The Future Regulation of Venture Capital in the EU

Introduction

The Irish Venture Capital Association (IVCA) is the representative organisation for all venture capital firms in Ireland.

Venture capital is the provision of capital for growth and expansion to companies with underdeveloped or developing products and revenues at an early stage of their corporate life cycle. Typically, investee companies are innovative, unquoted, small to medium sized enterprises. A more detailed description of the venture capital industry and the structuring of venture capital products is set out in Appendix I.

The venture capital industry recognises the need for appropriate and proportionate regulation in which the public can have confidence. The objective of the Alternative Investment Fund Managers Directive ("AIFMD") is to limit and control the potential systemic risk posed by certain types of fund management activities. This systemic risk mainly arises from activities that involve leverage. **Venture capital does not pose any systemic risk.** Venture capital funds are precluded by contract with their investors from taking on debt and usually invest equity into companies that are unable to access credit markets. **Leverage is not an issue.** Irish venture capital funds are structured, in the main, as limited partnerships under the Limited Partnerships Act 1907. The partners (investors) are long-term (10 year capital commitments) professional investors i.e. pension funds, insurance companies, family trusts, banks and endowment funds. Venture capital funds do not market to the retail sector.

Current Regulation of the Venture Capital Industry in Ireland

In 1993, the Investment Services Directive ("ISD") introduced the authorisation and ongoing regulation requirements for persons providing "investment services" in respect of "investment instruments" to third parties on a professional basis. Article 2.2(h) of the ISD provided an exemption for "collective investment undertakings whether co-ordinated at community level or not and the depositaries and managers of such undertakings". This exemption was transposed into Irish domestic law in Clause 2.6(f) of the Intermediaries Act 1995 (as amended) as follows:

> "Collective investment undertakings and the depositaries and managers of such undertakings in so far as the activities of the collective investment undertakings or the depositaries or the managers are subject to regulation by the Bank."

Thus, the exemption in Ireland was restricted to collective investment undertakings and the depositaries (i.e. custodians) and managers of collective investment undertakings regulated by the Central Bank of Ireland (the "Central Bank").

The exception, as transposed under Irish law, under Regulation 5.1(p) of the MiFID Regulations (the principal Irish legislation which transposed ISD's successor, MiFID, into Irish law) is reflected as:

> "collective investment undertakings and pension funds whether co-ordinated at community level or not and the depositaries and managers of the collective investment undertakings".

The situation in Ireland is that depending on the structuring of the particular venture capital fund, some IVCA members which provide only fund management services to venture capital funds have been required by the Central Bank to be authorised under the ISD (and, post-November 2007, under the MiFID Regulations).

The provisions of MiFID are inappropriate for venture capital managers and are causing an excessively onerous, competitive and administrative burden on our members. No other country in Europe regulates venture capital activities under MiFID. Set out in Appendix II is a summary of venture capital regulation across the most important venture capital European jurisdictions.

In an international context, in the US the SEC, in co-operation with the NVCA (National Venture Capital Association), has excluded venture capital from its proposed new additional regulatory process.

Impact of AIFMD and of Regulation on European Venture Capital Funds (EVCFR) on the Venture Capital Industry

AIFMD applies to all EU based managers of alternative investment funds ("AIFs"), i.e. collective investment undertakings (excluding UCITS) which raise capital from a number of investors with a view to investing it in accordance with a defined investment policy for the benefit of investors. AIFs may be open or closed-ended and whether constituted under contract law, trust law, statute or any other legal form. Thus it appears that limited partnerships would fall within the definition of AIFs.

An AIFM that manages an AIF, whose assets under management do not exceed the thresholds set out below, is exempt from the requirement to seek authorisation and is exempt from many of the provisions of AIFMD:

- AIFs with assets under management, including those acquired through the use of leverage, of less than €100m;

- AIFs with assets under management of less than €500m, provided that the AIFs are unleveraged and are subject to redemption lock up periods of at least 5 years from the date of initial investment in each AIF.

AIFMs choosing to avail of the exemption are required under Article 3 to comply with certain minimum registration and reporting requirements such as registration with the relevant state competent authority, notification of the investment strategies employed, periodic updates with regard to main instruments and notification of any breaches of the de minimis thresholds. Such AIFMs will not be able to avail of the passporting provisions of AIFMD.

In recognition of the fact that many venture capital fund managers would fall within the de minimis thresholds and the importance of the venture capital industry within Europe[1], the European Commission, in December 2011, issued a proposal to create a voluntary European Regulation on European Venture Capital Funds ("EVCFR"). The manager of a EVCF must be a legal person whose regular business is managing at least a qualifying European fund, established in the EU and subject to registration under AIFMD. Managers registered under the EVCF Regulations will have passporting rights to raise capital throughout Europe into qualifying funds. EVCFs may not use leverage and may only be marketed to professional type investors. All EVCFs must abide by uniform rules and quality standards (including disclosure standards to investors and operation requirements). It is anticipated that, although voluntary, regulation under the proposed EVCF Regulation will become standard throughout the venture capital industry, both in Ireland and throughout Europe. The intention is for the EVCF Regulation and AIFMD to be implemented at the same time.

As we understand it, venture capital fund managers currently authorised under the MiFID Regulations will, post implementation of AIFMD, no longer fall to be authorised under MiFID as they will come within the ambit of AIFMD (in any event, it is argued that they should not be subject to regulation under MiFID Regulations in the first place because of the exemption set out under Regulation 5.1(p) of the MiFID Regulations).

IVCA seeks clarity that the above reflects the approach to be adopted by the Central Bank in relation to venture capital funds currently authorised under MiFID.

[1] Europe's 23 million small and medium sized enterprises ("SMEs") provided 80% of all new jobs in Europe in the past 5 years and contribute significantly to European growth. (Source: European Commission).

It is also noted that as regards CP 60, Chapter 4 of the AIF Handbook sets out conditions which the Central Bank imposes on AIF management companies which do not require authorisation or are not authorised under the proposed AIFMD Regulations. It would appear that these requirements will only apply to non-UCITS funds currently authorised by the Central Bank (and perhaps also exempt unit trusts which the Central Bank is also contemplating bringing within its regulatory ambit) and again, we would seek clarification on this point.

Irish Venture Capital Association

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Appendix I

Venture Capital

Definition

Venture Capital refers to the provision of capital for growth and expansion to companies with underdeveloped or developing products and revenues at an early stage of their corporate life cycle. Typically, investee companies are innovative unquoted, small to medium sized enterprises.

As an asset class, Venture Capital is technically a subset of Private Equity. However the term Private Equity also includes Buyouts and investments into distressed debt and turnaround situations. Buyouts refer to the investment, through the use of leverage, in mature cash generative companies with established business models, to finance expansion, consolidation, turnaround and disposal. This activity can be initiated with a publicly quoted company being taken private. Buyouts generate relatively high returns by gearing up returns on equity through the use of leverage (debt).

Venture Capital differentiates itself in that the Fund is precluded by contract with its investors from taking on debt and usually invests equity funds into companies that are unable to access credit markets. Leverage is not an issue. Venture capital does not pose any systemic risk. Hence Venture Capital generates relatively high returns by accessing the superior growth rates of smaller, unquoted, immature, developing companies.

A **Venture Capitalist** is a person or investment firm that makes venture investments. Venture capital firms typically comprise small teams (in Ireland 4-6 members) with technology backgrounds (scientists, researchers) or those with business training or deep industry experience. A core skill is the ability to identify novel technologies that have the potential to generate high commercial returns at an early stage. By definition they also take a role in managing entrepreneurial companies at an early stage, thus adding skills as well as capital, thereby further differentiating venture capital from buy-out private equity activity where the investment is into companies that have proven revenues.

In essence venture capitalists:

- invest in ground breaking innovation, fostering the commercialisation of ideas into new products and processes while always seeking the disruptive technology;

- build fast growing businesses, only financing a sliver of the most promising start-ups that could have a multiplier effect on wealth creation and on higher living standards.

Structure

In exchange for the high risk that venture capitalists assume by investing in smaller and less mature companies, they usually get significant control over company decisions, in addition to a significant portion of the company's ownership (and consequently value). Inherent in realizing abnormally high rates of return is the risk of losing all of one's investment in a given startup company. As a consequence, most venture capital investments are done in a pooled format i.e. a **Venture Capital Fund** that is usually structured as a **Limited Partnership (LP) (in Ireland under the Limited Partnerships Act 1907)**, where several investors, in order to spread their risk, combine their investments into one large fund that invests in many different startup companies. In Ireland the average number of LPs in each fund is 15-20 partners.

Among the terms set out in the LP Agreement are the following:

- term of the partnership - typically 10 years;

- management fees - an annual payment made by the investors to the fund's manager;

- carried interest - a share of the profits paid to the fund's management company as a performance incentive;

- hurdle rate - a minimum rate of return (e.g. 8–12%), which must be achieved before the fund manager can receive any carried interest payments;

- transfer of an interest in the fund – venture capital funds are not intended to be transferred or traded. However, they can be transferred to another investor. Typically, such a transfer must receive the consent of and is at the discretion of the fund's manager.

- restrictions on the General Partner - the fund's manager has significant discretion to make investments and control the affairs of the fund. However, the LPA does have certain restrictions and controls and is often limited in the type, size, or geographic focus of investments permitted, and how long the manager is permitted to make new investments.

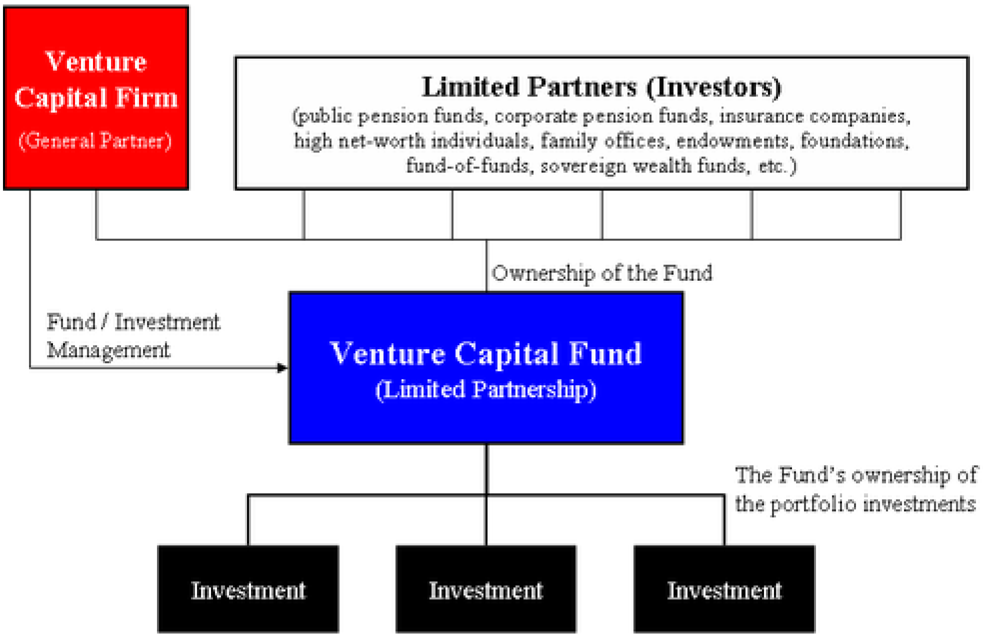

Diagram of the structure of a generic venture capital fund

The Venture Capital Firm, commonly known as the General Partner (GP), is an LP in the Venture Capital Fund and is usually structured as a Limited Liability Company. The Firm serves as the manager and investment advisor to the Fund. Other LPs in the Fund will include long term institutional investors like pension funds, family offices, sovereign wealth funds and endowment funds. All transactions are carried out by the Firm on behalf of and in the name of the Fund. The Venture Capital Firm is compensated through a combination of **Management Fees** and **Carried Interest** (often referred to as a "two and 20" arrangement). In a typical Venture Capital Fund, the general partners receive an annual management fee equal to up to 2% of the committed capital. In addition the GP will receive carried interest as a performance incentive of typically 20% of the profits of the Fund.

Common features of a Venture Capital Fund include :

- alignment of interests i.e. all parties including investors and entrepreneurs within the investee companies have a common interest in building a business and exiting it through an IPO or a Trade Sale over time The closer the alignment the more successful the Fund will be;

- most Funds have a fixed life of 10 years. Sometimes extensions are granted to facilitate liquidating the last of the investments (known as the Tail):

- investors commit a fixed amount of capital to the Fund. This capital is only "drawn/called down" into the Fund by the GP as the Fund makes its investments. Within a two week period the cash moves through the Fund from the LPs to the investee company;

- the investment cycle for the Fund is generally three to five years, after which the focus is on managing and making follow-on investments in an existing portfolio. After the initial investment is made additional capital is reserved to fund further development within the company and is only drawn down as it is required;

- investments are harvested in years 5-10 i.e. sold through an IPO or a trade sale, the cash is returned to the investors and the Fund is closed. In essence a Venture Capital Fund by its nature is self liquidating;

- after the five year investment period the GP raises capital for a new Fund. Typically a Venture Capital Firm (GP) manages approximately three overlapping Funds at the same time, the earliest would be at the end of its life, the middle Fund would be into its harvest period and the latest fund would be in its investment period. At a point in time, it is not unusual that total funds under management would not exceed the total committed capital to one fund alone. (See below for a worked example.)

Model Fund : Assumptions			**Model Firm : Assumptions**	
				€m
Each Fund Size	€ 200m		Fund Raised every four Years	
Assume 92% Drawn	€184m		Fund 3 (Year 1)	23
Average Investment Size	€11m		Fund 2 (Year 5)	92
No of Investments	16		Fund 1 (Year 9)	69
No of Years to Invest	8		Total Funds under Management	**184**

Cash Flow based on Model Fund										
Year	1	2	3	4	5	6	7	8	9	10
Number of divestments					2	2	2	2	2	2
	€m	€m	€m	€m	€m	€m	€m	€m	€m	€m
Invested at cost	23	23	23	23	23	23	23	23		
Cumulative invested at cost	23	46	69	92	115	138	161	184	184	184
Divested at cost					23	23	23	23	23	23
Cumulative divested at cost					23	46	69	92	115	138
Cumulative remainder at cost	23	46	69	92	92	92	92	92	69	46

APPENDIX II

VC Regulation in Europe

It must be noted at the outset that VC Funds and their fund managers, depending on the legal structure, abide by and conform to:

- local company legislation
- local partnership law
- international contractual agreements
- self regulation (local and international professional standards of conduct and governance - EVCA)

Country	Regulated
UK	Yes
Germany	No
France	Yes
Netherlands	No
Spain	Yes
IRL	Yes
Denmark	No
Finland	No
Sweden	No
Norway	No

UK:
Financial Services and Markets Act 2000 and FSA Rules. VCs are regulated and supervised by the Financial Services Authority (FSA) under the Financial Services and Markets Act 2000 and FSA Rules. The UK recognised the manager of collective investment scheme exemption in not applying MiFID to these firms. The system includes a proportionate regime of capital requirement (£5k), disclosure and monitoring financial information, communication with investors and management and disclosure of conflict of interest. The reporting relationship between the fund manager and the FSA is similar to the relationship to LPs and to those proposed in the EVCFR.

France:
French Financial and Monetary Code and AMF Regulations. VCs are regulated and supervised by the Securities Market Authority (AMF). In general if the scheme attracts retail investment then MiFID like rules apply (the retail investor is a significant player in funding VC activity). If there is no retail, then the AMF has no regulatory role.

Spain:
Spanish Private Equity Law 2005. VCs are regulated and supervised by the Spanish Securities Market Commission. The system includes a proportionate regime of capital requirements, diversification rules and disclosure requirements similar to those already in place for LPs and similar to those proposed in the EVCFR.

Ireland:
MiFID Regulations. VCs are regulated and supervised by the Irish Central Bank. VC Funds are inappropriately and unnecessarily treated as transaction based sellers of product to retail investors.