

Public Consultation

Staff working paper

A new European regime for Venture Capital

Consultation document

Important notice: this document is a staff working paper of D. G. Internal Market and Services for discussion and consultation purposes. It does not purport to represent or pre-judge the formal proposal of the Commission.

1. Venture capital and SME

What is venture capital?

Venture capital provides equity finance to companies that are generally very small and young, often innovative start-ups, with strong growth potential. This type of investment, which often takes the form of temporary stakes in the capital of the companies, entails high risk since the returns are linked to the success of newly created companies. For this reason venture capital also provides important non-financial support to these companies, including consultancy services, financial advice, marketing strategy, training, etc.

Why is venture capital important?

Venture capital is particularly important for the small and medium enterprises (SMEs)¹ 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.

Venture capital thus helps to drive innovation, economic growth and job creation. It has a lasting effect on the economy as it mobilises stable investment. Moreover, venture capital backed companies often create high-quality jobs as venture capital supports the creation of the most successful and innovative businesses. According to recent research, an increase in venture capital investments is associated with an increase in real GDP growth and the impact of an early-stage investments in SMEs has even more pronounced impact on the real economic growth².

When reviewing where Europe stands in terms of its competitive position as regards research and innovation, there is a recognition that more could be done to make venture capital funding available³. Such funds are crucial for new technology-based firms and for promoting radical innovation⁴.

What is the immediate funding problem?

The annual amount invested by European venture capital funds in SMEs before the financial crisis amounted to around € 6-7 billion. The latest figures for 2009 and 2010 indicate investments within a range of about €3-4 billion. Reduced funding for venture capital has affected the number of start-up companies, mostly SMEs, which were targeted by venture capital funds. In 2007, about 3.000 SMEs received venture capital funding compared to only 2.500 last year.

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 Th. MEYER, "Venture Capital Adds Economic Spice", *Deutsche Bank Research*, September 14, 2010

³ In 2009 the levels of invested venture capital in Europe reached only 21% of the amount invested by the venture industry in the US: "Global Venture Capital Insights and Trends Report 2010", Ernst&Young.

⁴ Communication from the Commission to the European Parliament, the Council, the Economic and Social Committee and the Committee of the Regions Europe 2020 Flagship Initiative Innovation Union
http://ec.europa.eu/research/innovation-union/pdf/innovation-union-communication_en.pdf#view=fit&pagemode=none

The value-based share of venture capital investments into SMEs as a percentage of total private equity investment amounted to only about 8%.

Investments in SMEs account for 80% of all private equity investment. However, when looking specifically at venture capital funds, we observe that 98% of these investments are targeted at SME projects which are at an early stage or growth phase of their development.⁵

These figures give rather a static picture on the scale and proportion of venture capital financing in Europe directed to the young and innovative SMEs sector and do not expose in quantitative terms the financing gap faced by SMEs. This may be a difficult task as stated in recent analytical paper, which notes that: "One fundamental problem in dealing with the SME financing gap is lack of basic information about just how big such a gap may be. Often the only evidence being in the form of complaints from SMEs themselves and this is difficult to use in analysis or for comparison."⁶ However, having observed the difficulties that SMEs faced when provision/extension of credit lines by banks during the financial crisis practically evaporated, one starts to look out for alternative solutions. At the core of any solution could be to support actions that would tip the balance between the traditional financing sources for SMEs towards those, like venture capital, whose business model is able to sustain the more volatile pattern of growth and earnings of SMEs in their early stages of existence.⁷

Improving conditions for SMEs to access venture capital financing

In the Communication on the Review of the "Small Business Act" for Europe⁸, published on 23 February 2011, the Commission stressed the need to take into account the financing needs of SMEs, and in particular the problem of financing the initial start-up and growth phases of new companies. In the Communication on the Single Market Act⁹, the Commission acknowledged that venture capital is an essential source of finance, in particular for innovative start-up businesses that face difficulty in accessing traditional bank lending or finance through stock exchanges.

Access to venture capital in the EU, however, is complicated by the existence of fragmented markets for venture capital. The Commission considers that the fragmentation of the European Union's venture capital markets along national lines could limit the overall supply of capital for innovative SMEs. Venture capital funds face problems reaching the critical mass they need to spread their portfolio risk and cover their costs¹⁰. Apart from the cultural or linguistic constraints, venture capital funds that intend to raise funds and invest on a cross-border basis in the EU are confronted with two problems: the fact that they do not benefit from a real internal market and in certain cases claim to face problems of double taxation.

⁵ Moreover, 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

⁶ <http://www.oecd.org/dataoecd/53/27/37704120.pdf?q=smes>

⁷ Ibid: Bank credits are the most common source of financing for SMEs, with its share at about 80% compared to other sources of financing, where venture capital funding fares at about 2%

⁸ Communication from the Commission *Review of the "Small Business Act" for Europe* COM(2011) 78 final, 23.2.2011

⁹ Communication from the Commission to the European Parliament, the Council, the Economic and Social Committee and the Committee of the Regions *Single Market Act, Twelve levers to boost growth and strengthen confidence. "Working together to create new growth"* COM(2011) 206 final, 13.4.2011

¹⁰ See the Communication from the Commission on *Removing obstacles to cross-border investments by venture capital funds* COM(2007) 853 final, 21.12.2007

- a) First, venture capital funds do not benefit from a real internal market. There are currently 27 different operating environments for venture capital in the EU. Fundraising and investing across borders is possible, but it is complex and costly and therefore smaller venture capital funds tend to avoid operating outside their home jurisdictions. Venture capital funds often need to go for a separate registration or establishment in each Member State where they operate, which increases costs and time spent for fund structuring¹¹. Some larger venture capital funds that are nevertheless operating across EU borders have to channel investments through complex and costly parallel vehicles established in other countries.

In the light of the above, the European Council of 4 February 2011 concluded that every effort should be pursued to remove the remaining legal and administrative obstacles to the cross-border operations of venture capital funds. Facilitating cross-border operations could help venture capital funds to add to the overall supply of capital for growth-oriented firms.

- b) Second, venture capital funds claim they often face problems of double taxation, tax treatment uncertainties and administrative obstacles related to taxation when investing on a cross-border basis. As a consequence, we understand that venture capital funds that would otherwise invest in other Member States tend to be restricted to domestic national markets rather than extending to the larger EU markets.¹²

Creating an Internal Market for venture capital

The fragmentation of markets for venture capital is an issue that requires immediate action. This is why the present consultation focuses on the creation of an Internal Market for venture capital. As announced in the Communication on the Single Market Act, the immediate priority is to enlarge the geographical base in which venture capital funds can raise and invest capital. In light of the circumstances described below, the creation of a single market for venture capital is the immediate priority to be dealt with in this consultation.

In its Communications on the Single Market Act, Small Business Act and the Innovation Union¹³, the Commission committed itself to considering the adoption of new rules, ensuring that by 2012 venture capital funds established in any Member State can operate and invest freely throughout the EU. In addition, Member States were invited to ensure that differences in tax treatment in different Member States will not lead to double taxation, which would hamper cross-border venture capital investments.

The Commission's goal is to achieve a real internal market for venture capital funds in the EU and reduce tax barriers to the greatest extent possible. In this way venture capital funds would benefit from economies of scale and specialised sectoral expertise would emerge. This situation would have a number of positive consequences. Firstly, there would be more and bigger venture capital funds able to provide capital to a greater number of SMEs. Secondly,

¹¹ Expert group report on removing obstacles to cross-border investments by venture capital funds: http://ec.europa.eu/enterprise/newsroom/cf/_getdocument.cfm?doc_id=1094

¹² See the Report of Expert Group on *Removing tax obstacles to cross-border Venture Capital Investments* at http://ec.europa.eu/taxation_customs/resources/documents/taxation/company_tax/initiatives_small_business/venture_capital/tax_obstacles_venture_capital_en.pdf

¹³ http://ec.europa.eu/research/innovation-union/pdf/innovation-union-communication_en.pdf

competition between funds would be promoted. Thirdly, there could be higher portfolio diversification and, in consequence, better returns for investors. Since SMEs would receive more finance, new European rules facilitating the cross border activity of venture capital funds could have a significant positive impact on economic growth, competitiveness and job creation in the EU.

Current legal framework

Managers of venture capital funds are covered by the Directive on Alternative Investment Fund Managers (AIFMD)¹⁴, since venture capital would fall under the generic category of alternative investment. Therefore, managers of venture capital funds with assets under management above EUR 500 million can benefit from the European passport provided by the AIFMD¹⁵. Managers under that threshold do not benefit from the AIFMD passport unless they decide to make use of the *opt-in* procedure envisaged in the AIFMD, in which case they have to comply with the full set of obligations and requirements of the AIFMD.

The objective of the Single Market Act in relation to venture capital and the objectives that inspired the AIFMD are different. Whereas the goal of the Single Market Act is to increase the access of innovative SMEs to venture capital finance, the AIFMD aims at increasing transparency, ensuring the oversight of AIF managers and facilitating the monitoring of systemic risk in the field of the alternative investment funds, in line with the G20 commitments¹⁶. This is the reason why the AIFMD does not always appear to be the ideal instrument for the promotion of the cross-border activity of venture capital in the EU. There are two arguments supporting this approach. First, the majority of the venture capital business in Europe lies below the EUR 500 million threshold of the AIFMD, so in order to benefit from the passport venture capital managers would have to opt-in under the AIFMD regime. Second, since venture capital was not at the focal point of the AIFMD rules, the AIFMD requirements are not tailored for venture capital managers. The AIFMD imposes strict conditions for the authorisation and supervision of AIF managers in order to provide a coherent approach to the related risks and their impact on investors and markets in the EU. However, venture capital funds are not likely to either pose important systemic risk to the financial system or create specific investor protection concerns (insofar they are addressed to professional investors). Therefore, it would seem to be disproportionate to require venture capital managers the compliance with the strict AIFMD requirements in exchange of the passport.

Policy options

There are several options to create an internal market for venture capital in the EU.

First, Member States, on the basis of directly applicable Treaty provisions on the free provision of services and the free movement of capital, could mutually recognise the existing national frameworks on venture capital funds, as suggested in the Expert Group report of

¹⁴ Directive on Alternative Investment Fund managers (pending publication in the Official Journal of the European Union)

¹⁵ In case the managers do not meet the conditions of point (b) in Article 3 (2) of the AIFMD the threshold is EUR 100 million.

¹⁶ See G20's Declaration on Strengthening the Financial System – London, 2 April 2009
http://www.g20.org/Documents/Fin_Deps_Fin_Reg_Annex_020409_-_1615_final.pdf

March 2007¹⁷. The Commission endorsed this proposal in December 2007¹⁸ and invited Member States to take steps towards recognising the registration of venture capital funds that operate in other jurisdictions. This mutual recognition would allow venture capital funds to operate across borders without having to go through separate registration and regulation processes or to invest through complex parallel structures. However, in December 2009 the Commission services noted that so far this process had not yet contributed to a reduction of the fragmentation of venture capital markets.¹⁹

In light of this, two legislative alternatives emerge. The first option would entail re-examining the suitability of the AIFMD in relation to certain venture capital funds. Particular attention would be focused on assessing whether the AIFM framework is always suitable for venture capital activities or whether a special system, tailor-made for the need of venture capital, should be created within the AIFMD framework²⁰. The second option would consist in creating such a tailor-made system as a stand-alone initiative.

This consultation document presents the core elements of a possible European framework approach that would achieve the desired objectives.

Such a framework would not by itself solve the double taxation problems that venture capital funds often face when investing on a cross-border basis. However, a common European understanding of venture capital based on a strict definition might be helpful for those Member States who would be prepared to promote venture capital investments through targeted tax incentives that would be compatible with State Aid rules.

¹⁷ See footnote n. 11

¹⁸ See footnote n. 10

¹⁹ Cross-border venture capital in the European Union. European Commission work on removing obstacles. December 2009 http://ec.europa.eu/enterprise/newsroom/cf/_getdocument.cfm?doc_id=5646

²⁰ This would in particular concern those managers of investment funds, including venture capital funds with assets under management below EUR 500 million (or EUR 100 million under the conditions of Article 3(2)(a) 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?*
- 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?*
- c) *Is a targeted modification of AIFMD rules for venture capital or a stand-alone initiative in this area the more appropriate tool to increase venture capital activities? Please specify.*
- 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?*
- 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?*
- f) *How could a possible passport for venture capital operators facilitate targeted tax incentives in favour of cross-border venture capital investments?*

2. Elements of a European legislative framework for venture capital

A European legislative framework that would foster the cross-border activities of venture capital could consist of the following elements:

- 1) **Voluntary registration with a competent authority.** Any European approach to venture capital funds and their managers should be based on voluntary adherence by the latter. Some Member States already have a legal framework for venture capital funds in place. A European approach would not aim to supersede national venture capital rules. Venture capital funds would remain subject to these national rules. However, the European approach would introduce, in addition to the existing national rules, the opportunity for venture capital managers who choose to broaden their investor base, to benefit from a European 'passport'. In order to become eligible for the European passport and operate in the 26 other Member States, the venture capital manager would, e.g., ask for a specific "European registration" with the competent authority of the Member State where it is established (or, alternatively, with ESMA). This registration would then have to be recognised automatically by the competent authorities of the other Member States. Such a system would, in turn, not require the manager to register in their jurisdiction or perform any other administrative obligations.

It seems appropriate to use an extensive concept of a passport, i.e. not restricted to either the manager or the fund. The proposed approach would make clear that the registration would cover both the manager and all the funds it manages. Therefore, in

principle, there would be no need to apply for a separate registration for the manager and each fund. If the manager sets up a new fund following the registration, it would only have to update the information held by the competent authority. The passport would imply the possibility to offer units or shares of venture capital funds to professional investors throughout the EU, while the fund could invest freely in SMEs situated in different Member States without the need for further registration or authorisation.²¹

In order to become registered, the manager would provide the competent authority with certain basic information: identification, domicile, structure, resources, identity of the persons conducting the business, objectives, investment policy, geographical area of activity and identity of significant shareholders. The funds under management would also be described and the fund rules or instruments of incorporation should be filed with the competent authority.

Box 2

- a) *Do you agree with this approach? If not, what alternative approach would you suggest? Could you then briefly outline the pros and cons of such an alternative?*
- b) *Do you consider such a voluntary regime to have any major cost implications for the key stakeholders? (Investors, competent authorities, venture capital business). Please specify.*
- c) *Based on your experience, could you provide qualitative and/or quantitative assessment of potential cost savings that the European 'Passport' would bring about?*
- d) *What information should the manager provide to the competent authority?*
- e) *What option would you favour: registration with the national authority or with ESMA? Alternatively, ESMA could hold a European register of venture capital managers and funds with the information provided by national authorities. Would you favour this solution?*

- 2) **Simple notification procedure.** Once registered in a Member State, a venture capital manager would be entitled to provide its services, raise, and invest capital on the basis of an EU passport in its home Member State and all 26 other Member States. However, to ensure that the competent authorities are at least informed of the activities of these managers and their funds while on their territory, it seems appropriate to create a system of notification, allowing the competent authorities to coordinate the exchange of basic information among themselves, in particular for statistical purposes. Once the manager is registered, the home competent authority would notify this fact to the authorities of other Member States. A simple notification identifying the manager and the funds would be sufficient. The cooperation between authorities would be of particular relevance when the manager sets up a fund in a jurisdiction other than its home Member State.

²¹ To illustrate the complexity of fund structuring with parallel structures in different jurisdictions, please refer to point 4.1 in the Report of Expert Group on *Removing tax obstacles to cross-border Venture Capital Investments* (reference in footnote 12)

Box 3

- a) *Do you agree with this approach? If not, what alternative approach would you suggest?*
- b) *What should be the content and timeframe of the notification? Should the notification cover both, the places where the manager intends to invest in SMEs and the places where it intends to raise funds?*
- c) *Do you consider such a procedure to have any major cost implications for the key stakeholders? (Investors, competent authorities, venture capital business). Please specify.*

- 3) **Restriction for retail investors.** Since investment in venture capital implies a certain level of risk, it is generally not considered a suitable investment vehicle for retail investors. Therefore venture capital funds covered by the proposed European passport system would only be offered to professional investors as defined by MiFID²². As a consequence, venture capital funds covered that would operate under the proposed passport system would not be obliged to face the traditional disclosure obligations and requirements linked to investor protection which would imply an offer to retail clients (prospectus in accordance with Directive 2003/71/EC²³, Key Investor Information Document, MiFID standards). 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. These investors are expected to closely monitor the activity of the manager of the venture capital fund and the evolution of their investments.

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

²² Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC.

²³ Directive 2003/71/EC on the prospectus to be published when securities are offered to the public or admitted to trading, as amended by the Directive 2010/73/EU of the European Parliament and of the Council of 24 November 2010.

- 4) Reporting obligations.** In order to facilitate their cross-border activities, the proposed European approach should avoid creating unnecessary new burdens for these entities in so far as possible. Therefore, the venture capital managers would only be required to produce an annual report including the annual financial accounts and a report of the activities of the financial year for each fund, and this report would be made available to investors and competent authorities. The financial information would be audited. The proposal would not include any other specific information requirements to investors, since the information for investors will follow industry standards and will be specified in the fund rules or instrument of incorporation of the venture capital fund.

Box 5

- a) *Do you agree with this approach? If not, what alternative approach would you suggest?*
- b) *Do you agree with the need to require an annual report for each fund?*
- c) *Do you agree that the annual report should reflect the annual financial accounts and a report of the activities of the financial year?*
- d) *Do you agree with the obligation to audit the financial information of the annual report?*
- e) *What reporting requirements/obligations exist within the fund structures used in your country for the purpose of venture capital investments? Would you consider that the proposed information requirements would constitute a significant administrative burden? Please specify.*
- f) *Do you think that more information requirements should be imposed on venture capital managers? If so, please specify*

- 5) Operating conditions for venture capital entities.** In accordance with European financial legislation, managers of other types of collective funds, such as UCITS or AIF, are subject to a number of operating conditions to ensure that business is carried out fairly, efficiently, in a safe manner and skilfully. Firstly, managers have to abide by rules of conduct when dealing with their investors. They have to act fairly, with due skill, and in the best interest of the investors. They have to avoid conflicts of interest and must treat their investors fairly, etc. Secondly, they have to meet certain organisational requirements such as the use of adequate and appropriate human and technical resources (administrative and accounting procedures, safeguard arrangements for electronic data processing, internal control mechanisms). Thirdly, the persons who effectively conduct the business should have good reputation and experience. Finally, the significant shareholders should be suitable, as defined in the UCITS²⁴ and AIFM Directives.

²⁴ Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) (recast)

In order to fully exploit the positive impact of the new cross-border rules for venture capital investments, the new framework would aim to minimize the compliance costs relating to requirements on managers' operating conditions. To constitute an appropriate EU level framework for venture capital managers, the new rules would consider an approach lighter than that of the aforementioned EU legislation.

Box 6

- *Do you think there is a need to specify any operating condition for venture capital entities? If yes, what would you consider as sufficient EU level framework for venture capital managers in this area and what level of compliance cost would this entail?*
- *Do you think that it should be specified that venture capital entities should comply with rules of conduct when dealing with their investors? If yes, to what extent?*
- *Do you think that it should be specified that venture capital entities should comply with specific organisational requirements? If yes, to what extent?*
- *Do you think that it should be specified that the persons effectively conducting the business should have good repute and experience? If yes, to what extent?*
- *Do you think that it should be specified that the significant shareholders should be suitable? If yes, to what extent?*

- 6) **Legal form of the venture capital funds.** Venture capital funds would be entitled to adopt any of the legal forms traditionally used in the different Member States. This would not represent a limitation for the recognition of a venture capital fund in a host Member State. In some countries, venture capital funds would be constituted in accordance with contract law (as common funds), trust law (as unit trusts), or statute (as investment companies). In the case of common funds, a management company would be appointed to manage the fund and act on its behalf. Where the legal form of the venture capital entity permits an internal management, the venture capital entity itself could undertake the management, similar to the situation with UCITS or AIFMD.

Box 7

- a) *Do you agree with this approach? If not, what alternative approach would you suggest?*
- b) *Is it convenient to specify in the legislative proposal the legal forms that the venture capital funds might adopt?*
- c) *Is there any other aspect relating to the legal form of the venture capital entities that the proposal should take into account?*

- 7) **Investment focus on SMEs** The European passport would benefit funds that invest or commit to invest the biggest part of their assets in SMEs (or projects of future SMEs: some funds will invest even in the phase prior to the incorporation of a company). The rest of the assets of the fund would exist solely in cash or cash equivalents.

While the focus of the venture capital investment should be SMEs, this requirement would however be interpreted in a flexible way, allowing venture capital funds to include in their portfolio minor stakes in other types of assets, as an exception to the previous principle.

Box 8

- a) *What, if any, investment criteria determine your existing national fund structures used for purposes of venture capital investments?*
- b) *Do you think it is worth specifying any investment rules for venture capital funds? If yes:*
- c) *Do you think there is a need to define a compulsory investment percentage of assets that the venture capital fund should invest in SMEs? If yes, what compulsory investment percentage would you propose and how should it be calculated?*
- d) *Do you agree with the need to envisage a flexible application of the principle described?*

- 8) **Determination of the scope of the activities of venture capital funds.** A key element of a European approach to foster venture capital will be to develop precise and accurate parameters to delineate what a venture capital fund is. It is difficult but essential to get this definition right, since the proposed European passport would be conditioned on the fulfilment of these criteria. Furthermore, possible tax benefits that Member States might design for this type of investment could be linked to the fulfilment of these criteria. The following criteria may be helpful in distinguishing venture capital funds that would fall within the scope of this initiative:

1. **Description of the activity.** Venture capital funds are committed to the long term development and viability of the company they invest in. A venture capital fund is an entity that takes a stake of an SME with a view to remain in the capital for the medium-long term, generally from two to ten years (though they are not forced to remain invested in the capital of the SME in all circumstances). Usually the venture capital manager takes an active involvement in the development, growth and success of the SME, adding value to the invested SME with its guidance and expertise in the form of financial advice, consultancy, marketing strategy, training, etc.

Box 9

- a) How do your national rules capture (if at all) the definition of venture capital funds?
- b) Should the temporary nature of the venture capital investment activity in SMEs constitute a criterion that should be reflected?
- c) Do you think it should be specified any temporal limit (minimum and maximum) to the participation of the venture capital fund in the capital of the SME (i.e., from at least 2 to 10 years)?
- d) Are there any other means of finance that venture capital funds provide to SMEs that should be reflected (e.g. loans)?
- e) 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? Or should the passive investment in an SME also be considered by the proposal as venture capital investment?
- f) What other criteria would you consider appropriate to capture the venture capital activity?

2. **Description of the venture capital investment strategy.** The initiative should cover venture capital *stricto sensu* and not other stages of private equity, since the goal is to promote financing projects of SMEs that are at an early stage of their lives or in an expansion phase. It is at this stage that a clear funding deficit exists in the EU and where all efforts should be concentrated. SMEs are defined in the Commission Recommendation of 6 May 2003, concerning the definition of micro, small and medium-sized enterprises.

In defining the scope of the proposed legal framework for venture capital, it is important to take into account the type of companies that compose the portfolio of venture capital funds. It is therefore envisaged to define a venture capital fund as an entity that invests in SMEs with growth potential that are in the first or very early stages of development or expansion. More precisely, it seems appropriate to concentrate the legislative initiative on venture capital funds that invest in either *seed*, *start up* or *expansion* stages, as defined by the industry practices and the Community Guidelines on State Aid to promote risk

capital investments in SMEs²⁵. In addition, venture capital funds do not normally employ leverage.

- a) *Seed* stage: This is the setup stage. A person presents an idea or product to a venture capital fund and asks for funding. At this stage, the risk of losing the investment is very high, since the investment is very uncertain. In accordance with the State Aid Guidelines and the EVCA glossary, at this stage the financing is provided to research, assess and develop an initial concept before a business has reached the start-up phase.²⁶
- b) *Start up* stage: This is the next stage in financing an idea or new project. The organisation of the new company is being set up and the idea or the product is formed. The venture capital manager monitors the feasibility of the product and the capability of the management-team from the Board of Directors. The risk of the investment is high, but less than in the previous phase, since there is less uncertainty. In accordance with the State Aid Guidelines and the EVCA glossary, at this stage, the funds of the venture capital fund finance companies that are in the process of being set up or may have been in business for a short time, but have not sold their product commercially and are not yet generating a profit. The investment is meant for product development and initial marketing.
- c) *Expansion* stage (also called development capital) is defined by the State Aid Guidelines and the EVCA glossary as financing provided for the growth and expansion of a company, which may or may not break even or trade profitably. Capital may be used to finance increased production capacity, market or product development and or provide additional working capital.

Later stages are generally defined as *replacement capital* and *buyout* stages of investment.

- a) *Replacement capital* is defined by EVCA as the purchase of existing shares in a company from another private equity investment organisation or from another shareholder or shareholders.
- b) A *buyout* is defined by EVCA as a transaction financed by a mixture of debt and equity, in which at least a controlling percentage of a business, a business unit or a company's equity is acquired with the help of a financial investor from the current shareholders through negotiations or a tender offer. A buyout can take several forms²⁷.

²⁵ OJ C 194/02, 18.8.2006

²⁶ The European Venture Capital Association. www.evca.eu

²⁷ In accordance with EVCA glossary, a buyout operation can take the following forms: 1) management buyout (MBO): a buyout in which the target's management team acquires an existing product line or business from the vendor with the support of private equity investors; 2) management buy-in (MBI): a buyout in which external managers take over the company. Financing is provided to enable a manager or group of managers from outside the target company to buy into the company with the support of private equity investors; 3) institutional buyout (IBO): outside financial investors (eg private equity houses) buy the business from the vendor. The existing management may be involved from the start and purchase a small stake. Alternatively, the investor may install its own management); 4) leveraged buyout (LBO): a buyout in which the capital structure of the new company

Box 10

- a) *To what extent does your national regime capture the above definitions of typical venture capital strategies?*
- b) *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? If not, do you believe that SMEs in a restructuring phase should also benefit from venture capital? What other alternative approaches would you suggest?*
- c) *Would you propose other definitions to define the permitted portfolio of venture capital funds?*
- d) *Do you agree that venture capital funds do not/should not use leverage?*

- 3. Definition by exclusion of certain types of investments.** There are some types of investments which per se do not seem to comply/fit into the notion of venture capital helping to develop SMEs. In particular, it does not seem appropriate to allow venture capital funds who wish to benefit from the EU regime to invest in companies that are traded on a secondary market, in financial entities, other funds or financial instruments.

The US Securities and Exchange Commission (SEC) proposed a definition of a venture capital fund on 19 November 2010, in the context of the implementing provisions of Title IV of the Dodd-Frank Wall Street Reform and Consumer Protection Act. The SEC defines a venture capital fund as a fund solely investing in “qualifying portfolio companies”. A “qualifying portfolio company” (SME financed by the fund) should meet the following criteria:

- a) It is not publicly traded (or controlled by a publicly traded company).
- b) It does not borrow or issue debt obligations, directly or indirectly, in connection with the private fund’s investment in the portfolio company.
- c) It does not redeem, exchange or repurchase any securities of the company, or distribute to pre-existing security holders cash or other company assets, directly or indirectly, in connection with the private fund’s investment in such company.
- d) It is not itself a fund.

incorporates a particularly high level of debt, much of which is normally secured against the company’s assets;

5) Buy in-management-buyout (BIMBO): a combination of a management buy-in and a management buyout. In a BIMBO, an entrepreneurial manager or group of external managers financed by venture capitalists buys into a company and teams up with members of the target management team to run it as an independent business.

Box 11

- a) *Do you agree with the list of entities described as not being proper investment targets for venture capital funds?*
- b) *If not, what types of companies would you specify as eligible investment targets?*
- c) *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?*

- 9) **Third country entities.** Non-European venture capital funds could help to boost economic growth and job creation in the EU by providing funding and support to European SMEs. It could therefore be positive for the European economy to provide for an open venture capital market in the proposal.

Box 12

What could be an appropriate regime for third country venture capital funds?

- 10) **Impact on other pieces of EU legislation.** The new legislative framework for venture capital funds may have an impact on other pieces of EU legislation, in particular the AIFMD.

In accordance with the AIFMD, in case a venture capital manager is below the threshold and does not choose to opt-in to the AIFMD, it is in any event required to register and provide information to its competent authority on the investment strategies of the funds it manages and, in order to enable the authority to monitor the systemic risk it may pose, on the instruments in which it trades, its exposures and concentrations.

In order to provide legal certainty, the interaction of the new regime on venture capital with the AIFMD should be clarified. There are two options to do this. The first one is to exempt from the AIFMD only those managers that are below the threshold of the AIFMD. The second option is to exempt from the scope of the AIFMD the managers that fall under the new venture capital regime even if they trespass the thresholds of the AIFMD. In any event, the managers falling within the scope of the new venture capital initiative should exclusively manage venture capital funds investing in SMEs.

Box 13

- a) *Do you agree with this approach?*
- 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?*
- c) *Are there any particular elements from the AIFMD that in your view should also apply to the venture capital managers?*

11) Supervision and sanctions. The new legislative framework for venture capital should aim at imposing very light obligations to venture capital managers. However, competent authorities should have adequate supervisory tools to ensure that the conditions of this new legal framework are respected and the introduction of sanctioning regime may need to be considered.

Box 14

- a) *Do you agree with this approach? If no, what alternative approach would you suggest?*
- b) *What supervisory powers should be granted to the competent authorities for the supervision of venture capital funds and managers?*
- c) *What type of sanctions should be envisaged?*

The Commission services would like to receive feedback from stakeholders on this proposal. Contributions should be sent to the following email address: Markt-g4@ec.europa.eu. The deadline for receiving such contributions is 10 August. In accordance with the better regulation principles, the Commission services will undertake an impact assessment of the proposal taking into account the input received from stakeholders. The Commission intends to put forward a legislative proposal by the end of 2011.