IRISH VENTURE CAPITAL ASSOCIATION

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EuVECA Regulation (the "Regulation")

Dear Martina

I refer to our meeting on 28 November and your follow up email of 6 December 2013. During the meeting, a number of issues were raised including certain matters which I agreed would be discussed amongst the IVCA members and upon which we would provide our views, as follows:

1. **Own Funds**

Article 10 of the Regulation provides that *"At all times, managers of qualifying venture capital funds* ***shall have sufficient own funds*** *and shall ensure that they are able to* ***justify the sufficiency of their own funds*** *to maintain operational continuity and disclose their reasoning as to why those funds are sufficient as specified in Article 13";*

Article 13 of the Regulation provides that "*Managers of qualifying venture capital funds shall, in relation to the qualifying venture capital funds that they manage****, inform their investors, prior to the investment decision of the latter, in a clear and understandable manner****, of the following:*

> *(a) the identity of that manager and any other service providers contracted by that manager in relation to their management of the qualifying venture capital funds, and a description of their duties;*
>
> ***(b) the amount of own funds available to that manager and a detailed statement as to why that manager considers that amount to be sufficient for maintaining the adequate human and technical resources necessary for the proper management of its qualifying venture capital fund".***

The Regulation places the onus on manager to have sufficient own funds, to be able to justify the sufficiency of own funds and to inform and disclose to prospective investors of qualifying funds, prior to the investment decision being made, of that information. This is entirely appropriate given that the parties are entering a long-term (typically ten year) relationship. It is not prescriptive in terms of an amount and this is also appropriate as the exact nature of the relationship between the VC manager and its investors involves many facets and the investors, as professionals clients, are already well placed to take a view on the sufficiency of the resources of the chosen manager and the requisite management fee income to fund those resources.

The CBI is proposing to impose a prescriptive requirement in relation to compliance with Article 10 as follows:

"EuVECA/EuSEF managers shall hold own funds at least equivalent to one quarter of the fixed overheads of the preceding year. This amount shall be calculated in accordance with the rules set out in Article 97 of Regulation (EU) No 575/2013 and in the regulatory technical standards referred to in that Article.

For the purpose of paragraph 1, own funds means eligible capital as defined in point 71 of Article 4(1) of Regulation (EU) No 575/2013 and calculated in accordance with the rules set out in Part Two of Regulation (EU) No 575/2013."

During our meeting you mentioned that one quarter's fixed overheads was intended to reflect the cost of an orderly wind down of the firm, similar to the minimum capital requirement firms.

The IVCA disagrees with the CBI's proposed approach for the following reasons:

- the proposed one quarter's fixed overheads level is far too high. In the UK the FCA EuVECA registration form, section 6.9, specifically refers to "sufficient resources" of £5,000 unless a "total capital" requirement applies. Article 5.2.3(2) of the FCA's IPRU (rule book) provides for a liquid capital requirement where the AIFM carries out MiFID activities e.g. trustee/depository activities. Otherwise a small authorised UK AIFM that invests in venture capital for non retail clients is only required to provide "own Funds" of £5,000. The IVCA has confirmed with a number of practitioners in the UK who have applied for EuVECA registration that the £5,000 "own funds" satisfies the FCA and Article 10. A copy of the FCA EuVECA registration form and IPRU are enclosed for ease of reference;

- the EVCA has confirmed that no other country in Europe is proposing to insert additional requirements over and above those stated in Article 10;

- we believe that the disclosures and commitments set out in the legal agreements between the AIFM and the fund investors provide adequate comfort in terms of disclosure, ongoing resourcing and orderly windup. See Appendix A for further details;

- the provision of venture capital finance in an economy, and particularly in the Irish economy, is now seen as an engine of growth. It has been government policy to promote Ireland as a good place to base venture capital funds and government fund was provided [last year] to attract international VC's to Ireland. Should the initial capital requirements be set at too high a level and disproportionate to those set elsewhere in Europe, venture fund managers will be discouraged from establishing here and local managers will be placed at a competitive disadvantage to their European peers. Ultimately venture capital is mobile and if Ireland create higher barriers to entry for new funds, there is a risk that the capital will flow elsewhere in Europe.

2. **Client Assets**

You advised at the 29 November meeting that the CBI would be applying the relevant client asset requirements ("CAR") to any AIFM registered under the EuVECA Regulations which is holding client assets save in accordance with the EuVECA Regulations. We did not discuss it at the time but in any event Article 12(2) of the Regulation provides that "the annual audit **shall confirm that the money and assets are held in the name of the qualifying venture capital fund** and that the manager has established and maintained adequate records and checks in respect of the use of any mandate or control over the money and assets of the venture capital fund and the investors therein".

As the manager may not hold money or assets of the fund in its own name under the Regulations then CAR will not apply and we would be grateful if you could confirm the position.

3. **Good Repute**

Article 14(2) of the EuVECA Regulations refers to the fact that the manager must be of sufficiently good repute. The CBI has suggested using its Fitness & Probity regime to meet the requirements of this Article. This will mean that the directors, secretary and specific senior personnel in the AIFM would be subject to the Central Bank's fitness and probity Standards as holders of pre-approval controlled functions ("PCFs"). The IVCA accepts that this approach satisfies the requirement.

Can you please confirm that for existing MiFID firms which act only as venture capital firms which may choose to opt out of MiFID and instead seek sub-threshold AIFM/EuVECA Regulation status, a new F&P exercise will not be necessary as the day to day activities of the relevant personnel in those firms would be similar regardless of whether the firms were MiFID authorised or EuVECA regulated.

4. **Structure of Venture Capital Funds**

Typically, venture capital funds are established as limited partnerships pursuant to the Limited Partnerships Act, 1907 ("LPs"). Each LP has a general partner which, under the limited partnership agreement, undertakes the management activities in respect of the LP and the limited partners are essentially the principal investors in the LP and not involved in the day to day activities of the LP. In some LP structures, the general partner is the venture capital firm itself and the LP is regarded as being "self managed" and is not subject to regulation. In other LP structures, the general partner delegates most of the management activities, including the investment management and advisory activities to an affiliate. In that situation the affiliate is typically authorised under MiFID on the basis that it is providing investment services to third parties (i.e. it is provided investment management services to each LP via an outsourcing contract between the general manager of the LP and the MiFID authorised affiliate).

Article 2 of the Investment Services Directive ("ISD")/MiFID provided an exemption for collective investment undertakings ("CIUs"), whether co-ordinated at Community level or not, and the depositaries and managers of such undertakings. The exemption in Ireland was restricted to CIUs and the depositaries and managers of CIUs regulated by the CBI. In addition, the CBI sought to draw a distinction between persons who are managers of CIUs and persons providing investment management services to CIUs. When the ISD/MiFID were introduced in the UK, the FSA (now FCA) adopted a somewhat different regime for PE/venture capital firms In the UK, venture capital firms avoided MiFID because the FSA took the view that if the managers were also the "operators" of the CIU and the transactions involved new as opposed to existing securities (new issues were not caught by the investment service of "receiving and transmitting orders" because the transaction in question was between the investor and issuer and not between two or more investors) the managers came within the CIU exemption. Thus pure venture capital firms in the UK have traditionally been regulated under a lighter non-MiFID regime.

During our meeting, you made it clear that you were of the view that all venture capital organisations fundamentally carrying on the same types of activity should be regulated in the same way, regardless of structure and that the CBI would concern itself with "substance" over "form" and look through the LP structure to the person who is actually providing the services.

The IVCA welcomes this approach in principle and, on the basis that where IVCA members currently authorised under MiFID and which are carrying out investment management and advisory activities in respect of venture capital firms and are not also, for example, providing MiFID services to other parties which are not covered within AIFMD (e.g. executing orders on behalf of third parties in respect of financial instruments) then, in the view of IVCA, these firms are entitled to opt out of MiFID and instead register as sub-threshold AIFMs and under the EuVECA Regulations.

I look forward to hearing from you.

Yours faithfully,

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Regina Breheny
Director General

c.c. Patricia Dunne - CBI
John Canny - CBI
Patricia Taylor – William Fry

Appendix A Limited Partnership Agreements and Articles 10 and 13 of EuVECA

The thrust and the intent of Article 10 and 13 of the EuVECA Regulation is clearly that managers should be able to demonstrate to prospective investors, ahead of time, that they will be sufficiently resourced to provide the service for which they are about to contract, i.e. the long term investment and management of the fund in appropriate qualifying assets.
In the context of the above, it is worth noting a number of points:

- the parties to whom a venture fund manager will have to demonstrate that it is sufficiently resourced are overwhelmingly institutional and are sophisticated, professional investors investing funds on a recurring basis;

- since the relationship between a venture fund manager and investors in a venture fund is long-term, typically for ten years, prospective investors conduct extensive due diligence and multi-faceted risk assessment before making an investment commitment to a fund;

- the agreement (Limited Partnership Agreement) between the venture fund manager, (acting as the General Partner), and the investors, (Limited Partners), will set out in a carefully prescribed manner, the rights and duties of both set of parties and will have been negotiated over a considerable period by such parties and their respective legal teams;

- the investment team within the venture fund manager is typically contracted to devote substantially the whole of the business time of the individuals within the team to the affairs of the fund during the investment period (normally the first five years) and after the investment period, to devote sufficient time to the fund as is necessary to manage its affairs;

- in return for this level of commitment, the venture manager is compensated with a contractual management fee calculated according to a negotiated formula set out in the Limited Partnership Agreement. The management fee is set at a level that is sufficient to adequately resource the venture fund manager to manage the affairs of the fund. This is of fundamental importance when considering the level of capital that might be deemed adequate for a venture fund manager.

Given that the contractual management fee is set at a level sufficient to maintain the human and technical resources necessary for the proper management of the fund, the determination of the amount of own funds required should be primarily risk based. In respect of venture fund management, we can consider the main risks as those outlined below.

<u>Credit Risk.</u>

There is a level of credit risk, but this is very small. The greatest credit risk would arise from the failure of the bank with whom the manager banks. There is almost no credit risk in respect of management fee income as it ranks as a first call, not only on current fund assets, but also on undrawn committed capital. The capital required to cover the credit risk of a manager is therefore quite small. Applying the “standardised approach” of a 20% weighting and 8% capital reserve to a €200,000 bank balance would produce a capital cover requirement of €3,200;

<u>Operational Risk</u>

The main operational risk is that the manager operates a continuous budget deficit and runs out of resources in the short or medium term. This is easily addressed by an annual budget cycle. Both the income stream and the expenditure level are set for the term of the fund and are predictable. Consequently it is a straightforward exercise to budget accurately. Again, the level of capital required to address this risk should be small and not exceed €10,000;

<u>Market Risk</u>

In circumstances where the performance of the firm is very poor over a sustained period of time, there may be a risk that the Limited Partners would invoke a “divorce clause” in a Limited Partner Agreement. However in these circumstances the agreement will invariably provide for a compensation amount (one year’s fee being not uncommon) providing more than adequate funds to address any deficiencies that might otherwise arise. Capital is not required to address this risk.

<u>Insurance Risk</u>.

Venture fund managers will have insurance for normal business risks. In respect of their activities as fund managers, most Limited Partnership Agreements will indemnify the manager out of fund assets (absent wilful negligence). Where insurance policies contain an “excess” clause, representing the first amount to be paid before the insurance cover applies, it can be argued that capital should be set aside to cover this (notwithstanding that in most cases fund assets provide an indemnity). Again, this level will be relatively low. A typical excess would usually be in the order of €25,000. Using the standardised approach would give a capital requirement of £400.

Reputational Risk

The business of managing venture capital funds is only possible with the trust of an investor base. To be offered the opportunity to manage new venture capital funds in the future, a venture capital manager needs to maintain and protect its good reputation. However, while the long-term continuity of the venture capital management company would be jeopardised by damage to its reputation, the immediate capital base of the company is not threatened. As outlined above under market risk, there are compensation clauses in the VC funds to cover any “divorce”.