ADVISORY | Funds and Investments

February 15, 2013

EUROPEAN VENTURE CAPITAL FUND REGULATION - AN OVERVIEW

WHAT IS THE EUROPEAN VENTURE CAPITAL FUND REGULATION?

In June 2011, the European Commission consulted on a new European regime for venture capital. The Commission recognised that there was a shortage of funding in the European Union ("**EU**") for venture capital, which in turn affected the growth of small and medium enterprises ("**SMEs**") in the EU. The Commission also recognised that in the absence of an internal market for EU venture capital funds, the venture capital markets in the EU were fragmented along national lines, where venture capital funds were exposed to increased funding costs when they operated outside their home jurisdictions. The Commission considered that these issues, together with concerns around double taxation and tax treatment uncertainties, had the effect of limiting the supply of capital to SMEs in the EU.

Following feedback to the consultation from relevant stakeholders, the Commission published a legislative proposal for a Regulation on European Venture Capital Funds (the "**Regulation**") in December 2011. The Commission considered that the proposed Regulation would address the problems identified in its consultation by introducing uniform requirements for managers of funds designated as "European Venture Capital Funds" ("**EuVECA**"). The proposal provided for uniform registration and compliance requirements for managers of venture capital funds across the EU and significantly, in return, an EU wide passport, which would enable managers to market venture capital funds across the EU by complying with a single rule book.

In light of the Commission's intention to fully exploit the positive impact of the new regime and to minimise the compliance costs of venture capital fund managers, the operating conditions and on-going requirements under the Regulation are less onerous than corresponding requirements for larger fund managers under the Alternative Investment Fund Managers Directive (the "**AIFM Directive**").

The new regime is not compulsory. The Regulation will not apply to venture capital managers unless they opt in to the requirements under the Regulation in order to benefit from the EU marketing passport. Existing national rules will continue to apply to managers who do not opt in.

On 12 December 2012, the Cyprus Presidency of the Council of the EU published a press release announcing that political agreement had been reached on the proposed Regulation, on the basis of a text of the Regulation dated 7 December 2012 provisionally agreed with the European Parliament.

WHAT IS THE SCOPE OF THE REGULATION?

The Regulation is available to EU managers of alternative investment funds which are qualifying venture capital funds and whose total assets under management do not exceed the €500m threshold of the AIFM Directive. The Regulation defines an alternative investment fund by reference to the corresponding definition in the AIFM Directive, i.e. a collective investment undertaking that is not a UCITS and that raises capital from a number of investors with a view to investing it in accordance with a defined investment policy for the benefit of those investors.

AIFM Directive registration requirement: EU managers to whom the Regulation applies will be subject to the registration requirement under Article 3(3)(a) of the AIFM Directive for smaller alternative investment fund managers. This registration requirement requires smaller managers to register with, and provide information relating to themselves and the funds they manage (including information on the investment strategies of those funds) to, the competent authority in their home member state, in addition to providing prescribed information on an on-going basis to the relevant competent authorities.

Qualifying Venture Capital Fund: A qualifying venture capital fund is an alternative investment fund that is established in an EU member state and intends to invest at least 70% of its aggregate capital contributions and uncalled committed capital in qualifying investments within a timeframe specified in its rules or instruments of incorporation. The Regulation also specifies that in order to constitute a qualifying venture capital fund under the Regulation, a fund should never use more than 30% of its aggregate capital contributions and uncalled capital for the acquisition of assets other than qualifying investments.

Qualifying investment: The definition of a qualifying investment includes equity or quasi equity instruments that are acquired on issue by a qualifying portfolio undertaking. The recitals to the Regulation clarify that the term "quasi equity" is meant to capture a variety of financing instruments such as subordinated loans, silent participations, participating loans, profit participating rights, convertible bonds and bonds with warrants.

In addition to equity and quasi equity, secured and unsecured loans granted by a qualifying venture capital fund to a qualifying portfolio undertaking in which the fund already holds qualifying investments also constitute qualifying instruments. However, the Regulation restricts the aggregate amount of such loans to 30% or less of the aggregate committed capital of the fund. Further, shares of a qualifying portfolio undertaking acquired from existing shareholders of the undertaking are also qualifying investments, as are units or shares in other qualifying venture capital funds which have not themselves invested more than 10% of their aggregate committed capital in qualifying venture capital funds.

Qualifying portfolio undertaking: The definition of a qualifying portfolio undertaking is similar to the definition of a SME, which is used in other EU legislation. Significantly, a qualifying portfolio undertaking must, at the time of investment by the qualifying venture capital fund, not be admitted to trading on a regulated market or multilateral trading facility, employ fewer than 250 persons and either have an annual turnover not exceeding €50m or an annual balance sheet total not exceeding €43m. Further, the qualifying portfolio undertaking must not be an alternative investment fund and must be established within the territories of an EU member state, or a third country that is not listed as a Non-Cooperative Country and Territory by FATF and has signed a tax information exchange agreement with the home member state of the manager of the qualifying venture capital fund and with any other member state in which the qualifying venture capital fund will be marketed.

THRESHOLD CONSIDERATIONS

Portfolio composition: The Regulation requires that a qualifying venture capital fund's investment in assets other than qualifying investments must be no more than 30% of its aggregate capital contributions and uncalled committed capital. This 30% limit is calculated on the basis of amounts available for investment after the deduction of all relevant costs. Further, holdings in cash and cash equivalents are disregarded in calculating the limit, since cash and cash equivalents are not considered as investments for the purposes of the Regulation.

Leverage: The manager of a qualifying venture capital fund is prohibited from employing, at the level of the fund, any method to increase the exposure of the fund beyond its committed capital, whether by borrowing, through the use of derivatives or any other means, as the manager may borrow, issue debt obligations or provide guarantees at the level of the qualifying venture capital fund, only if the borrowings, debt obligations or guarantees are covered by uncalled commitments.

Eligible investors: The Regulation restricts the marketing of units and shares of a qualifying venture capital fund exclusively to investors who are, or who elect to be treated as, "professional investors" under the Markets in Financial Instruments Directive. However, the Regulation permits the marketing of a qualifying venture capital fund to other investors who commit to investing a minimum of €100,000 and who provide a statement in writing, separate from the contract for the commitment to invest, that they are aware of the risks associated with the commitment or investment. Further, executives, directors or employees of the manager may also invest in qualifying venture capital funds managed by the manager.

Limits on assets under management: The Regulation only applies to managers whose assets under management in total do not exceed €500m, i.e. the threshold specified under the AIFM Directive for managers of unleveraged funds. However, managers of qualifying venture capital funds who are registered under the Regulation to market their qualifying venture capital funds with the EuVECA designation and whose assets under management subsequently grow to exceed the €500m threshold (so that they become subject to the authorisation and other requirements of the AIFM Directive), are nonetheless permitted under the Regulation to continue to market their qualifying venture capital funds under the EuVECA designation, provided that they comply with the requirements of the AIFM Directive and certain specified provisions under the Regulation.

MARKETING UNDER THE EU PASSPORT

Managers who wish to use the EuVECA designation to market their qualifying venture capital funds in the EU are required to apply for registration with the competent authority in their home member state. The application must include the identity of the persons who effectively conduct the business of managing the qualifying venture capital funds, the identity and investment strategies of the qualifying venture capital funds to be marketed, information on the arrangements made to comply with the requirements of the Regulation, a list of member states where the manager intends to market each qualifying venture capital fund and a list of member states where the manager has established or intends to establish qualifying venture capital funds.

Once the competent authority grants registration, it is required to notify the registration to the member states listed on the manager's application as target jurisdictions for marketing. In order to ensure uniform application of this provision, the Regulation states that the European Markets and Securities Authority ("**ESMA**") should develop technical standards to determine the format of the notification. It is expected that these technical standards be published by ESMA in early 2013. On completion of registration, the manager is permitted to market the qualifying venture capital funds under the designation "EuVECA" throughout the EU.

ON-GOING REQUIREMENTS

The Regulation sets out a number of requirements that a fund manager will need to comply with in order to be entitled to use the "EuVECA" designation for marketing a venture capital fund in the EU. These conditions are less onerous that the conditions imposed on larger alternative investment fund managers under the AIFM Directive.

Conduct of business: The Regulation sets out requirements governing the conduct of a manager of a EuVECA, including requirements to act honestly with due skill, care and diligence and fairly in conducting its activities, conduct business activities so as to promote the best interests of the EuVECA that it manages, apply a high level of diligence in selecting and monitoring investments in qualifying portfolio undertakings, treat investors fairly and ensure that no investors are given preferential treatment or that such treatment is disclosed in the EuVECA's rules or instruments of incorporation.

Delegation: The Regulation permits the manager of a EuVECA to delegate its functions to a third party. However, the Regulation states any delegation shall not affect the manager's liability towards the EuVECA. Further, the Regulation prohibits the manager from delegating its functions to an extent that it can no longer be considered to be the manager of the EuVECA and to the extent it becomes a "letter box entity".

Conflicts of interest: The Regulation requires managers to identify and avoid potential of interests, and put in place and operate effective organisational and administrative arrangements for the identification and disclosure of potential conflicts of interest.

Own funds: The Regulation requires a manager of a EuVECA to have at all times sufficient own funds and to use adequate and appropriate human and technical resources as are necessary for the proper management of the EuVECA. The Regulation states that it will be incumbent on managers to ensure that they are able at all times to justify the sufficiency of their own funds to maintain operational continuity and disclose their reasoning to investors (as a part of their pre-investment disclosure obligations) as to why these funds are sufficient for maintaining adequate human and technical resources necessary for the property management of its EuVECA.

Valuation: The Regulation requires that the rules for the valuation of assets of a EuVECA shall be laid down in the rules or instruments of incorporation of the fund, and that such rules shall ensure a sound and transparent valuation process.

Annual report and transparency requirements: The manager is required to make available an annual report to the regulator in its home member state for each EuVECA it manages within 6 months of the end of the financial year. The report must be made available to investors on request. The Regulation specifies the content requirements of the report, which include the composition of the portfolio of the EuVECA and the activities of the past year. The report should also include the audited financial statements of the fund and must disclose the amount of the fund's profits by the end of its life time and the amount of profits distributed by year.

Managers are also required, in relation to each EuVECA they manage, to provide certain prescribed information to investors in a clear and understandable manner prior to the investors taking any investment decision. The prescribed information includes the identity of the manager and other service providers and their duties, the qualifying venture capital fund's investment strategy and objectives, risk profile, valuation procedure and historical performance, and a description of how the manager's remuneration is calculated.

EUROPEAN COMMISSION CONSULTATION ON REMOVING CROSS-BORDER TAX OBSTACLES

In August 2012, the Commission consulted on the tax obstacles that hindered cross-border venture capital investment, with a view to presenting solutions in 2013 aimed at eliminating such obstacles without facilitating tax avoidance and evasion. The Commission referred to the Expert Group's Report, which discussed how mismatches between 27 tax systems across the EU could lead to double taxation, tax treatment uncertainties and administrative obstacles for cross-border venture capital investment. The Commission considered that more evidence of the impact of such mismatches on the venture capital industry was required before it could ask member states to put in place tax structures for venture capital investment.

The Commission asked stakeholders to contribute their knowledge and understanding of actual direct tax problems that have arisen when venture capital has been invested across borders. The Commission also solicited the views of stakeholders on structures that have been put in place to avoid such tax problems and the extra costs involved, together with any feasible solutions to remedy the current problems. The consultation closed on 5 November 2012.

NEXT STEPS

It is intended that the Regulation come into force in parallel with the AIFM Directive on 22 July 2013. The immediate next step is a plenary vote of the Parliament in March 2013 on the Regulation, followed by formal approval of the Regulation by the European Council. The European Securities and Markets Authority is expected to produce technical advice on the format of the notification under Article 15 of the Regulation in early 2013.

If you have any questions concerning the material discussed in this client alert, please contact the following members of our funds practice group:

Simon Currie	+44.(0)20.7067.2011	scurrie@cov.com
Prem Mohan	+44.(0)20.7067.2025	pmohan@cov.com