

A new European regime for Venture Capital

The European Commission's public consultation

EuroInvestors' reply

10th August 2011

EuroInvestors (the European Federation of Investors or EFI) was created in the summer of 2009, following the financial crisis which demonstrated the limits of the almost exclusive dialogue between regulators and the financial industry, largely ignoring the user side. EFI aims at representing and defending at the European level the interests of financial services users in order to promote training, research and information on investments, savings, borrowings and Personal Finances of individuals in Europe, by grouping the organizations pursuing the same objectives at a national or international level. Already about 45 national organizations of investors and other financial services users have joined us, and EFI already represents about two million European citizens.

Summary & general comments

EuroInvestors (EFI) agrees with the European Commission (EC) that venture capital is particularly important for small and medium enterprises (SMEs) in the EU, since venture capital provides finance to companies with promising but untested business models that are confronted with high levels of uncertainty as regards their future prospects. In these circumstances, these companies often face difficulties to find access to other more traditional sources of funding, in particular innovative start-up businesses that face difficulty in accessing traditional bank lending or finance through stock exchanges.

But, at the same time, EFI is concerned that by legitimately trying to ease venture capital funding for SMEs, the EC may be lowering the investors' protection level.

EFI believes that the cross-border venture capital fundraising and investments are hampered mainly by quite different tax regimes for venture capital funds between member states. At the same time, those member states explicitly or implicitly use quite different definitions of "venture capital". Another important impediment is the difficulty for SMEs to access capital markets, especially since the implementation of MiFID which fragmented the capital markets, complicated them, and made them less accessible for non financial issuers and investors, in particular for smaller ones (we refer to our reply to the MiFID Review consultation closed 2 February 2011¹).

We are not convinced by the EC proposal to add yet another regulation, as venture capital fund managers are already targeted by the yet to be enacted AIFMD Directive. We are quite surprised to read the EC's statement that "*the AIFMD requirements are not tailored for venture capital managers*". In that case we would like to know why the EC included them in the AIFMD scope in the first place. EFI believes that either AIFMD should be modified to accommodate some particularities of venture capital managers or AIFMD must clearly exclude venture capital managers from its scope. We are definitely against the creation of another standalone regulation covering venture capital activities which would then fall under two sets of regulations with diverging objectives.

Regarding the important issue of investor protection, and the statement by the EC that venture capital investors are professional ones, we think it is important for the EC to substantiate this statement with evidence, and to take into account that a lot of retail investors are actually offered and sold venture capital funds, usually with significant tax incentives. This situation for venture capital funds also calls for the urgent need to place all retail investment products under consistent disclosure and selling practices rules. We are again very concerned that the EC is restricting the scope of the "PRIIPs" initiative, is delaying its completion, and is now backtracking on its initial objective of increasing the consistency of investor protection rules by proposing yet another "silo" approach, this time specific to venture capital funds.

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<http://euroinvestors.org/upload/positions/MiFID%20EFI%20reply%20%2020Feb%202011%201296749279.pdf>

Last but not least, we would like to stress that experience of retail and institutional investors as well as Academic research shows that the lack of transparency and the importance of hidden costs is usually very high in private equity (including venture capital) funds, creating indeed specific investor protection concerns².

1. Venture capital and SME

Current legal framework

Managers of venture capital funds are covered by the Directive on Alternative Investment Fund Managers (AIFMD)³. Therefore, managers of venture capital funds with assets under management above EUR 500 million can benefit from the European passport provided by the AIFMD.

Box 1

a) Do you think that encouraging Member States to a process of mutual recognition of venture capital funds, based on the direct enforcement of the Treaty freedoms, could facilitate the cross-border activity of these funds?

Yes

b) 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?*

Neither. We believe the main impediments preventing cross-border venture capital fundraising and investments are:

- the quite different definitions of “venture capital” between member states and the quite different tax regimes regarding venture capital funds between member states.
- the difficulties for SMEs to access capital markets, especially since the implementation of MiFID which fragmented the capital markets, complicated them, and made them less accessible for non financial issuers and investors, in particular for smaller ones (we refer to our reply to the MiFID Review consultation closed 2 February 2011⁴).

² “Why is the evidence on private equity performance so confusing” by Ludovic Philappou, University of Oxford, June 2011.

³ Directive on Alternative Investment Fund managers (pending publication in the Official Journal of the European Union)

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<http://euroinvestors.org/upload/positions/MiFID%20EFI%20reply%20%202%20Feb%202011%201296749279.pdf>

c) Is a targeted modification of AIFMD rules for venture capital or a standalone initiative in this area the more appropriate tool to increase venture capital activities? Please specify.

Certainly not another standalone rule, as the AIFMD is not even published yet. We are quite surprised that the EC states that “the AIFMD requirements are not tailored for venture capital managers”. So why did the EC include them in the AIFMD scope in the first place? Either AIFMD is modified to accommodate some particularities of venture capital managers or AIFMD must clearly exclude them from its scope.

d) From your experience, could you provide concrete examples where you encounter additional administrative or regulatory hurdles when raising or investing funds across the EU?

N.A.

e) Do you believe that an initiative on cross-border operations of venture capital could contribute to eliminating the cross-border tax problems encountered and if so, how?

No. 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.

f) How could a possible passport for venture capital operators facilitate targeted tax incentives in favour of cross-border venture capital investments?

See reply to e)

2. Elements of a European legislative framework for venture capital

1) Voluntary registration with a competent authority

Box 2

N.A.

2) Simple notification procedure.

Box 3

N.A.

3) Restriction for retail investors.

Box 4

a) Do you agree with this approach? If not, and in case you believe venture capital should be accessible to retail investors, what kind of measures would you recommend to ensure their protection?

No. We would like the EC to provide evidence for its statement: *“Venture capital investors are professional and are supposed to apply high standards of due diligence, while undertaking a thorough examination of any fund before they decide to make an investment”*.

We have evidence to the contrary. The EC should be aware that a lot of retail investors are offered and sold venture capital funds, usually with significant tax incentives. In France alone, multiple investment vehicles and tax incentives are designed to generate retail investments into venture capital funds:

- “Fonds commun de placement à risque” (FCPR) in 1983,
- “Fonds commun de placement dans l’innovation” (FCPI),
- “Fonds d’investissement de proximité” (FIP).
- In addition these funds open or specifically targeted to retail investors also benefit from further tax benefits if they are included in specific unit-linked insurance contracts (called “DSK” or “NSK since 2005). One needs to understand that even when retail investors subscribe to venture capital fund through unit-linked insurance contracts - and therefore do not legally own them – they are the ones to make the decision and to bear all the risks and rewards of such an investment: they are definitely the economic or “beneficial” owners.

Before considering any new regulations on venture capital funds after the AIFMD, we respectfully believe the EC should first thoroughly investigate the share of those already offered to retail investors, and substantiate its statements with evidence.

This situation for venture capital funds also shows the very urgent need to place all retail investment products under consistent disclosure and selling practices rules. We are again very concerned that the EC is restricting the scope of the “PRIPs” initiative, is delaying its completion and is now backtracking on its initial objective of increasing the consistency of investor protection rules by proposing yet another “silo” approach, this time specific to venture capital funds.

We also respectfully challenge the EC statement: *“venture capital funds are not likely to ...create specific investor protection concerns (insofar they are addressed to professional investors).”* Academic research demonstrated quite the contrary as well as the experience of both retail and institutional investors. We refer to the example of the findings and works of Professor Philappou of the University of Oxford⁵: *“the lack of transparency and the importance of hidden costs is usually very high in private equity (including venture capital) funds, creating indeed specific investor*

⁵ See for example “Why is the evidence on private equity performance so confusing” by Ludovic Philappou, University of Oxford, June 2011.

protection concerns". Quite a few serious issues arose for example in France on the sale of "FIP" funds where quite a few intermediaries would charge up to 15% up-front commissions. Also, venture capital funds are very high risk.

b) What are the restrictions (if any) on participation of retail investors in your country within the fund structures used for venture capital investments?

See a) above: there are for instance very few restrictions for retail investors to invest into FCPR, FCPI, or FIPs, either directly or via unit-linked insurance contracts.

4) Reporting obligations.

Box 5

a) Do you agree with this approach? If not, what alternative approach would you suggest?

See our replies to Box 4. This approach could be considered only for venture capital funds that cannot be marketed or sold to retail investors, either as legal or beneficial owners. Again, our experience is that this is not the case of a large number of those funds. So, again, is it worth creating yet another piece of "silo" investment regulations that would deal only with part of the targeted scope?

Also, again, there are specific investors' protection issues that do not plead for an exclusion from the already light (compared to UCITS) requirements of the AIFMD.

5) Operating conditions for venture capital entities.

Box 6

6) Legal form of the venture capital funds.

Box 7

7) Investment focus on SMEs

Box 8

a) What, if any, investment criteria determine your existing national fund structures used for purposes of venture capital investments?

The definition and scope of venture capital funds is very different and sometimes inconsistent between member states and even within member states. In France alone, each of the five venture

capital investment vehicles we mentioned above have different investment eligibility rules. In addition, many of these confuse venture capital and private equity or with capital invested in SMEs (whether they are listed or not). We are concerned that adding a new EU eligibility rule on what is and what is not “venture capital” will only add to the confusion and further complicate the task of investors.

8) Determination of the scope of the activities of venture capital funds.

8.1. Description of the activity.

Box 9

a) How do your national rules capture (if at all) the definition of venture capital funds?

See reply to Box 8

8.2. Description of the venture capital investment strategy.

Box 10

8.3. Definition by exclusion of certain types of investments.

Box 11

9) Third country entities.

Box 12

10) Impact on other pieces of EU legislation.

Box 13

a) Do you agree with this approach?

No. See our previous replies.

b) Would you support the first (exemption for entities below the AIFMD threshold) or the second option (exemption independently from the threshold)? Would you suggest an alternative approach?

We would support the first option only if these funds cannot be marketed or sold to retail investors as legal or beneficial owners.

c) Are there any particular elements from the AIFMD that in your view should also apply to the venture capital managers?

As previously stated, we do not see any important reason to exclude venture capital funds from the brand new AIFMD requirements. Or why having included them in the AIFMD scope in the first place?