

Venture Capital Funds - Recent European Developments

February 27, 2012

Introduction

Recent months have seen a significant shift in the approach of European regulators and lawmakers to the regulation of venture capital funds. The European Alternative Investment Fund Managers Directive (the "**AIFMD**") has been assumed to be the European legislation that would frame the venture capital fund industry in Europe from July 2013. While that currently remains the case, there is a growing recognition that the industry requires specialist legislation that balances the compliance burden with a constructive facility for marketing venture capital funds cross-border. Set out below are those developments that illustrate this trend.

The developments (other than the EU parliamentary study) do not relate to non-EU managers, although the fact that Europe seems to be thinking about whether to "go light" on EU venture capital managers is, hopefully, a good sign that similar proposals could arise for non-EU managers, as the EU parliamentary study also illustrates.

European Venture Capital Funds Regulation and European Social Entrepreneurship Funds Regulation

In December 2011, the European Commission proposed two new fund marketing regimes with the introduction of two separate draft Regulations on European Venture Capital Funds and European Social Entrepreneurship Funds (together, the "**Regulations**"). The Council of the European Union proposals published on 1 February 2012 amended and refined the proposed Regulations, which currently remain under negotiation and review.

The proposed Regulations have several complementary purposes, aiming to remedy the perceived shortcomings of the AIFMD in relation to the regulation and marketing of small venture capital and social business funds, introduce a tailor-made "Single Rulebook" across the EU for the marketing of such funds and, as a result, boost investment activity in the two sectors.

The proposed Regulations themselves introduce what is essentially a voluntary registration and marketing passport regime, with the imposition of "light touch" regulation. Fund managers established in the EU, falling within the scope of the regime and wishing to benefit from the marketing passport, must register in their home member state under the AIFMD (as distinct from full authorisation under the AIFMD). Qualifying funds managed by the registered managers will be branded with the designation "**EuVECA**" for venture capital funds, or "**EuSEF**" for social entrepreneurship funds. The EuVECAs or EuSEFs may then be marketed by the fund manager across the EU under a single set of rules using the EU marketing passport.

The proposed Regulations apply to EU fund managers whose assets under management in total do not exceed €500M, provided they manage qualifying funds; if this threshold is exceeded, the fund manager will need to seek authorisation under the AIFMD. Fund managers falling within the scope of this definition may then use the EuVECA or EuSEF designation in relation to a qualifying fund if the fund fulfils essentially two key requirements:

1. the qualifying fund must invest at least 70% of its capital contributions into qualifying investments; and
2. the qualifying fund must not employ leverage.

The scope of "qualifying investments" in the proposed Regulations is narrow, intended to demarcate boundaries and limit use of the designations by excluding from the scope other, less specialized sectors like private equity. For EuVECAs, a "qualifying investment" is an equity or quasi-equity instrument acquired by the fund directly from a qualifying undertaking, which is essentially a small or medium enterprise ("**SME**"), defined in both proposals as an undertaking that is not listed on a regulated market, has an annual turnover not exceeding €50M or an annual balance sheet total not exceeding €43M, and is not itself a fund. Investments into other EuVECAs also fall within the scope of qualifying investments.

While EuSEFs are permitted to invest in a wider range of qualifying instruments (including, for example, securitised debt), those instruments must be issued by SMEs which are social businesses, meaning that they have the achievement of positive social impact as a primary objective in their statutory documents, use their profits to achieve such positive social impact, and are accountable and transparent. Investments into other EuSEFs also fall within the scope of qualifying investments.

The "light touch" regulation regime in the proposed Regulations imposes certain other operational and disclosure requirements, but falls well below the level of regulation provided for by the AIFMD. However, the recent Council amendments appear to have tightened the proposed regime, adding further operational requirements on the part of managers (for example, new requirements to treat all investors fairly and ensure there is no preferential treatment unless it is expressly provided for in the fund's statutory documents).

Additionally, the fund manager is limited in marketing the fund to eligible investors only. Under the proposed Regulations, EuVECAs and EuSEFs can be marketed to investors categorised as "professional clients" under current EU financial services law; these are, generally, institutional investors. Marketing to other investors, for example high net worth individuals, is permitted only if certain conditions are met, including that the investor commits a minimum of €100,000 to the fund, the fund manager undertakes an assessment of the investor in relation to his knowledge and experience, and the fund manager is reasonably assured that the investor is capable of making his own investment decisions and understanding the risks involved and that the commitment is appropriate for the investor.

The proposed Regulations are subject to further negotiation by the European Parliament and the Council before formal adoption takes place, which could be as early as late 2012. It is intended that the Regulations will apply in EU member states from 22 July 2013, the AIFMD implementation date.

UK Financial Services Authority Consultation on the Implementation of the AIFMD

The UK Financial Services Authority (the "**FSA**") has issued a discussion paper (DP 12/1) which invites comments on 69 questions that it poses regarding implementation of the AIFMD. The FSA specifically identifies a number of areas in which the particular issues faced by private equity and venture capital funds need to be addressed, including (a) whether limited partnerships are internally or externally managed, (b) the valuation rules that will apply to partnership interests and (c) whether, under the power given by the AIFMD to individual member states, stricter rules should be applied to small venture capital fund managers (e.g., the venture capital fund managers that will be covered by the Regulations).

It is important to note that the discussion paper does not concern itself with AIFMD implementation issues for non-EU managers and non-EU funds in 2015, but rather for EU managers in relation to EU funds in 2013. Nevertheless, many issues decided in relation to the 2013 implementation will obviously impact the 2015 implementation.

Industry should be encouraged to participate in this consultation, which closes on 23 March 2012.

European Parliament Study on the Potential of Venture Capital in the European Union

The European Parliament, Directorate General for Internal Policies, Policy Department A: Economic and Scientific Policy (Industry, Research and Energy), this month issued a study entitled "Potential of Venture Capital in the European Union". The study sets out, among other things, potential legislative reforms that might be made in Europe including:

- a framework for larger venture capital funds being made available to experienced or professional investors (including funds outside of the EU);
- a European passport reducing the complexity of cross-border venture capital fund-raising;
- a pan-European fund structure which should be a long-term goal, providing tax efficiency for all investors; and
- policy measures which help create a liquid exit market for venture capital investment.

It is very early days, but this may point to a desire to develop a separate regime for large venture capital fund managers outside of the AIFMD, which relieves the compliance burden and is more helpful to the industry in marketing its products within the EU.

Related Professionals

- **Nigel van Zyl**
Partner
- **Amanda H. Nussbaum**
Partner
- **Scott S. Jones**
Partner
- **Charles (Chip) Parsons**
Partner
- **Jamiel E. Poindexter**
Partner
- **Marc A. Persily**
Partner
- **Ira G. Bogner**
Managing Partner
- **Sarah K. Cherry**
Partner
- **Bruce L. Lieb**
- **Arnold P. May**
Partner
- **Mary B. Kuusisto**
Partner
- **David W. Tegeler**
- **Howard J. Beber**
Partner
- **Robin A. Painter**
- **Christopher M. Wells**

- **Stephen T. Mears**

Partner