European Venture Capital Funds and European Social Entrepreneurship Funds.

Twin proposals from the European Commission to promote small and social businesses

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Outline.

1) Introduction

2) European Venture Capital Funds
   > Scope
   > Rules
     > Eligible Investors
     > Conduct of business
     > Substance
     > Valuation
     > Disclosure

3) European Social Entrepreneurship Funds
   > Scope
   > Rules
     > Differences with Venture Capital

4) Common Provisions
   > Passporting
   > Differences between the texts
   > Implementation and Review
   > Integration in AIFMD framework
   > New Brands?
   > What’s next?
1) Introduction.
Origins.

> 98% of the managers of Venture Capital funds excluded by the AIFMD threshold (EUR 500 million or 100 million)

→ VC managers excluded from the positive effects of passporting

> Social businesses = emerging but booming sector in the EU
> Sector could rapidly grow to become a market exceeding EUR 100 million (J.P Morgan study)

→ Ensure stable and appropriate regulation to accompany this growth

> Enhanced European VC and Social business markets are objectives of global Europe 2020 Strategy
> European Council of February 2011 called for removal of remaining regulatory obstacles to cross-border Venture Capital and Social Business Investment.

> Commitment of the Single Market Act (SMA)
Review of the Venture Capital in EU.

“Compared with competing global centres of high-tech and innovation, most notably the United States, the European venture capital industry is fragmented and dispersed”

Amounts invested in EU during the period 2003-2010 (in billion €)

- Venture Capital: €373 billion
- Rest of Private Equity: €64 billion

Percentage of financing of SMEs coming from venture capital specialists:
- In the US: 14%
- In the EU: 2%

Share of Venture Capital investment as a financing tool (in % of GDP):
- In the US: 0.14%
- In the EU: 0.03%

Amount channelled by USA into VC Funds from 2003 to 2010: €131 billion
Amount channelled by EU into VC Funds from 2003 to 2010: €28 billion
2) European Venture Capital Funds.
Scope.
The regulation applies to managers that are managing:

- Collective investment undertakings that are not UCITS
- Qualifying as **Venture Capital Funds** (as defined in the regulation and explained hereafter)
- Whose assets under management in total does not exceed a threshold of EUR 500 million

The assets of other types of funds (that are not VC Funds) managed by the same manager will not be taken into account

→ Possibility for an accumulation of passports (VC+AIFM)
Qualifying Venture Capital Fund.

> a qualifying venture capital fund shall be a fund that dedicates

> at least 70 percent of its aggregate capital contributions and uncalled committed capital to investments

> in small and medium sizes enterprises (SMEs) that issue equity or quasi equity instruments, and

> that are made directly to the venture capital investor ("investment targets"), not excluding the use of intermediary Soparfi structures.
Portfolio Composition.

> At least 70% of aggregate investment = qualifying investment
> Other 30% (max) = any other use

> Cash and Cash equivalent are not taken into account in the calculation.
> The regulation prohibits, for the VC fund managers, the use of any method that would increase the exposure of the fund whether through:
  > Borrowing of cash or securities
  > Engagement into derivatives positions
  > Any other mean
> Exception: short-term (<120 calendar days) non-renewable borrowing to provide liquidity to cover the gap between call and reception of commitments.
Qualifying investment.

Equity or Quasi-Equity instruments that are:

> issued by a qualifying portfolio undertaking and acquired directly by the qualifying venture capital fund from the qualifying portfolio undertaking, or

> issued by a qualifying portfolio undertaking in exchange for an equity security issued by the qualifying portfolio undertaking, or

> 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;
Qualifying Portfolio Undertaking.

> Not listed on a Regulated Market as defined by MiFID (Directive 2004/39/EC Article 4(1) point (14))
> Employs < 250 persons
> Either
  > Annual turnover < EUR 50 million
  > Annual balance sheet < 43 million
> Not a collective investment undertaking itself

> Does not concern the other types of venues as defined by MiFID or to be defined by MiFID II (MTF, OTF, SI)
> The definition of a Qualifying Portfolio Undertaking is aligned with AIFMD definition of SMEs
Schema of the scope construction.

Manager

Collective investment undertaking ≠ UCITS + Qualifying as Venture Capital Funds + Under threshold of EUR 500 million

70% = Qualifying investments

Equity or quasi-equity + Issued by a Qualifying Portfolio Undertaking + Acquired directly or through an exchange of equity instrument

Not listed on a Regulated Market + Employs < 250 persons + Annual Turnover < EUR 50 million

Or
Balance Sheet Total < EUR 43 million
Rules.
Eligible Investors.

> Exclusively professional (as defined by MiFID)
> Exception:
  > Minimum EUR 100,000 invested
  > Statement in writing of awareness to the investment realised
  > Knowledge assessment made by the manager
  > Suitability evaluation made by the manager
  > The Manager has to confirm in writing that the preceding two conditions are respected
**Conduct of business.**

Obligation towards good conduct of business are imposed to the VC managers:

> act with due skill, care and diligence in conducting their activities
> appropriate policies and procedures for preventing malpractices
> promote the best interest of the qualifying venture capital funds / the investors and the integrity of the market
> high level of diligence in the selection and ongoing monitoring of investments
> adequate knowledge and understanding of investments that are made

The manager shall also identify, avoid and, when necessary, disclose the conflict of interests arising:

> Effective organisational and administrative arrangements must be put in place to monitor potential conflicts and take reasonable actions.
> ESMA shall provide for the types of conflict concerned + steps managers are expected to take

These obligations are in line with AIFMD (and MiFID accordingly) but less detailed and burdening.
The regulation imposes a few obligations towards substance:

> Sufficient own funds

> Appropriate human and technical resources

These requirements are less extensive than those imposed to AIFM subject to AIFMD.

There is no precision on what is considered to be « appropriate ». Besides, the proposal does not call for a precision in this area through delegated act.
Valuation.

The valuation shall be made according to the rules stated in the statutory documents.

Once again, the requirements are lightened compared to AIFMD.
Disclosure.

In line with AIFMD there are several types of disclosure:

1. Annual Reports to the competent authority:
   - Composition of the portfolio of the qualifying venture capital fund
   - Activities of the past years
   - Audited financial accounts
   - Produced in accordance with existing reporting standards

2. To a potential investor, prior to an investment in a fund:
   - Identity of VC managers and service providers
   - Investment strategies and objectives (types of undertakings invested in, techniques used, investment restrictions, ...)
   - Risk profile
   - Pricing methodologies (incl. NAV calculation method)
   - Managers’ remuneration determination
   - Fees, charges and expenses
   - Historical performance (when available)
   - Procedure for changing investment policy/strategy

Logically, no disclosure regarding investment in SMEs (like in AIFMD) since it is the whole point of the regulation

Lighter annual reports and ex-ante disclosure compared to AIFMD
3) European Social Entrepreneurship Funds.
General definition of the scope.

The regulation applies to Managers that are managing:

> Collective investment undertakings that are not UCITS
> Qualifying as *European Social Entrepreneurship Funds (EuSEF)* (as defined in the regulation and explained hereafter)
> Whose assets under management in total does not exceed a threshold of EUR 500 million

The assets of other types of funds (that are not EuSEF) managed by the same manager will not be taken into account

→ Possibility for a accumulation of passport (EuSEF+AIFM)
Qualifying European Social Entrepreneurship Fund.

> a qualifying venture capital fund shall be a fund that dedicates
> at least 70 percent of its aggregate capital contributions and
uncalled committed capital to investments that are qualifying portfolio undertakings.
Portfolio Composition.

> At least 70% of aggregate investment = qualifying investment
> Other 30% (max) = any other use

> Cash and Cash equivalent are not taken into account in the calculation
> The regulation prohibits, for the EuSEF fund managers the use of any method that would increase the exposure of the fund whether through:
    > Borrowing of cash or securities
    > Engagement into derivatives positions
    > Any other mean
> Exception: short-term (<120 calendar days) non-renewable borrowing to provide liquidity to cover the gap between call and reception of commitments

> The regulation prohibits also the issuance of debt obligations and the provision of guarantees by the fund.
Qualifying Investment can be determined as any of the following instruments:

1. an equity instrument that is:
   - issued by a qualifying portfolio undertaking and acquired directly by the EuSEF from the qualifying portfolio undertaking or
   - issued by a qualifying portfolio undertaking in exchange for an equity security issued by the qualifying portfolio undertaking or
   - issued by an undertaking of which the qualifying portfolio undertaking is a majority-owned subsidiary and which is acquired by the EuSEF in exchange for an equity instrument issued by the qualifying portfolio undertaking;

2. securitised and un-securitised debt instruments, issued by a qualifying portfolio undertaking;

3. units or shares of one or several other EuSEFs;

4. medium to long term loans granted to qualifying portfolio undertakings by the EuSEF;

5. any other type of participation in a qualifying portfolio undertaking.
Qualifying Portfolio Undertaking.

- Not listed on a Regulated Market as defined by MiFID (Directive 2004/39/EC Article 4(1) point (14))
- Employs < 250 persons
- Either
  - Annual turnover < EUR 50 million
  - Annual balance sheet < 43 million
- Is not a collective investment undertaking itself

- Has the achievement of measurable positive social impact as primary objective
- Uses profits to achieve this primary objective
- Is managed in an accountable and transparent way

→ Does not concern the other types of venues as defined by MiFID or to be defined by MiFID II (MTF, OTF, SI)
→ The definition of a Qualifying Portfolio Undertaking is aligned with AIFMD definition of SMEs
Schema of the scope construction.

Manager

Collective investment undertaking ≠ UCITS + Portfolios of EuSEFs + Under threshold of EUR 500 million

70% = Qualifying investments

Equity or quasi-equity (acquired directly or similar) of + Securitised/unsecuritised debt instrument issued by Qualifying Portfolio Undertaking

Units/share of one or several other EuSEFs + Any other participation in

Employ < 250 persons + Medium-LT loans granted

Not listed on a Regulated Market + Measureable, positive impacts as primary objective

Annual Turnover < EUR 50 million + Profits used to achieve this objective

Balance Sheet Total < EUR 43 million + Managed in an accountable and transparent way
Rules (differences with European Venture Capital Funds).
Disclosure.

The sole difference in the rules governing the management of these two types of funds concerns the disclosure.

The Manager of a EuSEF has to disclose to the investor, prior to any investment, along with the other information already mentioned, information about the support activities the EuSEF manager is providing to facilitate the development, growth, or on-going operation of the qualifying portfolio undertakings.

Integration of the social impact in the ex-ante disclosure requirements → important variable for the investors’ choice.
4) Common Provisions
Passporting.

EuSEF Managers and European Venture Capital Funds Managers will benefit from two separate independant passports.

In order to use it they shall follow the following procedure:

> Registration process to the home Member State authority
  > Identity of the managers
  > Identity of the funds
  > Information on the arrangements put in place to satisfy the various requirements stated by the regulation
  > A list of Member States where the manager intends to market each qualifying venture capital fund.

→ The registration shall be valid for the entire territory of the Union, i.e. the manager can market its funds immediately after having been registered in one country.

> Immediately after the registration process, the home Member State authority must notify to each of the targeted host Member State the registration of the managers

> No further requirements shall be imposed to managers

→ Similar registration process as for AIFMD marketing Passport, but major difference: no need to wait for the confirmation of home Member State (which transmit notification) → immediate start.
Differences between the two texts.

The two proposals are highly similar. Although several differences can be noted:

> **Qualifying investment:**

  > EuSEF have larger investment possibilities that integrate debt instruments, units or shares of other EuSEFs medium to long term loans granted to qualifying portfolio undertakings by the EuSEF, and any other type of participation in a qualifying portfolio undertaking

> **Qualifying portfolio company:**

  > EuSEF regulation integrate an additional criteria: the social impact of the undertaking

> **Disclosure:**

  > Ex-ante disclosure to potential investors in EuSEF must include information about the social utility of the fund (through its support services to the undertakings)
Application and Review.

> Both regulations are programmed be applicable as from 22 July 2013
  > It is the same date as for AIFMD
  > The regulations are part of the AIFMD larger framework

> A review is programmed by the regulations themselves, after 4 years. It should assess for:
  > Utility
  > Adequacy of the EUR 500 million threshold
Integration in AIFMD.

- The two regulations complete the AIFMD.
- They avoid an ostracism of the « non-passported funds » thanks to the introduction of two dedicated passports.
- The three passports shall not be mutually exclusive and a same manager could be able to benefit from the three, and even four (UCITS marketing, AIFMD marketing, Venture Capital, EuSFE).
New Brands?

One of the aim of the Commission, according to the formulation it used, is to install new brands beside AIFM and, to a larger extent, UCITS

> Both regulation use a specific reference to two new denominations to be used for these types of funds:

> “European venture Capital fund”

> “European Social Entrepreneurship Fund”

> These references are the proof of a will to integrate a marketing effort in the implementation of these new practical schemes
What’s next?

The two texts are programmed to apply from July 2013 on, along with the AIFMD.

> The proposals now pass to the European Parliament and the Council (Member States) for negotiation and adoption under the co-decision procedure.
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Any questions?

Please, feel free to contact us.