



EUROPEAN COMMISSION

Brussels, 7.12.2011
SEC(2011) 1516 final

COMMISSION STAFF WORKING PAPER
EXECUTIVE SUMMARY OF THE IMPACT ASSESSMENT

Accompanying the document

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

European Venture Capital Funds

{COM(2011) 860 final}
{SEC(2011) 1515 final}

1. INTRODUCTION

Venture capital funds are operators that provide mostly equity finance to companies that are generally very small, in the initial stages of their corporate development. These firms are often innovative and demonstrate a strong potential for growth and expansion. In the EU, venture capital funding has high, but largely unexploited, potential for the development of small- and medium-sized enterprises (SMEs)¹. SMEs that rely on venture capital financing fare better than those that receive no venture capital backing. 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. Supporting venture capital can thereby drive the real economy.

In Europe, raising funds for venture capital finance remains at sub-optimal levels. The small size of an average European venture capital fund (€60 million) 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, a prerequisite for the specialisation necessary to operate a successful venture capital fund.

The focus of the impact assessment is on the appropriate regulatory measures to provide deeper capital pools for venture capital funds and allow European venture capital funds to expand assets under management. The underlying policy aim is to make such funds into a more important financing tool for innovative start-up companies. In pursuing this aim, the impact assessment focused on rules governing the 'private placement' of venture capital funds to potential investors.

2. PROBLEM DEFINITION

Driver 1: Regulatory fragmentation. Compared with competing global centres of high-tech and innovation, most notably the United States, the rules that govern the marketing of venture capital investments are fragmented and dispersed. Nine out of 27 Member States have adopted specific rules on the operation of venture capital funds, the composition of their investment portfolio, qualifying investment instruments, qualifying investment targets, the geographic location of investment targets, the types of investors that are eligible in such funds. All of these rules diverge in their substance on some or all of the above mentioned points. This has prevented the emergence of a uniform concept of what constitutes a venture capital fund. Eighteen Member States have not adopted specific rules on the fundraising activities conducted by venture capital operators. They apply general rules on company law and prospectus obligations to funds that wish to market 'private placements'² of venture capital. Compliance with this heterogeneous set of rules causes additional cost and complications.

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 the marketing of venture capital funds, the

¹ 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)

² 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.

procedural and preparatory steps (identification of local rules, seeking of legal advice, cost/benefit analysis prior to targeting the market) necessary to raise venture capital become more complex as the number of targeted jurisdictions increases.

Driver 3: Raising venture capital funds abroad involves costs that are not incurred when raising capital domestically. In order to ensure compliance with the various legal requirements that apply to the marketing of venture capital funds, the fund manager needs to undertake 'due diligence' ensuring proper identification of all applicable rules and requirements. Costs related to adapt legal documentation to the requirements of different national private placement rules may amount to € 500 to € 1,000 for each jurisdiction. If the venture capital fund sponsor wanted to raise capital across the EU, these costs would rise from €13,500 to €27,000.

Driver 4: Several jurisdictions apply prospectus rules to venture capital offerings. Major costs are associated with national prospectus requirements. For example, Member States and their regulatory authorities take different views on whether interests in limited partnerships (which is the typical structure used for venture capital funds) qualify as securities or not and hence are covered by the Prospectus Directive. A prospectus registration for one host Member State alone (Germany) would cost around €40,000. Prospectus requirements and prior approvals have been identified for Austria, Belgium, the Netherlands, France, Sweden and the United Kingdom.

Driver 5: Several jurisdictions require local registration and a local distribution presence. Many Member States require that a local and licensed marketing agent (i.e. a financial institution) is employed when a venture capital fund is marketed in their territories. Alternatively, the venture capital manager himself has to obtain a license qualifying him as a marketing agent. The costs for obtaining a distribution license range from €20,000 to €40,000³. The annual costs for maintaining a regulated "local presence", e.g., in the United Kingdom, would be at least €25,000 per year. This figure does not include costs for personnel.

The 2007 *Expert group report on removing obstacles to cross-border investments* by venture capital funds estimated that the cost of managing four parallel fund structures necessary to raise funds in four different jurisdictions exceeded 0.4% of the total capital committed to this fund.

3. ANALYSIS OF SUBSIDIARITY

A solution based on action by Member States has already been tested, and failed to achieve the intended goal. The Commission, in 2007, proposed mutual recognition of venture capital funds that are legally marketed in another Member State. However, in a report of December 2009 the Commission concluded that mutual recognition in itself has not contributed to opening host Member States markets to venture capital fund managers legally established in one jurisdiction. Therefore, only targeted harmonisation of key requirements applicable to venture capital funds at European level will allow cross-border marketing.

4. OBJECTIVES

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

³ Estimates provided by an EVCA legal advisor on 25 October 2011.

The overarching objective is to make European SMEs 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.

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. The proposed course of action therefore focuses on the development of deeper capital markets for venture capital funds.

Operational objectives

Establish a notion of what constitutes a 'qualifying venture capital fund'. In order to enhance the practical operation of cross-border fundraising, a common understanding of the concept of 'venture capital' is necessary. It is therefore proposed to harmonise the essential features of a venture capital fund.

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 uniform framework that applies when qualifying venture capital funds are marketed in the Community.

Create a network of administrative cooperation for the effective introduction and supervision of managers of 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 uniform rules that apply to venture capital funds.

5. POLICY OPTIONS

With respect to substantive policy options, the impact assessment considers how best to define the essential features, in terms of portfolio investment thresholds, target undertakings and qualifying investment instruments, which characterise a venture capital fund. Options assessed ranged from instituting an investment threshold of 50%, 70% or up to 90% of committed capital in favour of eligible target undertakings (unlisted SMEs). Instruments assessed include equity and quasi-equity instruments. In terms of eligible investors, options assessed included funds open to professional investors (as defined in Mifid), funds open to the larger population of family offices, angel investors, management teams and wealthy individuals or funds open to all retail investors.

Several options on legal form are assessed. These included options whereby special venture capital fund 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 thereof, 'private placements'.

6. ASSESSMENT OF IMPACTS

The assessment of impacts revealed the merits of an intermediate approach. An approach whereby an intermediate target of 70% of committed capital has to be invested in equity or quasi-equity

issued by the eligible SME, offers the highest likelihood that a distinct European brand for 'venture capital funds' would emerge without the risk of dilution of the new brand. With respect to eligible investors, the favored approach is to create a scheme limited to professional investors that, upon certain conditions, is also open to investments by family offices, angel investors, management teams and wealthy individuals, but not to retail investors. This approach would capture the typical venture capital investor base without requiring a fully fledged retail framework.

In respect of the legal instrument, the impact assessment favours the stand-alone approach. Options creating uniform rules on venture capital funds within the existing AIFMD framework are considered as causing friction within the AIFMD framework, a directive which would have to accommodate a strict supervisory approach vis-à-vis a heterogeneous population of alternative fund managers. Also, in the absence of a higher level of regulatory convergence between Member States, an option based on 'mutual recognition' of lawfully marketed venture capital funds is not considered effective in reaching the first operational aim (a common understanding of what constitutes a venture capital funds and the creation of uniform conditions for their marketing).

7. COMPARISON OF OPTIONS AND POLICY CHOICE

The final comparative analysis of all substantive and procedural options concludes that the preferred option is a stand-alone harmonisation instrument that would create uniform conditions under which a fund manager may market of qualifying venture capital funds in the Community.

The chosen approach appears the most efficient because, in practical terms, a fund manager who complies with all of the uniform requirements set forth in the proposed instrument would be able to market uniform funds in the entire Community without : (i) having to opt into the regulatory framework provided in Directive 2011/61/EC or (ii) comply with the residual – and very heterogeneous - national rules on either venture capital funds, private placements, prospectuses or requirements on local distribution.

8. COSTS AND BENEFITS

Compliance with the uniform criteria is not expected to result in significant compliance costs or administrative burden. The harmonization of quality requirements that apply to venture capital funds would considerably reduce existing costs linked with having to comply with different and very heterogeneous national rules that would apply in the absence of harmonization.

While a venture capital fund is likely to incur some costs linked to adapt its reporting and disclosure standards to align with the uniform rules, these costs are likely to be a fraction of the operating expenses that arise under the 'business as usual' scenario where funds have to comply with a variety of national provisions governing reporting and disclosure.

It is not expected that the cost of supervising compliance with the uniform framework would be significant, as all alternative investment funds are, if they were not registered under the proposed framework, subject to the general registration and disclosure requirements stipulated in Article 3(3) of the Alternative Investment Fund Managers Directive (AIFMD).

Certain requirements 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'.

Creating a European venture capital framework, based on a common notion of what constitutes a qualifying venture capital fund, is expected to improve efficiency in cross-border fundraising, promote competition among venture capital fund managers and increase opportunities for specialization. From the perspective of investors, uniform rules governing venture capital funds would create more trust in this particular asset class and -- in combination with improved access to funds -- would aid investors in allocating their capital more efficiently. Finally, a uniform framework for venture capital funds will channel more capital to innovative and high-growth potential companies.

9. MONITORING AND EVALUATION

In line with the objectives underpinning the Commission's policy choice, the post-adoption monitoring and evaluation will focus on three issues: (1) has the new framework established a notion of what constitutes a 'qualifying venture capital fund', (2) has the new framework contributed to a common regulatory approach governing qualifying 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.

Monitoring of these issues will be done in close cooperation with ESMA who will be tasked with maintaining a central register, publicly accessible by internet, which lists all qualifying venture capital fund managers registered in the Union in accordance with the proposed Regulation.