TRAVERS SMITH

Investment Funds

The European Venture Capital Fund Regulation

Hidden in the long shadow cast by the AIFM Directive, the European machine has also been working on a new set of regulations aimed at encouraging venture capital financing. On 12 December 2012, the Cyprus Presidency of the EU Council announced that political agreement had finally been reached between the Council and the relevant European Parliament committees on the proposals.

This note sets out an overview of the proposed Regulation. In general, the Regulation will allow EU managers to market EU qualifying venture capital funds to certain EU investors on the basis of a marketing passport, whilst imposing fewer and less onerous compliance obligations than with the AIFM Directive. However, the requirements on the types of permitted investments are restrictive so, although the Regulation may be of benefit to some venture capital organisations, it is likely to be too narrow for many development capital and lower mid-market private equity houses. This note also, therefore, highlights some of the challenges that will be faced when trying to fit within the requirements of the Regulation.

It is intended that the Regulation should come into force in parallel with the AIFM Directive from 22 July 2013.

The good news

The Regulation is part of a policy objective to stimulate growth in small, innovative businesses. There is an acknowledgement that venture capital can be a force for good, providing financing for early stage companies but also providing valuable expertise, business contacts and strategic advice. As such, the Regulation is intended to encourage and support venture capital funds.

The main thrust of the Regulation is the creation of a new pan-European designation: a 'European Venture Capital Fund' (**EuVECA**). Provided the Regulation is complied with, a manager can designate a fund as an EuVECA and can use this designation throughout the EU. In the same way that UCITS now have a recognised and trusted brand, the intention here is to create a similar brand for venture capital funds, one with an EU stamp of approval that will provide investors with confidence. Interestingly, one of the recitals to the Regulation states that the European Investment Fund (the **EIF**) should be encouraged to invest in EuVECA funds.

The biggest advantage a fund manager will gain by registering under the Regulation is that it may market qualifying funds throughout the EU under the EuVECA designation to certain categories of investor. The regulation contemplates a marketing passport for the EU, so that the fund manager does not have to rely on national private placement regimes and fundraising should be more straightforward. It remains to be seen whether this passport (and the AIFMD passport) in fact removes all impediments to marketing under local laws. Marketing is permitted to institutional investors who would be considered 'professional clients' under the MiFID test. However, in an improvement on the AIFM Directive, the EuVECA marketing passport also allows for marketing to certain sophisticated investors who would be deemed "retail" for the purposes of MiFID and the AIFM Directive. These are investors who make a minimum investment of €100,000 and who state in writing that they are aware of the risks associated with the investment in the fund. Further, any executives, directors or employees of the manager may also invest in qualifying venture capital funds that they manage.

Further good news: some of the more onerous provisions of the AIFM Directive have not been carried across to the Regulation. Therefore, there is no requirement for the manager to maintain liquid assets, the regulatory capital requirement is simply to have "sufficient own funds" and there is no requirement for a depositary to be appointed in relation to the fund (although there is some provision about how fund assets must be custodied).

The Regulation is not compulsory; if a fund manager does not want to use the EuVECA designation then it does not have to comply with the Regulation for a particular fund (or at all). If this is the case, existing national laws and EU regulations would continue to apply, such as national private placement regimes.

The requirement to make Qualifying Investments

As referred to earlier, in order to qualify as an EuVECA, there are restrictions placed on the types of investment that may be made by the fund.

The basic test is that, to be a ***'qualifying venture capital fund'***, the EuVECA must:

1. intend to invest at least 70% of its aggregate capital contributions and uncalled committed capital (in effect, this is the aggregate commitments to the fund) in assets that are 'qualifying investments'. These investments must be made within a time frame set out in its rules or instruments of incorporation (i.e. within the investment period set out in the LPA); and

2. never invest more than 30% of aggregate fund commitments for the acquisition of assets that are not 'qualifying investments'.

Helpfully, both of the above limits are only calculated on the amount of capital available for investment. Therefore, the fund may deduct all fees, charges and expenses which are directly or indirectly borne by investors. The fund may also deduct all holdings in cash and cash equivalents, because these are not considered to be investments.

For the purposes of this basic test, the Regulation also sets out a number of important defined terms, which need careful consideration to fully understand the implications. These defined terms are set out in the schedule to this note.

A key issue is that in the vast majority of cases a qualifying investment must be in a 'qualifying portfolio undertaking', which is essentially the small and medium-sized enterprises (**SMEs**) definition that has been widely used by the European Union. The core concepts are that a qualifying portfolio undertaking must, at the time of an investment by the venture capital fund, employ fewer than 250 persons and either have an annual turnover not exceeding €50m or a balance sheet of less than €43m. Care will need to be taken to ensure that investments fall within these criteria, for example some retail or service businesses may employ more than 250 people (we understand that part-timers would count as a whole person) despite having a low turnover or being regarded as a small enterprise. There are also a number of exclusions from the definition of 'qualifying portfolio undertaking', such as excluding most firms regulated under EU financial services regulation and excluding undertakings established in a non-EU state which does not meet certain anti-money laundering standards and is not a party to a tax information exchange agreement with the Member State of the manager.

A further issue is that a significant proportion of investments made by the venture capital fund will need to be structured as 'equity' or 'quasi-equity', which will reduce the structuring options available when making investments. As well as ordinary shares, we would expect preference shares to be caught by the definition of 'equity'. The definition of 'quasi-equity' is less clear, although the recitals to the Regulation state that what is intended is "financing instruments such as subordinated loans, silent participations, participating loans, profit participating rights, convertible bonds and bonds with warrants". Also, the quasi-equity must not be fully secured.

In addition to 'equity' and 'quasi-equity', secured and unsecured loans by the fund to the underlying portfolio company may still be regarded as a 'qualifying investment'. However, it should be noted that the aggregate amount of such loans would not be permitted to equal more than 30% of the aggregate commitments to the fund.

Finally, similar to REITs, EuVECAs would be permitted cross-holdings in other EuVECAs, provided those underlying EuVECAs do not invest more than 10% of their capital in further EuVECAs.

Additional conditions in order to be classified as an EuVECA

The Regulation sets out a number of additional rules that a venture capital fund manager will need to comply with in order to use the EuVECA designation for the marketing of a qualifying venture capital fund in the EU. In general, these conditions should not give rise to difficulties, especially for any manager that is already authorised by the FSA. The requirements are certainly pitched a long way below the more onerous compliance obligations imposed by the AIFM Directive.

Limit on assets under management: the Regulation only applies to managers whose assets under management in total do not exceed €500m. This is the threshold that is carried across from the AIFM Directive. A slight modification is that, if a manager is registered under the Regulation but subsequently grows to exceed the threshold, it can still use the EuVECA designation. Obviously, in these circumstances, the manager would also have to be authorised under the AIFM Directive and its funds would need to comply with the AIFM Directive, so the only advantage is being able to continue to use the EuVECA badge.

Collective investment undertaking: the Regulation only applies to managers of 'collective investment undertakings', being entities that would be AIFs under the AIFM Directive (i.e. a collective investment undertaking that raises capital from a number of investors, with a view to investing in accordance with a defined investment policy for the benefit of those investors). One note for the UK market is that VCTs could be structured as EuVECAs.

Domicile of the fund: the qualifying venture capital fund must be established within the EU. This requirement will be reviewed by the Commission within two years of the Regulation commencing, so that it may be possible in the future for funds established in third countries to also use the EuVECA designation.

No leverage: the venture capital fund may not employ leverage at the level of the fund, whether that be by the borrowing of cash or the use of derivatives or any other means. This is intended to prevent EuVECAs contributing to the development of systemic risks. However, as a concession, it is now also noted that the manager may borrow, issue debt obligations or provide guarantees at the level of the fund where such borrowings, obligations or guarantees are covered by uncalled commitments. This should permit, for example, investor call bridging facilities or other short-term borrowing to be used.

Governance: the Regulation sets out a number of governance obligations with which the manager must comply, including: acting honestly with due skill, care and diligence and acting fairly in conducting its activities; having appropriate policies and procedures in place, including valuation policies; conducting its business activities so as to promote the best interests of the qualifying venture capital funds it manages, apply a high level of due diligence in the selection and monitoring of investments and treat investors fairly; and ensuring that no investor obtains preferential treatment, unless such preferential treatment is disclosed in the rules or instruments of incorporation of the fund. For a FSA-authorised manager in the UK, these governance requirements should not impose any significant extra burden. However, the last point on preferential treatment is worth noting. This is carried across from the AIFM Directive and may change the approach fund managers take to side letters when negotiating with investors on a fundraising.

Delegation: a venture capital fund manager may delegate functions to third parties, however any delegation shall not affect the liability of the manager towards the fund and its investors. Another concept that has been lifted from the AIFM Directive relates to "letter-box entities". Although little information is given in the Regulation, it does state that the manager is not permitted to delegate to the extent that, in essence, it can no longer be considered to be the manager of the fund and to the extent that it becomes a "letter box entity".

Conflicts policy: the manager must identify and avoid potential conflicts of interest and have a system in place for the prompt disclosure of conflicts.

Reporting to the regulator: A more onerous obligation on the manager is that is must provide an annual report to the applicable regulator, which must be made available to investors on request. Although the reporting requirement is not as prescriptive as under the AIFM Directive, it must describe the composition of the portfolio and the activities of the previous year, it must also include the audited financial statements of the fund (the auditors are required to confirm that the money and assets are held in the name of the fund and that the manager has established adequate records and controls in respect of the assets) and it must also disclose the amount of profits of the fund by the end of its life time and the amount of profits distributed by the fund.

The process for registration and marketing

A venture capital manager that intends to use the EuVECA designation must become registered in the EU. Once this is done, it may market qualifying venture capital funds throughout the EU under the EuVECA badge. For an internally managed fund, the fund itself may be registered as the venture capital manager.

To be registered, certain limited information must be provided to the regulator in the home Member State of the manager before any marketing begins. The information includes the identity of the persons who will be managing the fund; the identity of the qualifying venture capital funds and their investment strategies; the arrangements for complying with the conditions set out in the previous section; the Member States where the manager intends to market the fund; and the Member States where the manager has established or intends to establish the funds. No details are given at this stage as to the process or timing for the regulator confirming the registration of the venture capital manager. The regulator will also assess if the persons who conduct the business of the manager are of sufficiently good repute and sufficiently experienced.

Once the manager is registered, to launch any new fund as an EuVECA, the manager must simply notify the regulator in the EU Member State where the manager is regulated.

The regulator will not be permitted to impose any additional approval process on marketing of funds as EuVECAs. However, the manager must provide certain information to investors prior to their investment decision. Whilst one or two disclosures may be challenging, in general, this information is of the type that would normally be included in a private placement memorandum, so it is unlikely to be a significant hurdle for the marketing process and it is certainly less onerous than the type of information this is required to be disclosed under the AIFM Directive.

And now the bad news...

A lot of what is contained in the Regulation should be viewed in a positive light, especially when compared to the AIFM Directive. However, there are still gaps in understanding how the Regulation will work in practice, for example, how the registration process will operate and how long it will take.

It is also unclear the extent to which the Regulation will be of much use to the wider private equity industry. It is obvious that the policy is for the Regulation to only be applied in a venture capital context, but there is a slightly blurred line between venture capital and growth/development capital activities in the lower mid-market private equity space. Even if a private equity fund is able to fit within the 'qualifying investments' criteria, it should be noted that the Regulation states clearly that it is not intended for typical private equity strategies, such as leveraged buyouts or speculative real estate investments. So, it is possible that further guidance will be introduced to restrict further the types of activity that are permitted under the Regulation.

Because the 'qualifying investments' requirements are prescriptive, this will reduce the types of investment that a fund is able to make and also narrow the structuring options available to a manager, which in turn may have an impact on the overall returns of the fund. As an example, a common private equity investment structure is for the fund to make its investment by way of a combination of equity and shareholder loans. The interest coupon on the shareholder loan is theoretically deductible for corporation tax purposes for the group. However, the fund would need to restrict all shareholder loans to no more than 30% of total investments that are made. It may be possible to structure the shareholder loan as 'quasi-equity' by (for example) attaching a warrant, but careful consideration would need to be given to such a structure to ensure it did not prejudice the availability of the corporation tax deduction on the interest coupon.

More generally, for each venture capital fund manager, an analysis will need to be undertaken to determine if the benefits of being an EuVECA (which are mainly to do with the pan-European marketing passport) outweigh the additional obligations and restrictions that are imposed.

The next steps in the process

As noted above, the Regulation is intended to come into force in parallel with the AIFM Directive from 22 July 2013, although it is unclear whether this timetable will be met. The next step is a plenary vote of the Parliament in early 2013, followed by formal approval by the European Council.

The Regulation will take direct effect in EU Member States, not requiring any further domestic implementation, although there is provision for the European Commission to make harmonised detailed implementing rules.

There is also provision for the European Commission to undertake a review of the Regulation at the latest by July 2017. This review is intended to take account of developments in the venture capital market, the functioning of the rules, the interaction of the Regulation with the AIFM Directive and whether it is necessary to extend the scope of the Regulation to larger alternative investment funds.

Schedule

Defined terms for the purposes of the Regulation

'qualifying investments' means any of the following instruments:

(i) 'equity' or 'quasi-equity' instruments that are:

(a) issued by a 'qualifying portfolio undertaking' and acquired directly by the 'qualifying venture capital fund' from the 'qualifying portfolio undertaking';

(b) issued by a 'qualifying portfolio undertaking' in exchange for an equity security issued by the 'qualifying portfolio undertaking'; or

(c) issued by an undertaking of which the 'qualifying portfolio undertaking' is a majority-owned subsidiary and which is acquired by the 'qualifying venture capital fund' in exchange for an equity instrument issued by the 'qualifying portfolio undertaking';

(ii) secured or unsecured loans granted by the 'qualifying venture capital fund' to a 'qualifying portfolio undertaking' in which the 'qualifying venture capital fund' already holds 'qualifying investments', provided that no more than 30% of the aggregate capital contributions and uncalled committed capital in the 'qualifying venture capital fund' is used for such loans;

(iii) shares of a 'qualifying portfolio undertaking' acquired from existing shareholders of that undertaking;

(iv) units or shares of one or several other 'qualifying venture capital funds', provided that those 'qualifying venture capital funds' have not themselves invested more than 10% of their aggregate capital contributions and uncalled committed capital in 'qualifying venture capital funds'

'equity' means ownership interest in an undertaking, represented by the shares or other forms of participation in the capital of the 'qualifying portfolio undertaking', issued to its investors

'quasi-equity' means any type of financing instrument which is a combination of equity and debt, where the return on the instrument is linked to the profit or loss of the 'qualifying portfolio undertaking' and where the repayment of the instrument in the event of default is not fully secured

'qualifying portfolio undertaking' means an undertaking that:

(i) at the time of an investment by the 'qualifying venture capital fund':

(a) is not listed on a regulated market;

(b) employs fewer than 250 persons; and

(c) either has an annual turnover not exceeding €50 million, or an annual balance sheet in total not exceeding €43 million;

(ii) is not itself a collective investment undertaking (i.e. is not itself a fund);

(iii) is not one or more of certain types of entity that are defined in other areas of European legislation, such as a credit institution, an investment firm, an insurance undertaking, a financial holding company or a mixed-activity holding company;

(iv) is established within the EU, or in a third country, provided that the third country is not listed as a Non-Cooperative Country or Territory by FATF and it has signed a tax information exchange agreement with the home Member State of the venture capital fund manager and with each other Member State in which the qualifying venture capital fund is intended to be marketed

For further information on these issues, please contact one of the members of the Investment Funds Group or your usual contact at Travers Smith.

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