potential is the absence of appropriate forms of long-term (equity) finance.

### 3.1 Structural issues behind the lack of equity financing

The primary reason for SMEs lack of access to finance, and in particular its lack of equity capital, is the lack of information pertaining to innovative start-up SMEs as an asset class. As knowledge about these companies, their strategies and their prospects is more difficult to research, potential investors face higher transaction costs when investing in SMEs as compared to more mature assets. Transaction costs are indeed mostly due to difficulties in gathering reliable information on the business prospects of a particular SME and the absence of financial intermeidaires that can perform a valuable screening function. This leads to a wide spread risk aversion among potential venture capital investors.

The existence of a general financing gap creates an environment in which innovative undertakings are also prone to having a less than optimal financing structure. This, in turn, will make it difficult for undertakings to create and capture the value of their new and/or innovative idea. A theory put forward in late 1980s'[27] predicted that firms with highly specific assets and low amounts of equity relative to debt will suffer from poor performance. A more recent study builds on this concept[28] and empirically confirms its thesis. The study provides evidence which shows a correlation between firms' lack of equity capital and its poor, sub-optimal performance or even failure. Concretely, it finds that as the misalignment between a start-up firm's capital structure and its asset specificity increases, the firm is more likely to exit/fail to capture its idea or to experience lower profitability.

To remedy this information and equity gap, venture capital operators can act as intermediaries between the supply and demand of capital resources and, through specialisation, facilitate the flow of appropriate capital to SMEs.[29]Indeed, the classical 'venture capitalist' business model aims to decrease the information gap between investors and enterpreneures and/or SMEs and can play a crucial role in reducing the

[27] Williamson, Oliver E. 1988. "Corporate Finance and Corporate Governance," Journal of Finance 43(3): 567-591 - Williamson argues that firms engaged in projects requiring highly specific assets are more likely to be financed with equity. He suggests that a firm's financial structure is akin to a governance structure and predicts that a firm's equity ratio will be positively correlated with asset specificity.

[28] A. Robb and R. Seamans, 2011. Entrepreneurial Finance and Performance: A Transaction Cost Economics Approach

[29] See also EVCA Survey (2002) on the function and value of VC investments in early stage and expansion stage companies, where some 95% of the companies replying to the survey stated that, without venture capital investment, they could not have existed or would have developed more slowly and where almost 60% of respondents said that the company would not exist today without the contribution of venture capital.
http://www.evca.eu/uploadedFiles/Home/Knowledge_Center/EVCA_Research/Economical_Impact/EconomicImpactofVentureCapital.pdf

equity financing gap that currently plagues young, innovative and high-growth start-up firms.[30]

### 3.2 Venture capital funds are more SME-centred than other alternative investment funds

Although the overall financing role of venture capital for SME is still very small (in Europe, venture capital accounts for 2% of SME financing, see Section 3.1. below), venture capital funds are significantly more SME-centric than the wider population of alternative investment funds. As table 9 (Annex X) shows, the target companies of venture capital funds are almost exclusively SMEs. Since 2009 the SME percentage in a venture capital fund's portfolio has been stable at 98%.

## 4 KEY CHARACTERISTICS OF THE EUROPEAN VENTURE CAPITAL INDUSTRY[31]

### 4.1 Venture capital funds remain a niche sector

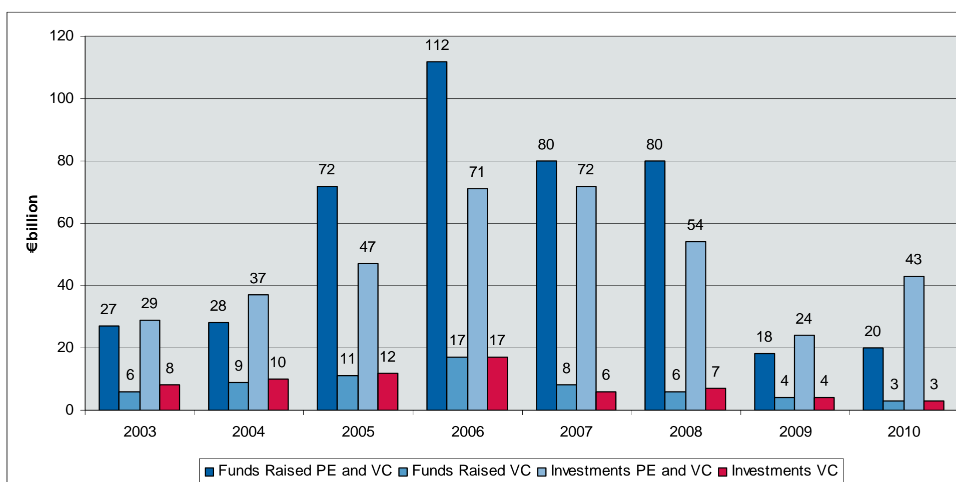
Despite years of policy initiatives that promote venture capital (see above), compared to other sectors of the European investment funds industry, venture capital remains a niche sector. As chart 1 demonstrates, the venture capital sector in Europe is small compared to the broader sector of 'private equity'. Within the broad range of private equity investors, venture capitalists account for between 10 and 15%, depending on the chosen year of reference. As at the end of 2010 there were about 1,500 private equity managers headquartered in the European Union. In aggregate, these managers accounted for €500 billion of assets under management.[32] Exactly 10% of this amount, approximately €50 billion, can be attributed to the venture capital funds.

**Chart 1: Private equity and venture capital fundraising and investments (2003-2010)**

[30] Chan, Y.S., 1983., On the Positive Role of Financial Intermediation in Allocation of Venture Capital in a Market with Imperfect Information. Journal of Finance 38, 5, 1543-1568

[31] See Annex VIII, IX and X on VC business model, on forms of SME financing and on Venture capital key facts and figures (fundraising, investments, performance)

[32] European VC industry is relatively small with its €50 billion of capital under management compared to European UCITS and non-UCITS assets under management that at the end of 2010 reached €8 trillion (€6 tr UCITS and €2 tr non-UCITS). Global hedge funds assets under management are about €2.5 trillion, with aobut €400 billion in Europe.




Source: EVCA, own calculations

Venture capital funds remain a niche player in the fund industry largely on account of their focus on SMEs at the very riskiest stage of their development. Due to their focus on small and innovative SMEs, it is often challenging for venture capital funds to create returns that would mobilise average investors' interest. Venture capital funds invest in order to provide equity start-up capital for a new but uncertain technology or business idea. A typical private equity fund, on the other hand, is much more diversified and consists in investments in more established and commercially successful companies. Private equity focuses on companies in a later stage of their development, in restructuring and in buyouts of established suppliers. A private equity investment thus entails a higher return and a lower risk than an investment in venture capital.

The steep rise and success of certain private equity fund strategies, such as leveraged buy-outs, during last decade did not help to boost the attractiveness of venture capital funds' attractiveness (see chart 1). In addition, European venture capital funds consistently generate lower returns than European or US buy-out funds (chart 2).

**Chart 2: Performance of venture capital vs. private equity**

| INVESTMENT HORIZON RETURNS FOR PERIOD ENDING 31ST DECEMBER 2010 | | | | | | |
|---|---|---|---|---|---|---|
| | | 1 YR | 3 YR | 5 YR | 10 YR | 20 YR |
| ALL VENTURE | EUROPE | 17.36 | -4.26 | -1.57 | -3.78 | 0.29 |
| | USA* | 17.94 | 0.62 | 1.16 | -6.59 | 21.08 |
| | | | | | | |
| ALL BUYOUTS | EUROPE | 20.87 | -4.48 | 6.02 | 8.39 | 11.91 |
| | USA* | 26.26 | 1.16 | 2.35 | -0.25 | 7.49 |
| | | | | | | |
| ALL PE | EUROPE | 20.66 | -4.34 | 4.33 | 4.59 | 9.32 |
| | USA* | 23.83 | 1.82 | 2.67 | -1.68 | 10.63 |

* Data for US is up to 30th Sept 2010

*Source: Thomson Reuters*

As a result, the past decade has seen less investment flow towards European venture capital funds. In consequence, venture capital fund managers are experiencing difficulties in attracting investors' interest in new venture capital funds. While this trend will have certainly produced negative effects on already underperforming venture capital

funds, it also represents a serious challenge to the prospects of newly launched venture capital funds. Furthermore, existing venture capital funds, on account of the lower returns associated with venture capital, may be tempted to shift their investment focus toward investments in more developed undertakings at a much later stage in their business cycles.

## 4.2 Venture capital activities are concentrated in eight EU Member States

Venture capital activities are not homogenously spread across the European Union. Around 90% of all venture capital fund managers are concentrated in eight Member States (UK, Germany Sweden, Denmark, Finland Netherlands, France and Spain all have venture capital assets under managemnt in excess of €1.5 billion). As table 1 (Annex X) demonstrates, funds managed and managers domiciled in these jurisdictions account for roughly 90% of all venture capital assets managed by funds.

## 4.3 A significant venture capital industry correlates with competitiveness

As chart 3 shows, there is a correlation between venture capital investments and the competitive ranking of countries. Six out of the eight countries for which chart 4 indicates significant venture capital activity (in terms of capital committed and capital under management) also score among the top 10 in the WEF Global Competitiveness Index (Finland, Denmark, Germany, the Netherlands, Sweden, and UK). Innovation and the provision of venture capital are, to a not insignificant extent, correlated.

**Chart 3: World Economic Forum (WEF) Global Competitiveness Index 2011**

| GCI Rank | GCI sub-index innovation | Country | Related top 10 country assessment on GCI sub-index – innovation |
|---|---|---|---|
| **3** | **2** | | Sweden has been placing significant emphasis on creating the conditions for innovation-led growth. Sweden has developed a very sophisticated business culture and is one of the world's leading innovators. |
| **4** | **4** | **Finland** | Finland is one of the innovation powerhouses in Europe. |
| **6** | **5** | **Germany** | Germany's business sector is highly sophisticated, especially when it comes to production processes and distribution channels, and German companies are among the most innovative in the world, spending heavily on R&D and displaying a strong capacity for innovation—traits that are complemented by the country's well-developed ability to absorb the latest technologies at the firm level. These attributes allow Germany to benefit greatly from its significant market size, which is based on both its large domestic market and its strong exports. |
| **7** | **9** | **Netherlands** | Dutch businesses are highly sophisticated and innovative, and the country is rapidly and aggressively harnessing new technologies for productivity improvements. |
| **8** | **8** | **Denmark** | Danish workforce has the skills needed to reach high levels of technological adoption and innovation. |
| **10** | **12** | **UK** | The United Kingdom continues to have sophisticated and innovative businesses that are highly adept at harnessing the latest technologies for productivity improvements and operating in a very large market (it is ranked 6th for market size). |

## 4.4 There is little cross-border fund-raising in the venture capital sector

As indicated in table 12 (Annex X), the rate of cross-border fundraising, in the field of venture capital, is low. In the period 2007-2010, funds raised outside a venture capital fund's home jurisdiction only accounted for 12% of funds raised in the venture capital sector (€2.5 billion). This contrasts with the situation in private equity, where around 20% of capital raised originates with investors in other jurisdicitons than the country where the funds are domiciled. For further details of fundraising geography for venture capital and private equity, reference is made to table 12, Annex X.

### 4.5 Traditional venture capital investors

Traditional investors in venture capital comprise entrepreneurs, family offices, angel investors, member of the management teams, industry sector experts, venture capital experts, finance sector experts and wealthy individuals (for the relative contributions of these investor groups, reference is made to table 3, Annex X).

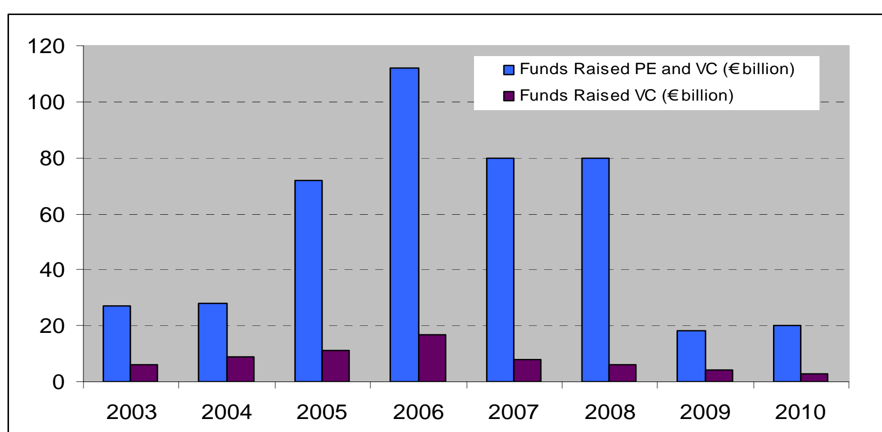
Traditional venture capital investors play an important part in fundraising especially for early stage venture capital funds. Their role and importance is expected to even increase in response to the newly introduced prudential rules for banks and insurance companies. These new provisions require banks and insurance companies to set aside additional regulatory capital once they invest in venture capital funds (see also section on risk). For example, under the Basel II rules, national supervisors may decide to apply a 150% or higher risk weight reflecting the higher risks associated with some other assets, such as venture capital investments.

### 4.6 The impact of the financial crisis on venture capital funds

Compared to the peak time for venture capital activity, when €17 billion were invested in 7.500 SMEs (2006), the investment rate has declined to €3 billion in 2010, a year in which only 2.800 SMEs benefited from venture capital funding (see table 9b, Annex X).

However, chart 4 illustrates that the venture capital sector has consistently suffered from a fund-raising deficit, especially when compared to private equity. This was true before the financial crisis of 2007/2008, during the crisis and thereafter. The crisis revealed the vulnerability of the venture capital funds sector, which seems to recover much more slowly than their private equity peers.

**Chart 4: Fund-raising by European private equity and venture capital in 2003-2010**




## 5 PROBLEM DEFINITION

### 5.1 Problem drivers

#### *5.1.1 Driver 1: Regulatory fragmentation*

Compared with competing global centres of high-tech and innovation, most notably the United States, the European venture capital industry is fragmented and dispersed. This fragmentation and dispersion leads to a perceptible investor's reluctance against investing

in venture capital funds. This, in turn, prevents venture capital funds from reaching or approximating more optimal fund sizes. Chart 5 summarises the main features of national laws and regulations that apply to the private placement of investments in 'venture capital' funds.

**Chart 5: Regulatory systems governing the activity of venture capital in Europe**

| Member State | Law | Qualifying fund portfolio | Qualifying investment instruments | Qualifying investment targets | Geographic location of targets | Eligible investors | Tax treatment |
|---|---|---|---|---|---|---|---|
| 1. Austria | MiFiG | No rules | Equity (not exceeding 49% of shares in target and €1.5 million/year) | No investments in energy and financial service companies | 2/3 of portfolio must be invested in Austrian development areas | No rules | Capital gains tax exemption |
| 2. Germany | WKBG | 70% of fund's total assets invested in equity issued by unlisted target | Equity | Unlisted company with less than €20 Mio equity and less than 10 years of existence | Only targets with registered office in Germany | No rules | Exemption from trade tax – deemed incompatible with EU state aid rules |
| 3. Estonia | | 60% of fund's total assets invested in equity issued by unlisted target | Equity | Unlisted company | No limitations | No rules | No rules |
| 4. France | FCPR à procédure allege | 50% of fund's total asset invested in equity issued by unlisted companies shares /units of investment funds invested in unlisted companies (FoF), 15% in shareholder accounts ("avances en compte courant d'associé") | Equity Quasi equity Convertible bonds Shares or units | Unlisted companies | No limitation | Institutional | Tax incentives for eligible investors |
| | FCPR contractuels | Equity and convertible bonds convertibles issued by unlisted entities, shares /units of investment funds invested in unlisted companies | Equity Quasi-equity Convertible bonds Shares or units Derivatives financial instruments | Unlisted companies | No limitation | Institutional | No rules |
| | FCPR | 50% of fund's total asset invested in equity and convertible bonds issued by unlisted or listed companies or shares /units of investment funds invested in unlisted companies 15% in Shareholder accounts ("avances en compte courant d'associé") | Equity Quasi equity Convertible bonds Shares or units | Unlisted company for 50% at least of the assets under management included unlisted companies and for 20 % max. of the assets under management (only small capitalization less than 150 millions euros) | Companies established in EU | Retail | Tax incentives for eligible investors |
| | FCPI | 60% invested in financial instruments issued by | Equity Quasi equity | Unlisted company for | Companies established in | Retail | Tax incentives |

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| | | unlisted or listed, innovative companies<br>15% in Shareholder accounts (“avances en compte courant d’associé”) | Bonds (i.e. convertible bonds) | 40% at least of the assets under management<br>Listed companies for 20% max of the assets under management (only small capitalization of less than €150 million) | EU | | for eligible investors |
| | FIP | 60% invested in financial instruments issued by unlisted companies, 20% of which in companies less than 8 years old<br>15% in Shareholder accounts (“avances en compte courant d’associé”) | Equity<br>Quasi-equity<br>Bonds (i.e. convertible bonds) | Unlisted company for 40% at least of the assets under management<br>Listed companies for 20% max of the assets under management (only small capitalization less than 150 millions euros) | Only SMEs that have activities in at least one French region | Retail | Tax incentives for eligible investors |
| 5.<br>Italy | Financial Act | 75% of fund's total assets in seed, start-up, early stage or expansion phase of unlisted companies | Equity | Unlisted companies established for less than 36 months with turnover less than €50 million/year | Companies established in the EU | No rules | Tax incentives for qualifying funds |
| 6.<br>Portugal | | 50% of fund's total assets in unlisted companies | Equity, credit, guarantees | Listed and unlisted companies with high appreciation potential | No limitations | No rules | |
| 7.<br>Slovenia | Venture capital companies Act (2007) | At least 50% of fund portfolio invested in SMEs and further 30% in private equity or mezzanine capital | Equity, quasi-equity; convertible loans, guarantees and mezzanine capital | Unlisted SMEs | No limitations | Minimum investment by investor is € 50.000 | SL based VC firms have 0% corporate income tax |
| 8.<br>Spain | | 30% of fund's total assets in equity, 30% in participating loans, no more than ¼ in one entity | Equity, quasi-equity | Some exceptions allowing investments also in listed companies | No limitations | Simplified system for private placements for investments exceeding € 500.000 | |
| 9.<br>UK | | Target must be listed on LSE or other EU stock exchange | Equity and loans in 70/30 ratio, investment | Listed companies only with less than £ 15 Mio in assets | 50% of target's activities in UK (as of | | Iincome and capital gains tax advantages |

|  |  |  | limit of £ 10 Mio/company | and not more than 250 employees | 2010 also activities outside UK |  | on a UK natural person tax payer |
|---|---|---|---|---|---|---|---|

**Source: Replies to the Commission public consultation on the new European regime for venture capital funds, Commission desk research**
**MifiG** - Mittelstandsfinanzierungsgesetz
**WKBG** - German Venture Capital Act - Wagniskapitalbeteiligungsgesetz
**FCPR** - Fonds Communs de Placement à Risques
**FCPI** - Fonds Communs de Placement dans l'innovation
**FIP** - Fonds Communs de Placement de Proximité (special form of FCPR that invest in regional SMEs)

All 18 Member States not listed in this table do not even have a dedicated legal framework on venture capital and therefore apply general rules on company law and prospectus obligations to funds that wish to execute 'private placements'[33] of venture capital. This causes additional cost and complications (see below).

### Box 3: Description of venture capital funds' cross-border fundraising process

Venture capital fund managers undertaking cross-border placement of venture capital funds have three broad areas of processes to go through.

*(i) Pre-marketing/pre-placement phase*
At the very beginning of any cross-border fundraising activity, the manager must decide on the number and identity of the other countries in which investors are to be sought. Due to the fact that there are different private placement regimes in different Member States and the absence of effective private placement regimes in certain Member States it is not a straight-forward decision. Managers usually need to obtain legal advice and undertake due diligence about each target country's applicable rules. The cost of this advice is described in Section 5.1.2. As a result of these preliminary investigations, managers typically will refrain from offering their funds in some Member States.

*(ii) Compliance with other Member States' marketing/placement rules*
Compliance with the relevant marketing or placement rules in several Member States' can entail a wide range of actions. The main areas of regulatory compliance are various national requirements on prior authorisation, registration of managers and/or funds, the licensing of managers and the separate registration of fund vehicles (this usually requires a setting up of parallel fund structures in those Member States), provision of disclosure documents and reporting requirements, and other rules applying to distributors or intermediaries, e.g. on ensuring marketing only to relevant qualified investors within the jurisdiction in question. Compliance will in some cases entail some restructuring of the overall offer and its documents (the cost for offering prospectuses are specified in Section 5.1.4); especially in relation to those Member States with more prescriptive and restrictive rules vis-à-vis foreign fund marketing/placement. Cost associated with marketing and placement are specified in Section 5.1.5.

*(ii) On-going management of compliance with Member States' placement rules and evaluation of potential new placement countries/opportunities*
On a daily basis, fund managers need to manage all their parallel vehicles set up for purposes of cross-border placement to investors in other Member States. The due diligence of host Member States' rules and regulations does not end with successful placement of funds in these countries, but has to continue on an ongoing basis to ensure smooth operation of the parallel structures in several jurisdictions.

[33] Private placement is widely understood as marketing/sale of (in this case) units or shares in investment funds to a small or limited number of usually professional investors. Private placement is the opposite to raising capital from public/issuing shares on public markets.

### *5.1.2 Driver 2: Raising venture capital funds abroad involves several procedural steps that are not necessary when raising capital domestically*

As a consequence of regulatory fragmentation and the need to comply with several sets of rules governing both venture capital and private placements, the procedural steps necessary to raise venture capital are more complex as the number of targeted jurisdictions increases. Raising funds from potential investors across several jurisdictions involves the following steps:

First the fund sponsor identifies the countries in which it wishes to approach investors. According to the experienced legal advisors to the industry, marketing would usually comprise around 5 to 7 countries in the EU, sometimes more.

Second, the fund sponsor would engage legal counsel for each target country in order to address questions on national 'private placement' systems, license and authorisation requirements that may be in place. The cost of such a survey of different national private placement regimes is difficult to estimate[34]. Generally, the costs of a major law firm experienced in advising on fundraising in relation to small venture capital funds charges around €1000 per jurisdiction for a mere update of their pre-existing advice on national 'private placement' systems, license and authorization requirements . As soon as more in-depth advice is required legal advice costs may rise considerably.

Generally, the costs of a major law firm experienced in raising funds for small funds charges around € 1000 per jurisdiction for a mere update of their pre-existing documentation. As soon as more in-depth advice is required legal advice costs may rise considerably.

Third, the sponsor will then decide whether the outcome of legal advice justifies further pursuit of fundraising in the chosen jurisdictions. According to the outcome of the survey, the sponsor may:

- Refrain from approaching investors in certain countries, or
- Comply with private placement rules or – where the private placement rules are not available or cannot be met in practice - meet prospectus registration requirements and
- If additional licensing requirements apply to local fundraising (distribution) activity: engage a licensed 'placement agent' or apply for authorization to engage in distribution activities in every host country.

In the latter case, typical licensing cost per jurisdiction can vary from €20.000 up to € 40.000[35]. The fund sponsor will only incur these additional licensing costs, once he has ascertained that there is sufficient investor interest in that country.

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[34] EVCA, Position Statement of 9 August 2011, p. 6.

[35] EVCA Legal Advisor's response of 25 October to Commission's questions.

#### *5.1.3 Driver 3: Raising venture capital funds abroad involves costs that are not incurred when raising capital domestically*

Respondents to the public consultation noted that the costs related to adapt legal documentation (i.e. 'securities legends') to the requirements of different national private placement rules may amount to € 500 to € 1,000 for each jurisdiction targeted by a venture capital sponsor. If the venture capital fund sponsor wanted to raise capital across the EU, these costs would rise from €13,500 to €27,000 for the entire European Union. Furthermore, these examples only relate to the cost inherent in updating pre-existing legal documentation; costs multiply exponentially as soon as more in-depth legal advice becomes necessary.

Costs arise even before a venture capital manager commences the actual marketing of its venture capital fund in other Member States. In order to ensure compliance with the various legal requirement that apply either to managing and marketing of venture capital funds or, in the absence of specific legislation, to the 'private placement' of investment opportunities, the fund manager needs to undertake 'due diligence' ensuring proper identification of all applicable rules and requirements. This is often a cumbersome process, as rules on private placement are not harmonized in the EU (cf. chart 7, above).

In the absence of harmonization, Member States and their regulatory authorities take different views on whether interests in limited partnerships (which is the typical structure use for venture capital funds) qualify as securities or not and hence are covered by the Prospectus Directive. This also means that exemptions from prospectus requirements, i.e. the private placement exceptions in the Prospectus Directive, are not applied in many Member States.

The costs of legal surveys naturally multiply in line with the number of Member States to be covered by the intended cross-border marketing. In addition, market participants reported that, due to national laws being unclear and leaving space for various interpretations in a significant number of cases, the legal advice obtained was not conclusive. According to respondents to the public consultation, even experienced legal advisors often came to opposite conclusions in assessing particular private placement rules in a specific Member State. In other cases the legal advice was to obtain a definite opinion or 'ruling' from the national regulatory authorities, a process which may again take several months. In such cases, potential offers are usually not marketed in the jurisdiction for which conclusive advice could not be obtained.

It is therefore difficult to make general statements on the costs that will accrue in case: (i) extensive legal advice is sought from a local law when a venture capital fund first wants to start marketing in a given jurisdiction or (ii) specific advice is sought on a particular fund structure that becomes necessary to satisfy the requests of non-domestic investors or (iii) legal expertise obtained previously has to be renewed in case domestic legislation has substantially changed when compared to previous fund-raising. But it is safe to state that the cost for often complex legal research will by far exceed the cost of legal documentation specified above.

#### *5.1.4 Driver 4: Several jurisdiction apply prospectus rules to venture capital offerings*

Major costs are associated with national prospectus requirements. In evaluating whether or not to allow the marketing of a particular venture capital fund in their territories, the relevant authorities in many Member States often demand submission of a full

prospectus, especially in case no specific 'venture capital' regime is available. This full prospectus needs to be approved by the relevant financial regulator. A prospectus approved by a regulator in one Member State cannot necessarily be used for marketing of a venture capital fund in another Member State. This is because, venture capital funds are often structured as limited partnerships and interests in limited partnerships are considered as financial instruments covered by MiFid rules only in some Member States but not all (e.g. Germany does not consider interest in limited partnerships as financial instruments and hence has its own national prospectus regime for closed ended funds organized as limited partnerships). A prospectus registration in Germany, in case private placement or venture capital requirements cannot be met, would costs around EUR 40.000.

Venture capital funds not covered by the narrow venture capital exemptions from the 'private placement' rules that apply in Germany[36] (see Chart 7, above), will have to submit a securities sales prospectus either under the Securities Sales Prospectus Act ("WpPG") (in case the fund is structured as a corporation) or the Sales Prospectus Act ("VerkPG") (in case the fund is structured as a limited partnership). This documentation also needs to be approved by BaFin, the financial regulator[37]. Prospectus requirements and prior approvals have also been identified for Austria, Belgium, the Netherlands, France, Sweden and the United Kingdom[38]. Costs are especially relevant when the private placement is designed to appeal to a limited group of specialised target investors.

#### *5.1.5 Driver 5: Several jurisdictions require local registration and a local distribution presence*

Additional costs result from the procedural steps that a venture capital fund incurs when actual fundraising commences. As mentioned above, these costs are linked to the need to undergo registration and notification requirements with the competent regulators in the Host Member States or the need to adapt offer documents for relevant distributors or intermediaries in different Member States. The system of prior notifications, licenses or authorisations is particularly complex and costly in the Member States that have neither venture capital rules nor rules pertaining to private placements.

Many Member States require that a local and licensed placement agent (i.e. a financial institution) is employed when a venture capital fund is marketed in their territories. Alternatively, the venture capital manager itself has to obtain a license qualifying him as a placement agent. Obtaining this license is costly and burdensome. Often it is impossible for a fund manager to obtain such a license because he has no local establishment.

Moreover, stakeholders point to additional complexity that is associated with local licensing arrangements. In relation to closed-ended funds, the MiFiD rules on financial instruments" are often interpreted in different ways in different Member States. This causes additional obstacles for so-called closed-ended funds, which are typically

[36] The conditions attached to the German WKBG rules are so strict that no venture capital fund has yet availed itself of this scheme, see EVCA, Position Statement, 9 August 2011, p. 41.

[37] EVCA, Position Statement of 9 August 2011, p. 40.

[38] EVCA, Position Statement of 9 August 2011, pp. 24-46.

organized as limited partnerships. While some countries consider such limited partnerships as "financial instruments" according to Annex I, Section C of MiFiD, others do not share this approach. This divergence of approach leads some countries to consider the offering of investments in closed-ended funds as in investment service, subject to authorization, while others do not.

For example, when a closed-ended fund originating in a country which does not consider offering limited partnerships as an investment service (e.g., Germany) is marketed in a country that considers these offerings as an investment service (e.g., France), an additional MiFid authorization in the country of destination becomes necessary. In these circumstances, the host country would refuse to recognize the lawful marketing of the limited partnership in the home country. Quite to the contrary, the manager now has to establish a physical presence in the host country and this local office is then required to obtain a marketing authorization for the host country[39].

The costs for obtaining a license for engaging in distribution activities are in the range of €20.000 to 40.000[40]. There would, of course, be additional costs of maintaining the local office, which may vary from jurisdiction to jurisdiction.

Stakeholders consider that annual costs for maintaining a regulated “MiFID office”, for example in the United Kingdom, would be at least in the range of €25.000 per year. This figure does not including costs for personnel[41].

The 2007 *Expert group report on removing obstacles to cross-border investments* by venture capital funds estimated that the cost managing four parallel fund structures necessary to raise funds in three different jurisdictions exceeded 0.4% of the total capital committed to this fund. This level of cost has a significant impact, especially on a smaller fund's overall performance record.

#### *5.1.6 Driver 6: The wider ecosystem in which innovative companies operate is underdeveloped*

The extent to which increased availability of venture capital financing will generate gains for Europe's competitiveness and other wider benefits depends on the evolution of other factors that influence the venture (risk) capital market ecosystem.

Developing fully integrated risk capital markets was recognized already in the RCAP in 1998 as an essential precondition to ensure job creation in the EU. Venture Capital Funds are one of the three major providers of risk capital (equity financing) to high-growth potential SMEs. Other providers are business angels and stock markets specialized in SME. Since SMEs are the key drivers behind future growth and jobs, they need to have access to the appropriate long-term financing at all stages of their development. Risk capital plays a particularly important role in the early stages of a SME's lifecycle.

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[39] Example supplied by an EVCA legal advisor on 25 October 2011.

[40] Estimates provided by an EVCA legal advisor on 25 October 2011.

[41] Estimates provided by an EVCA legal advisor on 25 October 2011.

The RCAP identified number of requirements for well functioning Risk Capital Markets that need to be simultaneously met so that the provision of risk capital can develop further. The RCAP identified six categories of barriers that impede a well-functioning risk capital markets in the EU: (i) fragmentation of stock markets ; (ii) institutional and regulatory barriers, (iii) taxation, (iv) weaknesses of high-tech small businesses, (v) human resources and (vi) cultural barriers. The RCAP also showed how interlinked these barriers can be, stressing that a coordinated effort at EU as well as Member States level in tackling the barriers was the only way by which the EU can succeed in creating a fully functioning and efficient risk capital market.

Empirical evidence confirms this.[42] A significant body of research and studies has analyzed the different factors. While this work has shown strong interconnections between the different factors, it has also shown that specific issues can be addressed in isolation, although the cumulative impact of the different measures aimed at establishing a fully functioning risk capital market will be vital. Based on this research, it appears that there is no one single factor that will act as a driver for a more successful venture capital financing. Progress requires incremental steps across a range of fields.

Regulatory fragmentation with respect to the markets for fund-raising (private placements) is therefore but one element in the overall ecosystem in which venture capital funds and the companies they invest in will develop. Many of the barriers identified in the RCAP have already been addressed and corresponding measures implemented[43], though not all. This patchy approach has been necessary for practical reasons, but creates a dis-equilibrium, in which theoretically possible increases in the volume of venture (risk) capital funding are not achieved due to the incomplete nature of measures already adopted. Amongst the outstanding areas where work remains to be done, regulatory barriers preventing efficient *cross-border fundraising* stands out.[44] Other barriers or inefficiencies may emerge with time as risk capital markets integrate and adjust to the new regulatory conditions.

Further analysis and assessments will be valuable in the future. In this regard, the Single Market Act (SMA) has provided already an updated assessment of the current situation and remaining barriers and relevant factors that should improved in order to further improve the cumulative impact of measures already taken on risk capital provision to SMEs..

For example, on the supply side, measures to ensure better SME access to public capital markets are being considered. Listings of SMEs and IPOs should be made less burdensome. Better listing conditions will also make SMEs more attractive targets for

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[42] See Annex XI and XII

[43] Final report on the implementation of the RCAP, 2003, http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2003:0654:FIN:EN:PDF
By end of 2003, the RCAP reported progress on measures included in the RCAP as well as in the Financial services action plan (FSAP) including among others: (i) Directive on prospectuses to facilitate risk capital exits via IPOs, (ii) Directive on supplementary pension funds was expected to increase provision of risk capital by this industry, (iii) endorsement of International Accounting Standards to improve transparency of reporting to investors, etc.

[44]Commission Communication implementing the Community Lisbon Programme, COM (2006) 349, identified regulatory fragmentation as an area that needs to be addressed in order to create a better environment for risk capital, http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2006:0349:FIN:en:PDF

venture capital funds, as listings prepare a successful exit strategy. On the demand side, entrepreneurs' knowledge about the benefits and opportunities of venture capital backing needs to be improved. The business advice elements inherent in the venture capital fund business model deserve greater emphasis.

In addition, delicate issues of national tax laws and the issue of double taxation of *cross-border venture capital investments* would have to be addressed at the appropriate moment whilst also assessing the risk for double non-taxation of such investments. Stakeholders have pointed out that the fiscal treatment of cross-border capital investment flows would need to be addressed once venture capital funds had greater opportunities to raise capital in different jurisdictions. Especially from the investor's perspective, the issue of double taxation of investment returns, both at the level of the fund and at the level of the non-domestic investor, would need to be addressed[45]. Nevertheless, stakeholders point to the fact that a precondition for any action on double taxation is the creation of a regulatory environment where cross-border fundraising becomes a realistic and attractive option for venture capital operators[46].

The above mentioned problem drivers have led to a series of features which characterize certain shortcoming in the European market for venture capital funds.

## 5.2 Problems

### *5.2.1 Investor's preference in the EU is skewed against venture capital*

Europe dedicates insufficient funds toward the financing of innovative start-up industries. While the United States, in the period from 2003-2010, raised approximately €131 billion into venture capital funds, European venture capital funds only managed to raise €28 billion in this period[47]. On the other hand, US fund's average investment per company amounted to € 1.5 million (2002) rising to € 4 million by 2009, while the European average remained at € 1 million throughout this period. Early (seed capital) stage investments per company, in the US, were stable at €3 million per company, while they amounted to €0.5 in Europe[48].

Investor's preference for private equity – to the detriment of venture capital – can further be illustrated by comparing the overall amounts dedicated to private equity financing with the narrower sub-category of funds that are channelled toward venture capital. In the reference period 2003-2010, funds dedicated to venture capital amounted to € 64 billion out of a total of € 437 billion invested in the wider field of private equity. Venture capital thus accounted for only 14.6% of the joint pool – with private equity accounting for 85.4%. Chart 4 shows that, in every single year, funds raised by private equity far exceed those raised by venture capital.

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[45] EVCA, Position Statement, 9 August 2011, p. 31

[46] EVCA, Position Statement, 9 August 2011, p. 31

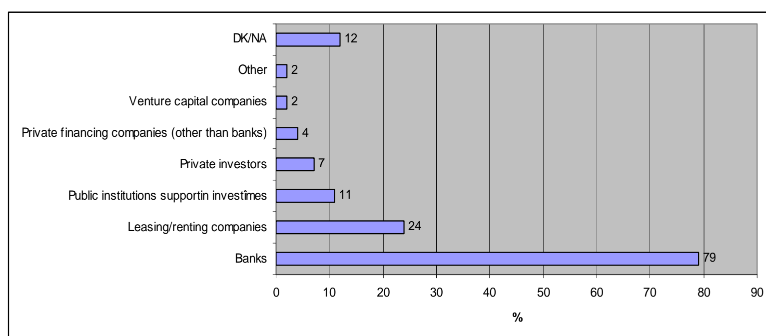
[47] The data source used for this comparison, Dow Jones VentureSource, is different than the one used when showing only European fundraising and investments (EVCA).

[48] Annex XI, box 1.

As long as this bias in favour of private equity -- a sector that invests in mature companies and organises leveraged buy-outs -- persists, available funds are not channelled to where they are most needed: to provide equity finance to seed and start-up ventures that are at the make-or-break phase in their corporate development. The lack of financial resources that are currently directed towards venture capital is responsible for the inefficient size of the average European VCF and their ensuing comparatively low capital investments per target company.

In consequence, venture capital, at this stage, plays a minor role in the financing of SMEs. As chart 5 illustrates, SMEs depend primarily on bank loans. Bank loans account for more than 80% of SME finance. Only 2% of SME finance is supplied by venture capital funds. The corresponding figure for the United States is 14%.

**Chart 6: Sources of financing for EU-based SMEs**




Source: OECD 2006

These findings are particularly striking in light of the fact that many SMEs, since the financial crisis of 2008 and 2009, had to pay much higher interest rates for bank loans.[49] Moreover, as a consequence of the financial crisis of 2008 and 2009, the provision and extension of credit lines by banks to SMEs has decreased significantly, so SMEs' search and demand for other alternative sources of finance has become pressing.[50] Still, venture capital, for want of sufficient capital resources, has not been able to step into this obvious gap.

### *5.2.2 EU venture capital funds are below the optimum size*

The average size of a European venture capital fund is significantly beneath the optimal size for this type of funding instrument. As indicated in table 2b (annex X), the average United States venture capital fund (VCF) has 280 million in assets under management, the average European VCF size is around €60 million. The Average European size is thus far below the optimum efficient size for a VCF, which a recent Ernst & Young study

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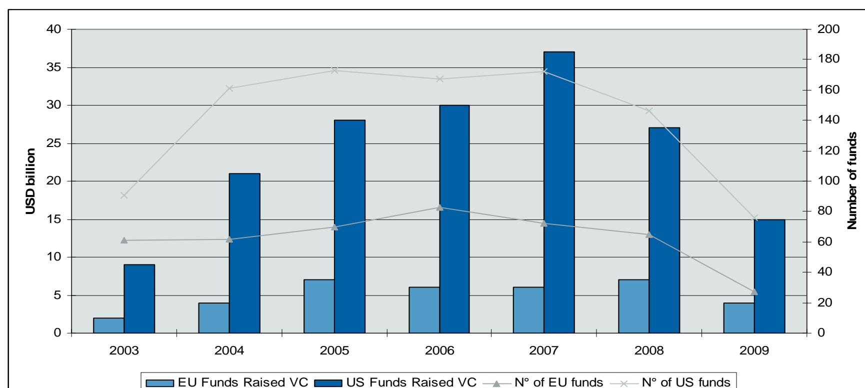
[49] According to the latest European Central Bank (ECB) survey where more than 50% of the sampled euro area SMEs reported increases in interest rates charged by banks and overall tightening of credit standards for bank loans to SMEs

[50] In the latest survey (09/2010 – 02/2011) carried out by the European Central Bank (ECB) and developed together with the European Commission on the access to finance of SMEs in the Euro area, around 15% of SMEs surveyed quoted "access to finance" as their most pressing problem and this has not changed compared to previous surveys.

http://www.ecb.europa.eu/pub/pdf/other/accesstofinancesmallmediumsizedenterprises201104en.pdf?b704f6b228e071bea9507d7569412805

puts at not less than €230 million. The study further argues that optimal specialisation can be achieved with funds in the range of €230 to 380 million.

**Chart 7: Amount of venture capital funds raised in Europe vs the US (2003-2010)**




Source: Ernst & Young, "Back to basics, Global venture capital insights and trends report 2010"

As mentioned above, this situation is also borne out when assessed from the perspective of the overall portfolio of venture capital funds managed by a particular fund manager. According to the latest figures available from the European Private Equity and Venture Capital Association (EVCA), 98% of European venture capital fund managers manage a portfolio of funds that would be beneath the € 500 million threshold set out in the Directive on Alternative Investment Fund Managers (AIFMD)[51].

*5.2.3 The inadequate SME 'financing mix'*

The key variable that determines the success of failure of a SME is not merely the overall amount of finance that is avaliable but the composition of its 'financing mix'. Typically, a European SMEs financing structure can be characterized by its equity to debt ratio. This ratio differs according to which stage of its 'lifecycle' the SME[52] finds itself. But the debt/equity ratio should, in principle, be skewed in favour of a high equity percentage as empirical studies demonstrate that a high level of equity investment, combined with a stable legal framework, provides the best financing structure for start-up SMEs[53].

Empirical studies show that start-up companies backed by venture capital financing fare better than those that rely on other, less stable, sources of financing. The superior efficiency of VC-backed firms is due, first and foremost, to the rigorous screening and monitoring that VCF apply to their investment targets. On average, VC-backed firms tend to be more profitable than those who do not receive VC-backing (VC-backing can increase relative profitability by 21 to 35%[54]). The relatively low rate of equity capital raised by VCF is therefore detrimental to the emergence of efficient market entrants.

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[51] Source: European Private Equity and Venture Capital Association (EVCA) estimates 2011

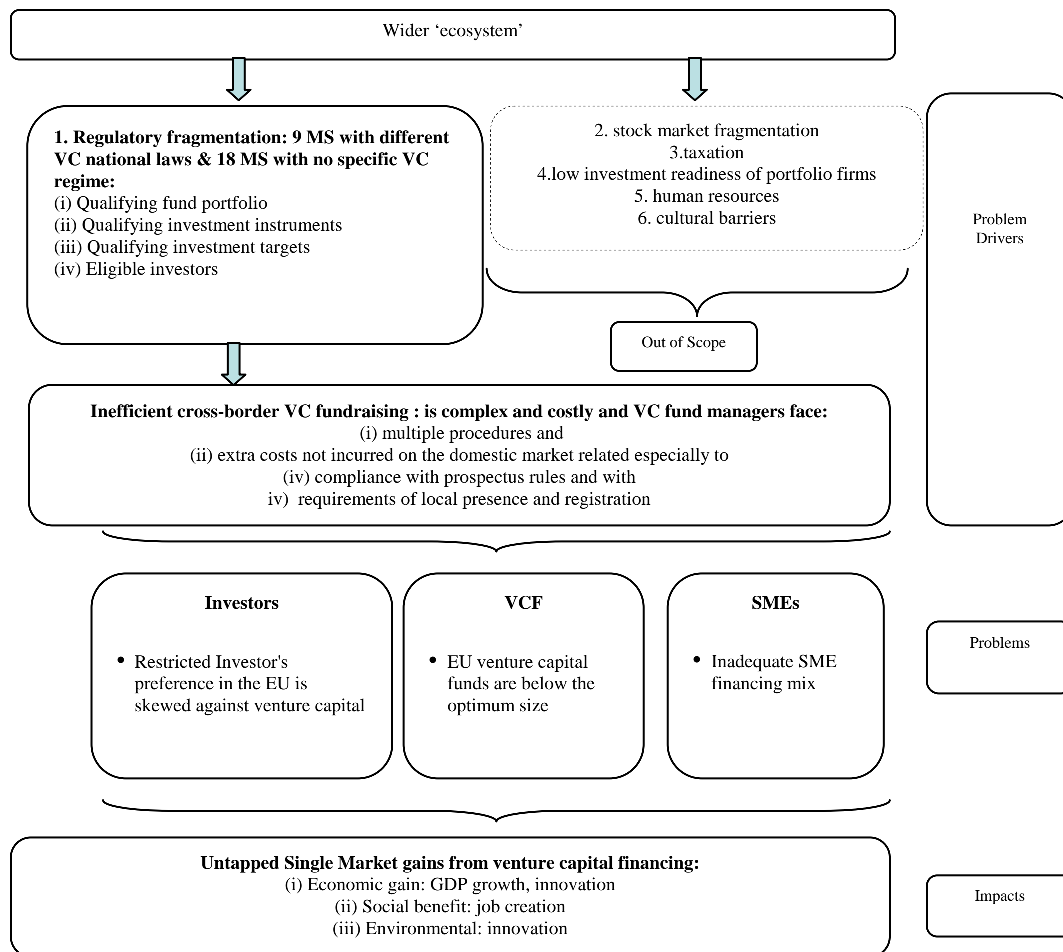
[52] Source: European Venture Capital Association (EVCA), quoted in Ruis, A., van Stel, A., Tsamis A., Verhoeven W., and Whittle M., *Cyclicality of SMEs finance*, DG Entreprise and Industry, 2009.

[53] See Studies cited in Annex XII.

[54] See Annex XII, Study by Chemmanur et. Al, CES 08- 16 June 2008.

According to a study conducted in late 1980s'[55], firms with low amount of equity investment (relative to debt financing) are prone to suffer from poor performance. A more recent study[56] confirms the superior performance of equity-backed ventures. This study finds that, on average, start-ups with higher levels of equity investors perform better than those that rely on high levels of debt. The lack of equity financing in Europe therefore constitutes a serious impediment to the faster development of innovative firms.

**Problem Tree:**




## 5.3 Baseline scenario

Should the problems described in previous chapter persist it is reasonable to assume that the following situation for the key stakeholders and the European economy would remain unchanged.

[55] Williamson, Oliver E. 1988. "Corporate Finance and Corporate Governance," Journal of Finance 43(3): 567-591 - Williamson argues that firms engaged in projects requiring highly specific assets are more likely to be financed with equity. He suggests that a firm's financial structure is akin to a governance structure and predicts that a firm's equity ratio will be positively correlated with asset specificity.

[56] A. Robb and R. Seamans, 2011. Entrepreneurial Finance and Performance: A Transaction Cost Economics Approach

Venture capital fund managers

The current system discourages smaller venture capital fund managers from raising capital on a European basis. Capital sources remain confined to national investors – for venture capital funds domiciled in smaller Member States this will lead to an often very narrow investor base. Funds that operate in such Member States do not, therefore, benefit from access to a large, liquid and integrated financial market and wil face difficulties in reaching economies of scale. In order for a venture capital fund manager to engage in cross-border marketing in the EU, it needs to go through a cumbersome and costly process including: identification of the suitable regime for potential investors, creation of complex parallel fund-raising structures, submission and approval of sales prospectuses, foreign registrations or authorisations, the establishment of a local distribution office and on-going regulatory compliance processes involving a multitude of host Member States[57].

Such formalities may effectively skew the cost benefit analysis against seeking capital beyond the venture capital fund's home jurisdiction. This makes it indeed hard for managers to achieve sufficient economies of scale, which results in too many small funds with a suboptimal size of assets under management and, in consequence, sub-optimal supply of capital that can be supplied per investment/company. The scale of the inneficiencies caused by the fragmented regulatory framework is difficult to capture and quantify, however the anectdal evidence cited in Section 5.4. indicates that the cost and complexity of fund-raising in multiple jurisdictions often outweighs what a small fund operator can afford, both in relation to financial and personnel resources.

As a consequence of fragmentation, various inefficiences can be observed in the European venture capital market: (i) Venture capital activity, both in terms of asset management, fundraising and fund domiciles remains concentrated in four big Member States plus the Netherlands and the three Nordic countries; (ii) European venture capital funds operate with half of the capital commitments of their US counterparts (Section 5.2.); (iii) as European venture capital funds aggregate annual capital commitments of only around 15% of those aggregatred by their US counterparts, the majority of them will ocntinue to operate below the optimum size for a long time in the future; (iv) European venture capital funds must satisfy the needs of more SMEs than their US counterparts with only half of the capital commitments, average size of financing provided per company/investment is therefore more thinly spread; (v) growth and innovation potential is lost as investoir's capital remains directed toward less innovative and growth-inducing fund activities (e.g., private equity and buy-outs); and (vi) the equity-base of European SMEs will remain low in relation to less stqble debt financing.

Funds' investors

The complex and costly marketing conditions for venture capital funds may lead to a decision of smaller fund managers to avoid offering their investments in more than one jurisdiction. The potentially interested investors in these markets, as a consequence, face a more restricted choice of foreign investment propositions. As with fund managers, this is especially detrimental to investors in smaller countries, not least because venture capital activity, both in terms of assets under management and domicile of managers, is

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[57] See EVCA reply to Commission consultation of 15 June 2011 and Feedback statement summary.

essentially concentrated in eight out of 27 Member States. Lower capital inflows, in turn, lead to less opportunities for specialisation and diversificaton of a venture capital fund's investment portfolio. Furthermore, the limited amount of supply side opportunities reduces competition among fund managers. Less competition impacts investors who may be faced with higher placement transaction fees.

SMEs

SMEs have fewer alternative sources of capital to draw on. Instead of being able to select from a larger pool of competing, sufficiently capitalised and highly specialized venture capital funds that operate internationally to achieve size and economies of scale, SMEs have a narrower selection of more domestically oriented, less capitalised and therefore less specialized venture capital funds. This decreases the bargaining power of SMEs, makes them more dependent on local venture capital funds, which may lack both capital and expertise to make a significant impact both on equity endowment and business expertise provided to the target company. This leads to higher cost of finance, and lower value-added support for the commercial development of the funded target company. Less funding opportunities decreases the innovation capacity that SMEs can build on.

National authorities

Prior to allowing a private placement by a venture capital fund, national supervisors have to make comprehensive assessments of the foreign venture capital fund, its managers and the regulatory requirement with which it complies. Often the detailed requirements that currently apply various jurisdictions (See Section 5.4.) cannot be met and the venture capital fund manager might be reluctant to change or adjust its business strategy to achieve compliance with the rules applicable in various host countries (i.e., create a parallel structure, or even local presence, in various jurisdictions in order to be able to market its investment strategy to local investors). All the compliance costs incurred by both the venture capital fund manager are sunk costs and documentation or structures created for one jurisdiction cannot be reused for others.

European Economy

Without any overhaul of the existing disparate regulatory frameworks governing venture capital throughout Europe, the supply of seed and start-up capital provided by venture capital funds to SMEs remains below efficient scale and the European economy is deprived of the potential benefits of an increased supply of venture capital to European start-ups. Growth, employment, efficiency of markets, innovation and competitiveness will suffer as a consequence. Improving the conditions for efficient venture capital allocation in European economy would lead to – (i) deeper capital markets enabling savings of professional and institutional investors to flow more efficiently to a more interesting variety of investments (ii) reduced transaction costs and increased market liquidity, (iii) a more diversified and innovative financial system and (iv) more opportunities to pool risk.

## 5.4 The EU's right to act and justification

According to the principle of subsidiarity laid down in Article 5(3) of the Treaty, action at EU level should be taken only when the aims envisaged cannot be achieved

sufficiently by Member States alone and can therefore, by reason of the scale or effects of the proposed action, be better achieved by the EU.

An approach based on action by Member States has already been tested and failed to achieve the intended goal. As mentioned above, the Commission in 2007[58] proposed an approach based on the mutual recognition, between Member States, of their respective venture capital funds, so as to allow cross-border placements with investors in their respective territories.

However, a report in December 2009[59] concluded that mutual recognition of the regulatory requirements imposed on venture capital operators had not contributed to a reduction of the fragmentation of venture capital markets in the EU. Furthermore, as shown in this impact assessment, the fragmentation of the operating rules for venture capital funds persists. Indeed, due to the fact that special rules for venture capital funds in the different Member States (see Chart 6, above) have taken rather different approaches, this regulatory fragmenation has arguably worsened. Therefore, targeted action at European level is necessary to establish a common understanding of what constitutes a venture capital fund and on the conditions under which such an entity can raise capital in different jurisdictions across the European Union.

The principle of proportionality, as articulated by Article 5(4) of the Treaty, will be respected. The proposed rules will attempt to introdsuce the least possible regulatry burden possible, without, however, sacrificing essential rules that aim to safeguard that capital committed to venture capital operators is channelled to the intended beneficiaries: innovative SMEs in the early phases of their entrepreneurial and commercial development.

# 6 OBJECTIVES

## 6.1 General objective – make European SMEs more competitive in a global marketplace

The overarching objective is to make European industries more competitive in a global marketplace. Europe is not short of ideas and innovators. It is in the area of start-up financing and entrepreneurship where Europe is lagging behind. Good ideas - take the example of the Internet - are often conceived in Europe but brought to commercial fruition in the United States. It is noteworthy that most successful internet business ventures have been born in an environment that is able to merge conceptual brilliance with the necessary financing tools. It is interesting to note that Silicon Valley, despite the emergence of competing centres of technological excellence, remains by far the most successful breeding ground for high-tech and latterly 'social media' start-ups. This is on account of the confluence of technological savvy and the appropriate start-up venture capital financing that characterises this technology cluster.

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[58] Communication from the Commission on *Removing obstacles to cross-border investments by venture capital funds*, http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2007:0853:FIN:en:PDF

[59] Summary report 2009: Cross-border venture capital in the European Union

rhttp://ec.europa.eu/enterprise/newsroom/cf/itemlongdetail.cfm?item_id=4053&tpa_id=127&lang=en

The problem for Europe is not a lack of technological innovation. Start-up financing to innovative enterprises must thus be radically improved, so that Europe can finally merge its technological expertise with the requisite financing tools.

## 6.2 Specific objective – Create a European system for the cross-border fundraising of venture capital funds

Venture capital is the tool of choice for start-up companies. Early-stage entrepreneurs need the stability of equity finance in preference over loans or other debt instruments. Venture capital combines stable capital commitments with entrepreneurial advice. Venture capital funds can act both as capital provider and business adviser.

This form of risk-sharing and entrepreneurial involvement is absent in all alternative forms of finance that may otherwise be channelled toward start-up companies. This deep involvement in the early business development can also not be achieved by means of specific SME "stock exchanges", as trading on exchanges intervenes at a later -- and more mature -- stage in a venture capital company's lifecycle. As mentioned above, these approaches are complementary to venture capital funding but cannot replace it. Venture capital financing is therefore deemed the best tool to increase the amount of start-up financing available to European innovators in a rapid, yet sustainable manner.

The proposed course of action therefore focuses on the development of efficient capital markets for dedicated venture capital funds. The preferred policy choice for boosting venture capital funds is to increase the depth and liquidity of their capital base. In line with the underlying principles of the Internal Market, this choice can best be implemented by opening up cross-border fundraising opportunities for those funds that specialise in venture capital financing.

## 6.3 Operational objectives

### *6.3.1 Establish a notion of what constitutes a qualifying 'venture capital fund'*

In order to enhance the capital base available to venture capital funds, a common understanding of the concept of 'venture capital' becomes necessary. A key building block of any future action in this area must therefore consist in developing a common approach to delineate venture capital funds from other alternative investment funds that engage in a broader range of investment strategies. The first operational goal of a proposed initiative will therefore consist in defining the core elements, in terms of financial instruments, investment targets and portfolio composition, which differentiate a venture capital fund from the broader population of alternative investment funds. Other aspects, such as the absence of leverage or a preference for specific investment tools (such as equity and quasi-equity instruments issued by the target companies) may also play a role in defining the essential features of a qualifying of 'venture capital fund'.

### *6.3.2 Create a common regulatory approach governing qualifying 'venture capital funds' and their managers*

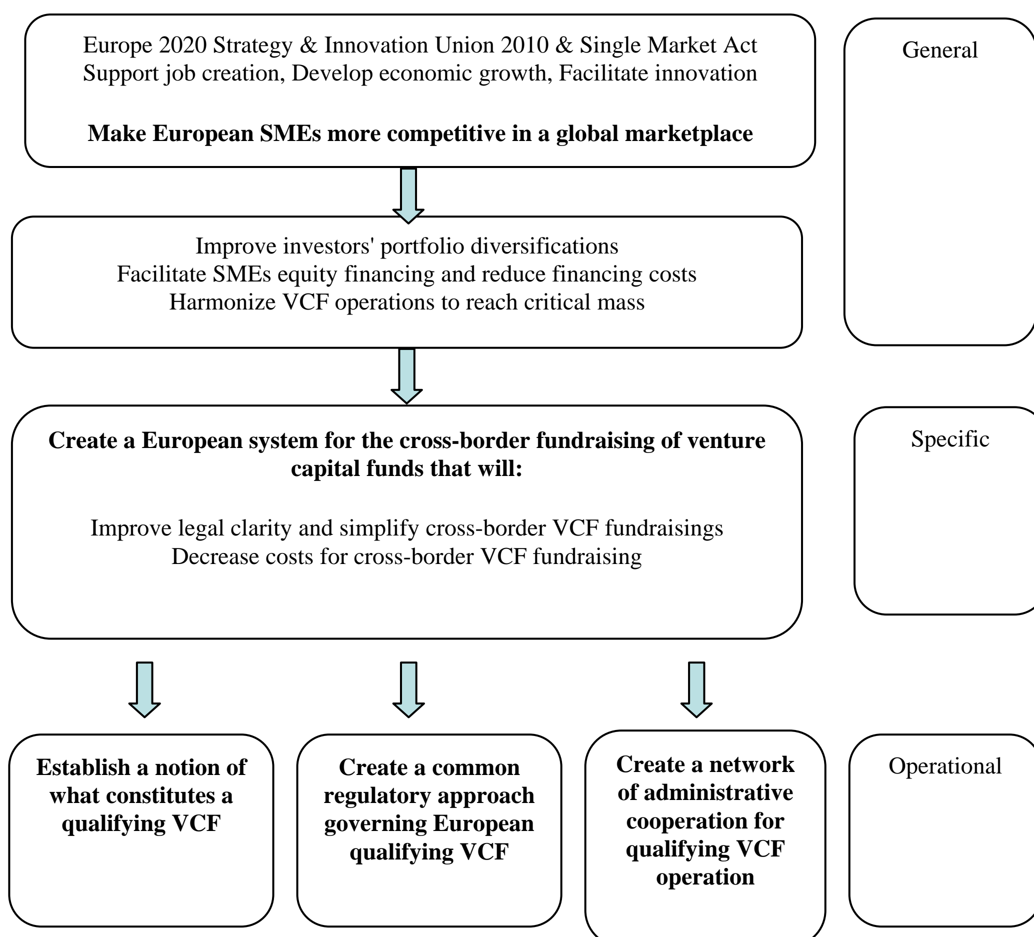
Once the notion of 'venture capital fund' is delineated with the requisite level of precision, the second operational objective will consist in providing a regulatory framework that attaches tangible advantages to managers who can demonstrate that their venture capital funds and their own operational infrastructures comply with this definition. Such advantages could consist in the creation of uniform rules for the

marketing of qualifying venture capital funds and a common approach in respect of those investors that are eligible to invest in such qualifying funds. Should cross-border marketing opportunities lead to more efficient European venture capital funds, the common notion of 'venture capital fund' may also serve as a suitable "point of attachment" to further explore, together with the Member States, those taxation issues, which may have an impact on cross-border fundraising by venture capital funds.

*6.3.3 Create a network of administrative cooperation for the effective introduction and supervision of managers of European qualifying venture capital funds*

An essential operational plank for the practical enforcement of cross-border fundraising is the institution of a framework of administrative cooperation in overseeing and enforcing the new marketing 'passport'. The importance of an effective framework of regulatory cooperation between the national authorities that need to oversee and enforce the new rules governing cross-border activities of venture capital fund managers cannot be overestimated. It is on the effectiveness of cross-border administrative cooperation that the ultimate success or failure of a European approach to venture capital depends.

**Objective tree:**



## 7 OPTIONS

This impact assessment will analyse several options that appear suitable to achieve the above-mentioned aims. A differentiation will be made between substantive policy options and options concerning the legal form of their implementation.

With respect to substantive policy options, this impact assessment will consider how to best define the essential features that characterise a venture capital fund that will be the subject matter of targeted alleviations in respect to their cross-border marketing.

The options on legal form will assess whether these special rules should be embedded into the directive on alternative investment fund managers (AIFMD), be promulgated as 'level 2' when implementing the AIFMD, be achieved with a targeted stand-alone legal instrument or be achieved by a legal instrument detailing the conditions of 'mutual recognition' between national approaches governing venture capital or, in the absence of such approaches, 'private placements'.

### 7.1 Options on the content and scope of a European framework for venture capital funds

The fist key building block of any options designing the appropriate venture capital framework is the definition of the investment strategy and portfolio composition that would characterise and differentiate a venture capital fund from other forms of collective investment funds. Options therefore revolve around the appropriate portfolio composition that would be deemed to characterise a venture capital fund.

The second building block relates to the choice of the eligible investors. Existing national rules generally restrict investments in venture capital funds to institutional, professional or other financially sophisticated investors. This is largely justified by the intrinsically risky nature of venture capital activities. Options in this building block therefore revolve around the issue to which types of investors a European venture capital fund should be marketed.

### 7.2 Presentation of options on portfolio composition

The following three key building blocks will be used to define the precise contours of what constitutes a European venture capital fund:

| INVESTMENT TARGETS | INVESTMENT INSTRUMENTS | PORTFOLIO COMPOSITION |
| --- | --- | --- |
| In line with the impact assessment's stress on the absence of appropriate long-term investments in the early stages of start-up companies, the qualifying investment target will be defined as:<br>1. A company that fulfills the following criteria: (i) it employs fewer than 250 persons and (ii) which have an annual turnover not exceeding EUR 50 million, and/or (iii) an annual balance sheet total not exceeding EUR 43 million.[60]<br>mall , AND | In line with the impact assessment's previous sections on the important role that equity investments play as a stable source of start-up financing (Sections 3.1 and 5.3), the qualifying investment instruments will be defined as equity and quasi-equity. Equity and quasi-equity instruments best embody the **long-term commitment** that is best suited to bring a business venture to fruition. For the purposes of this analysis 'equity' is defined as an ownership interest in an undertaking, represented by the shares or other form of participation in the capital of the target company, issued to the investors. Quasi-equity is | An essential policy choice needs to be made in relation to the percentage of the aggregate capital contributions and uncalled committed capital that need to be invested in qualifying investment instruments issued by qualifying target companies. Three options on this matter will be assessed as to their |

[60] These criteria are inspired by the SME definition contained in Commission Recommendation concerning the definition of micro, small and medium-sized enterprises of 6 May 2003.

| 2. A company that is unlisted if it is not listed on a regulated market as defined in Article 4(1)(14) of Directive 2004/39/EC. | defined as any instrument, whose return is predominantly based on the profits or losses of the qualifying portfolio undertaking and which is unsecured in the event of default. In this manner, quasi-equity displays a risk and reward profile which is closely correlated to that of equity. | suitability to achieve the operational objectives enumerated in the previous section |
|---|---|---|

These three building blocks are selected with a view to defining the notion of a venture capital fund with a high level of detail, thereby allowing a clear distinction between venture capital funds and other alternative investment funds. In order to fully develop the benefit of a venture capital system for the intended investment targets, the selection of the portfolio composition is crucial. In relation to the percentage of the aggregate capital contributions that must be invested in qualifying investment targets, three options are analysed:

### *7.2.1 Option 1: Flexible scope*

This option would require that a qualifying venture capital fund (VCF) invests at least 50% percent of its aggregate capital contributions in qualfying target undertakings. The investment tools available to a venture capital fund would comprise investment in equities or quasi-equity securities that are directly issued by the qualifying target company.

It is important to clarify that the venture capital fund has to acquire these instruments directly from the issuing unlisted SME. Direct acquisition is an essential safeguard as it aims to differentiate venture capital funds from the broader category of alternative investment fund (which predominantly trade in issued securities on secondary markets). However, in order to allow venture capital funds a high degree of flexibility in their investment and liquidity management, secondary trading in equity and other financial instruments would be permitted, as long as such investments do not exceed the maximum threshold of 50% that does not need to be invested in qualifying investments.

The 50 % ratio of qualifying investments is inspired by the 50% threshold that applies to venture capital funds that are eligible for participation in the Commmission's Competetivenes and Innovation Framework Programme (CIP) that aims to support innovation and growth of SMEs. The 50% threshold establishes an initial link between the venture capital fund and the promotion of innovative SMEs, but is less strict than, e.g., the other criteria contained in the framework programe or the thresholds in the Commission's guidelines on risk capital investments[61].

### *7.2.2 Option 2: Intermediate scope*

In this option, the qualifying venture capital fund needs to invest 70% of its aggregate capital contributions into equity or quasi-equity issued by qualifying target undertakings. The 70% threshold is inspired by one of the criteria according to which venture capital funds may be eligible for state aid that is established in the Community guidelines on State aid to promote risk capital investments: "*The risk capital measure must provide at least 70 % of its total budget in the form of equity and quasi-equity investment instruments into target SMEs. In assessing the nature of such instruments, the Commission will have regard to the economic substance of the instrument rather than to*

[61] OJ C 194/2, 18.8.2006

*its name and the qualification attributed to it by the investors. In particular, the Commission will take into account the degree of risk in the target company's venture borne by the investor, the potential losses borne by the investor, the predominance of profit-dependent remuneration versus fixed remuneration, and the level of subordination of the investor in the event of the company's bankruptcy*[62]".

However, compared to the aforementioned Community guidelines, the remaining 30% of aggregate capital contributions are not subject to any investment limitations.

#### *7.2.3 Option 3: Strict scope*

This option is designed in the same manner as the preceding ones, except that the percentage that needs to be invested in equity or quasi-equity issued by target companies is 90 percent. This high percentage reflects the UCITS approach according to which a UCITS funds may invest up to 10 percent of its assets in instruments that are not eligible assets as enumerated in the UCITS Directive[63]. The choice of a rather high percentage for qualifying investments also reflects the policy choice of the US Securities regulator (SEC) when implementing the venture capital exemption contained in section 203(1) of the Securities and Exchange Act[64].

### 7.3 Summary of Options on portfolio composition:

| OPTION | QUALIFYING INVESTMENTS (% OF COMMITTED CAPITAL) | TARGET UNDERTAKING | INVESTMENT INSTRUMENTS | NON-QUALIFYING INVESTMENTS (AS % OF COMMITTED CAPITAL) |
|---|---|---|---|---|
| 1 -Flexible | > 50% in target undertakings | Unlisted SME | Equity or quasi-equity, directly acquired from issuer | 50% in secondary trading or other instruments of choice |
| 2-Intermediate | > 70% in target undertakings | Unlisted SME | Equity or quasi-equity, directly acquired from issuer | 30% in secondary trading or other instruments of choice |
| 3 - Strict | > 90% in target undertakings | Unlisted SME | Equity or quasi-equiy, directly acquired from issuer | 10% in secondary trading or other instruments of choice |

### 7.4 Analysis of options on portfolio composition

Below, the three substantive options will be assessed in terms of their effectiveness, coherence and efficiency in attaining the above-mentioned operational objectives. Options on the portfolio composition of venture capital funds would directly address regulatory fragmentation that currently prevails with respect to the composition of a qualifying venture capital fund's portfolio, qualifying investment instruments and qualifying investment targets. Harmonisation of the appropriate portfolio composition, the eligible investment instruments and the eligible target companies serves to address

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[62] Risk Capital Guidelines, at Section 4.3.3.

[63] Cf. Article 50(2)(a) of Directive 2009/65/EC, OJ L 302/32, 17.11.2009

[64] The SEC rules stipulate that a venture capital fund must invest at least 80% of aggregate capital contributions must be invested in qualifying investments. Qualifying investments are defined as investments in equity issued by a qualifying portfolio company that is acquired directly by the fund. A qualifying portfolio company is defined as a company that is not traded on an exchange and is not itself an investment company. Further details of the SEC rules details are described in Annex VII.

confusion and legal uncertainty that venture capital investors, venture capital funds as well as SMEs encounter in a fragmented regulatory environment.

### 7.4.1 *Operational objective 1: Establishment of a notion of 'qualifying venture capital fund'*

The aim behind this operational objective is to provide a common definition of the essential elements that constitute a qualifying venture capital fund. The aim behind this definition is to precisely circumscribe the scope of a favourable European regulatory framework that attaches tangible advantages only to those qualifying venture capital funds that can demonstrate compliance with this definition. Such advantages could consist in the creation of a registration-based cross-border marketing permit and a common approach to those investors that are eligible to invest in such cross-border vehicles. Should cross-border marketing opportunities lead to more efficient and bigger European venture capital funds, the common notion of 'venture capital fund' may also serve as good starting point for further exploring with Member States solutions to those taxation issues that may have an impact on cross-border fundraising of such funds.

In light of these aims, a key concern is that the European venture capital framework must really achieve its aim of channelling funds to innovative start-up ventures and not emerge as a tool to circumvent the stringent requirements contained in the AIFMD. This ambition is most clearly expressed in the following stakeholder comment by the European Venture Fund Investors Network (EVFIN): "*As such, they (EVFIN members) believe that the EU initiative in question will serve a very useful purpose in terms of defining venture capital as a separate asset class, helping to improve the understanding and transparency of this sector still unfamiliar to many institutional investors as well as SMEs*."

A key concern therefore was to make a venture capital fund sufficiently distinct from other alternative investment funds. Making this distinction is essential in justifying the different regulatory framework that will govern qualifying venture capital funds.

The issue is particularly relevant as the principal aim of a European framework for venture capital funds would be to provide a venture capital fund manager with cross-border marketing and fundraising opportunities without the need to comply with the full set of operational, disclosure and risk management rules contained in the AIFMD. A key requirement of a common approach to venture capital funds is that the qualifying fund has an investment portfolio that is clearly distinct form that of an alternative investment fund.

In this respect, Option 3 would appear most suitable to create a clear and distinct notion of the essential elements that constitute a European venture capital fund. As the amount of non-qualifying investments is confined to a 10% ratio of aggregate capital contributions or committed capital, this option is best placed to foster the emergence of a 'venture capital brand' – not unlike the UCITS framework, where non-eligible investments are also confined to a 10% maximum threshold. A fund that allocates 90% of its aggregate capital contributions to equity or quasi-equity investments in qualifying target companies embodies a 'pure' venture capital approach and will be recognised as such by potential investors.

Indeed, many stakeholders that took part in the consultation stress the need to develop a clear definition of a venture capital fund, especially in order to distinguish this from a

private equity fund. Most prominent among the criteria discussed in the public consultation was the introduction of a compulsory investment percentage in favour of qualifying SMEs. Sixteen stakeholders (including seven industry organisations, the industry federation EVCA and six public authorities) spoke in support of a rule that a majority (50% as a minimum) of the aggregate capital contributed to a venture capital fund should be invested in qualifying SMEs. Four Member States that favour of a high compulsory investment percentage do not have specific venture capital framework in place, another Member State supports this rule because its own national regulation reflect the same approach and the sixth Member State supports this rule despite the fact that its specific national law requires a higher percentage of capital being allocated to SMEs.

Option 2 would equally offer a relatively high level of confidence that the qualifying venture capital fund essentially pursues a strategy dedicated to funding high-potential SMEs. Again, the long-term commitment is ensured by the requirement that 70% of capital raises is channelled toward investments that are in equity or quasi-equity that is directly issued by the SME. Especially the requirement of that the participation is 'directly' purchased from the SME issuer, ensures that investments are sufficiently channelled to the early start-up, seed and expansion phases of the target SMEs. A 70% threshold -- although less strict than the 90% variant -- appears ultimately more conducive to developing a successful and realistic notion of a European venture capital fund. The lower threshold might well be compensated by the fact that the venture capital's success in raising capital with investors is higher once the manager enjoys a somewhat larger discretion as to the composition of the fund's portfolio. Therefore, take-up of the funding scheme seems greater if the threshold is inferior to 90%.

The argument for an intermediate threshold is also borne out by comparing existing Member States venture capital frameworks (cf. chart 5) which contain mandatory investment targets in favour of unlisted SMEs within a range of 50-75%. Without any reasonable flexibility, there is a risk that few funds would be interested to make use of the new EU framework. The costs of complying with an ambitious 90% threshold might outweigh the benefits of the purer approach.

While some adaptations will always be necessary to comply with a single EU approach to the definition of what constitutes a venture capital fund, the intermediary approach is closer to the national requirements that prevail in the eight Member States that have adopted rules governing the activities of venture capital funds. An approach based on a 70% target therefore promises a higher immediate take-up than one based on a 90% target. A higher initial take-up is more conducive to establishing a common notion of venture capital funds than a somewhat ‘idealistic’ target of 90% (which would oblige all but the most pure breed venture capital funds to alter their investment strategies).

A certain preference for the intermediary approach can also be gleaned from the stakeholder consultation. While 28% of respondents to the public consultation were against any thresholds on the portfolio of investments a venture capital funds can engage into, a narrow majority of 35% favour a threshold ensuring that more than 50% of venture capital fund's investments pertain to SMEs. The rationale given is that there should be a safeguard that a high percentage of the aggregate capital raised by or pledged to a venture capital fund should be invested in qualifying undertakings.

Option 1, on the other hand, would offer a rather low guarantee that a clear distinction between venture capital, on the one hand, and other alternative investment strategies, on the other hand, emerges. While it could be argued that this option enhances the fund

manager's discretion in raising capital and presenting its investment proposition, a 50% threshold appears less conducive to create a clear European notion of what constitutes a venture capital fund. This option would not provide potential investors with a clear idea of the business strategy that stands behind the fund. This hesitation on the "venture capital" credentials of the fund might act as a considerable break in investor's willingness to entrust capital to the fund, especially as this entrustment entails a commitment not to redeem the investment for a considerable period of time (on average seven to ten years[65]). In this respect, limiting investment possibilities, within the 50% quota, would not fundamentally change the perceived lack of investor's willingness to commit capital to a venture capital fund.

In conclusion, Option 3 appears to offer the highest likelihood that a distinct European brand of 'venture capital fund' would emerge. However, Option 2 displays a series of features which allows a reasonable expectation that a European notion will emerge, while allowing a venture capital fund manager sufficient flexibility in the composition of its investment portfolio. A higher level of flexibility is deemed essential to ensure that fund managers actually take up the opportunity offered by a European framework dedicated to venture capital fundraising. Option 1, on the other hand, appears to offer an insufficient likelihood that the intended outcome is achieved.

#### *7.4.2 Operational objective 2: Common regulatory approach to 'qualifying venture capital funds'*

In this respect, there is a risk that Option 1 proves too permissive with respect to a fund's investment portfolio, therefore raising the spectre of "circumvention" and lack of focus on the core objectives of a venture capital fund. A threshold of 50% of aggregate capital contributions to be invested in equity or quasi-equity issued by qualifying target undertakings leaves open the possibility that 50% of the fund's aggregate capital, at any given time in its lifespan, is invested in buy-out transactions or secondary trading activities that are commonly associated with private equity operators. Also, a 50% rule would set aside considerable resources for the fund to invest in derivatives, thereby introducing levels of leverage that are not commonly associated with equity-based venture capital investments. Finally, a 50/50 approach carries with it as high risk that the rules will be circumvented by alternative investment funds that do not pursue a true venture capital strategy. The risk of regulatory arbitrage and free-riding by non-qualifying funds also arises.

Also, a 50% threshold would act as an inventive to deal with venture capital financing as one of many strategic objectives of a fund manager. This lack of focus on venture capital activity would not allow the fund to equip itself with the necessary personnel and material resources to fulfil the non-financial advisory and support functions associated with the operation of a genuine venture capital fund. A 50% threshold is therefore considered to diffuse to underpin a common European regulatory approach to venture capital.

A credible expectation therefore emerges that the 70% threshold (Option 2) is more suitable to create incentives for a business focus on true venture capital operations. A common approach to regulating venture capital therefore requires rules on investment

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[65] Venture capital funds are constructed as investment vehicles with usually a limited lifespan amounting to, on average, not more than seven to ten years.

portfolio, which are ambitious enough to provide an incentive that a fund focuses also on the business development and advisory functions commonly associated with venture capital funds[66]. Also the core focus on selecting promising start-up companies would be lost if selecting and advising such entities would no longer be the principal focus of the venture capital fund[67].

Naturally, Option 3 scores highest in respect of avoiding "circumvention" or regulatory arbitrage in relation to the new European regulatory framework dedicated to qualifying venture capital funds. It is also the Option that best ensures continued focus on the core selection and advisory role that a venture capital fund plays in the business development of a target undertaking.

### *7.4.3 Operational objective 3: Regulatory cooperation*

Option 1, the 50/50 approach between qualifying and non-qualifying assets, would raise practical issues in enforcing the new approach to cross-border activities engaged in by venture capital funds: Member States authorities, who need to cooperate in enforcing the practical modalities governing fund-raising in their respective territories, would need to trust the identity and business strategy behind a venture capital fund. A 50/50 approach might give rise to suspicions that the fund, operating as a venture capital fund in its home Member State, is masking a private equity strategy and using cross-border marketing opportunities to essentially raise capital for its private equity branch. This strategy might be perceived as a circumvention of the stricter passport requirements contained in the AIFMD. As mentioned above, a 50/50 rule leaves scope for leverage and it is commonly understood that reporting and supervision of leverage ratios is one of the core objectives of the AIFMD[68]. Host Member States might therefore be prone to requiring additional information on the fund, its leverage ratio and its investment strategy.

On the other hand, its does not appear that Option 2 will encounter insuperable obstacles in its enforcement. As long as there is a common approach in respect to portfolio thresholds, home and host Member State authorities can cooperate with relative ease in determining that the qualifying fund, at all times, complies with the European portfolio requirements. An additional advantage facilitating ease of enforcement is that the thresholds will be calculated as a percentage of aggregate capital contributions and not as a percentage of the assets managed by the fund. This method of calculation facilitates enforcement of the rules on the portfolio composition considerably: all the fund manager is obliged to verify is that, immediately after the acquisition of any asset other than qualifying investments, the qualifying venture capital fund holds no more than 30 percent of the fund's aggregate capital contributions in non-qualifying assets.

It will be significantly more challenging to enforce Option 3, as the high percentage of aggregate capital contributions that must be invested in qualifying assets may give

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[66] As mentioned above, venture capital is generally associated with financing of young and newly established undertakings to which it provides equity investments. As the venture capital fund receives an equity stake in the target undertaking, it becomes a partner in the business. Also, its equity stake exposes the investor to the full risk of the undertaking's success.

[67] Cf. Annex XII: "a key economic role of US venture capital is the allocation of financial and managerial resources to help grow firms that will have a dramatic impact on productivity in the economy".

[68] Article 25 AIFMD.

frequent rise to some borderline cases where regulators will have verify whether a certain venture fund remains within the prescribed limits or not. Experience shows that higher thresholds lead to more scrutiny when non-qualifying investments are envisaged. It is also to be expected that, with a high target for qualifying investments, a single non-qualifying investment may cause a fund to breach the investment targets[69]. In these circumstances, the fund has little flexibility in its investment mix and might therefore be inclined to breach the target, in the hope that the excess will be temporary and will go unnoticed. This possibility will then lead to high levels of suspicion in cross-border enforcement[70].

#### *7.4.4 Overall comparison of options on portfolio composition*

In conclusion, Option 3 appears to offer the highest likelihood that a distinct European brand for 'venture capital funds' would emerge. It is also the option must suitable to underpin a common, as well as coherent, approach to venture capital. Option 1 would score lowest on these points, while Option 2 reflects an intermediary approach.

Option 2 would not pose major difficulties with respect to its enforcement by the relevant national home and host authorities, while Option 1 might well give rise to suspicions as to the ‘true’ marketing objectives that a 50/50 fund pursues in a host Member State. Option 3 might also give rise to a very high number of 'borderline' cases, where funds 'oscillate' around the threshold for non-qualifying investments for significant periods in any given calendar year. These 'oscillators' require significant resources to supervise.

A choice will therefore have to be made between the 'pure' approach, as embodied in Option 3, and the slightly more flexible approach in Option 2.  In light of its higher likelihood of take-up by the relevant industries and its better score on practical enforcement, a preference is given to Option 2.

### 7.5 Summary of impacts: portfolio composition

| **Options/Objectives** | **Effectiveness** | | | **Efficiency** |
|---|---|---|---|---|
| | Create notion of qualifying venture capital fund | Ensure common regulatory approach to qualifying venture capital funds | Facilitate regulatory cooperation | Practical feasibility |
| Baseline | 0 | 0 | 0 | 0 |
| *1. Flexible scope* | -- | - | -- | -- |
| *2. Intermediate scope* | + | + | + | ++ |
| *3. Strict scope* | ++ | ++ | + | -- |

[69] This is because a single non-qualifying investment might lead to the fund exceeding the threshold (especially as capital commitments in closed ended funds will not increase over the lifetime of a fund).

[70] These concerns are borne out by the debate on the AIFMD threshold and the different views expressed as to when a fund's exceeding the threshold is of temporary or permanent nature, see ESMA Consultation Paper on possible implementing measures of the Alternative Fund Manager's Directive, Section III, 13 July 2011, available at: http://www.esma.europa.eu/index.php?page=consultation_details&id=185.

"++" strongly positive, "+" positive, "—"strongly negative, "-" negative, "=" marginal/neutral, "?" uncertain, and "n.a." not applicable.

## 7.6 Presentation of options on eligible investors

### *7.6.1 Option 1: Mifid investors*

According to this option only professional investor as defined in Markets in Financial Instruments Directive (Mifid) would be eligible to invest in qualifying venture capital funds.

### *7.6.2 Option 2: Traditional venture capital investors*

According to this option only professional investors as defined in Markets in Financial Instruments Directive (Mifid) and certain investors traditionally associated with venture capital investments would be eligible to invest in qualifying venture capital funds. Traditional investors in venture capital comprise entrepreneurs, family offices, angel investors, member of the management teams, industry sector experts, venture capital experts, finance sector experts, wealthy individuals.

This approach would be similar to that of the AIFMD regarding the scope of eligible investors. As such, the AIFMD marketing passport allows funds to be offered only to professional investors (as defined in Mifid, Annex II). In addition, the AIFMD gives the possibility to national regulators to allow retail distribution on their territory subject to their national rules (but without granting a passport for these funds).

This option aims to reflect the current practice in the venture capital market. Since the list of investors that traditionally invest in venture capital goes beyond the professional investors mentioned in Mifid, this option would include two important safeguards aimed at avoiding mis-selling of venture capital funds to unsuitable investors:

(a) a first safeguard would be to require those investors a minimum initial investment ("entry ticket") of at least 100.000 €, in line with the exemption in Article 3(2) (c) and (d) of the Prospectus Directive (as amended by Directive 2010/73/EU), and

(b) a second safeguard would be to require the manager to conduct an assessment of the ability of the investor to apprise the risks involved in the investment in the venture capital fund. This should take the form of a signed certificate stating that the investor is eligible and acknowledge the risks embedded in the investment. In addition, flawed assessments would lead to the invalidity of the subscription and compensation claims.

### *7.6.3 Option 3: Broad scope*

This option would be the one of the UCITS Directive, which is an investment vehicle open to all kinds of investors, irrespective of an entry ticket or an assessment of the investors' ability to appraise investment risks.

## 7.7 Summary of Options concerning eligible investors:

| OPTION 1<br>MIFID INVESTORS | OPTION 2<br>TRADITIONAL VC INVESTORS | OPTION 3<br>BROAD SCOPE |
|---|---|---|

| Professional investors as defined in MiFID | Professional investors as defined in MiFID, entrepreneurs, family offices, angel investors, member of the management teams, industry sector experts, venture capital experts, finance sector experts, wealthy individuals. | All types of investors mentoned under traditional investors, includsing retail investors |
|---|---|---|

### 7.8 Analysis of the options on eligible investors

Below, the three substantive options will be assessed in terms of their effectiveness, coherence and efficiency in attaining the above-mentioned operational objectives. Options on the eligible investors of venture capital funds are directly linked to the problem of regulatory fragmentation that prevails also in this area. As is the case with respect to options on portfolio composition, a uniform approach in relation to eligible investors would remove another obstacle that investors, venture capital funds as well as SMEs encounter in the existing environment.

#### *7.8.1 Operational objective 1: Establishment of a notion of 'qualifying venture capital fund'*

All three options would score neutral on this point. The development of a European notion of a 'venture capital fund' does not depend on the investors eligible to invest in such a vehicle. As mentioned above, this notion is linked to the intrinsic qualities of the fund, its portfolio composition and its investment strategy. Once these elements allow a clear distinction between venture capital funds and other types of alternative investment funds, it is irrelevant whether the cross-border placements are limited to professional investors, traditional venture capital investors or accessible to retail investors.

#### *7.8.2 Operational objective 2: Common regulatory approach to qualifying venture capital funds*

Option 3 would allow retail investors to have access to venture capital investment strategies that are currently, in most Member States, reserved to professional investors (see chart 7, above). Such a choice would imply that the EU new venture capital framework would need to include provisions ensuring a very high level of transparency/disclosure as regards the nature of the proposed investment policies as well as very effective protections (in terms of organisation/conduct of business by management companies, safekeeping of the assets, etc).

Rules included in the UCITS Directive could be extended for that purpose although they may not always be adapted to the specific nature of venture capital investment. For instance, UCITS have to invest in highly liquid financial instruments. This allows investors to redeem/repurchase their shares often on a daily basis. Venture capital investments, on the other hand, are normally not as liquid (as VC funds stay invested in target companies for between 7 to 10 years). A whole set of adapted investor protection rules would therefore need to be designed for the purpose of the venture capital regime. This would not be conducive for the immediate development of a common approach, more likely it would further complicate such an endeavour.

Option 3 would have two additional consequences. Firstly, it would create a precedent as it would open a part of the alternative investment fund industry to retail investors. Second, it would render the rules applicable to venture capital funds much less flexible and attractive to their managers -- as the costs of complying with the different provisions aimed at protecting investors would be very high. The advantage of the new venture capital regime compared to the AIFM Directive would be largely neutralised.

A more balanced approach between the type of eligible investors on the one hand and the obligations to be imposed on venture capital funds managers on the other is needed. This pleads in favour of options 1 or 2. In respect of operational objective 2, there is no discernable difference between these two options.

*7.8.3 Operational objective 3: Regulatory cooperation*

Option 3 potentially gives venture capital funds access to a larger pool of capital, as it includes the reserves of retail investors. On the other hand, regulatory cooperation in supervising cross-border placements to retail investors is, on account of the increased importance of investor protection rules, rather more complex than the supervision of placements to professional, or adequately assessed, investors.

Regulatory cooperation would be easier to achieve if Options 1 or 2 were chosen.

Option 2 is, however, preferable to Option 1 as it would increase the scope of eligible investors beyond those mentioned in Mifid, without causing additional burdens with respect to regulatory cooperation. As the chart below shows, funds raised by venture capital operators from investors other than MiFID professionals, in 2011, were about 5% for family offices, 10% for private individuals, 3% for other asset managers, which amounts to 18% of the aggregate capital committed to venture capital funds.

Option 2 is also the option that is largely supported by the responses received to the public consultation. 59% of respondents (including 6 out of 7 positions of public authorities) favoured a scope of eligible investors that exceeds the definition of professional investors in Mifid. The only Member State that was against extending the class of eligible investors beyond the scope of those mentioned in Mifid feared that this would create a "lighter" venture capital fund that could allow uniform funds to be offered to all retail investors in their jurisdiction. This concern is, however, addressed by the fact that the uniform venture capital fund will only be accessible to the uniform category of eligible investors. Only 6% of replies favoured an approach on eligible investors that reflects Mifid. In this respect, stakeholders clarified that: …"*the MIFID definition of professional investors would exclude many categories of institutional and individual investors who are currently part of venture capital investor base. Indeed, professional clients as currently defined under MiFID is designed to identify individuals who regularly trade in listed securities or are experts in the trading of listed securities (and derivatives based on these securities). This definition is not coherent with venture capital investment which is a long term investment and can not be characterized by short-term, high-volume transactions. Any proposed restrictions would have a negative impact on the amounts invested in venture capital funds or would dissuade small and mid sized venture capital funds from opting into the new regime…*".

Traditional venture capital investors play an important part in fundraising especially for early stage venture capital funds. Their role and importance is expected to even increase in response to the newly introduced prudential rules for banks and insurance companies. These new provisions require banks and insurance companies to set aside additional regulatory capital with respect to the amount of assets invested into private equity or venture capital funds[71]. Although the impact of these new provisions is yet to be seen, it

[71] One of the **risks** potentially endangering the success of the proposal resides in the potential consequences of recent changes in the prudential framework for insurance companies and banks resulting from solvency and capital requirements. According to the Basel III rules, national

is of utmost importance to ensure that any future regulatory framework aimed to increase size and liquidity of venture capital markets to the benefit of SMEs, is responsive and sensitive to the underlying realities and practices of the venture capital industry.

#### *7.8.4 Overall comparison of options on eligible investors*

In conclusion, Option 3 appears most difficult to implement in terms of a common approach. Also, on account of the high level of investor protection necessary when a broad scope of eligible investors is targeted, regulatory cooperation would be most difficult to implement in practice. As Option 2 allows for a broader investor base to have access to venture capital funds, without, on the other hand, entailing additional burden in relation to the intensity of regulatory cooperation, this option appears more efficient.

### 7.9 Summary of impacts: eligible investors

| **Options/Objectives** | **Effectiveness** | | | **Efficiency** |
|---|---|---|---|---|
| | Create notion of qualifying venture capital fund | Ensure common regulatory approach to qualifying venture capital funds | Facilitate regulatory cooperation | Practical feasibility |
| Baseline | 0 | 0 | 0 | 0 |
| *1. Mifid investors* | = | + | + | + |
| *2. Traditional VC investors* | = | + | + | ++ |
| *3. Broad scope* | = | -- | -- | -- |

"++" strongly positive, "+" positive, "—"strongly negative, "-" negative, "=" marginal/neutral, "?" uncertain, and "n.a." not applicable.

### 7.10 Presentation of procedural options on the legal form of a European framework for venture capital funds

#### *7.10.1 Option 1 – A new venture capital passport within the AIFMD*

As a consequence of regulatory fragmentation and the need to comply with several sets of rules governing both venture capital and private placements, the procedural steps necessary to raise venture capital are more complex as the number of targeted jurisdictions increases. Raising funds from potential investors across several jurisdictions involves the following

A first policy option to achieve the European venture capital passport would be to enlarge the scope of the passport provisions currently contained in the Directive on Alternative Investment Fund Managers (AIFMD, Directive 2011/61/EC) to incorporate 'venture capital funds' as defined in the amending directive.

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supervisors may decide to apply a 150% or higher risk weight reflecting the higher risks associated with some other assets, such as venture capital. In light of the potential impacts, the Commission shall oversee a study on the impact of the proposed prudential rules on SME financing. This effort should involve EBA and EIOPA.

This option would leave intact the current thresholds of application of Directive 2011/61/EC – the latter applies to fund managers whose aggregate assets under management exceed a threshold of €500 million – but introduce special provisions in favour of 'qualifying' venture capital funds (qualifying funds would be defined in accordance with one of the substantive choices described above) that are registered in a European jurisdiction in the relevant chapters governing the operation of the passports foreseen in Directive 2011/61/EC.

#### 7.10.1.1 Registration-based model

In the modified AIFMD, the envisaged European venture capital fund passport should be available to a qualifying manager on the basis of a simple registration in the EU Member State of his establishment. But the EU passport would be available to the managers of qualifying venture capital funds only to the extent that they market qualifying funds across different territories in the European Union. In order to ensure coherence between the new venture capital passport and the remainder of the prudential provisions contained in the AIFMD, the proposed passport would, in an initial phase, only apply to qualifying venture capital fund managers whose assets under management in total do not exceed the AIFMD's €500 million threshold.

For all of their other funds, whose aggregate assets under management exceed €500 million (calculated separately from the assets managed by the qualifying venture capital fund), the venture capital fund manager would need to comply with the AIFMD.

Triggered by a simple registration in the qualifying fund's Home Member State, the 'qualifying' venture capital fund (as defined in the substantive option) will be able to market its qualifying funds (those that comply with the relevant investment percentages) in all the Member States designated in this registration. Preference is given to a registration as a registration, as opposed to a formal authorisation procedure, becomes valid as soon as the Home Member State has verified that the registrant is a venture capital fund that fulfils the criteria set out in the proposed instrument. The overall effectiveness is further enhanced by the fact that the registration submitted by the venture capital fund manager can designate both the Home Member State and up to 26 Host Member States.

Registration in the Home Member State has important legal consequences which would need to be set out in the modified AIFMD. Most importantly, registration shall entitle the qualifying fund manager to market its qualifying funds in all Member States that are indicated in the Home Member State registration. This can be, as stated above, both the Home Member State of the qualifying venture capital fund and a variety of Host Member States.

#### 7.10.1.2 Carve-outs from substantial provisions of the AIFMD

In order to align the reporting obligations under the registration-based venture capital passport with the business model of the venture capital sector, the AIFMD would need to create a set of 'light' version on operating conditions and reporting obligations that would only apply to qualifying venture capital funds.

Certain carve-outs from the general principles governing the behaviour of a alternative fund manager, notably in the conduct of its activities and in its relationship to investors, rules on the handling of conflicts of interest, organisational requirements in terms of

adequate human and technical resources, rules on the valuation of a qualifying venture capital fund's assets and the provisions on annual reports would have to be inserted into the AIFMD.

In addition, certain modified disclosure requirements that are incumbent on a qualifying fund in relation to its investors would have to be introduced into the AIFMD. Notably, the AIFMD would have to be supplemented to contain special and tailor made rules on disclosure obligations on the qualifying fund's investment strategy and objectives, investment instruments used by the funds information on cost and associated charges, and the risk/reward profile of the investment proposed by a qualifying fund.

7.10.1.3 Special enforcement provisions

Seamless enforcement of the criteria applying to both qualifying managers and qualifying funds is necessary to safeguard the credibility of the new passport. The AIFMD will therefore have to contain special rules on the conditions in which the Home Member State is obliged to withdraw the European passport foreseen in this Regulation. It is important to note that the Home Member State must continually supervise compliance of the qualifying venture capital fund manager, notably with the substantive requirements that relate to the composition of its portfolio, the eligible investment instruments and the eligible target companies.

Once, material non-compliance is ascertained, it is incumbent on the Home Member State to withdraw the benefit of the European passport from the manager in relation to all its qualifying funds and inform the relevant Host Member States (those indicated in the registration) accordingly. To avoid regulatory ambiguity, the AIFMD would have to stipulate that, upon withdrawal, the benefits of the passport will cease with immediate effect.

The AIFMD would also have to be modified introducing detailed provisions on the requisite cross-border notification process between the competent Home and Host Member States; these provisions would only apply only to the supervision of venture capital funds. These notifications are triggered by the registration of a qualifying venture capital fund. The process and legal effects of these mutual notifications are conceived and legally structured in line with the principles of Article 93 of Directive 2009/65/EC (UCITS).

To ensure the effective supervision of qualifying venture capital funds and their managers, the AIFMD would need to contain a separate chapter whereby the competent authorities in the Member States would be equipped with the necessary supervisory powers and will contain provisions on the administrative cooperation between the Home and Host Member States affected by the marketing of the qualifying venture capital funds.

*7.10.2 Option 2 - Lower the thresholds of AIFMD*

A further policy option would be to lower – or entirely abolish -- the above-mentioned thresholds in Directive 2011/61. That would entail that small funds – most venture capital funds and their managers manage less than €500 million in assets – would benefit from the passport. This benefit would, however, come at the price of full compliance with all substantive provisions of Directive 2011/61.

As this option would rely on a general lowering of the AIFMD thresholds so that all managers whose funds aggregate less than € 500 million in assets under management would be included in the AIFMD, there would be no need to further delineate the scope of a 'qualifying' venture capital fund. Option 2 would therefore not require the substantive definition of a qualifying 'venture capital' fund. It would also not need to determine who would be eligible investors, because the definition of Article 4(1)(gg) AIFMD would apply.

Furthermore, as the general passport of the AIFMD would apply to all 'smaller' funds whose aggregate assets under management would not exceed €500 million, there would be no need for tailor-made rules on general operating principles and regulatory cooperation in enforcing the passport.

*7.10.3 Option 3 – Create special rules for venture capital as part of the implementing provisions of AIFMD 'level 2'*

An alternative approach would consist in modulating the implementing provisions that are necessary to make the AIFMD operational in order to take into account the 'special case' of venture capital funds. Essentially, this option would leave intact the current 'level 1' AIFMD framework, but would cater to the special situation of venture capital funds when providing for the measures of implementation.

In a first step, and in analogy to the current process of implementing the AIFMD, advice would be sought from ESMA on whether a tailor-made set of rules should be created to promote cross-border fundraising by qualifying venture capital fund managers who operate below the €500 threshold of the AIFMD.

Should ESMA conclude that the special situation of venture capital funds requires tailor-made rules creating a European fund-raising passport without the need of full compliance with the AIFMD, the corresponding rules would be codified at level 2. These rules would then form part of the implementation of the AIFMD. In substance, this approach would aim to create a European marketing passport for venture capital companies by tailoring the requisite 'level 2' provisions to exempt venture capital funds who wish to obtain a fundraising passport from certain substantive provisions in the AIFMD.

In line with the approach followed in Option 1, qualifying venture capital funds would be exempted from AIFMD's requirements that are perceived as either too onerous or to costly for a venture capital fund to comply with (e.g., minimum capital requirements, the need for a permanent depositary, regular valuation of all assets or rules on delegation).

*7.10.4 Option 4 – Light touch venture capital passport as a stand-alone instrument*

A further option would be to introduce the 'light' version of the European passport by means of a stand-alone instrument that would not amend Directive 2011/61/EC but would exist alongside this Directive.

7.10.4.1 Registration-based model

The envisaged European venture capital fund passport should be available to a qualifying manager on the basis of a simple registration in the EU Member State of his establishment. The EU passport is available to the managers of qualifying venture capital funds only to the extent that they market qualifying funds across different territories in the European Union.

In order to ensure coherence between the regulatory approaches of the AIFMD and the new instrument, the proposed stand-alone instrument would, in an initial phase, only apply to managers who operate beneath the €500 million threshold. It is envisaged that the Commission receives a mandate to review the scope and, if necessary, modify the relevant threshold.

Triggered by a simple registration in the qualifying fund's Home Member State, the 'qualifying' venture capital fund (as defined in the substantive option) will be able to market its qualifying funds (those that comply with the relevant investment percentages) in all the Member States designated in this registration. For the reasons set out in Option 1, preference is given to a registration that becomes valid as soon as the Home Member State has verified that the registrant is a venture capital fund that fulfils the criteria set out in the proposed instrument. The overall effectiveness is further enhanced by the fact that the registration submitted by the venture capital fund manager can designate <u>both</u> the Home Member State and up to 26 Host Member States.

Registration in the Home Member State has important legal consequences which are set out in the proposed stand-alone instrument. Most importantly, registration shall entitle the qualifying fund manager to market its qualifying funds in all Member States that are indicated in the Home Member State registration. This can be, as stated above, both the Home Member State of the qualifying venture capital fund and a variety of Host Member States.

Fund managers who comply with the criteria set out in the new instrument would be entitled to market all funds that qualify using the designation "European Venture capital fund".

7.10.4.2 An autonomous set of rules governing operating conditions

In line with the 'stand-alone' approach (in clear demarcation to the AIFMD), the proposed instrument would also contain reporting obligations incumbent on the venture capital fund manager in relation to the qualifying venture capital funds vis-à-vis the competent authority in its Home Member State.

Underlining the stand-alone nature of the proposed instrument, the instrument will contain general principles governing the behaviour of a qualifying venture capital manager, notably in the conduct of its activities and in its relationship to investors, rules on the handling of conflicts of interest, organisational requirements in terms of adequate human and technical resources, rules on the valuation of a qualifying venture capital fund's assets and the customary provisions on annual reports.

In addition, the instrument would contain certain key disclosure requirements that are incumbent on a qualifying fund in relation to its investors: these requirements shall contain pre-contractual disclosure obligations on the qualifying fund's investment strategy and objectives, investment instruments used by the funds information on cost and associated charges, and the risk/reward profile of the investment proposed by a qualifying fund.

7.10.4.3 Special enforcement provisions

Seamless enforcement of the criteria applying to both qualifying managers and qualifying funds is necessary to safeguard the credibility of the new designation

"European Venture Capital Fund". The proposed rules would therefore specify the conditions in which the Home Member State is obliged to withdraw the European passport. It is important to note that the Home Member State must continually supervise compliance of the qualifying venture capital fund manager, notably with the substantive requirements that relate to the composition of its portfolio, the eligible investment instruments and the eligible target companies.

Once, material non-compliance is ascertained, it is incumbent on the Home Member State to withdraw the benefit of the European passport from the manager in relation to all its qualifying funds and inform the relevant Host Member States (those indicated in the registration) accordingly. To avoid regulatory ambiguity, the proposed rules should stipulate that, upon withdrawal, the benefits of the passport will cease with immediate effect.

The proposed instrument would contain detailed provisions on the requisite cross-border notification process between the competent Home and Host Member States. These notifications are triggered by the registration of a qualifying venture capital fund in accordance with the proposed Regulation. The process and legal effects of these mutual notifications are conceived and legally structured in line with the principles of Article 93 of Directive 2009/65/EC (UCITS).

To ensure the effective supervision of qualifying venture capital funds and their managers, the proposed rules would equip the competent authorities with the necessary supervisory powers and will contain provisions on the administrative cooperation between the Home and Host Member States affected by the marketing of the qualifying venture capital funds.

*7.10.5 Option 5 – Administrative network to enforce mutual recognition*

A further option would be to create a stand-alone instrument covering the mutual recognition of lawfully registered venture capital or private placement funds. The main difference between Options 4 and 5 would be that the stand-alone instrument would be based on embedding the legal principle of 'mutual recognition' into a binding legal framework. Administrative cooperation among national regulators would ensure that funds that are lawfully registered as venture capital or private operators in one Member State could offer share or other participations in their funds to a group of pre-defined eligible 'professional' investors in other jurisdictions. These jurisdictions would not require compliance with additional formalities and authorisations, such as prior approvals of offer documentation, a sales prospectus or a local distribution presence (conditions as described in Section 5.4., above).

7.10.5.1 Registration-based system

In order to facilitate mutual recognition of either the national rules pertaining to venture capital funds (cf. chart 7) or, in their absence, the rules on private placements, the Host Member State in which the qualifying fund (which could be a venture capital fund or other entity undertaking private placements for investments in SMEs) is legally established would process a registration of the fund and then inform all Host Member States designated in that registration that the qualifying fund is legally registered in its territory. Mutual recognition of a lawful registration should be available to a manager on the basis of a simple registration as either a 'venture capital' manager or a 'private

placement' operator (see section on scope of mutual recognition, below) in the EU Member State of his establishment.

In order to ensure coherence between the regulatory approaches of the AIFMD and the new instrument, the proposed stand-alone instrument would, in an initial phase, only apply to managers who operate beneath the €500 million threshold. It is envisaged that the Commission receives a mandate to review the scope and, if necessary, modify the relevant threshold.

Triggered by a simple registration in the qualifying fund's Home Member State, the registered manager would be able to market its funds in all the Member States designated in this registration. Form that moment of registration onwards, Home and Host Member States would cooperate in enforcing the mutual recognition of national private placements in their respective territories.

7.10.5.2 Scope of mutual recognition

The principle of mutual recognition could either extend to venture capital funds or all private placement vehicles that operate below the €500 million threshold. In the former case, the stand-alone instrument would, apart from the administrative cooperation arrangements underpinning mutual recognition, contain a set of uniform criteria that define a qualifying 'venture capital' fund. These criteria would correspond to those identified in the substantive options above and would notably comprise an obligatory investment percentage in favour of unlisted SMEs. In that variant, only funds that prove compliance with these criteria may benefit from the principle of mutual recognition and administrative infrastructure that will be established among national regulators to enforce the mutual recognition of lawfully executed private placements by qualifying venture capital funds.

7.10.5.3 Special rules on enforcing mutual recognition

The proposed instrument would contain detailed provisions on the requisite cross-border notification process between the competent Home and Host Member States. These notifications are triggered by the registration of a fund. The process and legal effects of these mutual notifications are conceived and legally structured in line with the principles of Article 93 of Directive 2009/65/EC (UCITS).

To ensure the effective supervision of registered funds and their managers, the proposed rules would equip the competent authorities with the necessary supervisory powers and will contain provisions on the administrative cooperation between the Home and Host Member States affected.

### 7.11 Summary of procedural options:

| OPTION | SCOPE LIMITED TO QUALIFYING VENTURE CAPITAL FUNDS | LEGISLATIVE TECHNIQUE |
|---|---|---|
| 1 –Venture capital passport within the AIFMD | Limited to qualifying funds | Review of AIFMD, intorduction of special rules on regulatory cooperation and introductions of specific "carve-outs" from the AIFMD's operational rules to provide passport to 'qualifying' venture capital funds without full compliance with AIFMD. |
| 2- Lower the thresholds of AIFMD | All funds with assets below € 500 million | Review of AIFMD to modify the applicable thresholds without any further substantive changes to the rules of the |

| | | AIFMD. |
|---|---|---|
| 3 – Special rules for venture capital at level 2 of AIFMD | Limited to qualifying funds, as defined at level 2 of the AIFMD | Implementing rules at level 2. Advice will be sought from ESMA on how to cater to the special situation of venture capital funds. If ESMA advises on a tailor-made approach for such funds, the corresponding rules would be codified at level 2, when implementing the AIFMD. |
| 4- Venture capital passport as stand-alone instrument | Limited to qualifying funds | Creation of a stand-alone legal instrument containing rules on qualifying vneture capital funds, regulatory cooperation for their effective supervison and tailor-made operational rules different from those in the AIFMD |
| 5- Mutual recognition | Either limited to qualifying venture capital funds or applicable to all lafully offered private placements by registered funds. | Creation of a stand-alone legal instrument containing rules on regulatory cooperation for the effective supervison of the mutual recognition of lawfully registered venture capital or private placement providers. |

## 7.12 Analysis of the procedural options

Below, five options will be assessed in terms of their effectiveness, coherence and efficiency in attaining the operational objectives. Procedural options relate to the different legislative tools or vehicles that might be used for addressing the substantive options already noted. These procedural options form a second building block, in that different procedural options have different costs and benefits for addressing the problems that investors, venture capital funds as well as SMEs encounter in the current fragmented operating environment.

### *7.12.1 Operational objective 1: Establishment of a uniform notion of 'qualifying venture capital fund'*

A core feature of a European common EU definition of venture capital is the fact that a common regulatory approach can be attached to this definition. The common definition, in the instant case, serves to determine the kind of fund vehicle that will benefit from a passport exempting foreign fundraising activities both from both national rules on private placements that apply in various host countries and from the rules contained in the AIFMD (Options 1 and 4). A qualifying European venture capital fund should, once the common regulatory approach becomes applicable upon registration, no longer be burdened with administrative costs that venture capital fund managers currently face when operating in several Member States (setting up parallel fund structures, multiple and overlapping reporting obligations, etc.).

Most importantly, the costs related to starting up a new fund in each jurisdiction where placements are envisaged, as well as costs related to maintenance of parallel fund infrastructures (for a duration of often 10 years) would be eliminated.[72] The European passport would also increase legal certainty for venture capital fund managers that engage in cross-border placements. Both Options 1 and 4, by defining clear contours of what constitutes a venture capital fund, would allow for a reduction in the above-mentioned costs linked to obtaining legal advice for multi-jurisdictional fundraising.

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[72] See Expert group report on removing obstacles to cross-border investments of venture capital funds, chapter 4.1 showing an example of the costs associated with maintaining parallel fund structures in several Member States.

The advantage of Option 4 over Option 1 resides in the fact that this Option would achieve the benefits associated with option 1 without creating interference with the current rules as contained in the AIFMD. When compared with Option 1, Option 4 displays a series of further advantages. Due to the fact that Option 4 would grant a specific venture capital passport to qualifying managers by means of an autonomous instrument, the intended beneficiaries of this instrument can be narrowly circumscribed and therefore effectively supervised. Therefore, other operators who may wish to obtain the passport, such as private equity, real estate funds or other closed-ended vehicles that invest in real property are not covered by the scope of a stand-alone instrument. The stand-alone approach allows for a significant reduction of the potential for circumvention.

Option 2, on the other hand, would include all alternative investment funds that operate below €500 million into the scope of the AIFMD by lowering or entirely abolishing the applicable thresholds. The drawback with this approach would be that it would make compliance with all the provisions of the AIFMD obligatory on all alternative investment funds and thus comprise all 'small' funds, including venture capital funds, within the scope of the AIFMD. This option would not define the contours of what makes a European venture capital fund distinct from other alternative investment funds that operate beneath the thresholds. Essentially, a regulatory framework designed for fund managers whose aggregate assets exceed € 500 million and who are highly prone to employ leverage and other sophisticated financial techniques to increase their exposure to risky asset classes, would be enlarged to a category of fund managers that operate below the €500 million threshold, invest capital committed into equity stakes in SMEs, do not engage in leverage and cannot, in terms of human and material resources, comply with the regulatory requirements of the AIFMD (most venture capital funds do not employ more than a dozen people (see Annex VIII)). Option 2 would therefore not be a suitable tool to create a European notion of venture capital.

Although the lowering or complete abolition of the threshold would grant smaller venture capital funds a passport, the price in terms of additional administrative burden would be prohibitive. Compliance costs resulting out of regulatory fragmentation between host countries would be replaced by the cost of complying with a regulatory framework designed for funds that engage in much more complex financial instruments. Lowering the AIFMD thresholds would therefore be of limited or no value in creating a common notion of what constitutes a venture capital funds. Option 2 is therefore not effective in achieving the intended aim -- to create a European marketing passport without the necessity of full compliance with many of the AIFMD provisions that do not appear suitable for venture capital funds (e.g., rules on minimum capital requirements, delegation, depositaries, liquidity management, valuation of assets or the calculation of leverage).

Modulating the implementation rules at level 2 to create a special framework for venture capital funds (Option 3) would, at first sight appear to be a suitable approach in order to create a common notion of venture capital at EU level. However, the drawback of this option would be that the 'special regime' governing the European marketing activities of venture capital operators would be entirely dependent on the appropriate policy choices taken at a level inferior to that of primary legislation. In these circumstances, these level 2 choices would be constrained by the primary rules contained in the AIFMD, which take precedence over any deviating provisions contained in level 2 rules. As level 2 measures need to be firmly embedded within the parameters of the legal obligations that arise from the AIFMD itself, the scope for adopting a meaningful system for venture capital at level

2 appear rather constrained. Although the AIFMD, at level 1, provides for certain opening in favour of a modulated approach, the overall intention of the AIFMD is to apply a uniform set of reporting and operational requirements on all alternative investment funds, irrespective of their different lines of business. These constraints leave too little scope to develop a meaningful European approach to venture capital funds.

The Commission has been working on an appropriate system of mutual recognition for several decades now. The major pitfalls in this approach (Option 5) result from the fact that mutual recognition pre-supposes a requisite revel of regulatory convergence between the national systems that would be the subject matter of mutual recognition. However, the description of the national rules on venture capital and, in their absence those covering 'private placements' by venture capital funds, shows that various sets of rules covering either venture capital funds or, in their absence, private placements and prospectus requirements, are far too heterogeneous for the successful application of mutual recognition. As chart 7 demonstrates, even among the eight Member States that have instituted specific rules dedicated to the development of venture capital funds, aim and legislative techniques diverge considerably. Some Member States amalgamate the promotion of venture capital with regional policy (Austria, France), while others link it to the promotion of domestic industries (Germany, UK). It is easily conceivable that fund-raising by such entities would not be uncontested in host Member States (whose industry would not benefit from the activities of the particular venture capital fund). Furthermore, some Member States take a very narrow and targeted approach to venture capital funds, requiring that the fund invests a high percentage of its committed capital in entities that do not exceed a certain age of corporate existence and that do not themselves exceed strict turnover thresholds. Again, it is difficult to conceive that Member States that apply such a narrow view would be inclined to apply mutual recognition with respect to venture funds that originate in jurisdiction where the designation 'venture capital fund' denotes a broader approach (fear of dilution).

Finally, it is important to note that 18 Member States do not have rules dedicated to venture capital. These Member States apply general rules on private placements, prospectuses, financial intermediaries or rely solely on company law (e.g., Belgium). If venture capital funds originating in one of these countries would wish to raise capital with investors in another country that has no specific 'venture capital' rules, there is no tangible basis on which the concept of 'mutual recognition' could rest. In these circumstances, as also described in Section 5, national approaches to venture capital or private placements are too different for a system of mutual recognition to work on a conceptual basis. This conclusion would apply to both variants of mutual recognition, as described in the section on scope above (section 7.11.2). Mutual recognition is thus not an approach conducive to developing a common understanding on a European notion of venture capital funds.

#### *7.12.2 Operational objective 2: Create a common regulatory approach for qualifying venture capital funds*

The major disadvantage associated with a special 'venture capital' passport embedded within the "passport" chapter of the AIFMD (Option 1) would be the lack of coherence that a special passport for venture capital below the € 500 million threshold would be combined in one set of rules with a more general passport applying to all alternative fund managers. This lack of legal coherence introduces additional complexity into the already complex provisions of the AIFMD. The AIFMD would contain a general passport applicable to all alternative investment funds that manage assets in excess of € 500

million and comply with its provisions alongside a specific passport for sub-threshold venture capital operators. In these circumstances, it would require complex legal techniques to limit the benefit of the tailor-made passport to the intended beneficiaries. Despite these drawbacks, a solution along the lines was favoured by two Member States and found support among a few industry players. This option has not, however, gained wider stakeholder support.

In addition, careful reasoning would need to be deployed to delineate the passport to the intended beneficiaries and avoid that other operators who wish to escape full compliance with the AIFMD would obtain a passport without full compliance with the AIFMD. For example, operators who may wish to obtain the passport include private equity, real estate funds or other closed-ended vehicles that invest in real property. It might be difficult, in practical terms, to exclude these operators once the AIFM-D is under review.

It is also true that the AIFMD, as its name implies, pursues the approach of encompassing all alternative investment funds that operate above the thresholds. It would therefore be difficult for Option 1 to achieve the intended aim -- to create a common regulatory approach to venture capital -- within the more general framework of the AIFMD.

The inclusion of below-threshold fund managers into the scope of the AIFMD, as proposed in Option 2, might appear an easy way to align the divergent national regulatory approaches into a single EU one. As the lowering of thresholds in relation to all 'small' funds is, however, unsuitable to differentiate between venture capital funds and alternative investment funds that pursue other business strategies, Option 2 does not foster a common EU-wide understanding of venture capital funds this Option is not suitable for the development of a common regulatory approach to such funds.

It would also be difficult to achieve the desired level of regulatory convergence in the national approaches governing venture capital by adapting the AIFMD at level 2 (Option 3). An approach that relies solely on level 2 rulemaking on venture capital funds would face too many regulatory constraints resulting from the need to comply with level 1. Developing a common regulatory approach at level 2 of the AIFMD is therefore not able to lead to a common EU approach to the regulatory treatment of venture capital funds. Most stakeholder also converge in stating that any approach taking AIFMD, level 1 rules as a starting point would lead to an approach that was too burdensome and unsuitable for smaller and more specialised venture capital fund managers.[73]

As the venture capital passport foreseen in Option 4 is not embedded within the wider scope of the AIFMD, it stands a better chance of developing into a visible and recognised brand, a development that would potentially follow the development of the UCITS brand. As regulatory friction between the AIFMD and the proposed stand-alone instrument would be reduced, this instrument has higher potential to create a visible 'venture capital' brand and thus achieve the intended goal of a common EU approach to the regulatory treatment of venture capital funds. This option was the most strongly supported approach, both by industry and public authority respondents to the public consultation. These two groups differed, however, as to whether the new instrument should cover all qualifying venture capital fund managers regardless of the application of the € 500

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[73] www.evca.org

million threshold or only sub-threshold fund managers. Three Members States spoke in favour of a bespoke sub-threshold regime, while another Member State argued for a uniform framework that was independent of the AIFMD thresholds.

The enforcement of the 'mutual recognition' principle (Option 5) would be incumbent on the different national securities regulators, precisely the entities that, in the absence of further harmonisation of the 'private placement' rules, would be reluctant to apply the principle of mutual recognition. Option 5 cannot, in the absence of further harmonisation of the notion of the elements that distinguish a venture capital fund from other forms of alternative investment funds, achieve the intended goal of creating a common European approach governing the fundraising activities of such funds.

#### *7.12.3 Operational objective 3: Create a network of administrative cooperation for the supervision of qualifying venture capital funds*

Embedding the venture capital passport within the wider scope of the AIFMD (Option 1) provides less visibility and prevents the intended emergence of a 'European venture capital fund' as a recognised brand. Without this common brand, administrative cooperation will become a rather more difficult endeavour.

The result of Options 2 and 3 would, in light of the analysis above, amount to the exact opposite of the intended policy aim – a European approach to the fundraising activities of venture capital funds in a cost-efficient manner also for the regulators that have to supervise compliance – these options are not a suitable basis for administrative cooperation that is tailored to an effective supervision of venture capital funds.

With Option 4, the regulatory distinction between the supervision of alternative investment funds and venture capital funds would be maintained. This clear demarcation would allow regulatory cooperation for the all-encompassing approach pursued in the AIFMD to be clearly distinct from those applicable to venture capital funds. As a clear distinction between the two regulatory spheres would be maintained, appropriate forms of supervisory cooperation tailored to the activities of venture capital funds can be introduced into the stand-alone framework that exists autonomously alongside the AIFMD.

In light of the above analysis, it is not deemed realistic that Option 5 would be sufficient to overcome obstacles to mutual recognition that stem from divergent regulatory approaches on matters of substance. Quite to the contrary, due to high potential for friction between divergent regulatory approaches, a network of regulators confined to assessing mutual recognition between heterogeneous national schemes is not expected to be efficient on the ground.

## 7.13 Summary of impacts: procedural options

| OBJECTIVES:<br><br>OPTIONS: | CREATE NOTION OF QUALIGYING VENTURE CAPITAL FUND | ENSURE COMMON REGULATORY APPROACH TO QUALIFYING VENTURE CAPITAL FUNDS | FACILITATE REGULATORY COOPERATION |
|---|---|---|---|
| 1 –Venture capital passport within the AIFMD | Very effective to create a common EU notion of venture capital fund, valid across EU jurisdictions (++) | Regulatory friction with AIFMD, risks diluting aims of AIFMD, risk of freeriding by non-qualifying funds ( --) | Potentially less visibility for venture capital passport, thus difficult to create common enforcement culture (--) |
| 2- Lower the thresholds | General lowering of threshold, | No regulatory friction with | Inefficient, as no common notion is |

| of AIFMD | not distinguishing between business strategies, is not effective in creating common notion of venture capital (--) | AIFMD (+) | created, thus no basis for a common enforcement culture (--) |
|---|---|---|---|
| 3 – Special rules for venture capital at level 2 of AIFMD | Only effective in creating common notion, if there is flexibility at level 2 (-) | Regulatory friction with AIFMD, as level 2 cannot derogate from the level 1 provisions (--) | Potentially too many constraints at level 1 for this system to produce a common notion of venture capital funds that serves as a basis for a common enforcement culture (-) |
| 4- Venture capital passport as stand-alone instrument | Very effective to create common notion valid across all EU jurisdictions (++) | Stand-alone instrument avoids risk of friction with AIFMD (+) | Stand-alone instrument has higher potential to create a visible 'venture capital' brand creating basis for common enforcement culture (+) |
| 5- Mutual recognition | Ineffective, due to the heterogeneous set of national rules that cover 'venture capital' (--) | High potential friction between national regulators who would be tasked to apply the system of 'mutual recognition' (--) | Due to high potential friction, the absence of a common notion of venture capital funds, the network of regulators might not be efficient on the ground (--) |

"++" strongly positive, "+" positive, "—"strongly negative, "-" negative, "=" marginal/neutral, "?" uncertain, and "n.a." not applicable.

As reflected in the above table, procedural Options 2, 3 and 5 are not able to attain the stated aims in an effective manner. Option 2 is ineffective as a general lowering of the AIFMD threshold does not achieve the emergence of a common regulatory approach for venture capital funds operating beneath the thresholds. Option 3, while better suited to achieve the stated goals, ultimately fails as the envisaged level 2 measures must respect the constraints of the level 1 framework of the AIFMD. A tailor-made regulatory system for venture capital funds, even if carefully crafted, risks falling foul of the stringent requirements at level 1 that govern issues such rules on minimum capital requirements, delegation, depositaries, liquidity management, valuation of assets or the calculation of leverage. Full compliance with these requirements, tailor-made for systemically relevant investment strategies that involve a high level of leverage do not appear suitable for venture capital funds.

Option 5, in the absence of a higher level of regulatory convergence between Member States, is not effective in reaching the stated aim (a common understanding of what constitutes a venture capital funds that can serve as a basis for a joined-up regulatory and enforcement culture with regard to such funds).

A choice has, therefore, to be made between Options 1 and 4. Option 4 is deemed the most effective option to achieve the intended goal, which is to create a legal framework facilitating fundraising across the European Union. While Option 1 is also effective in achieving this aim, it comes saddled with issues involving the coherence of the AIFMD, a directive which would have to accommodate a strict supervisory approach vis-à-vis alternative fund managers with a more permissive approach for qualifying venture capital funds. Option 1 is also encumbered with a potential 'free-rider' issue, as funds that are not strictly qualifying venture capital funds would attempt to convince national regulators to extend the favourable treatment for venture capital funds to their cross-border fund-raising activities as well. Finally, Option 4 appears more efficient than Option 1 to establish a recognised European 'venture capital' brand.

# 8 COMPARISON OF OPTIONS AND POLICY CHOICE

The table below consolidates all substantive and procedural options and displays them in a single matrix. On this basis, a choice can be made by combining various substantive and procedural options.

## 8.1 Overall summary of procedural and substantive options

<table>
<tr><th>OPTION</th><th>LEGISLATIVE TECHNIQUE</th><th colspan="3">SUBSTANTIVE SCOPE</th></tr>
<tr><td rowspan="3">1 –Venture capital passport within the AIFMD</td><td rowspan="3">Review of AIFMD, introduction of special rules on regulatory cooperation and introductions of specific "carve-outs" from the AIFMD's operational rules to provide passport to 'qualifying' venture capital funds without full compliance with AIFMD.</td><td colspan="3">Passport limited to qualifying VC funds</td></tr>
<tr><td>Option 1:<br>> 50% of capital in unlisted SME</td><td>Option 2:<br>> 70% of capital in unlisted SME</td><td>Option 3:<br>> 90% of capital in unlisted SME</td></tr>
<tr><td>Option 1: Mifid investors</td><td>Opton 2: All traditional VC investors</td><td>Option 3: unlimited, including retail investors</td></tr>
<tr><td>2- Lower the thresholds of AIFMD</td><td>Review of AIFMD to modify the applicable thresholds without any further substantive changes to the rules of the AIFMD.</td><td colspan="3">All funds with assets below €500 million<br>Open to professional investors as defined in AIFMD</td></tr>
<tr><td>3 – Special rules for venture capital at level 2 of AIFMD</td><td>Implementing rules at level 2. Advice will be sought from ESMA on how to cater to the special situation of venture capital funds. If ESMA advises on a tailor-made approach for such funds, the corresponding rules would be codified at level 2, when implementing the AIFMD.</td><td colspan="3">Limited to qualifying funds and eligible investors as defined by ESMA and implemented in specific level 2 provisions</td></tr>
<tr><td rowspan="3">4- Venture capital passport as stand-alone instrument</td><td rowspan="3">Creation of a stand-alone legal instrument containing rules on qualifying venture capital funds, regulatory cooperation for their effective supervison and tailor-made operational rules different from those in the AIFMD</td><td colspan="3">Passport limited to qualifying VC funds</td></tr>
<tr><td>Option 1:<br>> 50% of capital in unlisted SME</td><td>Option 2:<br>> 70% of capital in unlisted SME</td><td>Option 3:<br>> 90% of capital in unlisted SME</td></tr>
<tr><td>Option 1: Mifid investors</td><td>Option 2: All traditional VC investors</td><td>Option 3: unlimited, including retail investors</td></tr>
<tr><td>5- Mutual recognition</td><td>Creation of a stand-alone legal instrument containing rules on regulatory cooperation for their effective supervison of the mutual recognition of lawfully offered private placements either by:<br>- registered funds or<br>- qualifying and registered funds.</td><td colspan="2">Option 1:<br>Mutual recognition limited to qualifying VC funds (as in Options 1 and 3) r applicable to all funds below €500 million.</td><td>Option 2: Mutual recognition for all lawful private placements offered by managers whose aggregate assets in total are below €500 million. The definition of the qualifying fund and that of eligible investors would be left to national rules.</td></tr>
</table>

On the basis of this matrix, the best combination of procedural and substantive options can be selected.

## 8.2 Presentation of most promising combinations between procedural and substantive options

In light of the analysis of substantial and procedural options that was conducted in the previous sections three combinations of substantive and procedural options are identified as promising a reasonable prospect of achieving the above stated policy aims.

| COMBINED OPTIONS | LEGISLATIVE TECHNIQUE | SUBSTANTIVE SCOPE |
|---|---|---|
| Option 1:<br>Sub-options 1/3/2:<br>Venture capital passport within the AIFMD, high threshold, all traditional VC investors | Review of AIFMD, introduction of special rules on regulatory cooperation and introductions of specific "carve-outs" from the AIFMD's operational rules to provide passport to 'qualifying' venture capital funds without full compliance with AIFMD. | **<u>Passport limited to qualifying VC funds</u>**<br>Option 3: > 90% of capital in unlisted SMEs<br>Opton 2: All traditional VC investors |
| Option 2:<br>Sub-options 4/2/2:<br>Venture capital passport as stand-alone instrument, intermediate threshold, all traditional VC investors | Creation of a stand-alone legal instrument containing rules on qualifying venture capital funds, regulatory cooperation for their effective supervison and tailor-made operational rules different from those in the AIFMD | **<u>Passport limited to qualifying VC funds</u>**<br>Option 2: > 70% of capital in unlisted SMEs<br>Option 2: All traditional VC investors |
| Option 3:<br>Sub-options 4/1/2:-<br>Venture capital passport as stand-alone instrument, low threshold, all traditional VC investors | Creation of a stand-alone legal instrument containing rules on qualifying venture capital funds, regulatory cooperation for their effective supervison and tailor-made operational rules different from those in the AIFMD | **<u>Passport limited to qualifying VC funds</u>**<br>Option 1: > 50% of capital in unlisted SMEs<br>Option 2: All traditional VC investors |

## 8.3 Analysis of combined options

The analysis of the short-listed options (combining options on (i) portfolio composition and eligible investors with (ii) procedural alternatives) directly addresses the costs and benefits of the options, including in particular their effectiveness in relation to problems relating to restrictions of investors' choice, inefficient venture capital funds/managers operating conditions, inadequate SMEs financing mixes, as well some broader economic and social issues.

### *8.3.1 Impact on venture capital flows – anticipated re-allocation effects*

All combined options would most likely have some desired re-allocation effects. In an ideal scenario Option 1/3/2, on account of its 90% threshold requirement, would achieve the highest level of reallocation between venture capital and other comparable asset classes. Option 4/2/2 would score at intermediate level, while Option 4/1/2 would most closely resemble the current EU asset mix. For these reasons, Option 4/1/2 would not achieve the intended aim of reallocating assets to venture capital funds.

A decision will have to be made between Option 1/3/2 and Option 4/2/2. With both options, anticipated reallocation effects would, however, be limited to comparable asset classes. It is not to be expected that an increase in capital flows to venture capital funds would reallocate assets across different risk classes. Pension funds, insurance companies, or other risk-averse investors, would not switch more than their current percentages of investments toward venture capital (these percentages are contained in table 3, annex X) just because fund-raising for this asset class has become easier.

Essentially, any replacement effect that more capital commitments to venture capital funds would produce would be replacements between asset classes that most closely resemble each other. Replacement effects would therefore occur in respect of asset classes that display a risk profile similar to that of venture capital. The greatest replacement impact would likely be on the market for comparable types of risky assets. The impact would be therefore mostly be on other categories of venture capital

investments, including funds targeting venture capital elsewhere globally, investments in emerging market assets, certain kinds of private equity investments or investments in speculative or innovative hedge fund strategies.

The scale of the anticipated reallocation effects is a reflection of the degree to which market efficiency relating to raising venture capital funds is increased. Option 4/2/2, on account of its expected take up and relative lack of regulatory friction is expected to lead to a higher reallocation to venture capital funds than Option 1/3/2. The latter, as mentioned above, suffers from some degree of regulatory friction in relation to the AIFMD. Even when combined with the higher threshold reserved for qualifying investments, Option 1/3/2 is not expected to give rise to the optimal reallocation that is achieved with a stand-alone instrument such as Option 4/2/2. Current experience with the implementation of the AIFMD, level 2[74], shows that the legal certainty arising from clearly delineated legal frameworks outweighs possible advantages related to a higher investment portfolio threshold.

In addition, as mentioned above, the enforcement of an option that stipulates a high percentage in favour of qualifying investments raises the difficult 'oscillation' issue of funds whose investment portfolio hovers on the threshold for considerable periods of their existence. This is a powerful disincentive for venture capital fund's using a passport that hinges on a 90% threshold.

Finally, the relative ease of regulatory enforcement that is associated with Option 4/2/2 (see analysis in Section 7.3 and 7.10) makes it easier for this option to achieve capital inflows to qualifying venture capital funds. It is a contention of this impact assessment that EU venture capital funds are under-represented in EU investment portfolios due to market inefficiencies. Option 4/2/2 is, on balance, the most promising option to correct the relative underperformance of EU venture capital operations and this Option would therefore enable EU venture capital funds to better compete alongside funds specialising in other risky asset classes on a level playing field.

As to the scope of the expected reallocation effect, the following assumptions can be made. If the implementation of Option 4/2/2 would increase investors funds that are allocated to venture capital funds, the cross-border capital flows channelled to venture capital would more closely resemble those of the private equity industry. Currently, as explained above, private equity raises 20% of their assets abroad while venture capital raises 12% of their assets abroad. If Option 4/2/2 was successful in rebalancing these flows, the assumption could be made that the capital inflows into qualifying venture capital funds would rise to between 15% and 17% (with a possible reduction on cross-border capital inflows to private equity).

Taking the figures provided in table 12 (Annex X), i.e., that venture capital raised €21,1 billion, €2.5 of which from other EU jurisidition than the fund's home Member State, the following inflow scenarii can be calculated:

| Scenarios | Cross-border capital raised in a three year period | **% increase** |
|---|---|---|

[74] Work at implementing AIFMD, level 2, is complicated by the fact that distinctions between different funds and different investment strategies are materially relevant but difficult to accomodate in a legislative instrument that follows an all-encompassing approach.

| 12% (current situation) | €2.5 billion | |
|---|---|---|
| 15% (intermediate short-term scenario) | €3.16 billion | + **26.4%** |
| 17% (optimistic short-term scenario) | €3.58 billion | + **43,2%** |
| 20% (long-term stable scenario) | €4.2 billion | + **68%** |

As the last row demonstrates, if cross-border fundraising for venture capital would be aligned with current levels achieved by UCITS funds – the 20% raised by UCITS funds in other jurisdictions than their home Member State seems to reflect a stable equilibrium that can be achieved after two decades of relatively open cross-border capital markets – the capital allocated to venture capital funds would rise to €4.2 billion - an increase of 68% over the current situation.

### 8.3.2 *Economies of scale*

On the basis of the above calculations, Option 4/2/2 would constitute an effective tool to increase cross-border fund-raising capacity for venture capital funds, thus potentially raising the capital pool that is available to specialist funds dedicated to provide equity financing to SMEs.

The overall impact that increased cross-border capital flows can have in increasing the average size of assets managed by a European venture capital fund is difficult to quantify. The starting point is that, in 2010, 635 venture capital funds operated in Europe (Table 1, Annex X). These funds, between themselves, raised €21.1 billion in three years (2007-2010) which, on average, equates to €33 million raised per fund in this period. Additional fundraising estimates can thus be calculated as follows:

| Scenarios | Cross-border capital raised in a three year period/fund | Anticipated cross-border capital raised in a ten year period | **% increase over ten years** |
|---|---|---|---|
| 12% (current situation) | €3.9 million | €12.9 million | |
| 15% (intermediate short-term scenario) | €4.9 million | €16.2 million | + **49%** |
| 17% (optimistic short-term scenario) | €5.6 million | €17.5 million | + **53%** |
| 20% (long-term stable scenario) | €6.6 million | €21.8 million | + **66%** |

As the table above shows, the increases in capital raised per fund will be considerable, especially when considered in a 10 year perspective. On the other hand, the impact on average assets under management will still be incremental. Over a ten year period (reflecting the average life span of a venture capital fund) the sums, would, however, start making a meaningful contribution to overall fund sizes. This is especially true as the entire table is based on allocating all increased cross-border flows to the overall amount of 635 venture capital funds that, in 2010, operated across Europe. In reality, the allocation of the net increases in capital flows will not be so evenly distributed, with bigger funds garnering a greater share of the anticipated overall increase.

In these circumstances, the fact that deeper capital pools would not immediately boost the average size of European venture capital funds from between €60 million in assets under management to the desired threshold of €230 million in assets under management, should not detract from the usefulness of Option 4/2/2. Progress will necessarily be incremental and, as the figures above demonstrate, will take several years to come to fruition.

The above calculations also neglect an important multiplier effect. While it is not possible to quantify precisely how much the additional capital that is raised across national borders would generate in additional capital that is overall committed to venture capital funds, a rough estimation would consider that an increase of cross-border capital commitments to venture capital in the range of 1% would result in additional € 50 million to be channeled into venture capital funds[75].

### *8.3.3 Impact on existing national rules governing venture capital funds*

All of the possible combinations of options would have some impact on existing national frameworks covering venture capital funds, especially in those Member States that have adopted rules dedicated to the operation of such funds. Option 4/1/2 which would seamlessly integrate within the existing status quo (which the industry estimates to be the 50/50 split between qualifying and non-qualifying investments), although the threshold in Option 4/2/2 would more closely resemble the benchmark in those Member States that have instituted rules dedicated to venture capital. The discrepancy between the status quo and the regulatory requirements detailed in chart 7 is mostly due to the low take-up that national systems have achieved, notably on account of the strict "location" requirements in relation to the target undertaking (c.f., the current systems in Austria, Germany, the UK and some of the models in France).

On the other hand, Option 1/3/2 entails a significant departure from the prevalent national systems, mostly on account of the more ambitious portfolio threshold that is reflected in none of the current regulatory approaches.

In the end, the issue of interaction between the new European rules governing venture capital and the existing national schemes should not be overestimated. While the venture capital fund framework could impact national fund regimes already targeting venture capital, it would be for Member States to consider whether existing frameworks might be adjusted for consistency with the new European framework. Even in those Member States that have rules on venture capital overall adaptation requirements are not expected to be very high, as the chosen EU approach, based on a qualifying investment portfolio and on investments in certain qualifying investment targets reflects the best practice found in existing national rules. It is also important to note that the European rules on venture capital fundraising would only apply for those funds who chose to register in order to benefit from the envisaged regulatory framework. Funds, whose activities remain focused on domestic investors, would not be affected by the envisaged rules.

### *8.3.4 Impact on the geographic location of venture capital activities*

All combined options presented above would, to various degrees, impact cross-border marketing. It is to be expected that, in a first phase, those fund jurisdictions that have developed strong infrastructures for investment funds (UK, Germany, Sweden, Denmark, Finland, the Netherlands, France and Spain, cf. Section 4.2 and 4.3), would attract more capital flows originating in those jurisdictions that have not done so. In a second phase, the latter jurisdictions will have a powerful inventive to 'catch up' and create attractive fund infrastructures, so as to attract capital from investors in other Member States.

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[75] Based on last 4 years' average of VC investing €5bn on an annual basis in approximately 3.000 SMEs.

Again, the impacts of any of the three combined options should not be overestimated. While there might be some reallocation to attractive 'fund jurisdictions', evidence suggests however that VC funds will continue to be located close to their target companies, thereby limiting the extent of such geographic redistribution of fund business.

#### *8.3.5 Shift in the SME 'financing mix'*

All options under discussion are based on a strict requirement that qualifying venture capital funds most invest in equity or quasi equity issued by the target companies. Due to the relatively strict requirements with respect to a venture capital fund's investment portfolio and the qualifying investment tools, the success of the envisaged fund-raising passport would likely have an impact on financing forms, with a re-allocation from debt instruments to equity. As Option 4/2/2 scores highest in respect of achieving the intended reallocation of funds toward venture capital, this option would, in consequence, be best placed to improve the SMEs financing mix. Option 4/2/2 therefore scores best in ensuring stable long-term financing to SMEs in the early stages of their development.

#### *8.3.6 Impact on European competitiveness*

This section discussed follow-on effects once the principal objective of raising more funds to be channeled into funds that reflect a European notion of venture capital funds is achieved.

A deeper and more liquid market for venture capital fundraising would increase the overall capital commitments that are channeled toward venture capital funds. Better allocation of capital flows to high growth and innovative sectors like life science, energy and environment or computer and electronics is beneficial for European growth.

Option 4/2/2, due to creating the deepest capital pool available to venture capital funds, could foster more specialization on the part of the European venture capital industry. Higher specialization would allow venture capital funds to concentrate on particular industries (e.g., biotechnology, cleantech, renewable energies) and increase the size of their investments per company. Larger fund sizes would thus lead to more meaningful investment, better focus in the venture capital fund sector and an increased performance and competitiveness of the venture financing business in Europe.

Furthermore, more venture capital financing being channeled into early stage developments of innovative products and services would also trigger positive spillover effects and increase research and development spending of public and private firms. According to latest research it is estimated that an increase in venture capital investments in the range of 0.1% of Gross Domestic Product (GDP) is statistically associated with an increase in real GDP growth of 0.30 percentage points. Early-stage investments have an even bigger impact of up to 0.96 percentage points[76].

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[76] Th. MEYER, "Venture Capital Adds Economic Spice", D*eutsche Bank Research,* September 14, 2010.

### *8.3.7 Impact on jobs*

According to a 2005 study[77], companies backed by venture capital between 1997 and 2004 created about 630.000 new jobs in the EU in the period from 2000 to 2004. Although difficult to predict how a venture capital passport would affect the creation of new jobs, the high potential of venture capital funded business to create above average employment growth is well documented (Yannis Pierrakis et al, NESTEA research report, June 2009, cited in Annex XII).

## 8.4 Overview of costs and benefits of combined options

| Option | | Costs and benefits by stakeholder group | | | | Overall Assessment |
|---|---|---|---|---|---|---|
| Combined option | Sub-options | VC Fund Managers | Investors | Portfolio companies | Economy | |
| 1 | Procedural:1<br>Portfolio: 3<br>Investors: 2 | (-) risk of regulatory overlap if new VC rules are contained in AIFMD<br><br>(--) disruption of existing business practices leading to limited uptake of the new framework | (++) all traditional VC investors can be offered VCF investments<br><br>(-) no improvement in portfolio diversification due to low VCFM take-up | (-) inefficiencies in portfolio companies financing structure remain<br><br>(--) may lead to disproportionately high reporting costs | (-) contribution of VCF sector to more efficient and competitive economy limited | (-) |
| 2 | Procedural: 4<br>Portfolio: 2<br>Investors: 2 | (++) benefit from single and separate set of rules, brings legal certainty<br><br>(+) intermediate obligatory portfolio benefits existing business practice | (++) all traditional VC investors can be offered VCF investments<br><br>(++) benefit of greater investment choice/portfolio diversification | (++) benefit from improved and more efficient financing structure<br><br>(+) proportionate compliance costs related to reporting | (++) VCF sector can explore its full potential<br><br>(++) conducive environment creates more VC flows – more firms financed and – more jobs created | (++) |
| 3 | Procedural: 4<br>Portfolio: 1<br>Investors: 2 | (++) benefit from single and separate set of rules, brings legal certainty<br><br>(++) high fund structuring | (++) all traditional VC investors can be offered VCF investments<br><br>(--) possible investor | (-) innovative, young companies do not benefit from increased VC flows, bias towards private equity persists | (-) limited chance for VCF sector to fully exploit its full potential | (+) |

[77] Employment contribution of PE and VC in Europe, EVCA Publication, October 2005

| | | | | | | |
|---|---|---|---|---|---|---|
| | | flexibility benefits existing business practice | confusion as difficult to distinguish between VCF and traditional private equity funds<br><br>(-) investors' bias towards private equity remains | | | |

### 8.5 Policy choice and its key features

It results from the impact analysis above, that the preferred Option (Option 4/2/2) would be a stand-alone instrument (preferably a Regulation), compliance with which would entitle only a qualifying venture capital fund manager (who invests at least 70% of aggregate capital contributions in equity or quasi-equity instruments issued by unlisted SMEs) to market all the funds in its portfolio which themselves comply with the Regulation in several Member States across the European Union (Option 4). Marketing would be allowed in respect of all traditional venture capital investors.

The coexistence of the proposed stand-alone rules and the AIFMD would be organised on the basis of mutual autonomy between two distinct sets of legal rules. This manner of proceeding avoids any unwanted legal complexity and possible ambiguity that would result from the EU passport for qualifying venture capital funds and the passport applicable to all other alternative investment funds being covered in one and the same legal instrument.

The chosen approach appears the most efficient because, in practical terms, a fund manager who complies with all of the substantive requirements set forth in the proposed instrument would obtain a European passport without the necessity to:

– opt into the regulatory framework and passport system provided in Directive 2011/61/EC or

– Comply with the residual – and very heterogeneous - national rules on venture capital funds, private placements, prospectuses or requirements on local distribution.

**Box 4: Key features and workings of preferred option**

- The new framework will be voluntary. This implies that venture capital managers will not be obliged to abide by the uniform rules. As long as they wish to market their qualifying funds across the Union under the designation "European Venture Capital Fund", compliance with the uniform rules will be necessary. Non-compliance with the uniform rules will be sanctions by the withdrawal of the right to use the designation.

- Should the manager wish to benefit from the marketing passport it has to register with the regulator in its home Member State (i.e., the Member State where the manager is domiciled). The passport will only be available for managers domiciled in a EU Member State. The home Member State will register all funds that comply with the uniform framework. Essential requirements are: the venture capital fund invests at least 70% of investor's capital into unlisted SMEs; the venture capital fund invests in equity or quasi-equity directly issued by the SME (i.e., provides 'fresh capital'); the venture capital fund does not engage in leverage (i.e., invests more than the capital committed by investors).

- The proposed instrument would contain detailed provisions on the requisite cross-border notification process between the competent Home and Host Member States. These notifications are triggered by the registration of a qualifying venture capital fund in accordance with the proposed Regulation. The process and legal effects of these mutual notifications are conceived and legally structured in line with the principles of Article 93 of Directive 2009/65/EC (UCITS)

- Fund managers benefiting from the passport will have to comply with general principles governing the behaviour of a qualifying venture capital manager, notably in the conduct of its activities and in its relationship to investors, rules on the handling of conflicts of interest, organisational requirements in terms of adequate human and technical resources, rules on the valuation of a qualifying venture capital fund's assets and the customary provisions on annual reports. In addition, the new instrument would contain key disclosure requirements that are incumbent on a qualifying fund in relation to its investors

- The home Member State can withdraw the passport if the venture capital fund manager does not fulfil any of the above mentioned essential requirements. Withdrawal of the passport will also lead to removal of the fund from the register of qualifying venture capital funds.

- To ensure the effective supervision of qualifying venture capital funds and their managers, the proposed rules would equip the competent authorities with the necessary supervisory powers and will contain provisions on the administrative cooperation between the Home and Host Member States affected by the marketing of the qualifying venture capital funds

- Third country venture capital managers will continue to market their funds in accordance with the national private placement regimes of the Member States where they market their funds.

- Only those fund managers can benefit from the marketing passport if the aggregate assets of their qualifying venture capital funds do not exceed € 500 million. Managers whose qualifying venture capital assets under management exceed this threshold will need to seek authorisation under the AIFMD. At the moment, the aggregate qualifying venture capital assets are, on average, €60 million. Therefore, the situation of having to seek full authorisation under the AIFMD should not arise very often. Should venture capital funds become more successful and increase average assets under management significantly in the future, the Commission has the right to review the € 500 million threshold.

#### *8.5.1 Enforcement provisions*

Enforcement of the criteria applying to both qualifying managers and qualifying funds is necessary to safeguard the credibility of the new designation "European Venture Capital Fund". The proposed rules would therefore specify the conditions in which the Home Member State is obliged to withdraw the European passport. It is important to note that the Home Member State must continually supervise compliance of the qualifying venture capital fund manager, notably with the substantive requirements that relate to the composition of its fund's portfolios, the eligible investment instruments used, the eligible target companies invested in and the eligible investors addressed by the manager's marketing. Non-compliance with one of these uniform set of criteria will oblige the Home Member State to withdraw the manager's eligibility to use the designation "European Venture Capital Fund". Withdrawal of this passport will also lead to removal of the fund from the national register of qualifying venture capital funds.

Once, material non-compliance is ascertained, it is incumbent on the Home Member State to withdraw the benefit of the European passport from the manager in relation to all its qualifying funds and inform the relevant Host Member States (those indicated in the registration) accordingly. To avoid regulatory ambiguity, the proposed rules should stipulate that, upon withdrawal, the benefits of the passport will cease with immediate effect°. Withdrawal of the passport will also entail that the fund manager will be removed from the register of qualifying venture capital funds.

To ensure the effective supervision of qualifying venture capital funds and their managers, the proposed rules would equip the competent authorities with the necessary supervisory powers and will contain provisions on the administrative cooperation between the Home and Host Member States affected by the marketing of the qualifying venture capital funds.

### 8.6 Risks and synergies

There is no evidence to suggest a re-balancing of portfolios of risky assets to ensure a more equal playing field for venture capital funds would lead to any funding problems related to other alternative investment managers. The scale of such re-allocations would reflect the growth of funds under the new framework; institutional and high net worth investors (who would be included as eligible investors in the chosen approach) can be expected to take a balanced approach on asset allocations; providing a stronger opportunity to target EU venture capital funds is likely to be viewed by such investors as a useful means for further diversifying their portfolios; but large-scale shifts between risky asset classes are unlikely in the absence of other incentives.

The extent to which venture capital financing will be able to develop its potential as a means of stable and long-term financing critically depends on the extent to which a series of other factors that influence the environment (ecosystem) in which venture capital funds and their investment targets operate.

Eliminating regulatory fragmentation is one, but an important, element to improve the overall ecosystem in which venture capital functions. The targeted fund-raising passport should have, in the first place, positive effects on venture capital fund's economies of scale and improve funds' potential for specialization.

The proposal for a new VC fund framework exhibits strong **synergies** with the Commission SME Financing Action Plan [reference] and the SMA. The SMA has identified other issues that should be improved in order for SMEs to have better access to finance. Some measures addressed in the SMA are complementary to the present proposal. For example, on the supply side, measures envisaged to improve SMEs access to public markets. Another option involves the creation of dedicated SME stock exchanges. Venture capital strategies and their investments would be greatly enhanced, if there were more promising exit strategies, once a venture has enjoyed initial commercial success. The easier it is to engineer a successful listing, the more attractive investors will find a venture capital investment.

On the demand side, improving entrepreneurs' knowledge about the benefits and opportunities that venture capital financing offers, increasing entrepreneurs business skills and focus on promoting their innovation are three elements that can also contribute positively to the impact the existing initiative will be able to bring about.

One of the **risks** potentially endangering the success of the proposal resides in the potential consequences of recent changes in the prudential framework for insurance companies and banks. Although these new rules have not yet been tested in practice, most industry practitioners and other experts predict that these developments will most likely make venture capital a less attractive investment opportunity, leading banks and insurance companies to scale back sharply their investments in this particular asset class: "*For example, we see in Europe new capital requirements coming up for pension funds*

*and insurance companies that will render it very unattractive to them to invest in private equity and venture. That's a very significant issue that the European Venture Capital Association is currently tackling in its lobbying work because it could have a major, completely unintended consequence of reducing the capacity to provide funding to innovative growth companies. It remains to be seen how it will play out. Lawmakers and regulatory bodies have some work to do in order to fine-tune the proposed regulations and to ensure that they don't have negative, however unintended, impacts on the VC industry's to fund innovations*[78].

The SME Financing Action Plan recognises these risks and proposes that in 2012, the Commission will, on the basis of technical work to be done by the European Banking Agency (EBA) and European Insurance and Pensions Agency (EIOPA), carry out a study on the relationship between prudential regulation and venture capital investments by banks and insurance companies.

Box 5 shows, that the Action Plan puts forward number of other complementary measures including deadlines for their implementation. This is necessary in order to ensure that overall coherence of individual measures is ensured, especially in cases where measures are closely interlinked: e.g. measures which will improve venture capital fundraising and the subsequent cross-border investments of these funds as well as prudential rules for banks and insurance companies.

Clearly, the overall impact of the steps and measures identified in the SME Financing Action Plan is expected to be greater than the individual elements taken on their own: while each step can be justified on its own merits, taken together they can be expected to be far more effective.

Box 5: Overview of SME Financing Action Plan measures

| SME financing focus area | Type of measure | Implementation horizon |
|---|---|---|
| **REGULATORY MEASURES** | | |
| 1.Improving regulatory framework for Venture capital | | |
| (i) Cross-border fundraising of venture capital funds | A New EU Venture capital framework creating a genuine internal market for Venture capital funds. | Short term: Commission adoption December 2011 |
| (ii) Assessment of prudential rules for banks and insurance companies when investing in venture capital | Study assessing the relationship between prudential regulation and venture capital investments to inform decision making whether to adapt prudential requirements related to venture capital investments | Short term: 2012 technical work by EBA and EIOPA, Mid-Long term: revision of CRD and Solvency II |
| (iii) Cross-border venture capital investments | The Commission will will in 2012complete its examination of the tax obstacles to cross-border venture capital investment with a view to presenting solutiohns in 2013 aimed at elimination the obstacles wiile at the same time preventing tax avioidance and evasion. | Mid-term: 2012 - 2013 |
| 2. Review State aid rules relevant to SME access to finance | The Commission will among others review a number of State aid guidelines, including on Risk Capital | Mid term - by 2013 |
| 3. Improve SMEs access to capital markets | | |

[78] Source: Ernst & Young, "Back to basics, Global venture capital insights and trends report 2010"

| | | |
|---|---|---|
| (i) More visible SME markets | The Commission proposed to attribute the label SME growth market to Multilateral Trading Facility (MTF) in the Directive on Markets in Financial Instruments (MiFID), | Short term: Commission adoption October 2011 |
| (ii) More visible listed SMEs | The Commission proposed modification of Transparency Directive to provide for a central access point at the EU level to high quality and comparable information | Short term: Commission adoption October 2011 |
| (iii) Reducing reporting burdens for listed SMEs | (i) Commission proposaed to modify the Accounting Directives to simplify and improve accounting rules for SMEs. (ii) Commission presented a proposal to reduce the regulatory burden for small issuers (Transparency Directive). (iii) Commission proposal for delegated acts specifying the content of a proportionate disclosure regime for SMEs and small issuers (Prospectus Directive) | Short term: (i),(ii) October 2011, (iii) By July 2012 |
| 4. Review the impact of bank capital requirements on SMEs and recapitalisation of banks | Review whether the preferential risk weight for SMEs exposures of 75% is too stringent. | Short-mid term: 2012 (review), later potential changes to CRD IV |
| 5. Accelerating the implementation of the Late Payments Directive | The Commission strongly encourages Membre States to accelerate its implementation | |
| **EU FINANCIAL MEASURES FOR SMEs** | | |
| 1. Measures to improve lending to SMEs | The Commission proposed Business Competitiveness and SME Programme with a guarantee and an equity facility | 2014-2020 |
| 2. Measures to improve access to venture capital and other risk financing | The Commission will in addition to the above, venture capital facility and mezzanine financing for growth-oriented and early stage SMEs | 2014-2020 |
| **MEASURES FOCUS ON IMPROVING THE ENVIRONMENT FOR SMEs** | | |
| 1. Better information for SMEs | (i) Commission will enhance training, communication and exchange of good practice to provide SMEs information about financing possibilities, (ii) create single portal about different source of EU finance available for SMEs | |
| 2. Improve monitoring of the SME lending market | Commission will work with bank federations and other to improve statistics and reinforce analytical framework for SMEs lending | |
| 3. Promote qualitative rating | Commission will promote exchange of good practices | |
| 4. Stimulate the activity of Business angels and cross-border investments | Commission will (i) encourage co-investments with BA, (ii) develop measure for cross-border matching between enterprises and investors, (iii) improve matching of offers and requests for venture capital within the Enterprise Europe Network | |
| 5. Promote information on SME access to capital markets | Exchanges encouraged to increase information to SMEs about advantages of market listing (ii) Commission will promote establishment of an institute to promote analysis and research on listed medium-sized enterprises | |
| 6. Policy coordination and implementation | Encourage other stakeholders to provide fora for improved access to finance | |

## 8.7 Compliance costs

The preferred policy design is not expected to result in creating significant new administrative costs or burden. The purpose of this initiative aims to eliminate costs related with raising venture capital funds across several jurisdictions. Having said this, any regulatory requirements are likely to incur some compliance costs.

*(i) Compliance with obligatory investment structure of the venture capital fund*

- <u>Venture capital fund managers:</u>

From the perspective of existing as well as new venture capital funds and their managers that will wish to benefit from the passporting opportunities, it is expected that some one-off costs related to assessing how to comply with the criteria that define the common EU approach to what constitutes a venture capital fund, especially the criteria on investment portfolios, investment tools and target undertakings, might occur. Fund managers with existing funds would need to assess whether it is appropriate to re-structure their fund portfolios along the new criteria to meet the definition of 'qualifying venture capital fund' or not. Adjustment costs could also arise – e.g. through disposal of assets if this is necessary, for preparing new documentation for investors, etc.

Such costs would likely remain relatively low for existing funds because the approach based on a 70% target is close to the national requirements that prevail in the eight Member States that have adopted rules governing the activities of venture capital funds. A target of 90% (which obliges all but the most pure breed venture capital funds to alter their investment strategies to fall within the new approach) would have incurred more substantive costs for funds and investors related to disposal of assets.

Moreover, these sort of considerations are part of a regular business decision-making process, given that the choice of whether to make use of the new framework or not is a decision that is left up to the individual fund manager; in this regard, the expected costs are in practice likely to be a fraction of the operating expenses that can be expected under 'business as usual' for funds that wish to operate cross-border. In this respect, adaptations of investment strategies do not appear disproportionate in relation to the benefits that are associated with access to a European marketing passport.

*(ii) Compliance with reporting and disclosure requirements*

- Venture capital fund managers

Costs related to reporting and disclosure requirements of the preferred option would arise from the need to assemble and transmit certain type of information to public authorities or investors.

As far as for example pre-contractual disclosure is concerned, fund managers have considered this type of obligation as a significant cost driver. Data collected on costs of the introduction of key investor information disclosures for UCITS funds estimated one-off costs of between EUR 290 and 730 million (depending on factors that remained open at that time).[79] This is for an industry of around EUR 7 trillion; for perspective, these one-off costs were around 0.016% of assets under management. However, these are estimates for measures that apply to UCITS funds in dealing with retail investor disclosure: costs for putting in place disclosure systems for high volumes of investors, and for entirely replacing all existing disclosures.

By contrast, the preferred option is unlikely to have significant cost implications. The content of proposed disclosure requirements merely refers to provision of information that fund managers already are likely to comply with as part of their usual business model when dealing with investors. This is the case in particular for information about the fund managers, its organizational structure, its investment strategies or information

[79] CSES study on costs for the UCITS industry from introduction of Key Investor Information document proposals.

relating to conflicts of interest. Moreover, fund managers will typically follow established industry reporting and transparency standards, and have readily entered into bespoke agreements with investors to make available specific disclosures or reporting as necessary for the high-risk nature of investments into venture capital funds, suggesting such costs are in practice readily absorbed into business as usual costs.

The requirement to provide annual report with information being audited is another cost driver under the transparency requirements of the preferred option. The extent to which related costs will pose significant burden for small and medium size fund managers in particular, depends on the level of details as to the content and form of such requirements, given that such reporting to a general degree is typical under commercial relations for such fund managers already. There was a broad support from great majority of respondents to the public consultation to require as a minimum that fund managers provide annual reports for each of their funds. German, Finnish and French public authorities, supported by an additional sixteen stakeholders, took the view that additional requirements should be included to audit financial information in the qualifying venture capital funds' annual reports. Denmark and a further eight stakeholders were of the opinion, however, that such audits should be a matter of agreement between funds and investors. Five other stakeholders, mostly representing UK venture capital industry practitioners viewed annual reporting linked with audit requirements on the individual fund basis as excessive, overly burdensome, costly and of little benefit.

In addition, the cost impact of proposed disclosure and reporting requirements would relate only to those venture capital fund managers that chose to benefit from the new European Venture capital fund framework. As such, it is a commercial decision for fund managers whether the acceptance of certain compliance obligations counterweighs the benefits managers will experience. To ensure a proportional approach, the proposed requirements seek a principle-based structure that reflects existing business practices. This approach was supported by the great majority of stakeholders. Moreover, the proposed disclosure and reporting requirements have the potential over the longer-term to become an acceptable standard which shall help in building investors' trust about an investment strategy decision to invest in venture capital funds – one of the riskiest asset classes.

- Venture capital fund investors

The preferred option is not expected to directly confer any additional costs to investors. Although it is possible that additional costs borne by venture capital fund managers can be passed on to investors, it is also the prerogative of investors to require clarity on costs being imposed on their investments and in the venture capital market these are typically subject to negotiations on case by case basis.

- National authorities

New requirements might increase costs for supervisors, including ensuring cooperation in ensuring effective supervision of those venture capital funds that decide to benefit from the new European framework. However, it is expected that these costs should not be significant because national authorities have already functioning systems in respect of other investment fund regulatory frameworks, be they European (e.g. UCITS) or national. The supervisory arrangements for oversight of qualifying venture capital funds build on existing framework and requirements vis-à-vis national authorities in the area of investment funds.

- Portfolio companies of qualifying venture capital funds

The proposed disclosure and reporting requirements contained in the preferred option could increase costs for portfolio companies targeted by qualifying venture capital funds. These costs may arise in particular as a result of funds' obligation to provide regular annual reports. However, it is unlikely that these costs would be significantly higher than those borne under business as usual, as it is a precondition for portfolio companies that seek venture capital financing to be 'investment ready'. Venture capital funds, in assessing their potential investment targets, subject to existing market practices, place a very high importance on portfolio companies having a sufficient level of quality and being able to provide information that is essential when funds face reporting obligation towards their investors.

Furthermore, the obligation of standardized reporting requirements placed on venture capital funds has the potential to steer the orientation of future portfolio companies as to the requirements they need to consider in order to be eligible investment targets.

## 8.8 Administrative burden

In regards administrative burden, harmonized disclosure and reporting standards imply better data flows in the investment market for venture capital, and these could entail certain costs over and against business as usual costs for both venture capital fund managers as well as their portfolio companies. However, providing for greater consistency in requirements could lead to some reductions in costs for some portfolio companies.

Overall, since the proposed option is a voluntary regime (in terms of the decision as to whether to operate under the regime or not, though of course) costs would only be borne those seeking access the funding that the regime makes available.

Moreover, it is expected that benefits of the proposed measure shall outweigh the costs from the perspective of venture capital fund managers. This is in particular due to the fact that the creation of a European venture capital framework, based on a common notion of what constitutes a qualifying venture capital fund, is expected to significantly reduce the administrative burden for those venture capital fund managers that currently raise capital outside of the fund’s home Member State. The proposed framework would eliminate costs related to parallel registrations, duplicate authorizations, the maintenance of parallel corporate infrastructures and multiple and varying reporting obligations. These duplicate costs are the price that fund managers pay for raising funds abroad in the current fragmented environment.[80]

All of these additional costs would be eliminated. The preferred option would therefore increase legal certainty and create a level playing field for venture capital fund managers when raising funds cross-border in the EU.

The issue of reporting costs for portfolio companies was addressed in previous section 8.7.

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[80] See Expert group report on removing obstacles to cross-border investments of venture capital funds, chapter 4.1 showing an example of concrete parallel fund structuring costs and what additional costs are associated with it.

## 9 MONITORING AND COMPLIANCE

The Commission will constantly monitor and evaluate the effectiveness of the the proposed policy choice in order to be able to review the proposed instrument, if necessary to better achieve the policy goals set out in this Impact assessment. Such review could e.g. take place 4 years from the transposition deadline of the new initiative that is estimated to be in 2014. This would be in line with the monitoring and assessment of the developments and implementation of the AIFM-D, whose transposition deadline is July 2013. For this purpose, the post-adoption monitoring and evaluation will focus on three issues: (1) has the new framework established a European notion of what constitutes a venture capital fund, (2) has the new framework contributed to a common regulatory approach governing European venture capital funds and, and (3) has the new framework contributed toward the creation of a network of administrative cooperation for the effective introduction and supervision of the managers of European venture capital funds.

*European notion of what constitutes a venture capital fund*

A core plank of the Commission's monitoring activities in relation to the regulatory framework for venture capital funds will consist in verifying whether the rules are specific enough so that investments channelled through the new regulatory framework reach the intended beneficiaries (unlisted, innovative SMEs who rely on equity finance for success in an early phase of their existence).

– The Commission will monitor in cooperation with national authorities, ESMA and the venture capital industry (in particular the European Private Equity and Venture Capital Association - EVCA) that the investment strategies of those funds that operate under the EU venture capital passport are sufficiently tailored toward the acquisition of equity stakes in innovative SMEs and that the portfolio composition of the venture capital funds reflects the regulatory target percentage (70%). For this purpose it will also gather empirical data, e.g. by the means of a study.

– Should empirical data gathered as part of this monitoring (this monitoring will be conducted in cooperation with ESMA who is tasked with keeping a register of fund managers) reveal that the chosen portfolio composition is not optimal in creating a workable notion of a European venture capital fund, the regulatory target percentage in favour of equity stakes in unlisted SMEs might part of the mentioned review. Revisions might lead to both an increase (to 90%), or a decrease (to 50%) of this target.

– Should empirical data furthermore reveal that the favoured investment instruments (equity or quasi-equity stakes) are not sufficient to provide finance to SMEs the choice of instruments will be reviewed. It will be particularly verified whether it is necessary to increase the scope of eligible financing instruments or whether there is a need for more precision in relation to the financing instruments as proposed under this impact assessment.

– Should empirical data reveal that the notion of qualifying investment targets (unlisted SMEs) not lead to the expected strengthening of Europe's SME sector, the range and breadth of possible investment targets will be reviewed.

– The Commission will also monitor that the applicable rules adequately reflect the evolving lifecycles of a start-up company and correctly define the stages at which a venture capital fund endowed with the EU passport is allowed to invest. In this respect, the Commission will regularly assess whether the core definitions underpinning a fund's eligibility for the new EU passport evolve in line with changing business practices, at European and international levels. The results of this monitoring will feed into the possible review.

*Common regulatory approach*

With respect to the emergence of a common regulatory approach governing venture capital funds, the Commission will regularly assess the success of the cross-border fund-raising passport, both in terms of uptake by venture capital managers and in terms of aggregate capital raised across national borders. Findings of this monitoring will also feed into a possible review of the proposed instrument.

– The Commission, in close cooperation with ESMA (*who will be tasked with maintaining a central register, publicly accessible by internet, which lists all venture capital fund managers registered in the Union in accordance with the proposed Regulation*), will monitor the amount of managers that are registered as 'European venture capital' fund managers in the European Union.

– With a view of enhancing the effectiveness of the registration-based passport, the Commission and ESMA will also monitor 'de-registrations' of venture capital fund managers and their probable causes.

– The Commission, in cooperation with ESMA, national authorities and the venture capital industry, will regularly assess the impact that the European passport rules have.

– The Commission shall furthermore assess regularly whether, or to what extent, the EU passport scheme is misused to effect investments in "buy-out" transactions that are not covered within the intended scope of the venture capital passport.

– The Commission will also assess whether the creation of a special framework for venture capital funds (that would otherwise operate within the framework of national private placement or within the rules of the AIFMD) has led to regulatory arbitrage.

*Administrative cooperation*

The Commission will monitor whether and to what extent the network of national cooperation is able to effectively supervise cross-border marketing by qualifying venture capital funds. In this respect:

– The Commission, in close cooperation with ESMA (*in case of disagreement between the home and host competent authorities on an assessment, action or omission of one competent authority concerning compliance of a qualifying venture capital fund or its manager, competent national authorities may refer the matter to the ESMA which may act in accordance with the powers conferred on it under Article 19 of Regulation (EU) No 1095/2010*), will monitor the resolution of disagreements concerning the compliance of a qualifying venture capital funds or their managers.

– The Commission will monitor practical issues that arise from the fact hat the new passport system remains limited to sub-threshold fund managers. In light of the empirical data collected, the Commission will potentially propose to review the current threshold of €500 million.

Box 6: Summary of indicators to be monitored

- effectiveness of the 70% obligatory share of venture capital funds' portfolio composition: the extent to which fund managers face difficulties to align or establish their investment strategies,
- effectiveness of financing instruments within the permitted portfolio composition – equity and quasi equity instruments: which instruments prevail and what stage of SMEs financing is being targeted,
- effectiveness of limited definition of investment targets (unlisted SMEs) within the 70% funds portfolio compositions,
- number of registered and de-registered venture capital fund managers in the EU
- the amount of funds raised by the venture capital funds (against the benchmark figures mentioned in chart 8, Section 5.1),
- the financing mix available to the venture capital industry (against the benchmark figures in chart 9, Section 5.1.),
- the average size of a venture capital fund (Section 5.2.),
- the compliance costs related to the new venture capital framework

Such monitoring would be based in particular on the data and information already collected by and provided by national authorities in combination with ESMA and on information and data already gathered by the EU industry association (EVCA) on its own part. This could be further complemented by a targeted study.

Since the data that would feed into monitoring of the above indicators is already collected and assessed under existing national and industry practices, it it not expected that the monitoring envisaged here would create any additional administrative burden for fund or SME stakeholders; the impact of additional monitoring activities on national and EU supervisory authorities is expected to be of a purely incremental nature that would be absorbed readily into business as usual practices.

## ANNEXES

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# 1. Annex I: Venture capital and private equity definitions

## 1.1 Definitions and terms used by the European Private Equity and Venture capital association (EVCA)

**Private equity:** provides equity capital to enterprises no quoted on a stock market. It includes the following investment stages: venture capital, growth capital, replacement capital, rescue/turnaround and buyouts. Private equity funds are pools of capital managed in general as closed-end, fixed-life funds doing primarily equity capital investments into enterprises not quoted on stock market.

**Venture capital:** is strictly speaking, a subset of private equity and refers to equity investments made for the launch, early development or expansion of a business.

**Equity value:** Stricto-sensu, the amount of capital invested to acquire shares in an enterprise. The equity value includes equity, quasi-equity, mezzanine, unsecured debt and secured debt financing provided by funds raised by private equity firms focused primarily on direct investments (including co-investment funds) or incorporated direct private equity firms investing from the balance sheet (evergreen and direct captive private equity programmes).

**Transaction value:** The sum of the "equity value" as described above, to which financing coming from the rest of the syndicate is added (LP co-investors, individuals, entrepreneurs, business angels, management, corporations, funds of funds, other asset managers and/or financial institutions), together with the leverage (debt provided by banks or other providers). In other words, stricto-sensu transaction value is equal to enterprise value multiplied by the percentage ownership by the acquiring syndicate in which at least one financial sponsor (private equity firm) is involved.

**Venture capitalist:** The manager of private equity fund who has responsibility for the management of the fund's investment in a particular portfolio company. In the hands-on approach (the general model for private equity investment), the venture capitalist brings in not only moneys as equity capital (i.e. without security/charge on assets), but also extremely valuable domain knowledge, business contacts, brand-equity, strategic advice, etc.

**Limited Partnership:** The legal structure used by most venture and private equity funds. The partnership is usually a fixed-life investment vehicle, and consists of a general partner (the management firm, which has unlimited liability) and limited partners (the investors, who have limited liability and are not involved with the day-to-day operations). The general partner receives a management fee and a percentage of the profits. The limited partners receive income, capital gains, and tax benefits. The general partner (management firm) manages the partnership using policy laid down in a Partnership Agreement. The agreement also covers, terms, fees, structures and other items agreed between the limited partners and the general partner.

Fund stage focuses (fundraising):

**Early-stage fund:** A venture capital fund focused on investing in companies in the early stages of their lives.

**Later-stage fund:** A venture capital fund focused on investing in later-stage companies in need of expansion capital, usually providing third or fourth – (or a subsequent) round of venture investment.

**Balanced fund:** A venture capital fund focused on both early-stage and development, with no particular concentration.

**Growth fund:** Funds whose strategy is to invest in or acquire relatively mature companies that are looking for capital to expand or restructure operations; they often provide the first private equity investment in a company.

**Buyout fund:** A fund whose strategy is to acquire other businesses.

**Mezzanine fund:** A fund that provides (generally subordinated) debt to facilitate the financing of buyouts, frequently alongside a right to some of the equity upside.

**Generalist fund**: A fund with either a stated focus of investing in all stages of private equity investment, or with a broad area of investment activity.

Stage definitions (investments):

**Seed capital:** Financing provided to research, assess and develop an initial concept before a business has reached the start-up phase.

**Start-up capital:** Financing provided to companies for product development and initial marketing. Companies may be in the process of being set up or may have been in business for a short time, but not sold their product commercially.

**Early stage capital:** means seed and start-up capital.

**Other early-stage capital:** Financing to companies that have completed the product development stage and require further funds to initiate commercial manufacturing and sales. They will not yet be generating a profit.

**Later stage venture:** Financing provided for the expansion of an operating company, which may or may not be breaking even or trading profitability. Later-stage venture tends to finance companies already backed by VCs, and are therefore involved in third or fourth (or a subsequent) round of financing.

**Growth:** A type of private equity investment – most often a minority investment but not necessarily – in relatively mature companies that are looking for capital to expand or restructure operations, enter new markets or finance a significant acquisitaion without a change of control of the business. Growth capital tends to be a company's first private equity financing. Additionally, most investments made by buyout funds into venture stages would be defined as growth capital.

**Bridge financing:** financing made available to a company for the period of transition between being privately owned and publicly quoted.

**Rescue/turnaround:** Financing made available to an existing business, which has experienced trading difficulties, with a view to re-establishing prosperity.

**Secondary purchase/replacement capital**: The purchase of a minority stake of existing shares in a company from another private equity firm or from another shareholder or shareholders.

**Refinancing bank debt:** An injection of capital to reduce a company's level of gearing.

**Management buyout:** Financing provided to enable current operating management and investors to acquire existing product lines or businesses.

**Management buy-in:** Financing provided to enable a manager or group of managers from outside the company to buy in to the company with the support of private equity investors.

**Initial Public Offering (IPO):** means the process of launching the sale or distribution of a company's shares to the public for the first time.

**Public-to-private:** A transaction involving an offer for the entire share capital of a listed target company for the purpose of delisting the company. Management may be involved in the offering.

**Other PIPE:** A private investment in public equity, as a minority or majority stake, ithout taking the company private.

**Other (leveraged) buyout:** Financing provided to acquire a company (other than MBI, MBO, public-to-private or other PIPE). It may use a significant amount of borrowed money to meet the cost of acquisition.

**Secondary buyout:** A secondary buyout is a form of buyout where both buyer and seller are private equity firms or financial sponsors (ie a leveraged buyout of a company that was acquired through a leveraged buyout). Secondary buyouts differ from secondaries or secondary market purchases which typically involve the acquisition of portfolios of private equity assets, including limited partnership stakes and direct investments in corporate securities.

**Divestment on flotation (IPO):** An initial public offering (IPO) is the sale or distribution of a company's shares to the public for the first time by listing the company on the stock exchange. It is one way a private equity firm can sell its shares and exit an investment.

**Repayment of preference shares/loans:** if a private equity firm provided loans or bought preference shares in the company at the time of investment, then their repayment according to the amortisation schedule represents a decrease of the financial claim of the firm into the company, and hence a divestment.

**Repayment of silent partnership:** A silent partnership belongs to the so-called mezzanine financing instruments. It is similar to a long-term bank loan but, in contrast to a loan, a silent partnership is subject to a subordination clause, so that in the event of insolvency all other creditors are paid before the silent partner. The company has to repay the partnership and has to pay interest and possibly a profit-related compensation. The subordination

clause gives the capital the status of equity despite its loan character. This financing instrument is frequently used in Germany.

**Sale of quoted equity post-flotation:** This relates to the sale of quoted shares only if connected to a former private equity investment, such as the sale of quoted shares after a lock-up period.

**Sale to financial institution:** The sale of company shares to banks, insurance companies, pension funds, endowments, foundations and other asset managers.

**Corporate investor:** corporations that produce products (manufacturing companies) or deliver non-financial services. This definition excludes banks, funds-of-funds, insurance companies, pension funds and other asset managers.

**Endowment:** An institution that is bestowed money (and possible other assets) via a donation with the stipulation to invest it and use the gains for specific objectives so that the principal remains intact ( for perpetuity, for a defined period of time or until sufficient assets have been accumulated to achieve a designated purpose).

**Family office:** An office that provides services such as investment management and other services (accounting, tax and financial advice etc) to one or several families.

**Foundations:** A non-profit organisation through which private wealth is contributed and distributed for public purpose (most often charitable purposes). It may either donate funds and support other organisations or be the sole source of funding for its own charitable activities.

**Funds of funds:** A private equity fund that primarily takes equity positions in other funds.

**Other asset manager:** Financial institutions (other than bank, endowment, family office, foundation, insurance company or pension fund) managing a pool of capital by investing it across asset classes with the purpose to generate financial returns. This category may include direct private equity funds that occasionally do indirect investments, but excludes funds of funds, which are a distinct category.

**Government agencies:** Country, regional, governmental and European agencies or institutions for innovation and development (including structures such as the EBRD or EIF).

**Sovereign wealth funds:** state-owned investment fund managing a pool of money derived from a country's reserves. The funding for a sovereign wealth fund (SWF) comes from central bank reserves that accumulate as a result of budget and trade surpluses, and from revenue generated from the exports of natural resources.

## 1.2 Related definitions in the Commission Guidelines on State Aid to promote Risk capital investments in SMEs: 2006/C 194/02 and amended 2010/C 329/05

For the purposes of these guidelines, the following definitions shall apply:

(a) **'equity'** means ownership interest in a company, represented by the shares issued to investors;

(b) **'private equity'** means private (as opposed to public) equity investment in companies not listed on a stock-market, including venture capital, replacement capital and buy-outs;

(c) **'quasi-equity investment instruments'** means instruments whose return for the holder (investor/lender) is predominantly based on the profits or losses of the underlying target company, are unsecured

in the event of default. This definition is based on a substance over form approach;

(d) **'debt investment instruments'** means loans and other funding instruments which provide the lender/investor with a predominant component of fixed minimum remuneration and are at least partly secured. This definition is based on a substance over form approach;

(e) **'seed capital'** means financing provided to study, assess and develop an initial concept, preceding the start-up phase;

(f) **'start-up capital'** means financing provided to companies, which have not sold their product or service commercially and are not yet generating a profit, for product development and initial marketing;

(g) **'early-stage capital'** means seed and start-up capital;

(h) **'expansion capital'** means financing provided for the growth and expansion of a company, which may or may not break even or trade profitably, for the purposes of increasing production capacity,

market or product development or the provision of additional working capital;

(i) **'venture capital'** means investment in unquoted companies by investment funds (venture capital funds) that, acting as principals, manage individual, institutional or in-house money and includes early-stage and expansion financing, but not replacement finance and buy-outs;

(j) **'replacement capital'** means the purchase of existing shares in a company from another private equity investment organisation or from another shareholder or shareholders. Replacement capital is also called secondary purchase;

(k) **'risk capital'** means equity and quasi-equity financing to companies during their early-growth stages (seed, start-up and expansion phases), including informal investment by business angels, venture capital and alternative stock markets specialised in SMEs including high-growth companies (hereafter referred to as investment vehicles);

(l) **'risk capital measures'** means schemes to provide or promote aid in the form of risk capital;

(m) **'Initial Public Offering' ('IPO')** means the process of launching the sale or distribution of a company's shares to the public for the first time;

(n) **'follow-on investment'** means an additional investment in a company subsequent to an initial investment;

(o) **'buyout'** means the purchase of at least a controlling percentage of a company's equity from the current shareholders to take over its assets and operations through negotiation or a tender offer;

(p) **'exit strategy'** means a strategy for the liquidation of holdings by a venture capital or private equity fund according to a plan to achieve maximum return, including trade sale, write-offs, repayment of preference shares/loans, sale to another venture capitalist, sale to a financial institution and sale by public offering (including Initial Public Offerings);

(q) **'small and medium-sized enterprises'** ('SMEs') means small enterprises and medium-sized enterprises within the meaning of Commission Regulation (EC) No 70/2001 of 12 January 2001 on the application of Articles 87 and 88 of the EC Treaty to State aid to small and medium-sized enterprises (1) or any Regulation replacing that Regulation;

(r) **'target enterprise or company'** means an enterprise or company in which an investor or investment fund is considering investing;

(s) **'business angels'** means wealthy private individuals who invest directly in young new and growing unquoted business (seed finance) and provide them with advice, usually in return for an equity stake in the business, but may also provide other long-term finance;

(t) **'assisted areas'** means regions falling within the scope of the derogations contained in Article 87(3)(a) or (c) of the EC Treaty;

## 2. Annex II: Overview of past actions and initiatives in relation to Venture Capital funds

– **Venture capital as essential source of financing SMEs to drive innovation and growth (1998-2009)**

**1998 - 2002** **Commission Communication on Risk Capital Action Plan (RCAP)**

(http://ec.europa.eu/internal_market/securities/riskcapital/index_en.htm)

The importance of creating a well functioning risk capital markets[81], of which venture capital funds form an essential part, to stimulate future growth, job creation and competitiveness has been recognised already in 1998, in the Commission Communication on **Risk Capital Action Plan (RCAP)**. The RCAP was a driver towards completing the single market in risk capital, and looked at policies focusing on early-stage financing. As part of the final report in 2003, the Commission indicated the need to review the merits and possibilities of a single fund structure and to ensure that the potential of the single financial market would be efficiently used, including further progress in functioning of venture capital markets.

**June 2005** – **Commission (DG ENTR) Workshop on Merits and possibilities of a European Fund Structure**

– (http://ec.europa.eu/enterprise/entrepreneurship/financing/docs/efs_report.pdf)

Commission organised a workshop on the merits and possibilities of a European fund structure that gathered together a wide range of stakeholders and industry practitioners. The workshop participants argued for simplifying the regulatory requirements for fund structures so that investors would not have to spend excessive time on analysing various requirements for establishing a fund in non-home jurisdictions. The experts concluded that a pan-European fund structure might be a solution in a long-term perspective, whereas in the short term, there was an urgent need for a mutual recognition at various levels.

[81] Risk capital cover three types of financing: (i) informal investment by business angels, (ii) venture capital and (iii) stock markets specialized in SMEs and high growth companies.

**October 2005** **Risk Capital Summit in London organised by the Commission (DG ENTR) and the UK Presidency –** " Investing for Growth and Competitiveness in Europe "

(http://ec.europa.eu/enterprise/entrepreneurship/financing/docs/risk_capital_conference_paper.pdf)

– The event brought together high-level policy makers and representatives from the risk finance sector to debate how risk capital should support innovation, growth and competitiveness of European SMEs and examine global good practices in risk capital intervention in Europe, US and Asia. Stakeholders agreed that European risk capital markets were functioning below their potential and stated that Pan-European early stage technology funds were needed. They highlighted that mutual recognition of legal structures for risk capital and reduction of obstacles to cross-border investment are required to stimulate Pan –European markets.

**June 2006** – **Commission Communication "Financing SME Growth – Adding European Value** (http://ec.europa.eu/enterprise/entrepreneurship/financing/docs/com2006_financing_sme_growth/sec2006_841_financing_sme_growth_en.pdf)

– The Commission outlined a set of measures to help innovative SMEs by improving access to finance, in particular at the early stages. Making cross-border investments in venture capital easier was one of the key goals and the Commission called for concrete and pragmatic steps to overcome the existing legal, regulatory and tax barriers and the Member States were asked to engage with the issue.

**Oct 2006 - March 2007** – **Commission (DG ENTR) Expert group on Removing obstacles to cross-border investments by VC funds** [1]

– (http://ec.europa.eu/enterprise/newsroom/cf/document.cfm?action=display&doc_id=1094&userservice_id=1&request.id=0)

A particular attention was paid to the development of cross-border venture capital operations and to reducing the fragmentation of the European venture capital market in the context of an extensive consultation with national and industry experts in 2006-2007, organised by Directorate General Enterprise and Industry. In the expert group report on removing obstacles to cross-border investments by venture capital funds from March 2007, experts recommended that apart from exchanging good practices and improving coordination between the Member States, the most reasonable way to progress in the short term would be the mutual recognition of the existing national frameworks on venture capital funds. National and industry experts suggested that Member States could take steps towards recognising venture capital funds, which are registered and operate in other jurisdictions in order to allow these funds to

operate across borders without having to go through separate registration and regulation processes or to invest through complex parallel structures. While the group recognised that it was up to the Member States to decide what would be the most suitable for them, there was a broad understanding that the findings would be taken into consideration in the Commission's reporting on the Council's request. Based on this and further policy deliberations, the Commission issued in 2007 a Communication on cross-border venture capital funds.

**2006 - 2010**

– **Community Guidelines on state aid to promote risk capital investment in SMEs** (2006/C 194/02)

(http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2006:194:0002:0021:EN:PDF) as amended in 2010, (2010/C 329/5)

– (http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2010:329:0004:0005:EN:PDF)

**December 2007**

– **Commission Communication** on "**Removing obstacles to cross-border innvestments by venture capital funds", COM(2007)853**

– (http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2007:0853:FIN:EN:PDF)

Based on the mentioned expert group report on cross-border obstacles from March 2007 and further policy deliberations, the Commission issued in December 2007 a Communication on *"Removing obstacles to cross-border investments by venture capital funds"*. The Commission advocated a broad partnership with and between Member States to work towards mutual recognition of the national frameworks for venture capital funds and to create a common understanding of the features of venture capital funds and qualified investors. The Commission invited the Member States to overcome the regulatory and tax obstacles by reviewing existing legislation or by adopting new laws. The aim has been to give all venture capital funds the opportunity to specialise and diversify, including smaller specialist funds. Especially smaller countries and those with a developing venture capital market and industry were invited to adopt or amend their legislation. With this Communication, the Commission announced that it would report on progress made in 2009.

**May 2007-**
**Early 2009**

**Commission (DG TAXUD) Expert group on Removing direct tax obstacles to cross-border VC investments**

– (http://ec.europa.eu/taxation_customs/resources/documents/taxation/company_tax/initiatives_small_business/venture_capital/tax_obstacles_venture_capital_en.pdf)

– Direct tax obstacles to cross-border operations of venture capital funds were analysed with another expert group in 2007-2009, organised by the Commission Directorate General for Taxation and Customs Union. The expert group highlighted that the risk

of creating a taxable presence ("permanent establishment") of the VC fund in the Member State of investment and the different treatment of VC fund ( transparent / non transparent) by different Member States are the main tax obstacles all of which may result in double taxation. The expert group recommended that VC fund managers should be classified as "independent agent" by all tax authorities and that Member States would agree on a list for the classification (as either transparent or non-transparent) of certain specific legal forms which are often used for VC funds. A report with main conclusions and recommendations of the expert group was published on February 2009.

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**29 May 2008** – **Competitiveness Council Conclusions** (Slovenian Presidency) – 'A fresh impetus for competitiveness and innovation of the European Economy'

– (http://www.consilium.europa.eu/ueDocs/cms_Data/docs/pressData/en/intm/100715.pdf - Page 4)

– The Council "*invited the Member States to make progress towards a mutual recognition of national frameworks as a promising initial step towards a gradual creation of an EU-wide framework… and invited the Commission and the Member States to work together*" and *"recognises the significant benefits of developing a more integrated and competitive VC market in Europe, and the contribution a regime for cross-border private placement in the EU could make to facilitating cross-border VC fund raising".*

**25 June 2008** – Commission Communication on Small Buiness Act (SBA) that is under the remaining regulatory and market gaps addressing also a "*reduction of venture capital market fragmentation at the EU level*"

– (http://ec.europa.eu/enterprise/entrepreneurship/sba_en.htm)

**July – December 2008** – Further to the Council Conclusions, the Commission continued the work together with the Member States and the industry towards a more integrated European venture capital market and organised **two workshops in July - December 2008**. During these workshops, the Commission launched a debate on measures that Member States have taken or plan to take to accommodate the mutual recognition principle in their respective VC legislation. Member States experts were asked to send written answers.

– Based on the inputs from the Member States, ongoing work and further policy deliberations, the Commission planed to issue a report by mid 2009 on progress made.

**September 2008** — **European Parliament resolution** (based on the Rasmussen report) with recommendation to the Commission on hedge funds and private equity (Annex, Recommendation 1, venture capital and SME sector)

– (http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//TEXT+TA+P6-TA-2008-0425+0+DOC+XML+V0//EN#BKMD-15)

– *"The Commission should propose legislation to provide a harmonised EU-wide framework for venture capital and private equity, and particularly so as to ensure cross-border access to such capital for the SME sector (…).For this purpose, the Commission should implement, without delay, the policy proposals set out in its communication on removing obstacles to cross-border investments by venture capital funds. The proposal should be in line with principles of good regulation and should avoid additional legal, fiscal and administrative complexities at EU level".*

**October 2008** — EESC- Internal Market section adopted **EESC opinion** (rapporteur: Morgan) on Commission Communication on cross-border venture capital: a favourable opinion welcoming Commission ongoing work (opinion was adopted at the EESC plenary on 21 October 2008).

**November 2008** – Commission (DG MARKT) published a call for tender to analyse the economics and the regulatory background of private placement as well as to examine obstacles to private placement across borders within the EU (more) with a timelimit for receipt of tenders: 30 January 2009

**November 2008** – Commission (DG ENTR) **focused workshop with researchers** - Conclusions and recommendations summarised by Prof Markku Maula and presented to the national experts on 8 December 2008

**December 2008** – **Competitiveness Council** Conclusions (French Presidency) 'Think Small First – A Small Business Act for Europe' and Council Action Plan – cross-border VC and private placement regime'

– (http://www.consilium.europa.eu/ueDocs/cms_Data/docs/pressData/en/intm/104403.pdf Page 4 & Page 13)

– The Council *"recalls the need for Member States and the Commission to reduce the present fragmentation of the venture-capital market by facilitating cross-border investments"* and identifies as priority the examination of *"options for a Community-wide private placement regime by the end of 2009 to facilitate cross-border investment in order to strengthen Europe's venture capital market".*

**December 2008** – Commission (DG ENTR) **follow-up workshop** with national and industry experts on the mutual recognition process of

national VC frameworks

**March 2009** – Commission (DG ENTR) **follow-up workshop** with national and industry experts on the mutual recognition process of national VC frameworks

**May-June 2009** – Commission (DG ENTR) **issued a report on the policy work carried out together with national and industry experts from 2005 to 2009 on removing obstacles to cross-border venture capital.**

– (http://ec.europa.eu/enterprise/newsroom/cf/_getdocument.cfm?doc_id=5646)

– While there is a consensus among the Member States on promoting mutual recognition of national frameworks, no significant measures have been taken yet that would make fundraising and investing across borders easier. Council has agreed with the goal and the process of mutual recognition, however, in practice Member States have not yet taken any significant measures that would make operating across borders easier for VC funds. Therefore, the Commission recognises an imminent need to strengthen the partnership with and between Member States and to work in a close cooperation with all relevant stakeholders in building a sustainable European venture capital market.

**October 2010** – **Europe 2020 Strategy**

– (http://ec.europa.eu/europe2020/index_en.htm)

– Commitment: "Making an efficient European venture capital market a reality, thereby greatly facilitating direct business access to capital markets and exploring incentives for private sector funds that make financing available for start-up companies, and for innovative SMEs."

**October 2010** – Communication from the Commission Europe **2020 Flagship Initiative Innovation Union COM** (2010)546 final

– (http://ec.europa.eu/research/innovation-union/pdf/innovation-union-communication_en.pdf)

– This communication states that: *" Most venture capital funds in Europe are too small to support the continued growth of innovative companies and do not have the critical mass to specialise and operate trans-nationally. Europe needs to improve its venture capital market by creating incentives to invest and by improving regulation. Europe needs to improve its venture*

*capital market by creating incentives to invest and by improving regulation."*

**February 2011** Communication from the Commission **Review of the "Small Business Act" for Europe** COM (2011)78 final (http://ec.europa.eu/enterprise/policies/sme/small-business-act/files/sba_review_en.pdf)

**February 2011** – **European Council conclusions** stating that: *"Every effort should be pursued to remove the remaining legal and administrative obstacles to the cross-border operations of venture capital funds."* http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/119175.pdf

**April 2011** – Communication from the Commission **Single Market Act, Twelve levers to boost growth and strengthen confidence**. *"Working together to create new growth"* COM (2011) 206 final. http://ec.europa.eu/internal_market/smact/docs/20110413-communication_en.pdf

**Venture capital as part of a wider investment fund universe (2006-2009)**

**July 2005** Commission **Green Paper** on the Enhancement of the EU framework for investment funds; SEC(2005)947

(http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:52005DC0314:EN:NOT)

**July 2006** – Commission (DG MARKT) **Expert group report** on Alternative investment funds – subgroup on Private Equity funds http://ec.europa.eu/internal_market/investment/docs/other_docs/reports/equity_en.pdf)

– To explore problems identified by stakeholders and ways to enhance the European framework for investment funds, Directorate General for Internal Market organised in July 2006 an Expert group on private equity funds. This group concluded that different national approaches to regulation and the resulting legal fragmentation caused high operating and administrative costs for investment funds operating across borders. Small or medium-sized funds were penalised more than big ones and were deterred from developing cross-border operations. Especially fund structuring and selling funds across borders should be improved at the European level. The group recommended that Member States should treat private equity funds in the same way as public equity investments and that private equity funds should be taxed solely in investors' home country. Mutual recognition of fiscally transparent fund structures and a common understanding of a 'private placement' might be a solution for this

**November 2006** – Commission **White Paper** on the enhancing the single market framework for investment funds; SEC(2006)1452 (http://ec.europa.eu/internal_market/investment/docs/legal_texts/whitepaper/executive_summary_en.pdf)

– Some of the problems that venture capital funds face are common to other investment funds as well. This has been the focus of the White Paper on Enhancing the Single Market Framework for Investment Funds published by the Commission in November 2006. The conclusion was that the question should be approached from two angles. Should some types of non-harmonised funds[82] be granted an EU passport similar to investment funds covered by the Undertakings in Collective Investments in Transferable Securities Directive (UCITS) to market their funds to retail investors across Member State borders? And should a European private placement regime for the cross-border distribution of non-harmonised funds (including venture capital funds) to institutional or sophisticated investors be established?

**July 2008** – Commission (DG MARKT) **preliminary impact assessment report on private placement** – revealing need for further preparatory work. http://ec.europa.eu/internal_market/investment/legal_texts/index_en.htm#nonlegis)

**September 2008** – EP-ECON committee adopts **Rasmussen report** on private equity and hedge funds.

**2009-2011** Commission proposal for a Directive on Alternative Investment Fund Managers (AIFM) – adopted in June 2011 (2011/61/EU)

[82] As of today, the non-harmonised funds sector, including funds like hedge funds, private equity, venture capital funds, infrastructure funds, etc. have been captured by the recently adopted Directive on Alternative Investment Fund Managers (AIFM) 2011/61/EU

## 3. Annex III: Summary of cross-border tax problems of venture capital funds

Tax regulation issues are seen by the venture capital industry as one of obstacles to the development of cross border venture capital market. The lack of cohesion between the 27 tax systems across the EU can lead to double taxation, tax treatment uncertainties and administrative obstacles, which would prevent cross border operation of venture capital funds.

To explore problems related to differences in tax treatment in different Member States and better understand the impact on venture capital market, the Commission organized in 2007 a Working group of public and private sector tax experts. The expert group had to identify cases of double taxation and to consider possible ways of overcoming such obstacles. A report of 30 April 2010 set out the experts' findings and conclusions.

According to the Report of Expert Group[83], the two the main tax issues related to cross-border venture capital investments consist on:

1) The risk of a deemed permanent establishment for the VC fund or its investors in any other jurisdiction other than that in which they are based or resident together with the resulting double taxation, and

2) The entitlement to double taxation conventions including the mutual recognition of the tax qualification of legal forms.

Venture capital funds' cross border investments require the local presence of the venture capital fund manager in the member state of investment, as many activities are carried out by the fund manager in the state where the portfolio company is established (research, advisory and managerial activities).

Thus, in order to invest in other states outside that where it is based, the venture capital fund manager needs to have some form of presence in the state of the portfolio company. The tax authorities of this state may consider a fund manager to be a permanent establishment of the venture capital fund or of the investors. Then, double taxation may occur (at the level of the permanent establishment and in the country or countries where the fund or investors are located).

According to the OECD Model definition, a permanent establishment is a fixed place of business through which the business of an enterprise is wholly or partly carried on in another jurisdiction. It can take a structural form, such as a branch, or it can just be created by the activities of the enterprise in that other jurisdiction. This concept also applies to the cases where an enterprise carries on its activities in a foreign state through a person acting on its behalf, provided that that person is not an agent of independent status acting in the ordinary course of his/her business.

Each state generally has its own domestic definition of what constitutes a permanent establishment. The different approaches adopted by the tax authorities of Member States

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[83] http://ec.europa.eu/taxation_customs/resources/documents/taxation/company_tax/initiatives_small_business/venture_capital/tax_obstacles_venture_capital_en.pdf)

create uncertainty as to whether the local presence of the venture capital fund manager in the Member State of investment would be considered to constitute a permanent establishment of the venture capital fund or its investors in that state.

The expert group argues that the optimum solution would be for the tax authorities to treat the local activities of a venture capital fund manager as those of an independent agent and therefore as not constituting a permanent establishment of the venture capital fund.

Double taxation may arise if the different states involved in a venture capital investment (i.e. the state of establishment of the venture capital fund vehicle, the state of residence of investors in that venture capital fund and the state of the portfolio companies in which that venture capital fund invests) classify the venture capital fund in different ways, e.g. as transparent (and not entitled to DTC benefits) or non-transparent (and entitled to DTC benefits).

So, if the state of residence of investor treats the venture capital fund as fully transparent and, thus, not entitled to the benefit of the DTC between the investor state and the venture capital fund state and the state of residence of the venture capital fund treats the venture capital fund as non-transparent and therefore as taxable on its own right, then, capital gains tax may be applied to the venture capital fund and to investor in his state of residence.

## 4. Annex IV: Executive Summary of the Impact Assessment on Private Placement

### What is private placement?

Private placement is an officially recognised distribution method through which designated market participants can buy and sell financial instruments to each other without having to comply with rules that would usually apply when the same instruments are offered to the public/retail investors. It provides participants with a flexible cost-effective tool to sell and buy tailor-made financial instruments. Participation in private placements is usually reserved to appropriately qualified market participants; typically these are authorised financial intermediaries, including placement agents, banks or investment funds/firms, pension funds, life insurance companies, in some cases also high net wealth individuals and corporate investors.

Private placement is particularly suitable for the distribution and marketing of investment propositions which may be considered less suitable for wider public offer. This could include distribution of new types of investment strategy, such as single hedge funds, private equity funds or some commodity funds, whose risk-reward profile may make them less appropriate for retail investors.

### Problems and objectives

Within Europe, Member States have developed different arrangements to support private placement between local buy-side and sell-side participants. Differences between national private placement regimes mean that it is often not possible to extend private offerings across EU Member States without adjusting the marketing material or even the offer itself. Offerors also have to be careful in determining the potential investors they can approach. This legal uncertainty is aggravated by frequent changes to national rules and conditions as reported. Offerors therefore have to bear substantial costs in order to identify and comply with the relevant rules. These may lead to self-imposed restrictions on the Member States where investments are privately placed. This means lost business opportunities for placement intermediaries. It restricts investment choices or increases costs for potential qualified investors in other Member States. Investors may be deprived of important portfolio diversification opportunities. Financial markets in smaller Member States might suffer from reduced liquidity in relevant financial instruments.

Problems with cross-border private placements result primarily from inconsistencies between and insufficient transparency of, national regimes with respect to the boundaries of the regime: Who can participate? Which products can be placed? Which rules have still to be complied with? These shortcomings prevent potential participants from profiting from the benefits of private placement, with the adverse consequences for financial markets and the wider economy as described above. An EU private placement regime[84] should help to overcome these problems.

[84] The term 'EU private placement regime' is used in a very broad sense here. A regime does not necessarily have to be a legal framework but could as well consist of a common understanding of the concept only.

### Options and assessment

Options for developing such a regime feature in the substance or coverage of such a regime and the appropriate instrument or technique to be used to give effect to it. The former set of options focuses on the eligibility of investors, offerors and products. The latter includes both legislative and non-legislative forms at industry, national and EU level. The analysis of the potential impacts of the options has revealed that, at this stage, there are not sufficient available data and information to come to a substantiated assessment and recommendation of the best way forward. Instead, the impact assessment work should be continued, with this report serving as a stocktaking and information document for all stakeholders and interested partners.

## 5. Annex V: Related initiatives

### 5.1 Risk Capital Guidelines

Access to capital is essential to spur growth of SME in their early stages of development and create more jobs in the EU. However, it is precisely innovative SME in seed and start-up phases (before the commercialisation of products takes place) that face the lack of means of funding from financial markets despite having a valuable business model and growth prospects. The Risk capital Guidelines (RCG) adopted in 2006[85] provide a clear set of rules designed in a flexible way to allow member States to target this specific market failure without interfering in the correct functioning of the market.

The aim of the RCG is to leverage private funds in cases where investors are reluctant to endorse the risks of financing innovative new or growing SME due mainly to imperfect and asymmetric information. This is a situation where potential investors face more difficulties in gathering reliable information on the business prospects of an SME and subsequently in monitoring and supporting the enterprise's development. The lack of information tends to exacerbate risk aversion and discourage equity investments in these companies.

In order to counter this market failure, RCG foresee the possibility to grant support through different means: the constitution of a commercially managed Fund (involving private and public money), fiscal incentives, guarantees to investors and other financial instruments in favour of risk capital investors or venture capital funds.

The RCG provide for a light assessment for equity investments that are limited to early stages (ie. start-up or expansion phase but only in assisted areas), mostly represented by equity or quasi equity instruments, where private participation is at least 50% (or 30% in assisted areas) and that are profit-driven. Investment tranches must also be limited in size to assume the existence of a market failure. As a response to the financial crisis the Temporary framework reduced the private participation from 50% to 30% in all areas and increased the original tranches of 1,5 M€ per target SME over each period of twelve months to 2,5 M€ Only the increase of tranches has been made permanent through a modification of RCG.

Above this threshold, because of the greater potential to distort competition, the Commission will make a detailed assessment, and Member States will have to provide evidence of a market failure. A detailed assessment will also be necessary for financing the expansion stage of medium-sized enterprises in non-assisted areas, for follow-on investments in SMEs beyond the €2.5 million and their early-growth financing, for investments with private participation of less than 50% in non-assisted areas or 30% in assisted areas and where there is little or no private participation and/or investing mainly through debt instruments in the seed phase. Also the two specific cases of investment vehicles (i.e. alternative market places) and costs linked to the screening of companies in

[85] Full text available at: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:52006XC0818(01):EN:NOT

view of the conclusion of investments ('scouting costs') are subject to a detailed assessment.

The RCG are valid until December 2013, but they foresee a mid-term review, as in the R&D&I Framework, 3 years after their entry into force. The Commission has launched a public consultation on the mid term review of the RCG and its modification from 06.10.2010 to 26.10.2010, focussing on those sections of the RCG that were subject to temporary measures (i.e: Increase of annual investment tranche ("safe-harbour tranche", reduction of private participation) and practical issues arising from case experience, such as limitation of expansion investments to assisted areas, scouting costs, cumulation rules models of investment and Commercial management. After the public consultation, the Commission adopted the modified communication on RCG[86], amending the Guidelines to increase the investment tranches from 1.5M€to 2.5M €, thus ending the mid-term review. The next step is the full revision of the RCG by 2013.

## 5.2 Financing instruments

EU facilities for venture capital investments into innovative SMEs address the market gap that SMEs face in getting access to equity.

These facilities have a long history. Under the Growth & Employment initiative (G&E) in the years 1998-2000 a facility called "ETF Start-up" pioneered EU investments into venture funds. The success of this facility led to its expansion under the Multiannual Programme for Enterprise and Entrepreneurship (MAP) in the years 2001-2006/7. Under G&E and MAP, EUR 310 million have been invested into 39 venture capital funds. Thanks to the catalytic effect of the EU investment, the venture capital funds attracted other investors - this allowed to leverage a total target fund size of nearly EUR 2 billion and to support investments into more than 480 innovative SMEs in their seed and early stages.

While the number of start-up businesses helped in this way has been relatively small, the impact of the most successful ones has been very important. For example, under MAP the EU invested into a Luxembourg-based New Tech Venture Capital Fund II which has in 2003 supported the start-up of Skype, an innovative company that has gone on to become the world leader in internet telephony, bought by Microsoft in May 2011 for 8.5 billion US dollars.

The current generation of the venture capital facility is the "High Growth and Innovative SME facility" (GIF). It falls under the EU's Competitiveness and Innovation Framework Programme 2007-2013 (CIP). It is implemented for the Commission by the European Investment Fund (EIF) on a trust basis. The GIF's objective is to improve access to finance for the start-up and growth of SMEs, and investment in eco-innovation**.**

This objective is achieved by investment into venture capital funds which then use these resources and resources from other investors, and also their technical expertise, to:

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[86] Full text available at: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:52010XC1207(02):EN:NOT

- contribute to the establishment and financing of SMEs and the reduction of the equity market gap which prevents SMEs from exploiting their growth potential, with a view to improving the European venture capital market.

- support innovative SMEs with high growth potential, in particular those undertaking research, development and other innovation.

The Total GIF budget for the period 2007-2013 is EUR 623 million. It is available in 35 participating countries. It is expected that by investing into more than 30 venture funds over the lifetime of the programme, the Commission will support investment into several hundreds of innovative SMEs. Every 1 euro of EU investment is expected to be matched by approx. 5 euro of investment from other sources.

Between 2007 and the end of 2010, the EU has invested EUR 220 million in 19 venture capital funds. This amount was supplemented by co-investments from private and public sources totalling EUR 1.2 bn. This means that overall, over EUR 1.4 billion has already become available for investment into innovative, high-growth SMEs. Currently, 143 have received investments from the venture funds. Out of these 19 venture funds 10 were focusing on investing in more than 1 participating country. The number of venture capital funds and SMEs supported by GIF is growing fast.

On 29 June 2011, the Commission presented its proposal for a new financial framework 2014-2020.

Building upon the positive experience of the Competitiveness and Innovation Programme in particular, the new multiannual EU budget will provide dedicated support and services and access to finance for SMEs. Access to SME finance will be provided through innovative financial instruments which are financed from a range of programmes targeting different policy areas. First, with a dedicated "Programme for competitiveness and SMEs" amounting to €2.4bn, SMEs will be supported through an **equity facility for growth phase investments** and through a loan facility to cover loans for SMEs. Second, under the new Research and Innovation Framework Programme called "Horizon 2020" with a total proposed amount of €80bn, a part will be dedicated to the increased use of innovative financial instruments. This will include **venture capital investments for innovative and high-tech companies and SMEs.**

See Policy fiches, Part II of the Communication - p. 17-20 and p. 83-86: http://ec.europa.eu/budget/biblio/documents/fin_fwk1420/fin_fwk1420_en.cfm

## 5.3 Action plan to improve Access to Finance for SMEs

The Action Plan is at the juncture between financial reform (G20 commitments, roadmap provided by the Communication of June 2010), the attention devoted to the problems of small and medium-sized enterprises (Review of Small Business Act and the Industrial Policy Flagship initiative), and the initiatives taken to relaunch the internal market (EU 2020 and the Single Market Act) to foster growth, job creation and innovation. The Action Plan marks the point when progress in financial reform allows to start turning the attention to growth-enhancing measures. Easier access to financer for SMEs in a more stable financial system, a significantly improved venture capital market in Europe and a better access to capital markets for SMEs will provide a large contribution to growth.

The Action Plan is related to a large number of initiatives, in the regulatory side, in the budgetary side and in the policy side.

In the regulatory side, the Action Plan links together the proposals the Commission is putting forward on the prudential requirements for banks (CRD IV) and insurance companies (Solvency II). In this regard the action plan proposes that in 2012, the Commission will, on the basis of technical work to be jointly done by the European Banking Authority (EBA) and European Insurance and Occupational Pensions Authority (EIOPA), carry out a study on the relationship between prudential regulation and venture capital investments by banks and insurance companies.

Moreover, the action plans further contains proposals more directly linked to the structure of financial markets (Review of the Markets in Financial Instruments Directive, Review of the Market Abuse Directive, Review of the Transparency Directive) and to the financial institutions more directly involved in financing small enterprises (Venture capital).

In particular it identifies opportunities to continue work to build on the European Venture Capital fund framework to tackle double taxation issues and to encourage the emergence of national incentives for investors.

In the budgetary side, the Action Plan links the proposals the Commission is going to propose for the financial instruments for SMEs under the Multi annual Financial Framework.

In the policy side, the initiative looks at policy initiatives that the Commission could take in the field of SME finance.

After an introductory section on the problem definition, the measures are presented in order of scale of financing needs for SMEs: first measures in favour of access to loans, which matter for the everyday work of million SMEs in Europe; second, measures in favour of venture capital, which targets its investments to those SMEs who bear more promises to grow; finally, measures favouring access for SMEs to capital markets.

This last section targets enterprises that have grown in size and that for their financing need access to larger sources of capital that can be provided by financial markets. In this case, the Action Plan refers to small issuers or small listed companies, as their size is normally larger than that of an SME as normally defined in EU policies.

In defining the measures, the right balance must be found between targeting measures to SMEs and avoiding putting them in a separate class that would make them unattractive for investors.

## 6. Annex VI: Feedback statement: Summary of responses to the public consultation on the European Venture Capital Framework

**GENERAL REMARKS ON CONSULTATION PROCEDURE AND FEEDBACK:**

The issues on which the Commission invited views and evidence included:

- **Venture capital investment strategy:** The forthcoming proposal on venture capital funds will aim to cover venture capital and no other strategies of private equity. In light of this, the consultation invited views on how best to capture venture capital strategies. The proposal would in addition focus on funds that invest the majority of their assets in SMEs. The consultation therefore also sought views on the definition of eligible portfolio composition, in terms of types of financing and eligible target companies. It also asked whether the proposed measure should specify the legal forms that the venture capital funds might adopt.

- **European legislative framework:** The consultation invited views on whether the new regime for venture capital should be based on voluntary registration. It also invited views on the notification procedures and it asked whether the introduction of a third country regime would be beneficial.

- **Operating conditions:** The consultation invited views on the introduction of rules on organisation and conflicts of interest, based on existing EU rules.

- **Impact on Alternative Investment Fund Managers Directive 2011/61/ EU (AIFMD)[87]:** The consultation invited views on the interaction between the new regime for venture capital and AIFMD. It also asked whether a stand-alone initiative for all venture capital funds would be a suitable approach.

- **Eligible investors:** The consultation invited views on whether the new regime on venture capital should be restricted to professional investors (as defined in Directive 2004/39/EU on Markets in Financial Instruments[88] (MiFID) or whether it should include other categories of sophisticated investors.

The deadline for responses to this consultation paper was 10 August 2011. Forty eight answers have been received: 38 from organisations, including representative bodies from across the banking and securities sectors, asset managers and investors' representatives, 2 from citizens and 8 from public authorities.

Responses to the consultation highlighted the following messages:

[87] OJ L 174, 1.7.2011, p.1.

[88] OJ L 145, 30.4.2004, p. 61

- A new European regime for venture capital would facilitate the cross border activities of these funds. However, it should be flexible to avoid creating unnecessary new burdens to the industry.

- Venture capital funds need flexibility regarding the forms of financing that venture capital managers may be willing to use. However, in order to fully meet the EU policy goals, a significant proportion of respondents support a view that a venture capital fund should invest as a minimum 50% of its assets in SMEs .

- The majority of venture capital funds are small funds with limited human and infrastructure resources. The rules on organisation and conflicts of interest should therefore be principle based and proportionate.

- Many categories of venture capital funds' investors (e.g. business angels, family offices, and wealthy individuals) fall outside of the MIFID definition of professional investors. The new regime should include these categories in the scope of eligible investors.

## I. OVERVIEW OF RESPONSES TO THE CONSULTATION

The consultation was launched on 15th June 2011 and closed on 10 August 2011. Responses were invited from all interested parties including representatives from venture capital fund industry, asset management organisations, European public authorities and citizens.

Forty eight answers to the consultation were received from a wide range of organisations and professional representatives, citizens and national and European public authorities.

Figure 1 provides a general presentation of the spread of the responses received, from organisations, public authorities and citizens.

| PUBLIC AUTHORITY | 8 |
|---|---|
| CITIZEN | 2 |
| ORGANIZATION | 38 |
| Total | 48 |

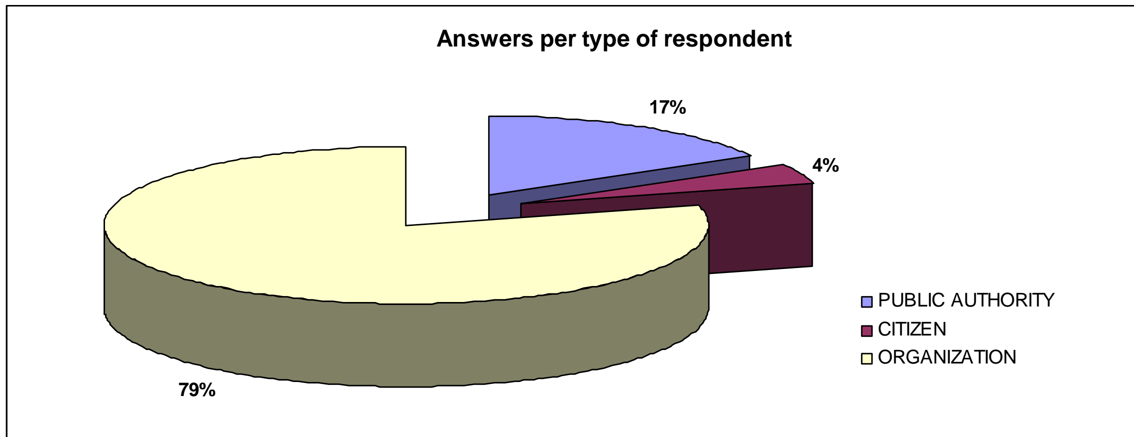



Figure 2 provides a more detailed presentation of the status of organisational respondents, broken down into six categories: asset management (i.e. asset managers and asset management association), banking and securities industries, insurance association, lawyers, investor associations and other professional associations.

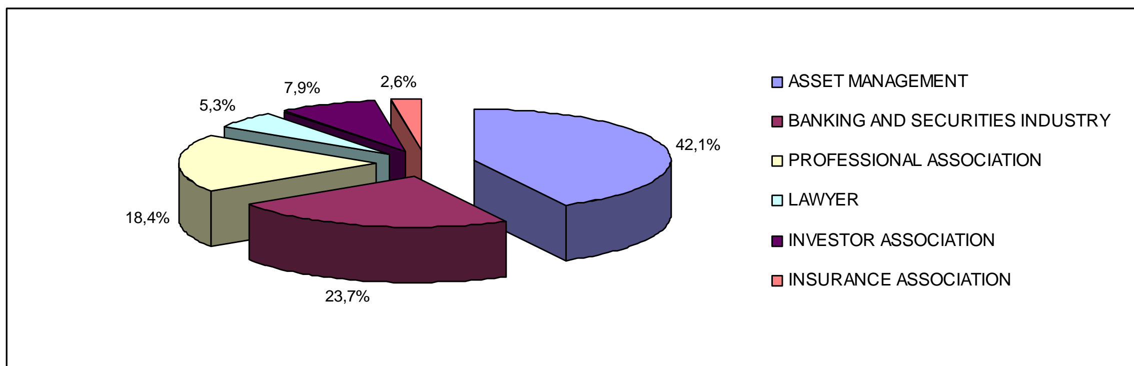
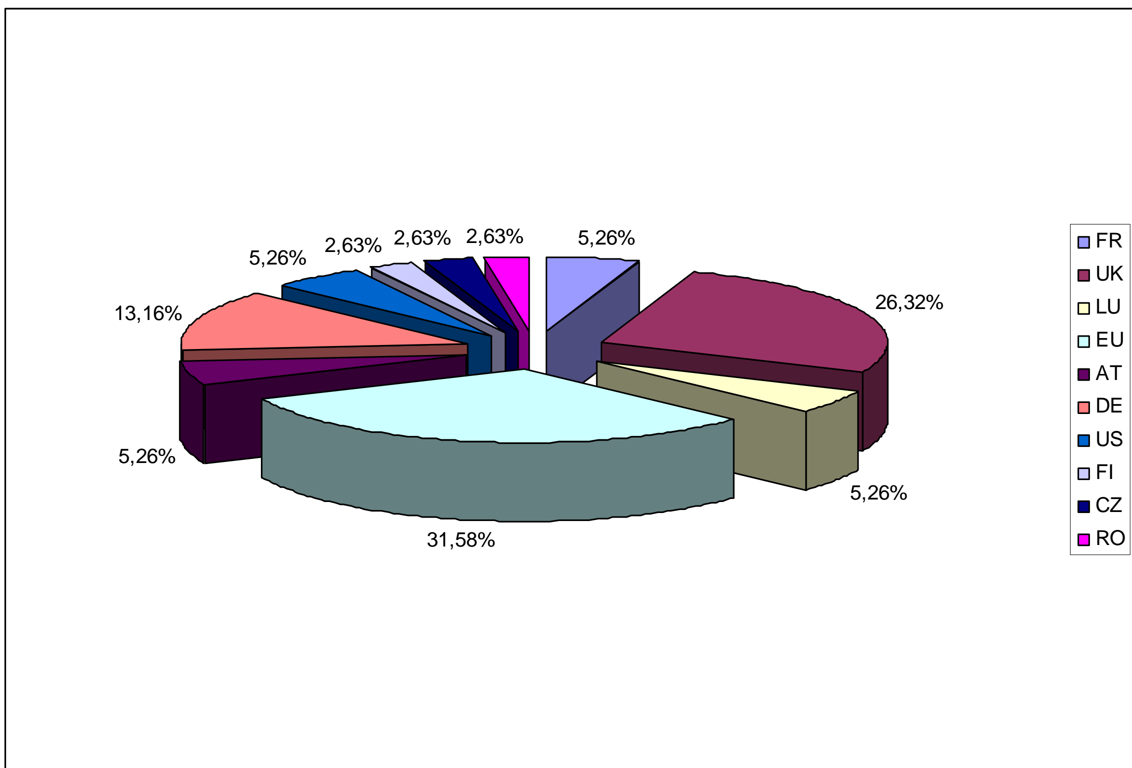


Figure 3 lists the thirty eight answers received from organisations according to their nationality:



## 2. DETAILED ANALYSIS OF RESPONSES:

The feedback statement presents a summary of responses to each of the eighteen questions raised in the consultation paper. The tables provide a quick overview of the respondents' opinions. These opinions have been categorized into 'yes/no' categories of answers whenever possible. Some respondents have also provided qualitative commentary to supplement or nuance their 'yes /no' answers.

### QUESTION 1

*Do you think that encouraging Member States to a process of mutual recognition of venture capital funds could facilitate the cross-border activity of Venture Capital Funds (VCF)?*

| Opinions expressed: | Number of opinions expressed | % over the total number of contributions | Public authorities | Citizens | Organisations | | |
|---|---|---|---|---|---|---|---|
| | | | | | Industry | Other | Total |
| Yes | 21 | 44% | 2 | 1 | *9* | *9* | 18 |
| No | 3 | 6% | 1 | 0 | *0* | *2* | 2 |

Most respondents expressed that mutual recognition could be a possible solution to remove obstacles to cross border activity of venture capital funds:

(a) In terms of fundraising: the current fragmented framework has a negative impact on fundraising and leads to substantive additional cost. A mutual recognition of venture capital funds could help to facilitate the registration process.

(b) In terms of investing: it could reduce administrative constraints for the fund manager and may help to remove the double taxation issue.

However, many respondents, including European Private Equity and Venture Capital Association (EVVCA), highlight that the main hurdle preventing venture capital manager from carrying on cross-border activities relates to fundraising and not to investing. Venture capital fund managers are facing several difficulties to attract international investors. Indeed, in order to operate across borders, they need to go through a cumbersome and costly process (identification of the suitable regime for potential investors, creation of complex parallel structures, registration and regulation processes...).

### QUESTION 2

*Do you believe that the main impediment preventing cross-border venture capital fundraising and investments is the absence of a passport for activities under the AIFMD thresholds or the fact that the AIFMD is not tailored to venture capital in general?*

| Opinions expressed: | Number of opinions | % over the total number | Public | Citizens | Organisations |
|---|---|---|---|---|---|

| | expressed | of contributions | authorities | | Industry | Other | Total |
|---|---|---|---|---|---|---|---|
| The absence of a passport for activities under the AIFMD thresholds | 12 | 25% | 2 | 0 | 5 | 5 | 10 |
| The fact that the AIFMD is not tailored to venture capital in general | 9 | 19% | 0 | 0 | 5 | 4 | 9 |
| Regulatory barriers (including double taxation issues and understanding and complying with local regulations) | 23 | 47% | 4 | 1 | 9 | 9 | 18 |

As mentioned above, many respondents, including industry organizations and public authorities acknowledge that raising funds across borders is more challenging than investing across border. There is a logistical and cost issue of having to raise funds country by country, without a passport. The main issues for VCF operating cross-border are related to the cost of structuring funds as well as the requirement to receive authorization in multiple jurisdictions, thereby increasing operating costs.

Seeking for international investors usually induces excessive costs, such as legal advice in order to comply with different private placement regimes in Member states.

The majority of respondents agree that AIFMD does not provide any passport regime suitable for small VCFs. And, the "opt-in" approach contained in the AIFMD would impose an excessive cost burden to VCFs and their managers. The adherence to the full set of provisions under the Directive would be unduly cumbersome and too expensive with regards to the operating costs of small funds.

On the other hand, if no such passport is available for smaller VCFs, there is a risk of discrimination between larger funds that benefit from the passport and are able to reach a broad investor base and the non-benefiting smaller funds. Moreover, many institutional investors may exclude non-AIFMD compliant funds from their investment scope, and this could significantly impair such funds fundraising ability.

However many respondents mention that it is quite difficult to currently have a clear assessment on the impact of the lack of a passport for activities under the AIFMD ( AIFMD passport will only become available to EU managers in mid-2013, the final date of the transposition period of the Level 1) .

**QUESTION 3:**

*Do you believe that an initiative on cross-border operations of venture capital could contribute to eliminating the cross-border tax problems encountered or could facilitate tax incentives?*

| Opinions expressed: | Number of opinions expressed | % over the total number of contributions | Public authorities | Citizens | Organisations | | |
|---|---|---|---|---|---|---|---|
| | | | | | Industry | Other | Total |
| NO | 14 | 29% | 3 | 0 | 4 | 7 | 11 |

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| YES. It could contribute to eliminating the cross border tax problems. | 10 | 21% | 0 | 1 | 5 | 4 | 9 |
| YES. It could facilitate tax initiatives. | 2 | 4% | 0 | 0 | 0 | 2 | 2 |

Many respondents don't believe that an initiative on cross border operations of venture capital will contribute to eliminating cross border tax problems. They argue that cross-border operations of other investment products have failed to eliminate or even reduce the double taxation of investment income inside the EU and the tax discrimination of EU investors based on their country of residence. Furthermore, national tax systems vary greatly and are of an extremely complex nature.

One respondent stated that that the diversity of fiscal regimes of Member States is strictly related to persisting differences in financial instruments across Member States. For this reason, a harmonized fiscal regime cannot be easily achieved as long as substantial differences in the financial instruments exist across Member States. In addition, they don't believe that a passport for venture capital operators should be linked to targeted tax incentives. This should remain a matter for national governments.

Against this, 10 respondents supported that this initiative would help to tackle tax hurdles. Incorporating a definition of a venture capital fund and manager in an EU directive may help in making progress on getting Member States to cooperate in relation to the taxation problems, and would lead to lead to a common classification of venture capital funds for tax purposes across the EU.

## QUESTION 4

*Do you agree with a regime based on voluntary registration & simple notification procedure? Do you consider such a voluntary regime to have any major cost implications for the key stake?*

| Opinions expressed: | Number of opinions expressed | % over the total number of contributions | Public authorities | Citizens | Organisations | | |
|---|---|---|---|---|---|---|---|
| | | | | | Industry | Other | Total |
| YES | 23 | 47% | 3 | 1 | 9 | 10 | 19 |
| YES. However AM companies should be authorised and not simply registered in order to benefit from the passport. | 3 | 6% | 2 | 0 | 1 | 0 | 1 |
| Costs depend on requirements | 20 | 41% | 2 | 1 | 6 | 11 | 17 |
| Registration should be made with national Authority | 20 | 41% | 5 | 0 | 9 | 6 | 15 |
| Registration should be made with ESMA | 3 | 6% | 1 | 1 | 0 | 1 | 1 |

The majority of the respondents believe that the new European regime for VCFs should be flexible to avoid any additional burden to the industry. Most respondents, including public authorities and industry organisations, agree to have a regime based on voluntary registration. It gives venture capital fund managers the freedom to decide, depending on their fundraising strategy, whether they want to use an EU-wide marketing passport or to comply with their national private placement regimes.

According to EVCA, while many small VCFs managers want to broaden their investor base and pursue an international fundraising strategy, many others are domestic and rely on national markets. Nearly 45% of all small funds raised by small funds' managers in the period 2007-2010 received capital commitments from domestic investors only. This can be explained by their limited technical and human resources, or by the fact that they choose to be dedicated to their regional communities both for fund raising and for investing.

Many respondents agree that the cost savings on a European passport depend on the new regime requirements. To make the EU passport attractive for fund managers, the key here is to keeping the information requirements to "register" simple, relevant and not cost-bearing. Generally speaking, since the European passport would allow the venture capital fund manager to act across the EU without being required to be locally authorized, it would reduce in particular:

(1) Set-up and management costs of parallel investment structures.

(2) Legal work and legal advisory costs.

(3) Additional advisory fees on capital raising in different markets.

It is difficult to quantify the potential cost savings as it will depend on several factors including the number of countries a small funds' manager would look to market into and their private placement regimes.

However, some respondents noted that the costs related to a legal advisory on different national private placement regimes may amount to EUR 500 to EUR 1,000 per jurisdiction (i.e. EUR 13,500 to EUR 27,000 for the European Union) , if it is only an update of a pre-existing documentation (i.e. where no in-depth advice is required)

These costs will be significantly higher in particular (i) if first time advice is sought from a local law firm with only limited experience in the field or (ii) if specific advice, e.g. a legal opinion, on the specific fund structure is sought or (iii) where domestic legislation has substantially changed compared to previous fund raisings.

A large majority of respondents favour a registration with the authority of the home member state of the manager. They argued that this option is much simpler as the relationship between the competent authority and these venture capital firms already exist. ESMA could consolidate a list of Managers duly approved by national authorities of the Member States.

## QUESTION 5

*Do you believe that the new regime on venture capital funds should be restricted to professional investors?*

| Opinions expressed: | Number of opinions expressed | % over the total number of contributions | Public authorities | Citizens | Organisations | | |
|---|---|---|---|---|---|---|---|
| | | | | | Industry | Other | Total |
| NO | 27 | 56% | 6 | 0 | 11 | 10 | 21 |
| YES | 4 | 8% | 1 | 1 | 2 | 0 | 2 |

Most respondents agree on that the new regime shouldn't be restricted to professional investors. The MIFID definition of professional investors would exclude many categories of institutional and individual investors who are currently part of venture capital investor base.

Investors in venture capital funds are typically institutional investors as well as family offices and certain types of individuals. Individual investors may include:

(4) Entrepreneurs, family offices and other so called "angel investors" (many of which are entrepreneurs themselves), who have traditionally constituted an important source of "intelligent capital" to the small fund sector;

(5) Members of management teams running companies in which the fund invests;

(6) Industry sector experts (where the fund has a sector focus)**;**

(7) Venture and enterprise capital experts which would include both venture and enterprise capital executives and other professionals connected with the industry**;**

(8) Finance sector experts; and

(9) Wealthy individuals.

The majority of these categories would fall outside of the definition of professional investor. Indeed, Professional client as currently defined under MiFID is designed to identify individuals who regularly trade in listed securities or are experts in the trading of listed securities (and derivatives based on these securities). This definition is not coherent with venture capital investment which is a long term investment and can not be characterized by short-term, high-volume transactions. Any proposed restrictions would have a negative impact on the amounts invested in venture capital funds or would dissuade small and mid sized venture capital funds from opting into the new regime.

However, those respondents in favour of access to these categories of institutional or individual investors (described above) are aware that the investment in venture capital

funds implies a high level of risk and recognise any such access should be accompanied by strong regulatory safeguards. They provide the following suggestions:

(10) Individual investors that require protection when investing may be defined both by minimum thresholds and by an assessment of their ability to appraise risks involved in the investment.

(11) The New regime should adopt the same approach as AIFMD

**QUESTION 6**

*Do you agree with the need to require an annual report for each fund?*

| Opinions expressed: | Number of opinions expressed | % over the total number of contributions | Public authorities | Citizens | Organisations | | |
|---|---|---|---|---|---|---|---|
| | | | | | Industry | Other | Total |
| Yes. Annual report should include the annual financial accounts. Financial information should be audited. | 16 | 33% | 3 | 1 | 6 | 6 | 12 |
| Yes. However, the audit of financial information should be a matter to be agreed between the investor and the fund manager. | 8 | 17% | 1 | 0 | 4 | 3 | 7 |
| Yes. However, Any blanket requirements on the reporting of such funds would add to the burdens of an SME investment regime. | 5 | 10% | 0 | 0 | 2 | 3 | 5 |

Most respondents agree that the regime should require fund managers to provide at least an annual report. However, the contents of such reports may vary according to investor requirements and domestic law. The future EU regime shouldn't be prescriptive about their contents or their form and shouldn't prohibit fund managers from preparing reports on a more frequent basis.

Many respondents favour that the financial information should be audited and consider it as a minimum requirement in terms of transparency to investors. They argue that it is already a standard practice in venture capital market and institutional investors generally demand an external audit to be made.

8 respondents were of the view that the obligation to audit financial information would pose an additional financial burden to venture capital funds without any justified

transparency benefit. Therefore, it should consequently be left to the fund managers and their investors' discretion.

## QUESTION 7

*Do you think there is a need to specify any operating condition for venture capital entities?*

| Opinions expressed: | Number of opinions expressed | % over the total number of contributions | Public authorities | Citizens | Organisations | | |
|---|---|---|---|---|---|---|---|
| | | | | | Industry | Other | Total |
| NO | 8 | 17% | 1 | 0 | 2 | 5 | 7 |
| YES. Venture capital entities should comply with rules of conduct. Rules of conducts should be partly aligned with those applicable to AIFMs under the AIFM Directive. | 15 | 31% | 5 | 0 | 7 | 3 | 10 |
| YES. However, organizational requirements should take into account that VC funds are small with little human and infrastructure resources. | 10 | 21% | 4 | 0 | 4 | 2 | 6 |

8 respondents believe that the new regime shouldn't specify any operating rules to venture capital fund managers. The new regime should impose as few burdens as possible on them. In support of this, it is argued that venture capital investment aims exclusively at sophisticated and professional investors. Hence, there is no need for a legislative code of conduct (these rules should be negotiated between the managers and their investors). Moreover, imposing specific organisational requirements would stifle the activity and increase costs.

However, the majority of respondents are convinced that there is a need to specify the operating conditions for venture capital entities in the legislative proposal. They agree that these requirements should be principles-based and depend on whether venture capital funds are marketed to retail investors.

15 respondents agree that venture capital entities should comply with rules of conduct when dealing with their investors. These rules could be aligned with those applicable under the AIFM Directive. Many respondents believe that rules set out under article 12 of the AIFM Directive enable a high-level of investor's protection without binding venture capital managers in a way that would be detrimental to the effectiveness of decisions-making.

Many respondents underline that most venture capital fund managers are small with little human and infrastructure resources. They should be subject to organizational requirements that are proportionate to their size.

## QUESTION 8

*Do you believe that VC funds should be allowed to adopt any of the legal forms traditionally used in Member States?*

| Opinions expressed: | Number of opinions expressed | % over the total number of contributions | Public authorities | Citizens | Organisations | | |
|---|---|---|---|---|---|---|---|
| | | | | | Industry | Other | Total |
| YES | 24 | 50% | 6 | 0 | 11 | 7 | 18 |
| NO. The legislative proposal should specify the legal forms VC funds might adopt | 3 | 6% | 0 | 1 | 0 | 2 | 2 |

Most respondents underline that there are a broad variety of legal forms within the EU member states that any harmonization seems almost impossible. Venture capital fund managers should be able to choose the most appropriate legal form available. This choice depends on investors' preferences, local regulatory regime and tax treatments (i.e. transparent or non-transparent). Fund managers need the freedom of choice with regard to the form of the vehicle in order to identify to the most suitable structure.

## QUESTION 9

*Do you think it is worth specifying any investment rules for venture capital funds?*

| Opinions expressed: | Number of opinions expressed | % over the total number of contributions | Public authorities | Citizens | Organisations | | |
|---|---|---|---|---|---|---|---|
| | | | | | Industry | Other | Total |
| NO | 13 | 27% | 0 | 0 | 5 | 8 | 13 |
| YES. Venture capital funds should invest more than 50% in SMEs. | 16 | 33% | 6 | 0 | 8 | 2 | 10 |

In order to fully meet the EU policy goals, the European passport would benefit funds investing in SMEs. A significant proportion of respondents support the definition of a compulsory investment percentage of assets that the venture capital fund should invest in SMEs. A threshold of 50% (calculated at the time of initial investment) ensures that the majority of VC funds' total assets is going to companies that are SMEs and enables venture capital managers to diversify their portfolios by investing in larger businesses.

Against this, few respondents argue that investment criteria are defined by close negotiation with the funds' investors and are based on a number of different factors (e.g. VC manager experience in different sectors and stages, return target…). Setting additional

investment rules by law or regulation would artificially restrict a fund manager's ability to maximise returns. Furthermore, adding a new eligibility rule would lead to a situation where many funds of strategic importance would choose not to opt in to the new framework and consequently reduced impact of the new legislation.

## QUESTION 10

*Should the temporary nature of the venture capital investment activity in SMEs constitute a criterion that should be reflected?*

| Opinions expressed: | Number of opinions expressed | % over the total number of contributions | Public authorities | Citizens | Organisations | | |
|---|---|---|---|---|---|---|---|
| | | | | | Industry | Other | Total |
| YES | 4 | 8% | 2 | 0 | 0 | 2 | 2 |
| NO | 19 | 40% | 4 | 1 | 8 | 6 | 14 |

The majority doesn't consider the temporary nature of the venture capital investment activity in SMEs as a relevant criterion for the design of the future EU venture capital regime. The timing of both entry and exit from the capital of the SME should be a venture capital manager's decision and it usually depends on different factors, including market opportunities and local tax regimes. However, they agree on that the investment in a typical venture capital fund is generally done on a long-term basis and some respondents suggested excluding trading-related activities, as well as any type of investment whose return result from successive short-term profits, from the scope of the new regime.

## QUESTION 11

*Are there any other means of finance that venture capital funds provide to SMEs that should be reflected (e.g. loans)?*

| Opinions expressed: | Number of opinions expressed | % over the total number of contributions | Public authorities | Citizens | Organisations | | |
|---|---|---|---|---|---|---|---|
| | | | | | Industry | Other | Total |
| YES | 18 | 37% | 4 | 1 | 8 | 5 | 13 |
| NO | 1 | 2% | 0 | 0 | 1 | 0 | 1 |

Almost all respondents consider that VCFs need flexibility regarding the forms of financing that venture capital managers may be willing to use. To date, investment in SMEs is made through various types of instruments. The investment will often take the form of an equity portion, together with quasi-equity contributions, loans, and even options. Defining the relevant type of financing depends on the need of SMEs and the taxation regime. Venture capital fund manager will choose the appropriate instrument with a view to ensuring that returns will not be adversely impacted by taxation at the level of the investment vehicles.

There are many occasions in the life of SMEs when alternative funding to equity is used:

(12) At the start or formation of SMEs, typically venture capitalists will employ convertible debt instruments.

(13) Between financings, inside investors typically would bridge a company via loans until investment from a new investor can be secured.

(14) Some VCFs provide finance for portfolio companies by means of a combination of equity and high-yield debt. A VCF may provide a portfolio company with a contingent loan which might be repayable at a premium if the portfolio company were 'successful' but might not be repayable if the company failed to reach certain targets. Further, some VCFs provide bridging finance in the form of a simple loan or a convertible security to portfolio companies.

## QUESTION 12

*Do you think that there is a need to specify that the manager should be actively involved in the development, growth and success of the SME?*

| Opinions expressed: | Number of opinions expressed | % over the total number of contributions | Public authorities | Citizens | Organisations | | |
|---|---|---|---|---|---|---|---|
| | | | | | Industry | Other | Total |
| YES | 5 | 10% | 1 | 0 | 4 | 0 | 4 |
| *NO. the passive investment in an SME should also be considered by the proposal as venture capital investment* | 14 | 29% | 3 | 1 | 4 | 6 | 10 |

All respondents believe that venture capital funding is not a passive funding and it requires some form of further involvement by the venture capital fund in the target business. Venture capital fund managers do not just invest capital; they also provide valuable know-how to help the SME develop. In particular, they bring strategic and operative advice and specialist sector knowledge.

Whereas such involvement does not mean that the VCF will run the business of the underlying target, the venture capital fund may play an important and active advisory, mentoring or consulting role.

Nonetheless, the degree of involvement depends on the type of investment and on the targeted SME. Most respondents feel that it would be challenging to have a rationale definition of "active involvement" which takes into account all the various situations what the investees are facing during their life-cycle.

## QUESTION 13

*Do you agree that the special rules on venture capital should only apply when funds invest in the seed, start-up and expansion stages of SMEs?*

| Opinions expressed: | Number of opinions | % over the total number | Public | Citizens | Organisations |
|---|---|---|---|---|---|

| | expressed | of contributions | authorities | | Industry | Other | Total |
|---|---|---|---|---|---|---|---|
| YES | 12 | 25% | 4 | 1 | 3 | 4 | 7 |
| NO | 10 | 21% | 1 | 0 | 5 | 4 | 9 |

Many respondents (including EVCA) recommend that there are no limits in terms of which stages of investment can be made by venture capital funds. They believe that these restrictions may result in funds having to avoid some investments that could be valuable to SMEs because they do not clearly fall within the reach of the definition of seed, start-up, and expansion stage. For example,

(15) Excluding replacement capital may have an adverse effect since venture capital funds often provide replacement capital and expansion capital at the same time.

(16) Venture capital can be ideal for a number of SMEs that are in a restructuring phase. This is particularly true in the life science sector where if a product fails in late stage development, a significant restructuring is required. Venture capital firms need the flexibility to be able to consider investment in all of these types of situations associated with SMEs.

On the other hand, 12 respondents (including 4 public authorities) expressed that limiting the investments to the seed, star-up and expansion stages of SMEs is essential to prevent abuse of the passport scheme.

**QUESTION 14**

*Do you agree that venture capital funds do not/should not use leverage?*

| Opinions expressed: | Number of opinions expressed | % over the total number of contributions | Public authorities | Citizens | Organisations | | |
|---|---|---|---|---|---|---|---|
| | | | | | Industry | Other | Total |
| YES | 7 | 15% | 3 | 0 | 2 | 2 | 4 |
| NO | 11 | 23% | 1 | 1 | 4 | 5 | 9 |

Most respondents agree on the fact that it is not a standard to use leverage in venture capital transactions. However, they specify that leverage may be used in fundraising and also if debt instruments are used.

As an example, if a lending institution is willing to participate in particular transaction as a debt provider a venture capital fund should not be prohibited to use leverage in such transaction.

**QUESTION 15**

*Do you agree with the list of entities described below as not being proper investment targets for venture capital funds?*

| Opinions expressed: | Number of opinions expressed | % over the total number of contributions received | Public authorities | Citizens | Organisations | | |
|---|---|---|---|---|---|---|---|
| | | | | | Total | Industry organisations | Other organisations |
| YES | 7 | 15% | 1 | 1 | 5 | 3 | 2 |
| NO. It's too restrictive. | 15 | 31% | 2 | 0 | 13 | 7 | 6 |

In the context of the implementing provisions of Title IV of the Dodd-Frank Wall Street Reform and Consumer Protection Act, the SEC proposed a definition of a "qualifying portfolio companies" (SMEs financed by venture capital funds).

The SEC excluded from the scope of the "qualifying portfolio companies", the entities that meet one of the following criteria:

(17) It is publicly traded (or controlled by a publicly traded company).

(18) It borrows or issues debt obligations, directly or indirectly, in connection with the private fund's investment in the portfolio company.

(19) It redeems, exchanges or repurchases the securities of the company, or distributes to pre-existing security holders cash or other company assets, directly or indirectly, in connection with the private fund's investment in such company.

(20) It is itself a fund.

Many respondents disagree with the list of entities described as not being proper investments targets for venture capital funds. They believe that investment activity indirectly targeted at SMEs (i.e. through a fund of fund) should be included in the scope of the new regime.

Other respondents argue that it would not serve the aim of facilitating financing to SMEs to prohibit the funds regulated under the regime to invest in companies listed on a regulated market. If such company qualifies as an SME and is having difficulty raising funds in the capital markets, the legislative proposal should not deter investment in such a company through an overly restrictive definition.

Further, listing portfolio companies on a stock exchange via an IPO provides an important route to exit for small funds; in such case the fund will retain certain amount of shares in the listed company that may only be sold after a certain lock-up period.

Listing new shares in a portfolio company at a stock exchange can also be an instrument to secure further development and growth without constituting an exit of the fund from the relevant portfolio company.

**QUESTION 16**

*Do you think that the EU should draw inspiration from the criteria set by the SEC to define the target companies of the venture capital funds?*

| Opinions expressed: | Number of opinions expressed | % over the total number of contributions | Public authorities | Citizens | Organisations | | |
|---|---|---|---|---|---|---|---|
| | | | | | Industry | Other | Total |
| YES | 4 | 8% | 2 | 0 | 1 | 1 | 2 |
| NO | 13 | 27% | 2 | 1 | 6 | 4 | 10 |

The majority of respondents believe that the criteria set by the SEC can be used for orientation but have to be adapted to the European needs. It should be taken into account that venture capital market is much more developed in the US than in Europe. Therefore, European regime needs to offer more flexibility and the scope of permitted investments should be much broader.

## QUESTION 17

*Would a third country regime be beneficial?*

| Opinions expressed: | Number of opinions expressed | % over the total number of contributions | Public authorities | Citizens | Organisations | | |
|---|---|---|---|---|---|---|---|
| | | | | | Industry | Other | Total |
| NO | 5 | 10% | 3 | 0 | 2 | 0 | 2 |
| YES | 15 | 31% | 2 | 1 | 7 | 5 | 12 |

Many respondents agree that third country regime would be beneficial. European commission can draw inspiration from AIFMD to design an appropriate regime for third country venture capital funds.

However, some respondents, including 3 public authorities, agree that funds from non-member countries should not be given an EU-passport.

## QUESTION 18

*Which option do you support?*

(21) *Exemption from the AIFMD only those managers that are below the threshold of the AIFMD.*

(22) *Exemption from the scope of the AIFMD the managers that fall under the new venture capital regime even if they trespass the thresholds of AIFMD.*

(23) *Creation a lighter regime for venture capital fund managers within the AIFMD itself.*

| Opinions expressed: | Number of opinions expressed | % over the total number of contributions | Public authorities | Citizens | Organisations | | |
|---|---|---|---|---|---|---|---|
| | | | | | Industry | Other | Total |

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| (1) Exemption for entities below the AIFMD threshold | 10 | 21% | 3 | 0 | 4 | 3 | 7 |
| (2) Exemption independently from the AIFMD threshold | 13 | 27% | 1 | 1 | 4 | 7 | 11 |
| (3) Creation a lighter regime for venture capital fund managers within the AIFM Directive itself. | 6 | 13% | 2 | 0 | 3 | 1 | 4 |

The majority of respondents believe that a new European regime for venture capital should be introduced as a standalone initiative. The AIFMD was designed for a rather different market segment. Simply modifying the Directive would lead to a situation where many of the original (non-fitting) concepts would be maintained. Respondents feel that such approach would be incomplete and wouldn't properly address the issue. The specific needs of the venture capital industry can be more efficiently dealt with under a standalone initiative. This approach would, in addition, give time to appropriately consult with various stakeholders without being caught by the AIFMD own deadlines

Many respondents, including 3 public authorities and EVCA, believe that the right approach is to exempt from the AIFMD those fund managers below the AIFMD threshold.

(24) This approach would encompass the majority of the venture capital business in Europe, and, the existing threshold could make it easier to draw a line between venture capital and other private equity funds.

(25) Moreover, including managers that exceed the threshold would require a more extensive modification of the AIFMD, as it would certainly re-open the discussion with respect to the scope of the AIFMD in general. This would necessarily imply an extension of its transposition period. As a consequence, uncertainty for market participants would most likely increase.

Furthermore, 7 respondents expressed that the arguments raised for the exclusion of VCFs from the scope of AIFMD would be also valid for other strategies.

The European Commission stated in the consultation paper that VCFs do not pose systemic risk or create investor protection concerns because they are focused solely on professional markets. Therefore, it would seem to be disproportionate to require venture capital fund managers to fully comply with AIFMD requirements in exchange for the passport. However, some respondents argue that the same findings are also true for other types of funds (e.g. open-ended real estate funds).

* * *

## 7. Annex VII: US SEC FINAL RULE: Venture capital fund defined

(a) *Venture capital fund defined.* For purposes of section 203(l) of the Act (15

U.S.C. 80b–3(l)), a venture capital fund is any private fund that:

(1) Represents to investors and potential investors that it pursues a venture capital strategy;

(2) Immediately after the acquisition of any asset, other than qualifying investments or short-term holdings, holds no more than 20 percent of the amount of the fund's aggregate capital contributions and uncalled committed capital in assets (other than short-term holdings) that are not qualifying investments, valued at cost or fair value, consistently applied by the fund;

(3) Does not borrow, issue debt obligations, provide guarantees or otherwise incur leverage, in excess of 15 percent of the private fund's aggregate capital contributions and uncalled committed capital, and any such borrowing, indebtedness, guarantee or leverage is for a non-renewable term of no longer than 120 calendar days, except that any guarantee by the private fund of a qualifying portfolio company's obligations up to the amount of the value of the private fund's investment in the qualifying portfolio company is not subject to the 120 calendar day limit;

(4) Only issues securities the terms of which do not provide a holder with any right, except in extraordinary circumstances, to withdraw, redeem or require the repurchase of such securities but may entitle holders to receive distributions made to all holders pro rata; and

(5) Is not registered under section 8 of the Investment Company Act of 1940 (15 U.S.C. 80a–8), and has not elected to be treated as a business development company pursuant to section 54 of that Act (15 U.S.C. 80a–53).

(b) *Certain pre-existing venture capital funds.* For purposes of section 203(l) of the Act (15 U.S.C. 80b–3(l)) and in addition to any venture capital fund as set forth in paragraph (a) of this section, a venture capital fund also includes any private fund that:

(1) Has represented to investors and potential investors at the time of the offering of the private fund's securities that it pursues a venture capital strategy;

(2) Prior to December 31, 2010, has sold securities to one or more investors that are not related persons, as defined in § 275.206(4)–2(d)(7), of any investment adviser of the private fund; and

(3) Does not sell any securities to (including accepting any committed capital from) any person after July 21, 2011.

(c) *Definitions.* For purposes of this section:

(1) *Committed capital* means any commitment pursuant to which a person is obligated to:

(i) Acquire an interest in the private fund; or

(ii) Make capital contributions to the private fund.

(2) *Equity security* has the same meaning as in section 3(a)(11) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(11)) and § 240.3a11–1 of this chapter.

(3) *Qualifying investment* means:

(i) An equity security issued by a qualifying portfolio company that has been acquired directly by the private fund from the qualifying portfolio company;

(ii) Any equity security issued by a qualifying portfolio company in exchange for an equity security issued by the qualifying portfolio company described in paragraph (c)(3)(i) of this section; or (iii) Any equity security issued by a company of which a qualifying portfolio company is a majority-owned subsidiary, as defined in section 2(a)(24) of the Investment Company Act of 1940 (15 U.S.C. 80a–2(a)(24)), or a predecessor, and is acquired by the private fund in exchange for an *equity security* described in paragraph (c)(3)(i) or (c)(3)(ii) of this section.

(4) *Qualifying portfolio company* means any company that:

(i) At the time of any investment by the private fund, is not reporting or foreign traded and does not control, is not controlled by or under common control with another company, directly or indirectly, that is reporting or foreign traded; (ii) Does not borrow or issue debt obligations in connection with the private fund's investment in such company and distribute to the private fund the proceeds of such borrowing or issuance in exchange for the private fund's investment; and (iii) Is not an investment company, a private fund, an issuer that would be an investment company but for the exemption provided by § 270.3a–7 of this chapter, or a commodity pool.

(5) *Reporting or foreign traded* means, with respect to a company, being subject to the reporting requirements under section 13 or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m or 78o(d)), or having a security listed or traded on any exchange or organized market operating in a foreign jurisdiction.

(6) *Short-term holdings* means cash and cash equivalents, as defined in § 270.2a51–1(b)(7)(i) of this chapter, U.S. Treasuries with a remaining maturity of 60 days or less, and shares of an open-end management investment company registered under section 8 of the Investment Company Act of 1940 (15 U.S.C. 80a–8) that is regulated as a money market fund under § 270.2a–7 of this chapter.

Definition of equity security:

The final rule incorporates the definition of equity security in section 3(a)(11) of the Exchange Act and rule 3a11–1 thereunder. Accordingly, equity security includes common stock as well as preferred stock, warrants and other securities convertible into common stock in addition to limited partnership interests.[96] Our definition of equity security is broad. The definition includes various securities in which venture capital funds typically invest and provides venture capital funds with flexibility to determine which equity securities in the portfolio company capital structure are appropriate for the fund**. Our use of the definition of equity security under the Exchange Act acknowledges that venture capital funds typically invest in common stock and other equity instruments that may be convertible into equity common stock but** does not otherwise specify the

types of equity instruments that a venture capital fund could hold in deference to the business judgment of venture capital funds.

**Rule 203(l)–1(c)(2) (equity security** ‘‘has the same meaning **as in section 3(a)(11) of the** Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(11)) and § 240.3a11–1 of this chapter.’’). *See* 15 U.S.C. 78c(a)(11) defining ‘‘equity security’’ as ‘‘any stock or similar security; or any security future on any such security; or any security convertible, with or without consideration, into such a security, or carrying any warrant or right to subscribe to or purchase such a security; or any such warrant or right; or any other security which the Commission shall deem to be of similar nature and consider necessary or appropriate, by such rules and regulations as it may prescribe in the public interest or for the protection of investors, to treat as an equity security.’’);

**Rule of section 3(a)11–1 under the Exchange Act (17 CFR 240.3a11–1) (defining ‘‘equity security’’** to **include** ‘any stock or similar security, certificate of interest or participation in any profit sharing agreement, preorganization certificate or subscription, transferable share, voting trust certificate or certificate of deposit for an equity security, limited partnership interest, interest in a joint venture, or certificate of interest in a business trust; any security future on any such security; or any security convertible, with or without consideration, into such a security, or carrying any warrant or right to subscribe to or purchase such a security; or any such warrant or right; or any put, call, straddle, or other option or privilege of buying such a security from or selling such a security to another without being bound to do so.’’). *See* rule 3a11–1 under the Exchange Act (17 CFR 240.3a11–1) (defining ‘‘equity security’’ to include any ‘‘limited partnership interest’’).

## 8. Annex VIII: Venture capital business model and selected managers profiles

The term "venture capital" does not always have the same meaning. Differences are observed in the main venture capital markets: the US and EU.[89] The US has a more distinctive approach to venture capital funds as comprising nearly exclusively investments in seed, start-up and expansion stage of a company. US understanding of venture capital does not include any form of buy-out activity, this is a preserve of private equity investment strategies. This has just been confirmed by the US Securities and Exchange Commission adopting rules that define venture capital.[90] In Europe, due to its development, venture capital is understood as more of a subset of private equity and as a concept it includes commitments to unquoted companies, with financing focus on their early stages of development. However, other forms of investments and other stages of companies are not excluded.[91] It is thus not an exception to find a European venture capital fund investing portion of funds' capital in buy-out transactions[92].

The remainder of this chapter though tries to identify the key aspects and characteristics of the funding activities that, in the EU, are generally grouped under the heading of venture capital and how these activities differ from other types of financing, mainly those of private equity – especially buy-outs.

Venture capital can be supplied in many ways. For example corporations provide venture capital directly to selected portfolio companies and remain the main investor therein. There are also venture capital funds that pool capital from a number of investors in a pursuit of a defined strategy and as such strive to diversify the individual investors' risks by investing into carefully selected portolio companies. Venture capital funds are usually structured as limited partnerships with a limited lifespan, usually 10 years. The investors are the limited partners and the venture capital firm is the general partner of the partnership/fund. Furthermore, venture capital funds are usually connected with investments in young and small companies that own or develop certain technological know-how (in the life sciences, computer electronics and software, to industrial products etc.).[93]

As venture capital is generally linked with financing of young and newly established companies, the provision of equity finance prevails. It provides fresh capital to companies for operating and business purposes. In exchange for the direct cash injection into the company, the fund receives an equity stake in the company in the form of a common or preferred stock and becomes part-owner or partner in the business. This form of financing

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[89] M. Bender, Spatial Proximity in Venture Capital Financing, 2010, chapter 2.1.1.

[90] See Annex VII: The US Securities and Exchange Commission adopted in July 2011 final rules that implement the Dodd-Frank act, among others on definition of venture capital fund; http://www.sec.gov/rules/final/2011/ia-3222fr.pdf

[91] A. Rigaut: The development of venture Capital fundraising in Europe; 2001; page 10 http://aloys.rigaut.free.fr/pdf/Thesis_Coleurop.PDF or G. Baygan and M. Freudenberg, DSTI/DOC(2000)70: The Internationalisation of Venture Capital Activity in OECD Countries: Implications for Measurement and Policy, page 11 http://www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?cote=DSTI/DOC%282000%297&docLanguage=En

[92] See Annex VIII: Examples of selected venture capital firms and their strategic focus

[93] Venture deals are directed at various sectors, of which life science, computer and consumer electronics, communications or business and industrial products and services accounted for more than 70% in 2010. Furthermore, the share of high-tech investments within the venture capital flows remains relatively steady, at about 30% on a yearly basis. Source EVCA: www.evca.eu

is referred to as primary or direct acquisition of equity from the target company as opposed to a secondary acquisition, where a fund buys shares from existing shareholders either on an exchange or by means of a buy-out of existing shareholders.

Venture capital being the equity provider accepts more risk than for example bank with its loans; as creditors are expected to be paid before owners in case of company's failure. Since the success of a venture capital funds' investments is directly linked to the success of the underlying companies, venture capital fund managers (unlike the traditional debt providers[94]) usually provide important non-financial support to these companies, through endorsement[95], contacts[96] and advice[97] to facilitate the professionalization[98], growth[99], internationalization[100] and performance[101] of their portfolio companies. In order to efficiently engage in such support, local presence and proximity to their target companies is essential. It is important especially in the early stages of portfolio company life when more intensive support is needed to get the business running. Recent research also finds that presence of local venture capital investors attracts foreign venture capital firms and target companies that are financed by such cross-border syndicates (European or

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[94] Sefano Caselli, 2010, Private equity and Venture Capital in Europe: Markets, Techniques, and Deals, chapter 4.4 on reasons for choosing a closed-end fund to provide equity financing rather than a bank or investment firm.

[95] Stuart, T.E., Hoang, H., and Hybels, R.C., 1999, Inter-organizational endorsements and the performance of entrepreneurial ventures. *Administrative Science Quarterly* 44(2): p. 315-349. and Hsu, D.H., 2004, What do entrepreneurs pay for venture capital affiliation? *Journal of Finance* 59(4): p.1805-1844.

[96] Maula, M.V.J., Autio, E., and Murray, G.C., 2005, Corporate Venture Capitalists and Independent Venture

Capitalists: What Do They Know, Who Do They Know, and Should Entrepreneurs Care? *Venture Capital:*

*An International Journal of Entrepreneurial Finance* 7(1): p. 3-19 and Lindsey, L., 2008, Blurring Firm Boundaries: The Role of Venture Capital in Strategic Alliances. *Journal of Finance*.

[97] See Maula et al.(2005) and Hellmann, T. and Puri, M., 2000, The interaction between product market and financing strategy: The role of venture capital. *Review of Financial Studies* 13(4): p. 959-984.

[98] Hellmann, T. and Puri, M., 2002, Venture capital and the professionalization of start-up firms: Empirical evidence. *Journal of Finance* 57(1): p. 169-197 and Davila, A. and Foster, G., 2005, Management accounting systems adoption decisions: Evidence and

performance implications from early-stage/startup companies. *Accounting Review* 80(4): p. 1039-1068.

[99] Bertoni, F., Colombo, M.G., and Grilli, L., 2008, Venture Capital Financing and the Growth of New

Technology-Based Firms. Working paper and Davila, A., Foster, G., and Gupta, M., 2003, Venture capital financing and the growth of startup firms.*Journal of Business Venturing* 18(6): p. 689-708.

[100] Fernhaber, S.A. and McDougall, P.P., 2008, Venture Capitalists as Catalysts to new Venture Internationalization: The Impact of their Investments, Reputation and Knowledge Resources. *Entrepreneurship Theory and Practice.* And Lockett, A., Wright, M., Burrows, A., Scholes, L., and Paton, D., 2008, The export intensity of venture capital backed companies. *Small Business Economics* 31(1): p. 39-58.

[101] Hsu, D.H., 2006, Venture capitalists and cooperative start-up commercialization strategy. *Management Science* 52(2): p. 204-219 and Bottazzi, L., Da Rin, M., and Hellmann, T., 2008, Who are the active investors? Evidence from venture

capital. *Journal of Financial Economics*.

International) show better performance than target firms supported only with local or locally syndicated venture capital firms. [102]

A venture capital fund's engagement follows several financing rounds. Each financing round is conditional upon the target or "portfolio" company achieving certain milestones. Usually these financing rounds correspond to the evolution of the portfolio company:

– the very first round of financing is supplied to a company that aims to prove the value of a new idea (also known as seed financing);

– the next round of financing is linked to marketing and product development (usually referred to as start-up financing);

– a subsequent round of financing aims to provide working capital is to companies who start selling product but are not yet turning a profit.

Up until this stage of financing, the capital provided to companies in these early stages is usually equity capital. Venture capital funds are also active providers of mezzanine financing, which is used predominantly in the expansion stage of SMEs but also in start-ups and is a helpful financing structure for innovation. Mezzanine finance is a collective term for hybrid forms of finance: it has features of both debt and equity. There are various types of mezzanine finance, each having its own unique characteristics. On the positive side, choosing the appropriate form of mezzanine financing SMEs can retain control over the company without surrendering ownership rights and the cost of it for SMEs compared to pure equity is usually lower. The most common form of mezzanine finance[103] is the **subordinated loan**, which is an unsecured loan with a lower ranking in case of bankruptcy compared to senior debt. **Participating loans** are normal loans, but rather than there being a fixed return, their remuneration is contingent upon the results of the business. **Silent participation** is closer to a stockholding than a subordinated or participating loan. There are also equity related mezzanine finance instruments. These instruments present a greater risk profile to the lender and, in turn offer a higher rate of return. Mezzanine products with **profit participation rights** are more related to equity and under company law the holder is entitled to rights over the company's profits. A further equity mezzanine financing instrument is the **convertible bond**. In addition to the usual right to fixed interest payments and repayment of principal, holders of convertible bonds or bonds with warrants have the right to acquire shares in the company instead of accepting repayment of the bond. Another equity mezzanine financing instrument is the **bond with warrants**, which in principal is similar to the convertible bond. The main difference is that the warrants (subscription rights) are separate from the bond and thus can be traded independently. Finally, venture capital funds can also provide bridge financing. It is a short term loan that usually facilitates portfolio company transition to an IPO or another stage of financing. A bridge loan can also be is assorted with an option to convert the loan into equity.

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[102] D. Devigne, T. Vanacker, S. Manigart and I. Paeleman: Cross-border venture capital and the development of portfolio companies, page 45, Figure 1: Predicted growth curves for portfolio company sales

[103] See Annex IX: Overview of different forms of SMEs mezzanine financing from Roundtable between bankers and SMEs, Mezzanine finance, http://ec.europa.eu/enterprise/newsroom/cf/_getdocument.cfm?doc_id=1065

The business objective of venture capital fund as an investor is to steer its portfolio companies towards a profitable sale and thereby realise a profit that should considerably exceed the investments made to the company throughout fund's time of engagement in it. There are number of possible exit routes, including, for example, a sale to management, repayment of principal. The two most common exits are the portfolio company's listing on a stock exchange (the so called initial public offering – IPO) or the sale of the portfolio company to a strategic buyer - either a private equity firm or a corporation (the so called trade sale).

Venture capital, being a very risky type of asset class, is a preserve of institutional and qualified investors. According to the latest industry data, the share of such these investors (e.g., banks, capital market experts, endowments and foundations, government agencies, corporations, fund of funds, insurance companies, asset managers, pension funds or sovereign wealth funds) in European venture capital comprises nearly 50% of assets collected by venture capital funds. The investments by private individuals and family offices account for roughly 15% of assets managed by European venture capital funds. This percentage is double the percentage that private investors contribute to financing of private equity.[104] Most Member States allow for certain private individuals (e.g. high net worth individuals) to invest in venture capital, as long as certain conditions are met. These conditions may involve a minimum investment limit or some form of appropriateness test to ensure that such investors are aware of and accept the inherent risks associated with investments in venture capital operations.

Data shows that venture capital funds make limited use of leverage. Leverage can occur at two levels, at the level of the fund and the portfolio company. (i) At fund level, neither venture capital nor private equity funds use extensively leverage or in other terms borrow, unless for a very short period of time, and for practical purposes – usually to cover their liquidity needs between committed capital from investors that has been called but takes usually couple of weeks before the fund receives it on its accounts. (i) At portfolio company level, debt can be used for different purposes. Usually venture capital equity investment in early stages of company's life is not accompanied by debt financing from other sources as no other viable financing alternative exists at that stage. However, European venture capital funds do engage in buy-out transactions where the venture fund provides only a part of the total acquisition with the remainder being matched by borrowing from a bank whereby the assets of the portfolio company serve as the collateral to the lender. Lastly, unrelated to the venture capital investment activity, portfolio companies borrow money in the ordinary course of their business.

Based on these key characteristics of venture capital funds, multitude of fund types emerge. Some venture capital funds may be focused on investing in new ideas – in new and early stages of companies, some may prefer to invest in already more established firms that need support in order to expand or become publically traded firms. Other funds may on the other hand focus solely in certain industries and as such their financing would cut across all the stages of portfolio companies' life-cycle before their successful exit is realised. Additional dimension is funds' geographical focus, some are local/regional others national or operating world-wide. The situation in Europe is now characterised by the move from locally focused ventures towards more sector specific venture capital firms looking out for opportunities globally.

[104] The remaining 30% is unknown – data assembled by the industry EVCA.

**Venture capital manager A**

| | |
|---|---|
| type of firm: | GP - Dept of corporation - financial institution |
| staff size: | 3 |
| capital under management: | €4,000,000 |
| financing stages: | Expansion – development, Other early stage, Seed, Start-up |
| type of financing: | Minority Equity, Debt, Shareholders loans |
| industry sectors: | Business and Industrial Products<br>Business and Industrial Services<br>Chemicals and Materials<br>Communications<br>Computer and Consumer Electronics<br>Energy and Environment |
| geographical preferences: | United Kingdom |
| remarks: | Our company provides investment and support for IT, med-tech and clean technology companies. Our strategy is to lead investment in technology-driven companies that seek to address markets with significant growth potential. We are authorised and regulated by the FSA. |

**Venture capital manager B**

type of firm: GP - Independent (no parent)

staff size: 17

capital under management: €373,130,000

financing stages: Expansion – development, Other early stage, Small buyout (<15m equity), Start-up

type of financing: Minority Equity

industry sectors: Communications, Computer and Consumer Electronic, Life Sciences

geographical preferences: Belgium, Finland, France, Germany, Ireland, Netherlands, Norway, Sweden, Switzerland, United Kingdom, United States of America, Israel

fund managed/advised: …Private Equity Fund II

fund capital: €115,000,000

vintage year: 1998

fund focus: Balanced fund

fund managed/advised: ….Life Sciences Fund

fund capital: €90,000,000

vintage year: 2011

fund focus: Balanced fund

**Venture fund manager C**

type of firm: GP - Independent (no parent)

staff size: 20

capital under management: €430,000,000

financing stages: Expansion – development, Other early stage, Seed, Start-up

type of financing: Minority Equity

industry sectors: Business and Industrial Products
Business and Industrial Services
Communications
Energy and Environment
Life Sciences

Other

geographical preferences: Germany, Western Europe

fund managed/advised: X

fund capital: €53,233,972

vintage year: 1998 / 1999

fund focus: Early stage fund

fund managed/advised: Y

fund capital: €240,000,000

vintage year: 2000

fund focus: Early stage fund

fund managed/advised: Z

fund capital: €128,500,000

vintage year: 2007

fund focus: Development fund, Early stage fund

**Venture capital manager D**

| | |
|---|---|
| type of firm: | GP - Independent (no parent) |
| staff size: | 8 |
| capital under management: | €156,000,000 |
| financing stages: | Start-up |
| type of financing: | Majority Equity |
| industry sectors: | Business and Industrial Products<br>Communications<br>Life Sciences |
| geographical preferences: | France, Switzerland, United Kingdom |
| fund managed/advised: | X |
| fund capital: | €61,000,000 |
| vintage year: | 1998 |
| fund focus: | Early stage fund |
| fund managed/advised: | Y |
| fund capital: | €150,000,000 |
| vintage year: | 2000 |
| fund focus: | Early stage fund |

| | |
|---|---|
| remarks: | Company D invests in early stage high-tech companies that have high-growth potential, with innovative products and/or unique solutions and led by seasoned management teams. |

**Venture capital manager E**

| | |
|---|---|
| type of firm: | GP - Independent (no parent) |
| staff size: | 11 |
| capital under management: | €185,000,000 |
| financing stages: | Expansion – development, Other early stage, Privatisation, Public to private, Replacement, Seed, Small buyout (<15m equity), Start-up |
| type of financing: | Majority Equity, Minority Equity, Shareholders loans |
| industry sectors: | Business and Industrial Products<br>Business and Industrial Services<br>Communications<br>Computer and Consumer Electronics<br>Consumer Goods and Retail<br>Consumer Services: others<br>Energy and Environment |

| | |
|---|---|
| geographical preferences: | Western Europe |
| fund managed/advised: | X |
| fund capital: | €160,000,000 |
| vintage year: | 2007 |
| fund focus: | Balanced fund |
| remarks: | Independent international venture capital fund with a service-oriented and labour-intensive style of investing. Investing in all technology sectors, including clean technology, focus is on high-growth, high-potential international companies based in Europe. Strong value-added approach, entrepreneurial style and with extensive local networks in several countries. |

**Venture capital firm F**

| | |
|---|---|
| type of firm: | GP - Corporate venturer - Industrial company<br>LP - Corporate investor |
| staff size: | 5 |
| financing stages: | Expansion - development<br>Other early stage<br>Seed<br>Start-up |
| type of financing: | Minority Equity |

| | |
|---|---|
| | Mezzanine<br>Shareholders loans |
| industry sectors: | Communications<br>Computer and Consumer Electronics<br>Consumer Goods and Retail<br>Consumer Services: others |
| geographical preferences: | Germany, Western Europe, Switzerland |
| remarks: | VC Firm F is a subsidiary of a leading media corporation based in Germany. VC firm F is actively seeking high-growth potential companies in the digital media and IT segments and financially supports the development, market launch and internationalisation of its partners. |

## 9. Annex IX: Overview of different forms of SMEs mezzanine financing[105]

Mezzanine finance can be a complementary source of finance to debt and equity and can be helpful in financing the start-up, and expansion of SMEs, innovation and business transfers. Mezzanine finance instruments are gaining in importance but remain little used compared with loan financing. The level of development in the market for mezzanine financing varies across Europe, especially where SMEs are concerned. While SMEs in some countries can choose from a wide range of different products, other countries still have ground to make up in this area.

Mezzanine finance is a collective term for hybrid forms of finance: it has features of both debt and equity. There are various types of mezzanine finance, each having its own unique characteristics:

The most common form of mezzanine finance is the **subordinated loan**, which is an unsecured loan with a lower ranking in case of bankruptcy compared to senior debt. Providers of subordinated loans receive a fixed interest rate and are ranked before equity investors should the borrower be wound up. **Participating loans** are normal loans, but rather than there being a fixed return, their remuneration is contingent upon the results of the business. Despite sharing in profits, participating loans do not give rise to an ownership relationship. Participation in losses is contractually excluded. In legal terms, a **"silent" participation** is closer to a stockholding than a subordinated or participating loan. The distinguishing feature of this form of financing is that one or more persons take an equity stake in a company, but without assuming any liability to the company's creditors. The typical "silent" participation affects only the company's internal affairs and is not apparent to outside observers. Participation in profits and losses and contractual rights of approval and control are structured flexibly.

There are also equity related mezzanine finance instruments. These instruments present a greater risk profile to the lender and, in turn offer a higher rate of return. Mezzanine products with **profit participation rights** are more related to equity and under company law the holder is entitled to rights over the company's profits. In general the financier has no voting or management rights. However, the instrument is rather flexible and the right to be consulted on business decisions can be included in the contractual documents. A further equity mezzanine financing instrument is the **convertible bond**. In addition to the usual right to fixed interest payments and repayment of principal, holders of convertible bonds or bonds with warrants have the right to acquire shares in the company instead of accepting repayment of the bond. This right is exercisable for a defined period and at a predetermined conversion or subscription rate. This way the issuer may convert debt into equity. Another equity mezzanine financing instrument is the **bond with warrants**, which in principal is similar to the convertible bond. The main difference is that the warrants (subscription rights) are separate from the bond and thus can be traded independently.

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[105] Roundtable between bankers and SMEs, Mezzanine finance,

http://ec.europa.eu/enterprise/newsroom/cf/_getdocument.cfm?doc_id=1065

One characteristic which the various mezzanine instruments share is that they can be structured flexibly in many different forms, and can be combined in numerous ways, to provide tailor-made solutions for the specific financing needs of the company in question. Mezzanine products can be complex. In cases where they are not obviously debt or equity then the classification of the instrument depends on national and/or international **regulations/principles** such as the prevalent national accounting principles or Basle II. Whether a mezzanine product can be classified as equity mezzanine or not is a very significant aspect for both the lender and the recipient. Equity mezzanine may positively influence the internal bank rating and/or the external rating of an SME and thus the price of finance. It also impacts on the aspects of tax-deductibility; and the level of default risk borne by the financial institution.

Mezzanine finance instruments have been gaining in importance but remain little used compared to classic loan financing. Mezzanine finance products usually have the following positive features:

• Mezzanine finance is in principle unsecured. Mezzanine finance is subordinated to senior loans. This results in an improved balance sheet structure and better access to additional loans or equity (leverage effect).

• By choosing the appropriate form of mezzanine finance SMEs can retain control over the company and avoid surrendering ownership rights.

• In general the cost of mezzanine finance for SMEs is lower than for pure equity.

• Interest payments on some types of mezzanine finance are tax-deductible.

• Mezzanine finance can be a very useful financial tool in the cases of business expansion,

business transfer, innovation and public to private transactions.

• The confidence of a mezzanine capital provider increases the image of the company.

Banks will invest more easily in a company that has the trust of a risk taking investor.

• For equity providers mezzanine finance can lead to smaller, more conservative stakes in

companies with potentially higher returns.

• The revenues for providers of mezzanine finance are higher than for senior debt.

• Providers of mezzanine finance are often more willing to offer advice and valuable strategic assistance than providers of debt finance, especially when the return on the investment is partly dependent on the performance of the company. Mezzanine finance provides also some challenges for financiers and SMEs.

• The understanding of mezzanine finance by SMEs is limited: SMEs are often not aware of the opportunities and the requirements.

• Mezzanine finance is often difficult to obtain by low-and middle-tier SMEs. There are many requirements to meet in order to obtain this type of finance. In particular, the transparency requirements are very high and stringent. In addition, the financing contract

may include restrictive covenants that the borrower has to abide by such as not to acquire additional capital. Mezzanine finance is more expensive than debt financing.

• The interest component and the debt-like characteristics of mezzanine finance make it

difficult for suppliers of mezzanine finance to low and middle-tier SMEs to arrange an early exit. For the upper-tier SME segment secondary markets exist.

• Individually structured mezzanine deals will often take several months to complete.

## 10. ANNEX X: Venture capital – fundraising, investments, performance

**Table 1: Geographical location of venture capital managers in the EU (2010)**

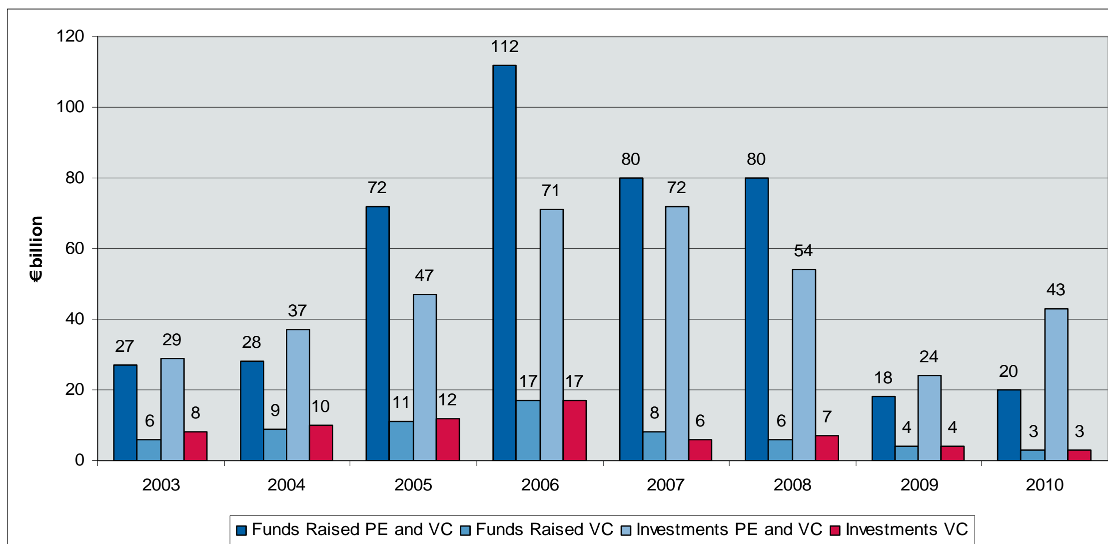
**Table 1: Geographical location of venture capital managers in the EU (2010)**

| MEMBER STATE | VC FIRMS | BUYOUT FIRMS | VC CAPITAL '000 € | BUYOUT CAPITAL '000 € |
|---|---|---|---|---|
| AT | 17 | 15 | 56.600 | 1.378.000 |
| Baltics | 7 | 4 | 124.000 | 431.000 |
| BE | 25 | 12 | 1.420.000 | 3.249.000 |
| BG | 2 | 0 | 47.000 | 0 |
| CZ | 1 | 2 | 12.000 | 217.000 |
| **DK** | 19 | 11 | ***2.367.000*** | 2.763.000 |
| **FI** | 19 | 12 | ***1.658.000*** | 1.642.000 |
| **FR** | **67** | 82 | ***8.698.000*** | 36.984.000 |
| **DE** | **124** | 68 | ***10.832.000*** | 14.058.000 |
| GR | 3 | 2 | 96.000 | 539.000 |
| HU | 7 | 3 | 232.000 | 46.000 |
| IRL | 13 | 5 | 950.000 | 833.000 |
| IT | 13 | 53 | 640.000 | 11.848.000 |
| LUX | 5 | 4 | 673.000 | 839.000 |
| **NL** | **32** | 31 | ***2.075.000*** | 8.026.000 |
| PL | 13 | 9 | 250.000 | 2.421.000 |
| PT | 7 | 1 | 754.000 | 30.000 |
| RO | 2 | 1 | 11.000 | 0 |
| **ESP** | **62** | 33 | ***2.785.000*** | 7.670.000 |
| **SE** | **68** | 33 | ***4.449.000*** | 29.510.000 |
| **UK** | **129** | 172 | ***12.780.000*** | 227.666.000 |
| TOTAL EU | 635 | 553 | 50.909.600 | 350.150.000 |

Source: EVCA Yearbook 2011

**Table 2: Funds raised and investments by private equity and venture capital 2003-2010 (industry statistics)**

| YEAR | Funds Raised PE and VC | Funds Raised VC | Investments PE and VC | Investments VC |
|---|---|---|---|---|
| | €billion | €billion | €billion | €billion |
| 2003 | 27 | 6 | 29 | 8 |
| 2004 | 28 | 9 | 37 | 10 |
| 2005 | 72 | 11 | 47 | 12 |
| 2006 | 112 | 17 | 71 | 17 |
| 2007 | 80 | 8 | 72 | 6 |
| 2008 | 80 | 6 | 54 | 7 |
| 2009 | 18 | 4 | 24 | 4 |
| 2010 | 20 | 3 | 43 | 3 |
| **TOTAL** | **437** | **64** | **377** | **67** |




Source: EVCA, own calculations

## Table 2a: Venture capital and private equity funds raised between 2007-2010

| 2007-2010 | | | | 2007-2010 |
|---|---|---|---|---|
| **Funds raised by fund stage focus** | **amount (€bn)** | **N° of funds** | **average fund size (€mn)** | **amount (€bn)** |
| | Independent funds only | | | All funds including captive and independent |
| Early-stage | 4 | 73 | 59 | 8 |
| Later stage venture | 4 | 35 | 116 | 4 |
| Balanced | 5 | 75 | 65 | 9 |
| **Total venture** | **13** | **183** | **72** | **21** |
| Growth capital | 58 | 79 | 738 | 8 |
| Buyout | 86 | 137 | 633 | 144 |
| Mezzanine | 8 | 15 | 338 | 8 |
| Generalist | 6 | 58 | 111 | 14 |
| **Total funds raised** | **170** | **472** | **360** | **197** |

Source: EVCA, own calculations

## Table 2b: Venture capital funds raised between 2003-2010 in the US and EU

| year | US funds raised (USD million) | N° of funds | Average fund size (USD million) | Average fund size (EUR million) |
|---|---|---|---|---|
| 2003 | 9000 | 91 | 99 | 82 |
| 2004 | 21000 | 161 | 130 | 98 |
| 2005 | 28000 | 173 | 162 | 138 |
| 2006 | 30000 | 167 | 180 | 135 |
| 2007 | 37000 | 172 | 215 | 146 |
| 2008 | 27000 | 146 | 185 | 170 |
| 2009 | 15000 | 76 | 197 | 130 |
| 2010 | 6000 | 33 | 182 | 138 |
| | | | | |
| Total | 173.000 USD mn | 1019 | | **130 EUR mn** |

| Total | **131.000 EUR mn** | | | |
|---|---|---|---|---|

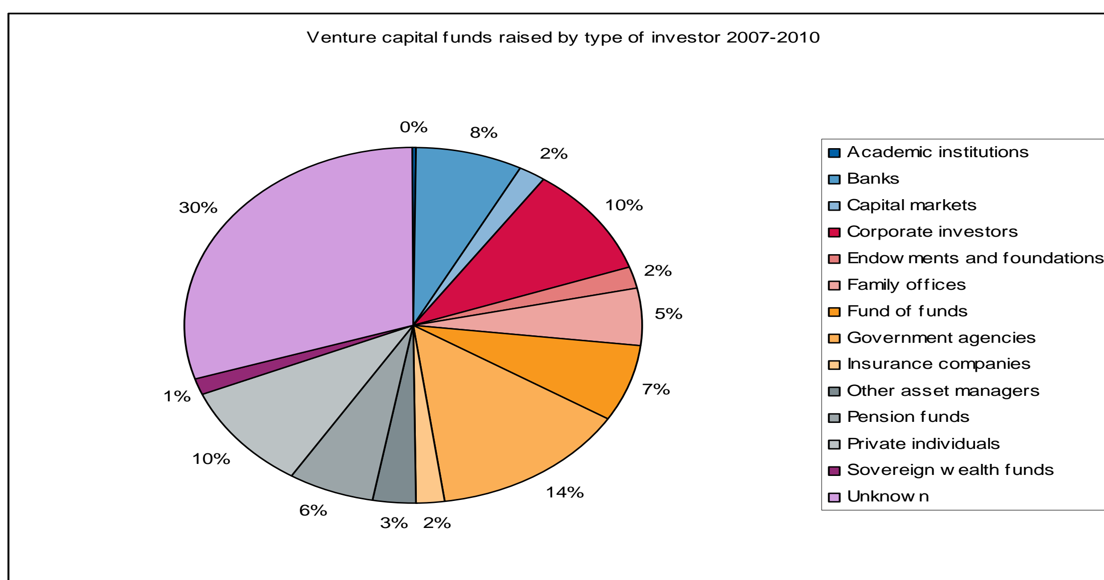
| year | EU funds raised (USD million) | N° of funds | Average fund size (USD million) | Average fund size (EUR million) |
|---|---|---|---|---|
| 2003 | 2000 | 61 | 33 | 27 |
| 2004 | 4000 | 62 | 65 | 48 |
| 2005 | 7000 | 70 | 100 | 85 |
| 2006 | 6000 | 83 | 72 | 54 |
| 2007 | 6000 | 72 | 83 | 66 |
| 2008 | 7000 | 65 | 108 | 85 |
| 2009 | 4000 | 27 | 148 | 98 |
| 2010 | 1000 | 11 | 91 | 69 |
| | | | | |
| Total | 37.000 USD mn | 451 | | **67 EUR mn** |
| **Total** | **28.000 EUR mn** | | | |

**Source:** Ernst & Young, "Back to basics, Global venture capital insights and trends report 2010, own calculations and estimates

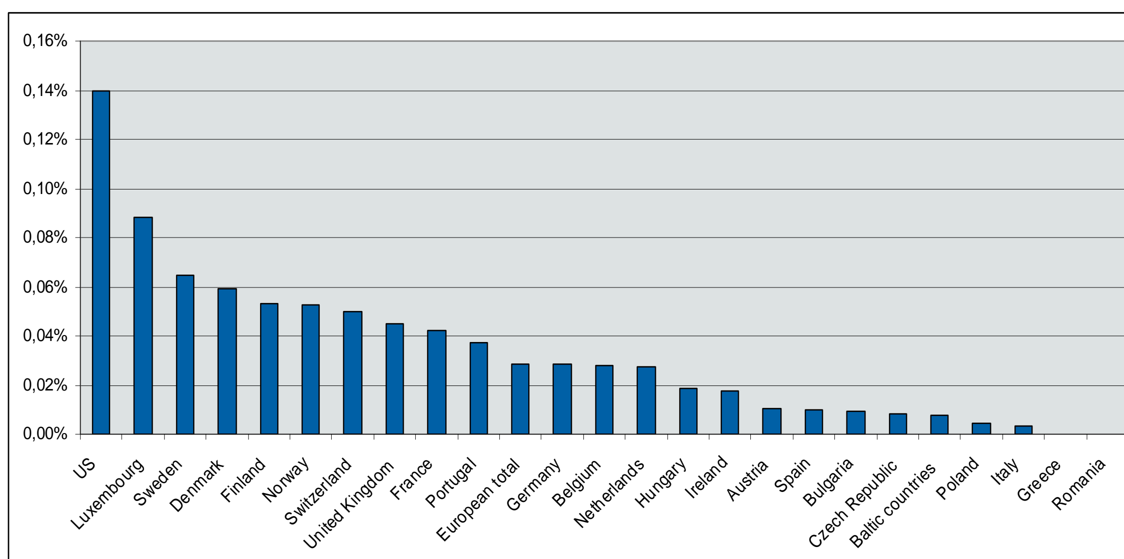
## Table 3: Private equity and venture capital funds raised by type of investor 2007-2010

| | Amount VC | Venture capital | Amount PE | Private equity |
|---|---|---|---|---|
| | €bn | % | €bn | % |
| Academic institutions | 32 | 0,2 | 472 | 0,2 |
| Banks | 1.614 | 8,0 | 20.317 | 10,4 |
| Capital markets | 402 | 2,0 | 3.820 | 1,9 |
| Corporate investors | 2.117 | 10,0 | 4.980 | 2,5 |
| Endowments and foundations | 446 | 2,0 | 5.475 | 2,8 |
| Family offices | 1.079 | 5,0 | 8.351 | 4,3 |
| Fund of funds | 1.451 | 7,0 | 23.670 | 12,1 |
| Government agencies | 2.935 | 14,0 | 6.853 | 3,5 |

| Insurance companies | 468 | 2,0 | 13.020 | 6,6 |
|---|---|---|---|---|
| Other asset managers | 590 | 3,0 | 9.315 | 4,7 |
| Pension funds | 1.335 | 6,0 | 40.696 | 20,7 |
| Private individuals | 2.037 | 10,0 | 8.952 | 4,6 |
| Sovereign wealth funds | 288 | 1,0 | 6.186 | 3,2 |
| Unknown | 6.353 | 29,0 | 44.040 | 21,6 |
| TOTAL | 21.147 | | 196.150 | |




### Table 4: European and US venture capital investments as a share of GDP (in %) in 2010



## Table 5: Average annual number of companies receiving venture capital investments in 2003-2006

| Investment phase (EVCA definitions) | EUROPE (number of companies) | | Investment phase (NVCA definitions) | US (number of companies ) | | EUROPE/U S |
|---|---|---|---|---|---|---|
| Seed | 349 | | Seed/Start-up | 233 | | 1.50x |
| Start-up | 2.142 | | Early stage | 839 | | 2.55x |
| ***Total early stage*** | ***2.490*** | | ***Early stage*** | ***1.072*** | | ***2.32x*** |
| Expansion | 3.372 | | Expansion | 1.253 | | 2.69x |
| Replacement capital | 314 | | Later stage | 841 | | 0.37x |
| ***Total later stage*** | ***3.686*** | | ***Total later stage*** | ***2.094*** | | ***1.71x*** |
| **TOTAL** | **6.179** | | **TOTAL** | **3.166** | | **1.95x** |

Source: K. Raade and C.T. Machado: Recent developments in the European private equity markets, Economic papers 319, April 2008
http://ec.europa.eu/economy_finance/publications/publication12419_en.pdf

## Table 6: Average deal size of venture capital investments in 2003-2006 for Europe and US

| Investment phase (EVCA definitions) | EUROPE (€million) | | Investment phase (NVCA definitions) | US (€million) | | EUROPE/U S |
|---|---|---|---|---|---|---|
| Seed | 0.425 | | Seed/Start-up | 2.181 | | 0.19x |
| Start-up | 1.425 | | Early stage | 3.449 | | 0.41x |
| Expansion | 2.652 | | Expansion | 6.011 | | 0.44x |
| Replacement capital | 7.208 | | Later stage | 7.699 | | 0.94x |

Source: K. Raade and C.T. Machado: Recent developments in the European private equity markets, Economic papers 319, April 2008
http://ec.europa.eu/economy_finance/publications/publication12419_en.pdf

## Table 7: Overview of European investments of private equity and venture capital in 2007-2010 for Europe (industry statistics)

| Stage distribution of investments | amount ('000) | N°of deals | averag e deal size | N°of compani es | average investment per company | of which N°of | of which in SMEs ('000) |
|---|---|---|---|---|---|---|---|

| | | | (€mn) | | (€mn) | SMEs | |
|---|---|---|---|---|---|---|---|
| Seed | 768.342 | 2.669 | 0.287 | 1.818 | 0.422 | | |
| Start-up | 8.918.652 | 11.562 | 0.711 | 7.023 | 1.270 | | |
| Later stage venture | 11.234.769 | 8.711 | 1.287 | 5.419 | 2.073 | | |
| **Total venture (EU+non-EU)** | **20.921.764** | **22.942** | **0.911** | **13.747** | **1.522** | **12.552** | **17.458.847** |
| Growth | 24.315.196 | 4.496 | 5.408 | 2.803 | 8.675 | 1.808 | 7.364.672 |
| Rescue/Turnaround | 1.643.578 | 529 | 3.107 | 401 | 4.099 | | |
| Replacement capital | 7.058.773 | 800 | 8.823 | 635 | 11.116 | | |
| Buyout | 139.100.033 | 5.429 | 25.622 | 3.769 | 36.906 | 2.536 | 21.630.333 |
| **TOTAL** | **193.039.344** | | | **21.355** | | **16.896** | **46.453.852** |

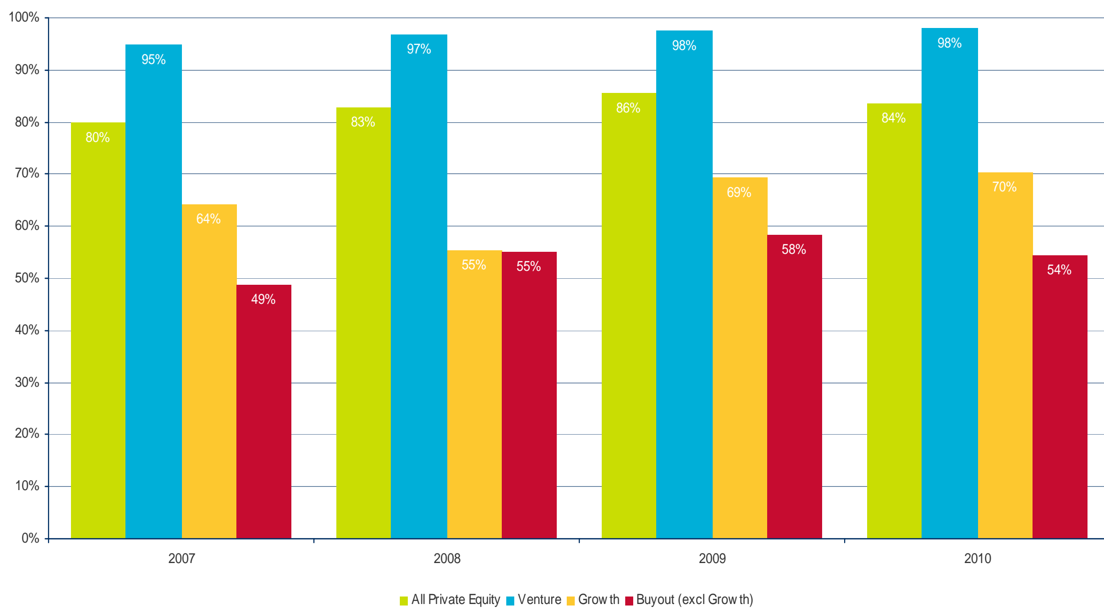
Source: EVCA, own calculations

## Table 8: Overview of European venture capital and private equity investments 2007-2010 (market statistics – in European companies)

| Stage distribution of investments | amount ('000) | Number of companies | of which SMEs | |
|---|---|---|---|---|
| Seed | 732.629 | 1.783 | | |
| Start-up | 8.295.356 | 6.595 | | |
| Later stage venture | 10.775.716 | 5.080 | | |
| ***Total venture*** | ***19.803.702*** | **12.961** | **11.665** | ***95%*** |
| Growth | 23.239.900 | 2731 | 1.775 | 65% |
| Rescue/Turnaround | 1.964.844 | 400 | | |
| Replacement capital | 6.832.167 | 618 | | |
| Buyout | 136.586.487 | 3.756 | 2.066 | 55% |
| **TOTAL** | **188.427.099** | **20.130** | **17.110** | **85%** |

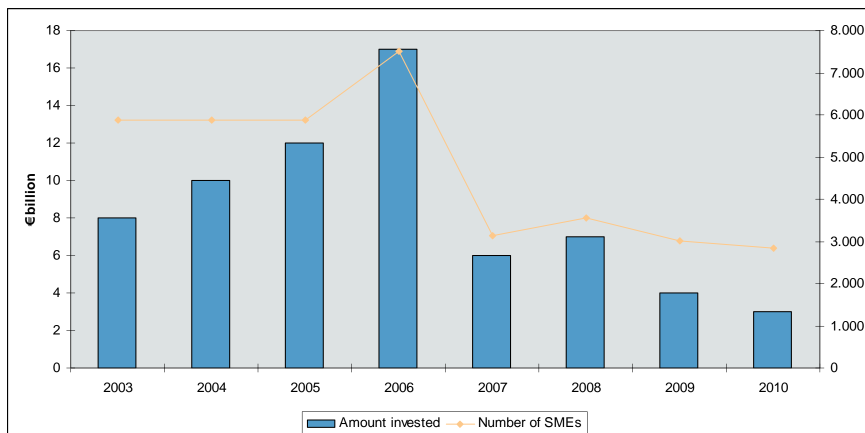
Source: EVCA, own calculations

**Table 9a: Share of European venture capital and private equity investments into SMEs 2007-2010**



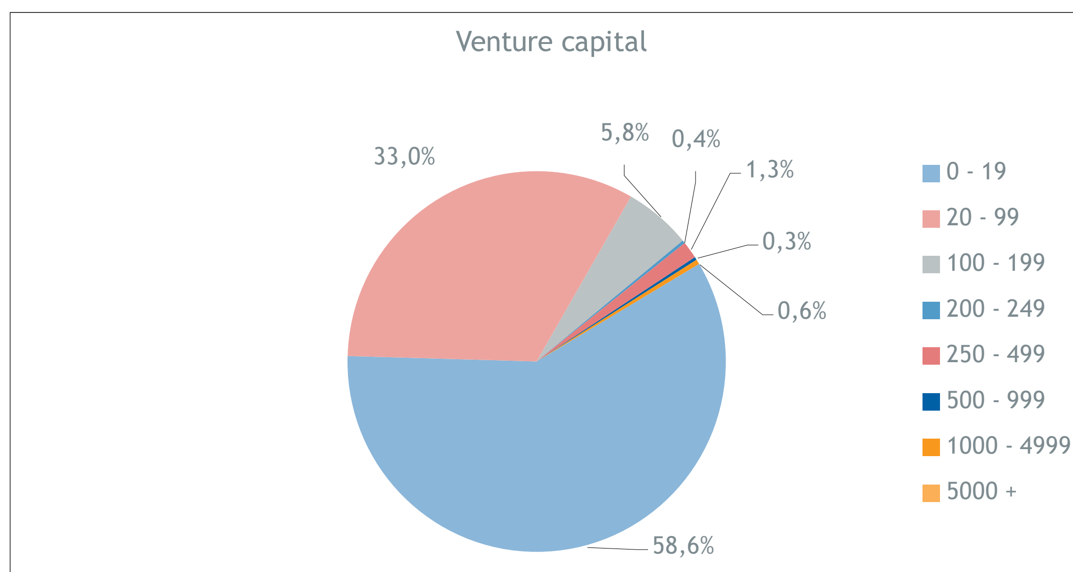

Source: EVCA

**Table 9b: European venture capital funds investments in SMEs (2003-2010)**




Source: EVCA, own calculations

**Table 10: Investments by number of employees in 2010 (% of number of companies financed) – market statistics**




**Source: EVCA**

**Table 11: Private equity and venture capital investments by sector 2010**

| Venture capital | | Private equity (buyout and growth) | |
|---|---|---|---|
| Unknown | 0,09% | Unknown | 0,07% |
| Transportation | 1,13% | Transportation | 5,51% |
| Real estate | 0,34% | Real estate | 0,49% |
| Life sciences | 30,04% | Life sciences | 12,33 % |
| Financial services | 1,15% | Financial services | 5,97% |
| Energy & environment | 10,74% | Energy & environment | 2,87% |
| Consumer services | 2,69% | Consumer services | 10,01 % |
| Consumer goods & retail | 4,07% | Consumer goods & retail | 20,99 % |
| Construction | 0,67% | Construction | 1,33% |
| Computer & consumer electronics | 20,26% | Computer & consumer electronics | 8,09% |

| Communications | 15,03% | Communications | 10,48 % |
|---|---|---|---|
| Chemicals & materials | 2,52% | Chemicals & materials | 2,40% |
| Business & industrial services | 3,54% | Business & industrial services | 8,76% |
| Business & industrial products | 7,29% | Business & industrial products | 10,19 % |
| Agriculture | 0,43% | Agriculture | 0,50% |

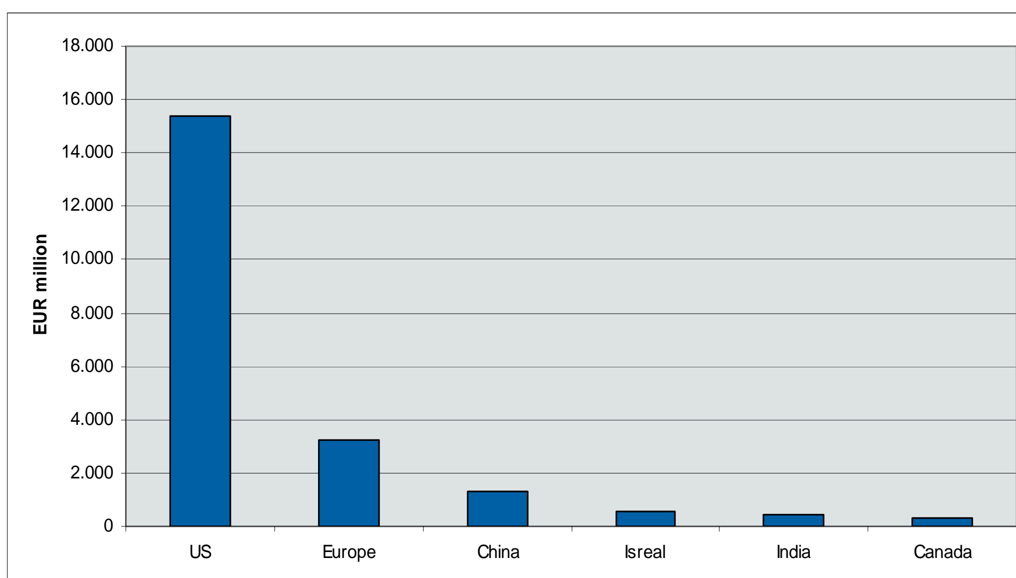
Source: EVCA

## Table 12: Venture capital and private equity fund raising geography 2007-2010

| | **All Venture capital** | | **Private equity (excluding Venture capital)** | |
|---|---|---|---|---|
| | €mn | % | €mn | % |
| Domestic | 10,896 | 51,5% | 48,315 | 27,6% |
| Non-domestic | **2,550** | **12,1%** | 34,860 | **19,9%** |
| Outside Europe | 1,297 | 6,1% | 49,121 | 28,1% |
| Unknown | 6,403 | 30,3% | 42,705 | 24,4% |
| **Total** | **21,147** | | **175,002** | |

Source: EVCA, own calculations

## Table 13: Global Venture capital investments in 2009



**Source:** Ernst & Young, "Back to basics, Global venture capital insights and trends report 2010, own calculations and estimates

In **China**[106], current VC consists of first or second institutional financings of companies. Venture capitalists invest in companies which are already profitable. Therefore, the VC market as understood in Europe and in the US is still emerging. For instance, the angel and seed investor network is highly fragmented. Moreover, former VC funds have moved into the equity market. Like in Europe, we observe a reluctance to take risk among the new entrepreneurs and engineers. VC could also have a role to play in terms of training, coaching.

China has advantages for VC investors. First of all, the Chinese domestic market is growing rapidly. The firms oriented towards the domestic market have great opportunities to capture growth with specific products and business models that fit with China's market. However, the infrastructure for early-stage companies is lacking:[107] "… this starts with finding high-potential CEOs and building world-class technical teams and ends with a captive funding vehicle that seeds new companies."[108] Moreover, many VC players in China need deeper knowledge of their local environment; they need to work better with good companies across China and across the different sectors.

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[106] Peter Liu, interview with Ernst &Young (ref.: "Global Venture Capital Insights and Trends Report 2010", Ernst&Young)

[107] Kai Fu, interview with Ernst & Young (ref.: "Global Ventutre Capital Insights and Trends Report 2010", Ernst&Young)

[108] "Global Ventutre Capital Insights and Trends Report 2010", Ernst&Young

## 11. Annex XI: Comparative analysis of European and US venture capital funds and their performance

The previous chapter provided a snapshot of the size and structure of the European venture capital fund industry. However, it is vital to also examine the importance of the industry in terms of trends and challenges – to lay the basis for assessing the impact of possible barriers to its further development. Venture capital is in essence a global activity and as such one shall look at the European venture market in a broader context. Comparative analysis with its US counterpart is particularly informative, given the European and US industries are globally the most mature and substantive..

Indeen, the venture capital industry has its roots in the US, and the US industry remains by far the largest and most mature. US sucesses in developing certain high-tech industries, which has helped the US to attract scientists and entrepreneurs from elsewhere, have been seen as also successes in part for its venture capital industry.[109] Growth accelerated through the 1970s compared to Europe, where venture capital was relatively new and only began to take hold in the late 1990s.[110] Both the EU and US venture capital markets proportionally decreased since 2000. The bursting of the dotcom bubble in the early years of the 2000s and the financial crisis from the end of 2007 onwards brought about severe reductions in available funding for venture capitalists, especially in the US. Since then, venture capital has been growing, but it still remains below 2000 values.

Most venture capital funds in the US are private. In Europe, strong public support and financial commitment through European and national initiatives and support programmes have been the decisive driving force. However, many experts now voice concerns that there is limit to what public policy providing financial incentives and subsidies can do on its own. Moreover, over-reliance on such financial incentives can indeed prevent the development and take-up of new financial products in the market or responsiveness of the venture capital market to innovation in the SME sector,since public policy must typically make decisions on acceptable targets *a priori*. This is in particular against the background of European venture capital markets that can be seen as underperforming when compared to the US, for instance.

It is important to understand more deeply the major differences between the EU and US markets and factors that could have potentially driven the performance of EU venture capital markets. The key differences observed by experts, academics and industry players are summarised below (see box 1).

**Box 1: Most important differences in the characteristics of European and US venture capital funds and markets in which they operate**

*Insufficient funding:* In 2000-2009 period, the US venture capital industry raised 1.933 funds with total value of US $ 314 billion compared to 800 funds with total value of US $ 60

[109] 2008, EVCA Yearbook.

[110] Atlantic Drift – Venture capital performance in the UK and the US, June 2011 http://www.nesta.org.uk/library/documents/AtlanticDrift.pdf

billion raised in the EU.[111] In other words, the amount raised in the EU for venture capital investments is only a quarter of its US counterpart. In 2010, the average European venture capital investment as share of GDP was 0.027% (highest for Sweden with 0.068%, followed by Finland 0.055% and the UK with 0.042%) compared to 0.14 % in the US.[112]

*Aavailable funding spread too thinly*: European funds invest only 20% of their US counterparts but support nearly twice as many companies. US average seed investment per company since 2002 amounted to € 1.5 million and reached an average of € 4 million in 2009, while the US average early stage finanicng was rather stable at around €3 million per company. EU on the other hand invested in the same period (2002-2009) about only € 0.5 million per company in the seed stage and around € 1 million in the startup phases. [113] Between 1990-2005 US venture funds invested in follow-up rounds in roughly 40 % of their companies, compared to only 20% in Europe.[114]

*Investment stage focus:* US investors invest more in early stages (seed and start-up) than their EU counterparts who focus more on later stage investments in protfolio companies. However, in the EU there is relatively long history of European public funding support for firms in their early stages of life, as a public policy response to the shortfall in appropriate sources of financing in these early stages.

*Risk-reward:* The US focus on financing earlier (and riskier) stages of companies is ultimately reflected in US venture capital fund returns (measured by their Internal Rate of Return – IRR) , which have been more rewarding than returns on EU funds. This is in line with the risk-reward thesis, where the riskier the investment, the greater the potential payoff in case of success. (EIF)

*Sector Specialisation:* Since 1990s, US venture capital funds exhibit higher levels of specialisation than their continental EU or UK counterparts. US funds focus on internet/computer, electronics and biotech/health sectors with almost 80% of their investments between 1990-2009. Although the years 2006-2009 saw a trend towards higher specialisation in the EU as well, these three specific sectors still only reached 60%; more generally EU funds' specialisation has been more dispersed than that of the US. (NESTA)

*Syndication[115]:* US funds tend to syndicate much more than EU funds (invest with a larger number of co-investors) and tend to syndicate more effectively, as their syndictes grow over time.[116] The motivating factors for syndication include risk diversification, improved screening of portfolio companies, complementarity in monitoring and advising portfolio companies, information sharing and pooling of contacts in the exit phase. This has been taken as an indicator of the greater maturity of the US venture capital market.[117]

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[111] Ernst & Young, "Back to basics, Global venture capital insights and trends report 2010"

[112] Josh Lerner, Yannis Pierrakis, Liam Collins and Albert Bravo Biosca, "Atlantic Drift - Venture Capital performance in the UK and the US, Research report June 2011

[113] Roger Kelly, "The performance and prospects of European Venture capital, European Investment Fund; Working Paper 2011/9

[114] Ulrich Hege, Frederic Palomino and Armin Schwienbacher, “Venture Capital Performance: The Disparity Between Europe and the United States”, *Revue de l’association francaise de finance,* vol. 30, no. 1, 2009, p. 26

[115] Syndication is the process whereby a group of venture capitalists will each put in a portion of the amount of money needed to finance a small business.

[116] See Hege et al., but also R. Kelly and Lerner et al.

[117] See Hege et al.

*Cluster concentration:* Information about potential investment opportunities generally circulates within circumscribed geogrraphic and industyr zones. This makes it advantageous for fund managers to locate near each other, close to agglomerations of high potential entrepreneurs. Funds raised in four of such geographical clusters (Silicon Valley, New York, Massachusetts and London) hosted 40 % of all venture capital funds launched in the US and Europe in 1990-2005.[118] This sort of concentration is rather an exception in Europe, although some signs of develoment in the US direction emerge, e.g. Medicon Valley in Denmark/southern Sweden, the Heidelberg Cluster or the Silicon Fen in the UK.[119]

*Internationalisation:* A much larger share of EU venture capital funds invest in US firms than the opposite, although in the period 2006-2009 the proportion of US investments in EU companies somewhat increased. Between 1990 and 2005, less than 20% of US funds raised were invested in European companies, compared to 40% of EU venture capital funds investing in US firms.[120]

*Exit market fragmentation:* European exit markets are fragmented as there is no single small cap market facilitating exit, along the lines of NASDAQ.[121]

*Enterpreneuership:* Becoming an entrepreneur is not regarded as a career in Europe – cultural attitudes are such that higher education and training tends to be focused on traditional career structures and there is less encouragement, advice or support for those who wish to pursue an entrepreneurial career.[122]

*Bankruptcy:* There is still a strong stigma attached to bankruptcy in most European countries, whereas in the US, this is less the case – the idea that it is better to have tried and failed than not to have tried at all is more prevalent – this tolerance for failure has been posited as vital for allowing entrepreneurship to flourish.(EIF)

*Culture, Language, Regulatory regimes:* 27 different cultures, languages and regulatory regimes compete in the EU, compared with a (broadly) single unified one in the US.

Before looking more closely at how these different factors might impact the relative performance of EU and US funds, the scale of the perceived performance gap between the EU and US and its evolution need to be established. This is briefly summarised below (see box 2).

**Box 2: Performance gap between UK[123] and US venture capital funds[124]**

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[118] See Lerner et al.

[119] See R. Kelly

[120] See Lerner et al.

[121] See R. Kelly

[122] ibid

[123] See Lerner et al.- explaining that performance data is only available for a subset of funds, so the analysis restricts itself only to UK and US as data compilation for these two regions is most complete.

[124] See Lerner et al.

UK venture capital funds have historically on average underperformed US funds, but the gap has narrowed. Clear UK-US gap exists for funds raised before the dotcom bubble (1990-1997).

For instance, the average IRR for funds raised in this period was 33% in the US and 13% in the UK. Funds raised between 1998 and 2005 reported -0.21% IRR for US funds and -1.21% for the UK. Overall funds followed the same pattern in the same period, however a relative convergence was driven by worsening US fund performances when the dotcom bubble burst, rather than by UK funds closing the gap.

However, average returns do not capture the large variability in returns within countries. The performance gap between bad and good performing funds within a country is much larger than the gap in the average returns across countries (UK versus US). Indeed, the best US funds prior to the dotcom bubble outperformed UK funds by 89%.

Recent studies have sought to identify the most statistically relevant factors that determine the performance differences between venture capital funds on either side of the Atlantic. Overall views and analysis vary on the relative importance of the different factors outlined. Conclusions differ depending on the timing of research, the pool of funds covered, as well as the methodologies used (see box 3).

**Box 3: Factors determining the performance gap - SUPPLY SIDE**

*Lindström (2006)*: Contrary to the common perception (that EU venture funds perform worse than US), the effect of the fund location was found to be insignificant when controlled for fund characteristics. This means that performance of EU and US funds is determined by fund characteristic rather than location. Further quantitative analysis however found that the differences in fund characteristics between EU and US are not very significant. Still, some clear differences were identified and the variables contributable to most of the performance gap between US and EU venture capital funds were: (i) low EU deal syndication (see table X), followed by (ii) fewer EU corporate ventures (corporate vs independent) and also (iii) low EU sector specialisation (lower share of IT and high-tech investments in the EU).

*Hege et al. (2009):* The key determinants of the performance gap are: (i) US venture capitalists show a positive relationship between total funding and performance while the reverse is true for Europeans. One reason appears to be that US venture capital react with an increased funding flow upon good early performance, in contrast to Europeans; (ii) US venture capitalists use instruments of control and contingent funding efficiently, since performance reacts positively to shorter funding intervals in the US, while the opposite is true in Europe; (iii) US venture investors use syndication more effectively, as their syndicates grow over time, while their European counterparts do not (but these results appeared to be weakly significant at the time of the study) and (iv) lastly, US venture capitalists are more sector specialised and include more corporate investors that in the European funds.

*Lerner et al. (2011):* Here the key findings indicate that the performance gaps between US and UK funds were driven by wider economic environments: (i) notably the background of investor or other cultural issues. Furthermore (ii) prior outperformance, (iii) early round investments, managers' experience as well as (iv) an optimal size of the fund are found to be the strongest quantifiable predictors of performance for venture capital funds. Lastly the (v) clustering of the venture capital industry in hubs and (vi) sectoral specialisation are also factors explaining historical performance differences.

**Box 4: Factors determining VC performance and the access to finance by SMEs - DEMAND SIDE**

*C. Masons and J. Kwowk*[125] *(2010):* Access by SMEs to finance is constrained by demand-side weaknesses. Most businesses are not investment ready (IR). Their owners are unwilling to seek external equity finance and those who are willing do not understand what equity investors are looking for or how to 'sell' themselves and their businesses to potential investors. These weaknesses, in turn, compromise the effectiveness of supply-side interventions, such as initiatives to stimulate business angels or which create public sector venture capital funds. This has highlighted the need for investment readiness programmes that seek to increase the pool of investable businesses.

*SQW Consulting*[126] *(2009):* From the experience of UK, those consulted reported a low level of IR amongst target firms. One venture capital fund turns down 98% of applications received due to a lack of IR. Another commented that IR schemes do not appear to have had much impact on the quality of applications submitted. However, other funds reported a lack of any form of IR assistance in their area and mentioned that Business Link (a scheme for this) did not seem to be able to signpost companies to suitable support. One fund manager stated that the problem with IR schemes is that they are not tough enough on businesses about their management. The schemes are good at showing people how to prepare business plans but fail to make businesses understand the importance that VCs place on the key investment criteria.

L. Silver, B. Berrgren, F. Vegholm (2010)[127]: From the Swedish experience, the research analysis indicates that an increased level of IR in SMEs results in closer working relationships with financiers and a higher level of commitment by the investors, which in turn leads to greater market accessibility for SMEs. This study supports public policy focused on programs that alleviate the problems associated with the lack of IR in SMEs.

*Luis Galveias*[128] *(2011):* Investors greatest concerns' about investing in SMEs fall into lack of market and customer validation, lack of experienced management team to take the business forward and lack of skills.

*Lerner (2011):* Here the key findings indicate to performance between US and UK funds being driven by the wider economic environment in which funds operate including also (i) number of oportunities available and the barrieers to their development, (ii) the ambition and ability of entrepreneurs are additional factors found to be the strongest quantifiable predictors of performance for venture capital funds.

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[125] Colin Mason, Jennifer Kwok: Investment Readiness Programmes and Access to Finance: A Critical Review of Design Issues, Local Economy June 2010 vol. 25 no. 4 269-292

[126] SQW Consulting: The supply of equity finance to SMEs: revisiting the "equity gap" A report to the Department for Business, Innovation (2009)

[127] L. Silver, B. Berrgren, F. Vegholm: The impact of investment readiness on investor commitment and market accessibility in SMEs, Journal of Small Business and Entrepreneurship, 2010 volume 23, Issue 1

[128] Improving Investment Readiness for ICT EU Funded Research Luis Galveias, EBAN, March 2011: http://www.vleva.eu/sites/www.vleva.eu/files/events/bijlages/luis_galveias_eban.pdf

**Table 14: European venture capital and private equity investment - Pooled average IRR% for investment horizon of 1, 3, 5, 10 and 20 years as of 30.6.2006**

| **Stage/horizon** | **1 year 2006** | **3 Years 2004-2006** | **5 Years 2002-2006** | **10 Years 1997-2006** | **20 Years 1987-2006** |
|---|---|---|---|---|---|
| Early stage | -10.2 | -0.7 | -6.4 | -0.9 | 0 |
| Development | 0.0 | 5.9 | 0.2 | 9.2 | 8.8 |
| Balanced | 0.0 | 14.4 | 3.7 | 12.8 | 10.3 |
| ***Total venture*** | ***-6.6*** | ***6.8*** | ***-0.8*** | ***6.8*** | ***6.9*** |
| Buyout | 36.1 | 13.2 | 7.1 | 14.3 | 13.9 |
| **All private equity** | **33.3** | **10.4** | **3.9** | **11.2** | **10.6** |

Source: K. Raade and C.T. Machado: Recent developments in the European private equity markets, Economic papers 319, April 2008

**Table 15: US venture capital and private equity investment - Pooled average IRR% for investment horizon of 1, 3, 5, 10 and 20 years as of 30.6.2006**

| **Stage/horizon** | **1 year 2006** | **3 Years 2004-2006** | **5 Years 2002-2006** | **10 Years 1997-2006** | **20 Years 1987-2006** |
|---|---|---|---|---|---|
| Early/seed stage | 2.6 | 5.5 | -5.4 | 38.3 | 20.5 |
| Development | 7.5 | 12.9 | 1.9 | 16.9 | 14.6 |
| Later stage | 14.5 | 8.9 | 1.8 | 9.0 | 13.7 |
| ***Total venture*** | ***7.0*** | ***9.1*** | ***-1.2*** | ***20.5*** | ***16.5*** |
| Buyout | 21.6 | 15.6 | 2.2 | 8.8 | 13.2 |
| **All private equity** | **16.5** | **13.1** | **6.8** | **11.2** | **14.0** |

Source: K. Raade and C.T. Machado: Recent developments in the European private equity markets, Economic papers 319, April 2008

In 2006, the long-term investment horizon and returns of US venture capital operators were high. They significantly outperformed European venture capital with 10-year returns at 20.5% as compared to 6.8% in Europe. Also the profitability levels of seed and start up investments measured in a 10-year perspective was

significantly higher in the US. While in the US investment in early/seed funds posted a 10-year return of 38.3%, the equivalent European figure remained at -0.9%.[129] The 2010 figures[130] do not show such a big profitability gap between the two continents. The mid term 5-year returns of European VCF investments were negative -1.57% compared to 1.16% for US funds. Interestingly, a 10-year horizon, both European and US VCF show negative returns of -3.78 % and -6.59 % respectively. It is true that US VCF show past consistent outperformance. However, recent study[131] points to the fact that average returns do not capture the large variability in returns within countries, when comparing UK and US ventrue capital funds performance. It found that the performance gap between bad and good performing funds within a country is much larger than the gap in the average returns across countries, thus suggesting that investors can find good performing funds everywhere. Furthermore, it suggests that returns are not driven by th changes in funds characteristics like size or an investment strategy but instead, it is most likely the result of characteristics of funds' environment in which they operate (venture capital 'ecosystem').

*The venture capital ecosystem*

Increasingly, latest studies refer to a venture capital 'ecosystem'[132] as having a decisive influence on whether venture capital funds perform badly or not. The venture capital ecosystem can be understood as a combination of all the factors as described above (see box 1), including sufficient capital flows between the market participants, specific knowledge and experience of the demand as well as supply side of the market, existence of supply of new ideas and willingness to pursue new business opportunities (box 4), but also existence of supportive economic, regulatory and fiscal frameworks. In other words, in such an environment, the demand and supply side should ideally be in equilibrium.[133]

The demand for cross-border venture capital is largely related to the existence of a strong pool of attractive investment opportunities indicated e.g. by high quality human capital[134], patents[135], world class science emanating from universities[136],

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[129] K. Raade and C.T. Machado: Recent developments in the European private equity markets, Economic papers 319, April 2008 http://ec.europa.eu/economy_finance/publications/publication12419_en.pdf

[130] EVCA, Thomson Reuters

[131] Atlantic Drift – Venture capital performance in the UK and the US, June 2011,

[132] Clarysse, Knockaer and Wright, 2009 or Lerner 2011 for example

[133] Aizenman, J. and Kendall, J., 2008, The Internationalization of Venture Capital and Private Equity: SSRN working paper.

[134] Ibid and and Tykvová, T. and Schertler, A., 2008, Syndication to Overcome Transaction Costs of Cross-border

Investments ? Evidence from a Worldwide Private Equity Deals' Dataset. Working paper

[135] Guler, I. and Guillén, M.F., 2007, Transnational Connections and Strategic Choice: Venture Capital Firms'

Entry into Foreign Markets. Working paper

[136] Wright, M., Clarysse, B., Mustar, P., and Lockett, A., 2007, *Academic Entrepreneurship in Europe*.

higher GDP growth rate, and supportive exit markets including mergers and acquisitions and initial public offering (IPO) opportunities[137].

The supply of venture capital is positively related to a functioning tax and legal framework for raising venture capital funds[138]. The frictions reducing the cross-border flows include e.g. distance, foreign language, different currencies, not belonging to a common market, trade relations, lack of availability of experienced co-investors, lack of information and trust, and lack of regulatory environment the investors would know and trust. The factors are largely similar also for cross-border

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Cheltenham: Edward Elgar

[137] Jeng, L.A. and Wells, P.C., 2000, The Determinants of Venture Capital Funding: Evidence Across

Countries. *Journal of Corporate Finance* 6: p. 241-289 and Cumming, D., Fleming, G., and Schwienbacher, A., 2005, Liquidity risk and venture capital finance.*Financial Management* 34(4): p. 77-105.

[138] Schertler, A. and Tykvová, T., 2008, Stay at Home or Go Abroad? The Impact of Fiscal and Legal

Environments on the Geography of Private Equity Flows. Working paper

fundraising[139]. From the brief overview of factors that determine the success of a venture capital it is evident that some of these factors are harder to influence (e.g. cultural factors impacting the supply of entrepreneurs or language barriers) than others

[139] Groh, A.P., Liechtenstein, H., and Canela, M.A., 2008, International allocation determinants of institutional

investments in venture capital and private equity limited partnerships. IESE Working Paper WP no 726 and Cumming, D. and Johan, S., 2007, Regulatory harmonization and the development of private equity markets. *Journal of Banking & Finance* 31(10): p. 3218-3250

# 12. Annex XII: Summary of selected academic literature related to the impact of Venture Capital

## 12.1. Venture capital, growth and employment

*On the Lifecycle Dynamics of Venture-Capital- and Non-Venture-Capital-Financed Firms*

Manju Puri, Duke University and NBER; Rebecca Zarutskie, Duke University; June 2010

- First, we examine the quantitative importance of VC in new firm creation in the economy. Using data from the Census we see that from the point of view of new firm founding, VC financed firms are an extremely small percentage of all new firms created in the LBD – accounting for 0.11% over our 25 year sample period and increasing to 0.22% in the late 1990s. However, the picture is different if we focus on alternative measures such as employment. The amount of employment generated by VC backed firms accounts for roughly 4-7% of employment in the US in the late 1990s till 2000, steadily rising from 2.8% in the 1980s. Hence, in terms of employment generated, VC is widely perceived to be an engine of growth for the economy.

*The impact of venture capital on innovation behaviour and firm growth*

Peneder, Michael (2010), Venture Capital, 12: 2, 83 — 107

- Second, the data show that, on average, VC-financed firms are more innovative and grow faster in terms of employment and sales revenue than other firms. However, the observed differences in innovation performance (measured as the share in sales revenue of new products and services) prove to be the result of pure selection effects and not the direct causal impact of VC financing on innovation. In other words, VC equity tends to finance firms with above average levels of innovation rather than making the firms more innovative. From the standpoint of the individual firms, this observation does not constitute a separate impact beyond that already captured by the specific financing function. However, from the perspective of the economy at large, it offers evidence of the selection function, telling us that venture capital succeeds in allocating resources to innovative firms, thereby fostering structural change and development.
- We argue that by offering a unique combination of ownership and incentives, private equity investment seems to lower the cost of start-up capital and result in higher industry dynamics. The results are generally robust to using different proxies for entry, contemporaneous or historical volumes of private equity investment, and to correcting for omitted variable bias. We also find that the effect of private equity is higher in countries with better judicial systems and in countries with smaller share of the informal economy. This result is only logical: to the extent that private equity targets industries that rely heavily on intangible assets like intellectual property, licenses and

patents, its effect should be more pronounced in countries where the returns to those are protected by the legal system. At the same time, we find that the relatively higher effect of private equity investment on entry in high-entry industries is robust to accounting for other industry characteristics, as well as for other characteristics of the business environment that have been suggested by the literature as determinants of entry rates.

*Venture capital financing and the growth of new technology-based firms*

Fabio Bertoni, Massimo G. Colombo and Luca Grilli; Department of Management, Economics and Industrial Engineering, Politecnico di Milano

- Our results clearly support the view that VC financing fuels firm growth. According to our estimates, after receiving the first round of VC financing portfolio firms exhibit a considerably greater growth rate measured in terms of both the number of employees and the amount of sales, during the three subsequent years. The difference of the growth rate with respect to that of otherwise similar non VC-backed firms is both statistically significant and of an economically considerable magnitude. At the end of the third year the estimated number of employees and amount of sales are 98.5% and 93.2% greater than those in absence of VC financing. We think that these results offer new interesting insights into the role of VC financing in fostering the growth of high-tech start-ups. Quite interestingly, they clearly document that even in an unfavourable environment as the one provided by the Italian financial system, VC financing has a dramatic positive influence on NTBF growth, especially when the investor is a financial venture capitalist. This evidence has important policy implications. In fact, in Europe the VC sector is far less developed than in the USA or in Israel. While an analysis of the determinants of this situation lies beyond the scope of the present work, the findings illustrated here support the view that the development of the demand for and supply of VC financing should figure prominently in the innovation policy agenda of European governments.

*From funding gaps to thin markets: UK Government support for early-stage venture capital*

BVCA – NESTA Research report; September 2009

- The econometric methods allow us to quantify the effects. This is important as it matters a lot whether the effects are small, medium or large. The actual number of additional jobs created by all the 782 recipient firms was 1,407 more than would be expected without funding (or 1.8 extra jobs per firm). These findings suggest these schemes are better at producing employment than the EIS and VCT schemes. Similarly, the scale of the capitalisation effect implies that 'treatment' (i.e. funded) firms have, on average, received £98,455.50 greater capitalisation than 'untreated' firms.
- A key economic role of US venture capital is the allocation of financial and managerial resources to help grow firms that will have a dramatic impact on productivity in the economy. When we compared the funded firms with the

control sample we found that recipient firms do have higher average labour productivity (mean sales per employee measured in £'000s) than matched firms that did not receive funding from the schemes being evaluated. In the first instance, this was identified as a one-off, upward shift in per capita labour productivity for supported firms, over and above that achieved by unsupported firms. After controlling for other influences, in the 'typical' supported firm this would equate to £57,800 (sales per worker) in increased labour productivity.

*Reshaping the UK economy: The role of public investment in financing growth*

Yannis Pierrakis and Stian Westlake; NESTA Research report, June 2009

- Different estimates put the number of businesses in the UK that are reliant on venture capital at between 880 and 1,100. These firms play an important role in economic growth and job creation. The largest recent survey showed that over the five years to 2006/7, firms backed by venture capital increased their worldwide employment by 8 per cent per year, a much higher rate of growth than the 3 per cent reported by most mid-sized companies. Venture-backed firms' UK employment also grew by 6 per cent, compared to a national annual rise in employment of 1 per cent. The evidence from the US, where venture activity has a longer pedigree, is even more compelling. The largest study showed that American companies that received venture capital from 1970-2006 accounted for 10.4 million jobs and $2.3 trillion in revenues in 2006. The total revenue of venture capital financed companies comprised 17.6 per cent of the nation's GDP and 9.1 per cent of US private sector employment in 2006. Venture capital-backed companies outperformed their non-ventured counterparts in job creation and revenue growth. Employment in venture-backed companies jumped by 3.6 per cent between 2003 and 2006 as national employment grew by just 1.4 per cent. At the same time, venture capital-backed company sales grew by more than 11.8 per cent, compared to an overall rise in US company sales of 6.5 per cent during the same period.

*The Economic and Social Impact of Private Equity in Europe: Summary of Research Findings*

Per Strömberg, Professor of Finance, Stockholm School of Economics, September 2009

- In cross-country data, there is a clear positive relationship between private equity investment activity and economic growth. However, no rigorous academic study has analysed whether private equity actually has an impact on the GDP growth of a country. The problem in undertaking such studies is to control for the reverse causality explanation – that growth causes private equity investment, rather than the other way around. Researchers argue that management buyouts played a catalytic role and helped restore the US economy during the 1980s and early 1990s. The overall research evidence shows a positive effect of leveraged buyouts on individual firm performance and productivity. This suggests that, on a macroeconomic level, leveraged buyouts contribute to better allocation of capital and a more efficient economy. As such, they can be a powerful tool for accelerating the

restructuring of the economies. Through leveraged buyouts, scarce equity capital can be freed from declining, low-value added industries and invested in high-risk, high-value-added emerging industries that may otherwise not be financed. Some studies suggest that private equity has a positive impact on stock market development. Since stock market development has been shown to increase economic growth, this suggests another causal route where private equity can impact economic growth.

*High Growth Entrepreneurs, Public Policies and Economic Growth*

Erik Stam, Kashifa Suddle, S. Jolanda A. Hessels, Andre J. Van Stel, Jena Economic Research Paper No. 2007-019; Hudson Institute Research Paper No. 08-02.

- The results of our empirical exercises suggested that ambitious entrepreneurship contributes more strongly to macro-economic growth than entrepreneurial activity in general. We found a particularly strong effect of high-expectation entrepreneurship for transition countries.

### 12.2. Efficiency gains and industry dynamics

*How does venture capital financing improve efficiency in private firms? A look beneath the surface*

Thomas Chemmanur, Karthik Krishnan, Debarshi Nandy; CES 08-16 June, 2008

- Our main findings are as follows. First, the overall efficiency of VC backed firms is higher than that of non-VC backed firms. Second, this efficiency advantage of VC backed firms arises from both screening and monitoring: the efficiency of VC backed firms prior to receiving financing is higher than that of non-VC backed firms and further, the growth in efficiency subsequent to receiving VC financing is greater for such firms relative to non-VC backed firms. On average, VCs select firms that have higher TFP of around 6% compared to non-venture backed private firms, and further VC firms are able to achieve an increase in their TFP of around 10% due to the monitoring services provided by the VCs. Both these effects are economically significant, resulting in an increase in profits of approximately 21% and 35% respectively. Third, the above increase in efficiency of VC backed firms relative to non-VC backed firms increases over the first two rounds subsequent to receiving financing, and remains higher till exit. Fourth, while the efficiency of firms prior to VC financing is lower for firms backed by higher reputed VCs, the increase in efficiency subsequent to financing is significantly higher for the former firms, consistent with higher reputation VCs having greater monitoring ability compared to lower reputation VCs. Our results indicate that this difference in monitoring ability between higher

and lower reputation VC backed firms results in TFP improvements that are 10% greater for higher reputation VC backed firms, which is economically very significant as it implies an increase in profits of approximately 35%. Fifth, the efficiency gains generated by VC backing arise primarily from improvement in product market performance (sales); however for higher reputation VCs, the additional efficiency gains arise from both an additional improvement in product market performance as well as from reductions in production costs.

*On the real effects of private equity investment: Evidence from new business creation*

Alexander Popov and Peter Roosenboom; ECB Working paper series, No 1078 / August 2009

- We find that private equity investment has a beneficial effect on entry, which is relatively higher for industries which naturally have higher entry rates and are more R&D intensive. The effect remains strong once we exclude investment allocated to buy-outs, suggesting that early stage finance is important in this respect. Our results hold both in 1998-1999 and 2006-2007, when we account for industry size, and when we exclude the transition economies. The results stay unchanged after we address the endogeneity problem (does private equity induce entry or is it attracted to countries with a more dynamic industrial structure?) by using an IV procedure in which variation in national prudential regulation guiding the investment behaviour of Europe's pension funds is used as an instrument for the supply of PE funds.

*Dynamic Interactions between Venture Capital Returns and the Macroeconomy: Theoretical and Empirical Evidence from the United States*

Roland Füss, Denis Schweizer; European Business School Research Paper Series 09-15

- Existing empirical evidence of the interrelationship between the Nasdaq and VC returns confirms that a well-functioning stock market can be considered a viable exit channel. These findings of comovements and short-term dynamics are in accordance with the empirical results of Cochrane (2005), who showed that VC returns behave similarly to the smallest Nasdaq stocks. We can also show that the returns of VC investments are influenced by industrial production, according to VEC Granger causality. Again, this finding confirms the results of Gompers and Lerner (1998) by using the GDP as a proxy for economic conditions. However, we do not find a direct connection between VC and long-term interest rate in the short term. The sign of the coefficient from the normalized cointegration vector is positive, which

implies the demand side has a larger influence. This effect was also found by Romain and van Pottelsberghe (2004) for aggregate country data.

## 12.3. Growth deficit in Europe

- **Entrepreneurs:** A vigorous and entrepreneurial economy needs a high birth rate of new businesses founded by properly resourced and well prepared entrepreneurs. According to the Global Entrepreneurship Monitor[140], high-expectation entrepreneurial activity (expectations of over 20 employees in five years) is highest in the USA, with Germany and the UK at less than half the US levels. Globally, start-ups expecting to employ 20 or more employees are responsible for almost 75% of total expected jobs in all entrepreneurial activity. The insufficiently growth-oriented financing of innovative enterprises is one of the causes for the EU's inferior performance in the last two decades.
- **Old firms:** The results of this are clearly visible. Among 500 largest listed European companies only 12 were born in the second half of the twentieth century, against 51 in the US. Only three were created after 1975 in Europe, compared with 26 in the US. The top US firms are changing constantly, while in Europe the largest companies are likely to stay on top for a long period. In the US they are challenged by new entrants and also by their own shareholders, who often force them to divest non-core activities or to split into separate entities[141].
- **Creative destruction:** Research in 2000[142] found that one-third to one-half of aggregate productivity growth in US manufacturing is directly due to reallocation between firms, creation of new firms, and disappearance of unsuccessful ones.

## 12.4. Financial constraints

- **Finance, labour:** One study[143] suggests that, in terms of obstacles to growth, financial constraints are at least as important as labour market rigidities when observed over a sample of companies across different countries.
- **Dynamics lacking:** The relative underdevelopment of Europe's financial sector is largely about the dynamics created by appropriate incentives. For example, initial public offerings (IPOs) in the US play a key role in

[140] Global Entrepreneurship Monitor: High-Expectation Entrepreneurship 2005, Summary Report.

[141] Philippon, T, Véron N 2008; *Financing Europe's Fast Movers*, Bruegel Policy Brief 2008/01, Brussels.

[142] Foster, L., Haltiwanger, J. Krizan C J; *Aggregate Productivity Growth: Lessons from Microecononmic Evidence,* NBER Working Paper 6803/2000.

[143] Aghion, P, Fally T, Scarpetta S, *Credit Constraint as a Barrier to the Entry and Post-Entry Growth of Firms,* Economic Policy 22/52, October 2007.

motivating people to both look for ideas and start new companies. Without a vibrant exit market, investors might not see many entrepreneurs asking for finance. The academic literature of the past decade has robustly established that financial development is not only the consequence of growth but also a cause.

- **Ambitious firms face difficulties:** The majority of SMEs in most European countries would not place access to finance for growth as the major barrier to their success[144]. This is because it is only a minority of the founders of small businesses would wish to grow their businesses aggressively. However, significant numbers of the most innovative and ambitious young companies in an economy still repeatedly cite financial difficulties as a major constraint to their continuing and rapid development.[145]

### 12.5. High growth potential is rare

- **But important:** It has been argued[146] based on UK evidence that essentially some 4% of new firms starts will represent over 50% of additional total benefits when measured by employment, sales, exports or other economic 'desirables'.
- **Focus needed:** Thus, an argument exists for financing mechanisms and programmes that fit more closely the circumstances and needs of valuable target groups. In this context, issues of formal and informal sources of venture capital, and initiatives to exploit mezzanine finance, securitisation of debt and the enhanced role of stock markets for 'alternative investments' become major points of an integrated SME finance policy response.
- **Diverse universe:** A comprehensive programme of SME finance targeting firms with potential for high growth needs to recognise the need for a diversity of instruments appropriate to the circumstances of enterprises of different sizes, operating in different sectors and at different stages of their life-cycle.
- **Use risk capital:** Given limited and erratic cash flows at the early period of the firm's growth trajectory, the so-called 'J Curve' effect[147], risk capital may be a much more appropriate form of finance that bank debt with the latter's requirement for regular interest payment from retained or trading income.
- **Entrepreneurs are not born:** Regardless of the quality and extent of the professional support available for business founders, the entrepreneurs themselves have to be sufficiently prepared and informed in order to make use of the resources available.

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[144] European Commission Flash Barometer 2005 *SME Access to Finance: Executive Summary*. Brussels

***[145] Maula, M., Murray, G. C. and Jääskeläinen, M 2007. Public Financing of Young Innovative Companies in Finland. Report to the Finnish Ministry of Trade and Industry. MTI Publications, Helsinki.pp127.***

[146] Storey, D. J. 1994. *Understanding the Small Business Sector*. Routledge, London.

[147] Mathonet P-Y, Meyer T *Beyond the J-Curve,* Wiley 2005.

- **Investment readiness:** Investors frequently allude to the poor level of understanding or preparation by entrepreneurs seeking commercial sources of finance. Training in, or an understanding of, investment readiness is a strong positive signal to investors of both debt and equity, as well as to customers and suppliers, as to the quality of the applicant SME firm.
- **Management skills:** Despite the increasing media interest in entrepreneurs, a large proportion of new business owners are both poorly informed and ill prepared for the rigours of commercial activity[148]. Poor management is largely responsible for the very high death rate of new enterprises in their first five years.[149] In order to survive and flourish, entrepreneurs need to be commercially credible. They must be able to demonstrate both a compelling business idea and the necessary managerial and financial competence.

### 12.6. Success stories

Many successful companies such as Skype, WaveLight AG, Fimasys, etc. would not exist today without the funding and guidance provided during their early stages by venture capitalists supported by the Competitiveness and Innovation framework Programme (CIP). This highlights again that VC funds and investors are particularly important for start-ups and SMEs. The SMEs should be considered as an essential job creator in the economy.

The following cases have been supported by the VC investments of EU programmes:

**Skype**, the internet communications company Skype received EU support, its success is a striking example of venture capital investment for innovation companies. Skype was a early beneficiary of the European Commission's ETF Start-up facility investment. **WaveLight AG,** formerly known as WaveLight Laser Technologie AG, a German firm making lasers for treatment of skin and eye complaints, has seen annual revenues grow more than ten times in the past five years, with turnover in 2003-04 reaching €62 million. It found finance from two funds to which the EU had contributed. **Fimasys**, a French financial-services software provider, also received support from EU funds. With annual revenues growing by more than 50% per year over the past three years, it is listed by the Deloitte Technology Fast 500 ranking of high-growth European SMEs. **Durham Graphene Science** Dutch physicist Andre Geim and his British partner Konstantin Novoselov won the 2010's Nobel Prize in Physics for their work on graphene, a new form of carbon material just one-atom thick which is not only the thinnest ever but

[148] European Commission. 2006. *Investment Readiness: Summary report of the workshop* 28 November. Brussles.

[149] Cressy, R. 2006. Why do most firms die young? *Small Business Economics*, 26: 103-116

also the strongest. graphene has some exceptional properties: it is almost completely transparent, yet so dense that not even helium, the smallest gas atom, can pass through it. It has numerous potential applications, such as super-fast, super-light graphene transistors, not to mention transparent touch screens, solar cells and light panels. The two scientists' work was partly funded by the EU's Competitiveness and Innovation Programme.

## 13. ANNEX XIII: ECONOMIC DIMENSION OF VENTURE CAPITAL

### 13.1 Impact of venture capital on economy

Venture capital helps to drive innovation, economic growth and job creation. VC has a lasting effect on the economy as it mobilises long term investment. Moreover, VC backed companies often create high-quality jobs as VC supports the creation of the most successful and innovative businesses. In the Information Technology (IT) sector the cost of creating new businesses has generally gone down, which is profitable for the existing and coming start-ups. The VC will amplify the benefits of the growing entrepreneurial culture.

According to research venture capital contributes to economic growth. One estimate is that an increase in VC investments of 0.1% of Gross Domestic Product (GDP) is statistically associated with an increase in real GDP growth of 0.30 percentage point. Early-stage investments have an even bigger impact of 0.96 percentage point[150] (the sample contained 14 European countries and the US in 1989-2009). The study also notes that bubbles, such as the dotcom boom in 2000 and the financial crisis in 2009, led to lower coefficients.

Regarding the causality between VC investments and economic growth, the conclusion is that countries with high VC activity typically have stronger economic growth. The opposite is not true: not all high-growth countries have a vibrant VC market. The link to growth is confirmed by another study, noting that an increase in the supply of VC in a metropolitan area stimulates the production of new firms in the area. [151]

Samila and Sorenson studied the impact of VC, using a panel of U.S. metropolitan areas, on employment and aggregate income. They found a positive correlation as VC stimulates the creation of more firms than it funds. Investing venture capital in an additional firm would stimulate the entry of two to twelve new companies. This naturally affects positively job creation and aggregate income: "A doubling in the number of firms funded by venture capital also results in a 0.22% to 1.24% expansion in the number of jobs and a 0.48% to 3.78% increase in aggregate income."

These results seem consistent with either of two potential mechanisms: "First, nascent entrepreneurs may recognize the need for capital in the future and establish firms only when they perceive reasonable odds of obtaining that funding. Second, the snowball effect, VC-funded firms may encourage others to engage in entrepreneurship through a demonstration effect or by training future firm founders."

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[150] Th. MEYER, "Venture Capital Adds Economic Spice", D*eutsche Bank Research,* September 14, 2010.

[151] Samila and Sorensosn (2011), "Venture Capital, Entrepreneurship, and Economic Growth", *TheReview of Economics and Statisti."*

At European level, various surveys suggest comparable results. VC-backed firms reported that they had been able to create a significant number of new jobs according to an EVCA survey (2002). Around 90% of the venture backed companies declared an increase in the total number of employees following the VC investment.

Moreover, venture backed companies were able to create an average of 46 jobs per company.[152] On top of this, employees at all levels (top-, middle management and other employees) achieved higher levels of earnings and other forms of remuneration (stock options, performance-related pay).

Venture capitalists are especially present in high-tech sectors, which might lead to rising levels of research and development (R&D) expenditures contributing to innovation and growth.

VC can also contribute to fighting climate change and promote sustainability. Start-ups in these fields will take time to mature, but they can offer the promise of green jobs located within the EU. VC may fasten the (industrial) reactions to climate change and at the same time deal with the employment situation of a country.[153]

### 13.2 IMPACT OF VENTURE CAPITAL ON BUSINESSES

VC investment is vital to the existence and success of growth-oriented businesses, in particular in the seed, start-up and expansion stages. For start-up companies, as the business generates more costs than revenues, the EBIT (Earnings Before Interest and Taxes[154]) is initially negative. Therefore investment in equity can help in these stages.

Hellmann and Puri (2000)[155] draw a positive correlation between VC and innovation; they suggest that VC stimulates innovative activities of firms: "A start-up financed by a venture capitalist needs less time to bring a product to the market; moreover, firms pursuing an innovative strategy potentially have better access to VC funds." Yet, Romain & Van Pottelsberghe (2004)[156] warn against this statement which might be too simplistic, as the sample Hellmann and Puri considered is based on 149 recently formed firms in the particular region of the Silicon Valley.

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[152] EVCA (2006), "Survey of the Economic and Social Impact of Venture Capital in Europe", *EVCA Research Paper.*

[153] Eco-Innovation, June 2009. (http://ec.europa.eu/environment/etap/files/eco_innovation.pdf)

[154] EBIT: Measure of a firm's profitability that excludes interest and income tax expenses.

[155] Hellmann and Puri (2010), "The Interaction between Product Market and Financing Strategy: The Role of Venture Capital", *Review of Financial Studies.*

[156] Romain and Van Pottelsberghs (2004), "The Economic Impact of Venture Capital", *Solvay Business School – Working Paper: WP-CEB 04/014.*

According to an EVCA survey (2002)[157], VC funds are focussing in certain business sectors and a substantial part of VC backed companies are active in high-tech industries (computer related, biotechnology, medical-health related). VC is used to achieve significant increases in development expenses: in the survey, all the respondents declared that the initial VC investment has been followed by a sharp increase in spending on R&D. "Half the seed/start-up companies multiplied their efforts in this area by more than four times (median increase 370%), while half the expansion stage companies almost doubled the amount invested (median increase 95%)."

The non-financial support provided by the VC investors includes consultancy, financial advice, marketing strategy, training, etc. This support has often led to an improved competitive position of the beneficiaries. For seed and start-up companies receiving VC, the median value of the training expenditure multiplied by more than four times and doubled for the expansion stage companies. Concerning the marketing expenditure, the median value more than tripled after the investment for the seed and start-up companies and by almost the same amount for the expansion stage companies. In their working relationships, the VC investors adopt a "hands-on strategy" with the companies; they usually meet on a weekly or monthly basis.

Engel (2002)[158] considered a panel dataset of around 1000 German start-ups and concluded that the German venture backed companies have achieved significantly higher growth rates due to the financial involvement and services provided by the venture capitalists. It should be noted that Engel does not observe growth rate differences between high-tech and low-tech industries.

With a panel dataset of 16 OECD countries[159] over the period 1990-2001, Romain & Van Pottelsberghe (2004) estimated the performances and the economic impact of VC.[160] They demonstrated that VC contributes to growth through two main channels. The first one is the introduction of new products and processes on the market. The social return of VC is much larger than the return of business or public R&D expenditure, probably due to a high risk premium and large potential spillovers or knowledge externalities.

The second channel is the development of an improved absorptive capacity of the knowledge generated by private and public research institutions. A high level of VC investment further allows improving the economic impact of private and public

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[157] EVCA (2002), "Survey of the Economic and Social Impact of Venture Capital in Europe", *EVCA Research Paper.*

[158] Engel (2002), "The Impact of Venture Capital in firm growth: an Empirical Investigation", *ZEW Discussion Paper.*

[159] These 16 OECD countries are: Australia, Belgium, Canada, Denmark, Finland, France, Germany, Ireland, Italy, Japan, the Netherlands, Norawy, Spain, Sweden, UK and US.

[160] Romain & van Pottelsberghe, "The Economic Impact of Venture Capital", *Solvay Business School*, 2004; (Working Paper: WP-CEB 04/014)

R&D. In other words, VC improves the "crystallisation" of knowledge into new products and processes.

The EVCA survey (2002)[161] showed changes in the turnover and profits for the responding companies since the VC investment. Compared to their competitors, 90% of the respondents considered the growth in their turnover had either been the same as or greater than that of their competitors. 57% reported a higher growth, and 77% considered that the growth in EBIT (Earnings Before Interest and Taxes) had either been the same as or greater than the growth in their competitors' profits.

VC investments are not "one-shot" actions, they provide medium to long term support. According to an EVCA survey (2002), 90% of the respondents said that the planned duration of the VC investments was between two and seven years.

Venture backed companies also increase their sales in export markets. Following the VC investment, companies at all stages in the EVCA survey (2002) reported an increase in exports. In terms of economic impact this improvement in exports strengthens the trade balance. Moreover, this enables companies to establish international contacts and to increase their visibility and credibility. Therefore, VC investors contribute to the creation of networks.

[161] EVCA (2002), "Survey of the Economic and Social Impact of Venture Capital in Europe", *EVCA Research Paper.*

## 14. Annex XIV: EU Member States Venture capital frameworks

**There are 2** Member States where existing legal frameworks designed specifically for venture financing are note used or proved impractical:

**Austria:** Funds established as Mittelstandsfinanzierungs AG (MiFiG) have some tax incentives in exchange for some restrictions: (i) must be founded by banks, (ii) take no more than 49% of stakes in a company, (iii) not allowed to invest in energy and financial services industry, (iv) at least 2/3 of funds' portfolio must be invested domestically, (v) loan financing of portfolio companies is restricted to the amount of equity the fund provided to the same company. It can invest a maximum of EUR 1.5mn per year and per company and this is only possible in development areas defined by EU. **This is one of the reasons, why this legal framework is not currently used at all by Austrian venture capital funds.** In addition, there are specific criteria set forth in the tax code which a fund needs to comply with in order to benefit from a capital gains tax exemption.

**Germany:** pursuant to the German Venture Capital Act (Wagniskapital-beteiligungsgesetz - "WKBG"), a company qualifies as a "venture capital company" under the WKBG if: (i) its articles of association have as their object the acquisition, holding, management and sale of venture capital participations; (ii) 70% of the total assets managed by the venture capital company must be equity capital participations in a target company - that is not listed and has its registered office in Germany. **Because the scope of the regulatory framework was too limited to work for a venture capital fund no single venture capital firm elected for the application of the WKBG.**

**There are 7** Member States with different legal frameworks designed specifically for venture financing:

**Estonia:** VC Funds definition (IFA): a) at least 60 % the assets of the fund are invested in shares or units not traded on the regulated market, debt securities, or shares or units of other VCFs.

**France:** *FCPR (Fonds Commun de Placement à Risque accounted for 717 funds at the end of 2010) - must have more than 50% of its funds invested in unlisted companies (of which 20% of public equity of small caps (< 150M euros) can be included)**;** *FCPI (Fonds Commun de Placemment dans l'Innovation accounted for 317 funds at the end of 2010) - a kind of FCPR with more constraints on investments but with tax incentives. FCPI must invest 60% of its funds in equity of unquoted *innovative companies* – of which 20% can be of public equity of innovative small caps (< 150M euros). Innovative companies means: their *research spending , as defined in Article 244 of the "Tax Code", represent at least 15% of the target company expenses. It the company is defined as "industrial company", it is eligible if its research spending is at 10%. In other cases, the companies will be eligible if they can prove that they create innovative products, processes or techniques. The latter, is subject to an assessment by a public institution responsible for promotion of research).* *FIP (Fonds d'Investissement de Proximité accounted for 240 funds at the end of 2010) - a kind of FCPR with more constraints on investments and with tax incentives. FIP must invest 60% of its funds in PE (10% must be invested in newly created companies, less than 5 years old). To be eligible at this 60% quota,

companies must be SMEs, have main activity in 1 or 2 or 3 regions which have common borders in France.

**Italy:** A measure included in the last Financial Act, recently approved by the Italian Government, foresees tax incentives for venture capital funds, which are defined as harmonized funds under the AIFMD that invest more than 75 % of their commitments in seed, start up, early stage or expansion financing in unlisted companies (target companies must be established in the EU, must have been established for less than 36 months and may have a maximum turnover of EUR 50m). The measure is yet to be implemented by an act of the Italian Ministry of Economics.

**Portugal:** (1) Acquire, originally or on a secondary basis, investment units in companies with high growth and appreciation potential; (2) Acquire, by assignment or subrogation, credits on companies in which they participate or in which they intend to participate; (3) Grant credit, under any form, or provide guarantees in benefit of companies in which they participate; (4) Apply their treasury surpluses in financial instruments; (5) Conduct any foreign exchange operations necessary to the development of the respective activity. Fund's investments in securities admitted to trading on a regulated market cannot exceed 50% of the net asset value of the funds.

**Slovenia:** Law: Venture Capital Companies Act (ZDTK; adopted in Oct 2007, amended in July 2009). Qualifying fund portfolio: VC company has to invest at least 50% of funds in SMEs and a further 30% in private equity financing or mezzanine capital to unlisted companies in which it has invested VC after the first year of operation. Qualifying investment instruments include Equity, Quasi Equity, Convertible loans and guarantees, mezzanine capital. Qualifying investment targets are unlisted SMEs and there is no geographical limitation on targeted companies. Rules on eligible investors have not been specified except the minimum investment of each investor into a VC company shall be €50,000. VC companies headquartered in Slovenia pay corporate income tax at rate of 0% on activities of allowed venture capital investments if the portfolio VC company submits a separate tax return just for that part of its activity.

**Spain:** *Common regime – defined by: mandatory investment ratio (60% of assets in stakes, of which 30% can be granted principatory loans), free disposal ratio, have no more than 25% of calculable assest invested in the same company or more than 35% in companies belonging to the same group). *Simplified regime: private placement (shares offered without any kind of publicity), min investment (500,000 EUR per investor, unless if institutional investor), reduced scope (max 20 shareholders, excl. institutional investors); more flexible investment regime (diversification - 40% of assets). Both regimes – several exceptions providing greater flexibility for investing in listed securities on domestic and foreign markets. VCEs may use up to 20% of mandatory ratio for investing in Annex III 54 other VCEs ( if the latter do not then invest more than 10% in other VCEs) Funds of funds: VCEs must invest at least 50% of mandatory ratio in direct investment VCEs (but max 40% of assets in one VCE).

**United Kingdom**: VCTs are companies whose shares trade on London stock market. Recent changes in legislation introduced in 2010: (i) VCTs will have the ability to invest in companies based outside of the UK (previously VCTs could only invest in companies with at least 50 percent of their qualifying activities in the UK) , (ii) VCTs will also be able to be listed outside of London on any European exchange,

(iii) VCT can invest in loans to investee companies as opposed to equity. For older VCT funds the maximum is 70%, but from this year it is 30%, a further attempt by the Government to increase the risk profile of VCTs (iv) There will also be changes to the qualifying company limits from April 2012. An increase in the size of company a VCT can invest in to £15 million from £7m, and an increase in the maximum number of employees from 50 to 250. Finally, there is to be a four-fold increase in the annual investment limit per qualifying company to £10m.

## 15. Annex XV: Examples of Member States Eligible investors' criteria

France: (FCPR à procédure allégée)

**(i)** Corporate and individual investors whose initial subscription is for at least EUR 30,000 and who meet one of the following three conditions: a) They provide technical or financial assistance to unlisted companies covered by the fund's purpose to promote their creation or growth; b) They provide assistance to the portfolio management company of the fast-track venture capital fund in finding potential investors or contribute towards the company's objectives in seeking, selecting, tracking and disposing of investments; c) They have acquired knowledge about investment capital by being a direct equity investor in unlisted companies or by subscribing to a venture capital fund that is not advertised or promoted, or a fast-track venture capital fund, or else an unlisted venture capital firm;

**(ii)** Investors whose initial subscription is EUR 30,000 or more and who hold a total of EUR 1,000,000 or more in deposits, life insurance products or financial instruments;

**(iii)** Companies that met two of the following three criteria at the end of the previous financial year: a) Total balance-sheet assets of more than EUR 20,000,000; b) Turnover of more than EUR 40,000,00; c) Shareholders' equity of more than EUR 2,000,000**.**

**(iv)** Investors whose initial subscription is EUR 500,000 or more.

Luxembourg: (SICAR /SIF)

**(i)** Institutional investors

**(ii)** Professional investors within the meaning of MiFID

**(iii)** Any other investor (including an individual investor) who: (A) Confirms in writing that he/she/it is a well-informed investor; and (B) Either: invests (or commits to invest) a minimum of EUR125 000 in the SICAR/SIF; or obtains a certificate delivered by a credit institution within the meaning of Directive 2006/48/EC, an investment firm within the meaning of Directive 2004/39/EC or a management company within the meaning of Directive 2001/107/EC certifying his/her/its expertise, experience and capacity to adequately appraise an investment in the SICAR/SIF. The directors and all other persons involved in the management of a SICAR/SIF may invest in the respective SICAR/SIF.

United Kingdom

Investors who do not meet the definition of MiFID professional investor can be offered venture capital funds under certain conditions:

(i) these investors must have signed a certificate of a given format recently which states both (a) his/her eligibility to be treated as high net worth or sophisticated investor, and (b) contains a written acknowledgement of the risks and

(ii) must have been given a written warning which is precisely defined in content and format