DechertOnPoint

October 2011 / Issue 15

A legal update from Dechert's Financial Services Group

A New Regime for Venture Capital

There has, for a number of years, been a feeling within the European venture capital community that the regulatory environment within the European Union ("EU") is not optimally configured to foster specialised equity investment focused on innovative start-up companies. This dissatisfaction has manifested itself across a plethora of industry and governmental papers and consultations, the most significant recent example being the European Venture Capital Association's ("EVCA") White Paper of March 2010. One of the White Paper's principal propositions was that the industry's failure to develop as hoped is closely linked to the fragmentation of the regulatory operating environment across the 27 member states of the EU.

The European Commission's (the Commission) response to the clamour for reform came on 15 June 2011, when it published a consultation document entitled **A New Regime for European Venture Capital** ("the Paper"). In this *DechertOnPoint* article we explore the centrepiece policy option, set out in the Paper, which is mutual recognition and passporting of venture capital funds throughout the EU.

Background

That all is not well within the European venture capital industry can be seen by comparative analysis of the top-line figures. Prior to the financial crisis of 2008, European venture capital investment across the EU amounted to around €6-7 billion annually. Figures for 2009 and 2010 suggest that that figure has fallen to around €3-4 billion for those years, which means that, according to Ernst & Young, European investment for those years amounted to just 21 per cent of the sums invested in the United States during the same period, despite the respective potential markets being of a similar size. The Paper goes on to agree with the EVCA that the state of affairs is principally down to a fragmentation of the single market in respect of venture capital investment.

It might also be said that venture capital is, in regulatory terms, a victim of its own benign impact on the sorts of issues that tend to attract political attention. Venture capital tends to be seen as the acceptable, nurturing face of the investment industry, rather than the "Barbarians at the Gate" image ascribed (unfairly) by politicians and the media to the wider private equity sector. Thus, venture capital was not perhaps at the forefront of the minds of European policymakers when they were framing the EU's new framework for the regulation of investment techniques including venture capital, the Alternative Investment Fund Management Directive ("the AIFMD") in 2009 and 2010.

Whilst the AIFMD does impose significant new obligations on managers of alternative investment funds (into which generic category venture capital fund managers fall for the purposes of the AIFMD regime), it must also be conceded that the possibility for passporting around the EU for fund managers with assets under management of at least €500 million (or who opt-in to the AIFMD regime) is a step

forward in terms of promoting a single market for this type of investment across the EU. However:

- most European venture capital fund managers will fall below the €500 million assets under management threshold; and
- are likely to be deterred from opting-in to the AIFMD regime on the grounds that the AIFMD is principally designed to minimise systemic risks from hedge funds and large private equity operators, and is therefore disproportionate in terms of regulatory burden when applied to smaller venture capital fund managers.

The European Commission endorsed mutual recognition of existing national frameworks on venture capital as long ago as December 2007, and the topic has been referred to regularly as part of the increased focus on ensuring the proper operation of the single market over the past few years. However, no meaningful steps have been taken since 2007 and the advent of the financial crisis, either at the EU or national level and the implementation of the AIFMD changes the landscape still further. The Paper identifies two principal legislative options:

- creation of a tailor-made "sub-regime" within the AIFMD for venture capital; or
- creation of a stand-alone regime separately from the AIFMD.

The Paper does not express a preference as between these two options (and the final position may very well end up being a function of the ultimate success or failure of the AIFMD itself), but it does emphasise the importance of ensuring that the interplay of AIFMD with the new regime is clear. The Paper suggests that this might be achieved either by:

- exempting venture capital fund managers falling under the €500m assets under management threshold from the AIFMD; or
- exempting all venture capital managers from the AIFMD regime.

Clearly, there is a risk that the first option results in double regulation of venture capital fund managers, although one might take the view that venture capital fund managers with more than €500m of assets under management might be capable of posing the sort of systemic threat which the AIFMD regime is intended to guard against.

What Constitutes "Venture Capital"?

Clearly any pan-European regime relating to venture capital funds will need to be clear on what constitutes a "venture capital investment". Qualification for passporting rights under the proposed regime will be dependent on the activities of the fund in question falling within this definition. A common definition will also make it easier for any jurisdiction looking to confer tax relief or other benefits on this type of investment to target the community more precisely. The Paper posits three main distinguishing factors:

- Venture capital funds are committed to the long-term development and viability of the investment, generally with an investment horizon of two to 10 years (although this would appear to overlap with the standard "private equity" model of three to five year investments), and usually taking an active role in day-to-day management, seeking to add value via the provision of guidance and expertise.
- Venture capital funds invest in small-to-medium enterprises ("SMEs") with growth potential that are in the first or very early stages of development. The Paper proposes that this criterion be tied to the following definitions to be found within the *Community Guidance on State Aid*:
    - the "seed stage", meaning capital invested to research, assess and develop an initial concept;
    - the "start-up stage", meaning capital invested in the process of set-up or in the very early stages of operation, but which have not sold the proposed product and are not yet generating a profit, with the invested capital being used primarily for product development and marketing; and
    - the "expansion stage", meaning capital invested in growing and expanding an investment, which may or may not break even or trade profitably, the invested capital principally contributing to increasing production capacity, marketing or product development, or to provide additional or working capital.

  Only funds which can show that their investments fall only within one or more of these categories will be eligible.
- The exclusion of certain types of investments that are *prima facie* incompatible with the venture capital concept. The Paper makes reference to the SEC's proposed definition of a venture capital investment (published in

relation to the implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act), which suggest that venture capital investments should:

- not be publicly traded, or controlled by a publicly traded company;
- not involve borrowing or issuing of debt obligations by the investee company, directly or indirectly, in connection with the investment by the venture capital fund—in other words, venture capital investments should be pure equity investments;
- not involve the redemption, exchange or repurchase of any securities of the investee company, or distribute to pre-existing security holders cash or other assets, directly or indirectly; and
- not itself be a fund.

Existing venture capital managers will therefore need to consider whether the investment guidelines and policies that apply to their funds converge sufficiently with the definition upon which the Commission ultimately decides.

Registration and Passporting

Under the proposals set out in the Paper, venture capital fund managers would apply to their national regulator (or, alternatively, to the European Securities and Markets Association ("ESMA")) for a pan-EU passport, which would cover both the manager and all of the funds which it manages (in contrast to the AIFMD passport which covers only the fund itself), and which would enable the manager to market those funds to professional investors throughout the EU. The funds themselves will be able to invest in appropriate investment opportunities throughout the EU without the need for registration in the jurisdiction where the investment opportunity is situated. The Paper proposes that managers seeking registration provide essentially the raft of information with which those who have sought Part IV authorisation under the Financial Services and Markets Act 2000 will be familiar. It is unclear whether existing fund managers would need to provide any further information on either themselves or their funds for the purposes of initial registration.

It is further proposed that, on registration, the regulatory authority granting registration would send a simple notification of the fact to all 26 other EU national regulators. The Paper leaves up for discussion whether there should be an interval between notification being received and the passport becoming active, and whether or not the notification should cover both the jurisdictions in which the manager intends to invest and those in which it wishes to fundraise.

Selling Restrictions

The Paper proposes that, on the basis that venture capital investments carry a certain level of risk, such investments, where offered under a passport, only be available to professional investors (as that term is defined in the Market in Financial Instruments Directive ("MiFID"). This would necessarily exempt passporting managers from the paraphernalia of retail offerings, for example the new Key Investor Information Document and certain of the MiFID conduct rules. The Paper asks for views as to whether there should be any circumstances in which retail investors should have access to passported venture capital funds, other than, presumably, by opting-up to the professional client level, although given the risks to inherent in venture capital investments, a blanket restriction would appear the most likely ultimate path.

Reporting Obligations

The Paper notes that it would be undesirable to burden managers with unnecessary further reporting requirements. It proposes that each fund be required to produce an audited annual report, to be made available to investors and the relevant authorities, as well as providing any other information required under "industry standards" or "in the fund rules or instrument of incorporation". The Paper does not provide further elucidation as to how this may apply to the many fund entities that are incorporated or established in jurisdictions that do not require audited annual statements for those entities as a statutory matter, and for whom the production of such statements may prove a significant additional administrative burden; for example, funds constituted via UK limited partnerships.

Legal Structure

The Paper proposes that venture capital funds would be able to constitute themselves in accordance with "any of the legal forms traditionally used in the Member States". Forms constituted under the law of trusts (unit trusts), contract law (common funds) and statute (investment

companies) are specifically referenced in the Paper. It is unclear to what degree those structures that are based offshore will need to demonstrate that they are analogous to forms "traditionally used in a Member State".

Asset Allocation

In order to be included in the regime set out in the Paper, a fund will need to commit to invest the lion's share of its assets available for investment in SMEs, or the future projects of SMEs. Uninvested assets would be required to be invested in cash or cash equivalents, although the Paper does state that there may be scope for funds to allocate "minor stakes" to other asset classes. No further clarity is given as to what might constitute a "minor stake" or which other asset classes might be acceptable.

Third-Country Entities

It will have been noted that the Paper is sparse on the subject of how the proposed regime might read across to fund managers and fund entities which are not incorporated or established in one of the Member States of the EU, particularly as regards structuring and ongoing reporting requirements. The Paper does, however, note that open access to the EU market for non-European funds could help to boost the overall environment for European SMEs, and that the regime will therefore need to accommodate such funds. This provides perhaps some comfort that in implementing the proposed regime, the Commission will seek to avoid disadvantaging non-EU market participants (often to the detriment of the EU market) in the same way as recent initiatives such as the Reinsurance Directive and, it might be argued, the AIFMD itself.

Sanctions and Enforcement

The quid pro quo for a more open and accessible cross-border venture capital market is, perhaps inevitably, an accompanying sanctions and enforcement regime. The Paper, however, suggests that this should "aim at imposing very light obligations". The Paper again does not specify exactly what it has in mind here, but one would presume that the regime will be more "light touch" that that set out more generally in the AIFMD.

Timeline

Clearly, the regime set out in the Paper will require a great deal of legislative fleshing-out. Following the closure of wider consultation on the Paper in August, the Commission intends to bring forward legislative proposals by the end of 2011. Venture capital fund managers will, as set out above, be eager to see how the Commission addresses:

- the definition of "venture capital", and consequently the scope of the activities which will fall within the new regime, which may require adjustments to investment guidelines and policies;
- how the new regime will deal with novel (and especially non-EU established) fund structures;
- the weight of any new ongoing reporting obligations, and how they will affect non-EU established fund structures; and
- the scope of any new sanctions regime.

If the Commission is able to get the legislative proposals right, and take the industry with it, it may at last be able to lay to rest the contention that the EU does not provide a fertile ground for venture capital.

A copy of the Paper may be found at: http://ec.europa.eu/internal_market/consultations/docs/2011/venture_capital/consultation_paper_en.pdf.

■ ■ ■

This update was written by Martin Day (+44 20 7184 7564; martin.day@dechert.com).

Dechert LLP

Practice group contacts

For more information, please contact the author, one of the attorneys listed, or any Dechert attorney with whom you regularly work. Visit us at www.dechert.com/financial_services and www.dechert.com/corporate.

If you would like to receive any of our other *DechertOnPoints*, please click here.

Jonathan Angell
London
+44 20 7184 7586
jonathan.angell@dechert.com

Peter D. Astleford
London
+44 20 7184 7860
peter.astleford@dechert.com

Gus Black
London
+44 20 7184 7380
gus.black@dechert.com

Martin Day
London
+44 20 7184 7565
martin.day@dechert.com

Peter Draper
London
+44 20 7184 7614
peter.draper@dechert.com

Olivier Dumas
Paris
+33 1 57 57 80 09
olivier.dumas@dechert.com

Sean Geraghty
London
+44 20 7184 7540
sean.geraghty@dechert.com

Angelo Lercara
Munich
+49 89 21 21 63 22
angelo.lercara@dechert.com

Angelyn Lim
Hong Kong
+852 3518 4718
angelyn.lim@dechert.com

Stuart Martin
London
+44 20 7184 7542
stuart.martin@dechert.com

Michelle Moran
Dublin
+353 1 436 8511
michelle.moran@dechert.com

Antonios Nezeritis
Luxembourg
+352 45 62 62 27
antonios.nezeritis@dechert.com

Declan O'Sullivan
Dublin
+353 1 436 8510
declan.osullivan@dechert.com

Achim Pütz
Munich
+49 89 21 21 63 34
achim.puetz@dechert.com

Marc Seimetz
Luxembourg
+352 45 62 62 23
marc.seimetz@dechert.com

Hans Stamm
Munich
+49 89 21 21 63 42
hans.stamm@dechert.com

Mark Stapleton
London
+44 20 7184 7591
mark.stapleton@dechert.com

Dechert
LLP

www.dechert.com

Dechert internationally is a combination of limited liability partnerships and other entities registered in different jurisdictions. Dechert has more than 800 qualified lawyers and 700 staff members in its offices in Belgium, China, France, Germany, Hong Kong, Ireland, Luxembourg, Russia, the UK, and the US.

Dechert LLP is a limited liability partnership registered in England & Wales (Registered No. OC306029) and is regulated by the Solicitors Regulation Authority. The registered address is 160 Queen Victoria Street, London EC4V 4QQ, UK.

A list of names of the members of Dechert LLP (who are referred to as "partners") is available for inspection at the above address. The partners are solicitors or registered foreign lawyers. The use of the term "partners" should not be construed as indicating that the members of Dechert LLP are carrying on business in partnership for the purpose of the Partnership Act 1890.

Dechert (Paris) LLP is a limited liability partnership registered in England and Wales (Registered No. OC332363), governed by the Solicitors Regulation Authority, and registered with the French Bar pursuant to Directive 98/5/CE. A list of the names of the members of Dechert (Paris) LLP (who are solicitors or registered foreign lawyers) is available for inspection at our Paris office at 32 rue de Monceau, 75008 Paris, France, and at our registered office at 160 Queen Victoria Street, London, EC4V 4QQ, UK.

Dechert in Hong Kong is a Hong Kong partnership regulated by the Law Society of Hong Kong.

This document is a basic summary of legal issues. It should not be relied upon as an authoritative statement of the law. You should obtain detailed legal advice before taking action. This publication, provided by Dechert LLP as a general informational service, may be considered attorney advertising in some jurisdictions. Prior results do not guarantee a similar outcome.

Dechert in Ireland is an Irish partnership regulated by the Law Society of Ireland.

© 2011 Dechert LLP. Reproduction of items from this document is permitted provided you clearly acknowledge Dechert LLP as the source.

EUROPE Brussels • Dublin • London • Luxembourg • Moscow • Munich • Paris • **U.S.** Austin Boston • Charlotte • Hartford • Los Angeles • New York • Orange County • Philadelphia Princeton • San Francisco • Silicon Valley • Washington, D.C • **ASIA** Beijing • Hong Kong