

Luxembourg, 6 January 2016

## **Response to European Commission consultation on the review of the EuVECA and EuSEF Regulations**

### **Introduction**

The Association of the Luxembourg Fund Industry (ALFI) is the representative body of the Luxembourg investment fund community. Created in 1988, the Association today represents over 1300 Luxembourg domiciled investment funds, asset management companies and a wide range of service providers such as custodian banks, fund administrators, transfer agents, distributors, legal firms, consultants, tax experts, auditors and accountants, specialist IT providers and communication companies. The Luxembourg Fund Industry is the largest fund domicile in Europe and a worldwide leader in cross-border distribution of funds. Luxembourg-domiciled investment structures are distributed on a global basis in more than 70 countries with a particular focus on Europe, Asia, Latin America and the Middle East.

The Luxembourg Private Equity and Venture Capital Association (LPEA) is a member-based, non-profit trade association established in 2010. LPEA represents, promotes and protects the interests of the Luxembourg private equity and venture capital industry. LPEA's role includes representing the interests of the industry to regulators and standard setters; developing professional standards; providing industry research; professional development and forums, facilitating interaction between its members and key industry participants including institutional investors, entrepreneurs, policymakers and academics. LPEA's activities cover the whole range of private equity, from venture capital (seed, start-up and development capital), to buyouts and buyins.

We thank the European Commission for the opportunity to participate in this consultation on the review of the EuVECA and EuSEF Regulations.

We support the submission of the European Fund and Asset Management Association (EFAMA).

### **Response to the consultation**

#### **Who can manage and market EuVECA and EuSEF funds?**

**1) Should managers authorised under the AIFMD be able to offer EuVECA to their clients? Please explain.**

Yes. Any manager complying with the EuVECA regime (in addition to the AIFMD rules for managers also authorised under the AIFMD) should be allowed to manage, name and market their EuVECA-compliant funds as "EuVECAs". This change would (a) be good for investors, as same products would be named the same way, (b) generally be good for the development of EuVECAs because bigger players could put more resources in promoting this product than smaller ones; if they were given access to the EuVECA brand they paved the way for smaller

players, and hence (c) further promote the development and financing of small and medium-sized enterprises.

As mentioned by ESMA in its Q&A document on the application of the EuSEF and EuVECA Regulations, it should be taken into account that, to the extent AIFMs above the threshold are required to be authorised under the AIFMD and comply with the rules of the AIFMD, there are no prudential concerns in allowing these AIFMs to set up and market EuVECA and EuSEF funds to professional investors. From a regulatory and supervisory perspective, an authorisation under the AIFMD is more stringent than a registration under the EuVECA and EuSEF Regulation.

**2) Should managers authorised under the AIFMD be able to offer EuSEF to their clients? Please explain.**

Yes. Any manager complying with the EuSEF regime (in addition to the AIFMD rules for managers also authorised under the AIFMD) should be allowed to manage, name and market their EuSEF-compliant funds as “EuSEFs”. This change would (a) be good for investors, as same products would be named the same way, (b) generally be good for the development of EuSEFs because bigger players could put more resources in promoting this product than smaller ones; if they were given access to the EuSEF brand, they paved the way for smaller players, and hence (c) further promote the development and financing of qualifying portfolio undertakings.

As mentioned by ESMA in its Q&A document on the application of the EuSEF and EuVECA Regulations, it should be taken into account that, to the extent AIFMs above the threshold are required to be authorised under the AIFMD and comply with the rules of the AIFMD, there are no prudential concerns in allowing these AIFMs to set up and market EuVECA and EuSEF funds to professional investors. From a regulatory and supervisory perspective, an authorisation under the AIFMD is more stringent than a registration under the EuVECA and EuSEF Regulation.

**What happens when a EuVECA or EuSEF manager, post registration, exceeds the €500 million threshold?**

**3) What would be the effect of EuVECA or EuSEF managers, managing EuVECA or EuSEF funds only, continuing to enjoy the relevant passports once the total EuVECA or EuSEF assets under management, subsequent to their registration as fund managers, exceed the threshold of €500 million?**

See our answers to 1) and 2) above – ALFI and LPEA believe that all managers authorised under the AIFMD should be able to manage, name and market their EuVECA / EuSEF-compliant funds as EuVECAs or EuSEFs respectively, irrespective as to whether they are above the thresholds and / or also manage non-EuVECA / EuSEF funds.

**4) What would be the effect of EuVECA or EuSEF managers, managing EuVECA and/or EuSEF funds, continuing to enjoy the relevant passports once their total assets under management, subsequent to their registration as fund managers, exceed the threshold of €500 million?**

See our answers to 1) and 2) above – ALFI and LPEA believe that all managers authorised under the AIFMD should be able to manage, name and market their EuVECA / EuSEF-

compliant funds as EuVECA or EuSEFs respectively, irrespective as to whether they are above the thresholds and / or also manage non-EuVECA / EuSEF funds.

It is worth noting that the fact that the threshold has been set at EUR 500 million has led to the (mis)perception that EuSEFs can only be set up in the closed-end form. Therefore, it would be important to clarify that EuSEFs can indeed be structured as open-ended fund.

### **Who can invest in EuVECA or EuSEF funds?**

#### **5) What has been the effect of setting the current threshold at €100,000?**

We do not see an immediate need to change the threshold of EUR 100'000 but an alignment to the ELTIF regime could be considered.

#### **6) What effect would a reduction in the minimum €100,000 investment have on the take-up of EuVECA? If you favour a reduction, what would be an appropriate level?**

As a result, the ELTIF rules could be applied.

In addition, we think an exception to the 100K€ *de minimis* should be provided for individuals working for the manager or for the target companies in which the fund invests. Based on concrete experience, we can say this would have played in favour of the development of EuVECA in the last couple of years. Therefore, no minimum should apply in that case.

#### **7) What effect would a reduction in the minimum €100,000 investment have on the take-up of EuSEF? If you favour a reduction, what would be an appropriate level?**

As a result, the ELTIF rules could be applied.

In addition, we think an exception to the 100K€ *de minimis* should be provided for individuals working for the manager or for the target companies in which the fund invests. Based on concrete experience, we can say this would have played in favour of the development of EuSEF in the last couple of years. Therefore, no minimum should apply in that case.

#### **8) How would any reduction of the minimum €100,000 investment be balanced against the need to ensure appropriate retail investor protection?**

We believe the MiFID already provides for a robust and sufficient framework.

### **Is it too expensive to set up EuVECA or EuSEF funds?**

#### **9) Are the costs relating to fund registration proportionate to the potential benefits for funds from having the passport?**

Regarding fees and other requirements imposed by Members States to managers in connection with the marketing of their funds in Europe, we are aware of the following:

- Luxembourg: The CSSF levies fees of EUR 5,000 with respect to the processing of the initial registration of EuVECA managers / funds.
- Spain: The CNMV is requesting the payment of an initial registration fee of EUR 2,500 (Tarifa 4.5.1) pursuant to Law 16/2014 (<http://www.boe.es/boe/dias/2014/10/01/pdfs/BOE-A-2014-9895.pdf>).

- Malta: The MFSA is requesting payment of notification and supervisory fees as described in the relevant local law.
- Norway: The Finanstilsynet is arguing that "the distribution of units under the EuVECA Regulation is currently not possible in Norway as the regulation has not been transposed into national law of Norway.
- Liechtenstein: The FMA does not accept notifications under the EuVECA Regulation pending its implementation into local law. During an interim period, the regulator will accept cross-border marketing of EuVECAs only in compliance with the law on Investment Undertakings of May 19, 2005 (IUG) and the Ordinance on Investment Undertakings of August 23, 2005, imposing the EuVECA manager to inter alia appoint a representative and a paying agent in Liechtenstein.
- Italy: CONSOB is requesting communication of information and data for the purpose of the calculation of fee amount due to the regulator.

Considering the wording of the EuVECA / EuSEF Regulation, it is our understanding that neither additional requirements nor fees shall be imposed to manager in relation to the marketing of EuVECA / EuSEF funds by host Member States listed in accordance with Article 14 para. 1(d) of the EuVECA Regulation / Article 15 para. 1(d) of the EuSEF Regulation. Article 16 para. 2 of the EuVECA Regulation (which corresponds to Article 17 para. 2 of the EuSEF Regulation) provides: "The host Member States indicated in accordance with point (d) of Article 14(1) shall not impose, on the manager of a qualifying venture capital fund registered in accordance with Article 14, any requirements or administrative procedures in relation to the marketing of its qualifying venture capital funds, nor shall they require any approval of the marketing prior to its commencement."

This does not seem to be complied with by certain Member States, and fees imposed for registration and marketing are often inappropriate, taking into account the size of the managers. Small managers may not have the financial means to pay high costs for numerous countries. A strict application of the EuVECA / EuSEF Regulation would clearly promote the setting up of related fund structures.

**10) Are the registration requirements for EuVECA a hindrance to the setting up of such funds in your Member State and, if so, how could this be alleviated without reducing the current level of investor protection?**

Registration requirements are indeed perceived as a hindrance for small managers which sometimes do not even consider an application for registration. Inappropriate requirements from a perspective of small managers include high minimum capital requirements, high registration and marketing fees, the requirement to set up a local IT infrastructure or to use local service providers as opposed to well-known international cloud offerings, the requirement to hire an external auditor for the manager, and finally the separation of roles for micro entities.

Moreover, the requirements are to a large extent aligned to the requirements of the AIFMD, especially in terms of human resources (segregation between portfolio and risk management), own funds (currently at EUR 125,000 in Luxembourg), infrastructure (including IT) and audit requirement at manager level (with annual costs of around EUR 20,000).

The time, costs and hassle for registering a small venture capital fund in numerous countries are not only too onerous but also a heavy burden for most EU venture capital funds (see further comments under 12).

Practitioners would appreciate clear guidance in respect of the level of the registration requirements.

**11) Are the registration requirements for EuSEF a hindrance to the setting up of such funds in your Member State and, if so, how could these hindrances be alleviated without reducing the current level of investor protection?**

We cannot respond to this question at this stage, because EuSEFs have not yet been registered in Luxembourg.

**12) Are the requirements for minimum own funds imposed on the managers relating to fund registration proportionate to the potential benefits for funds from having the passport?**

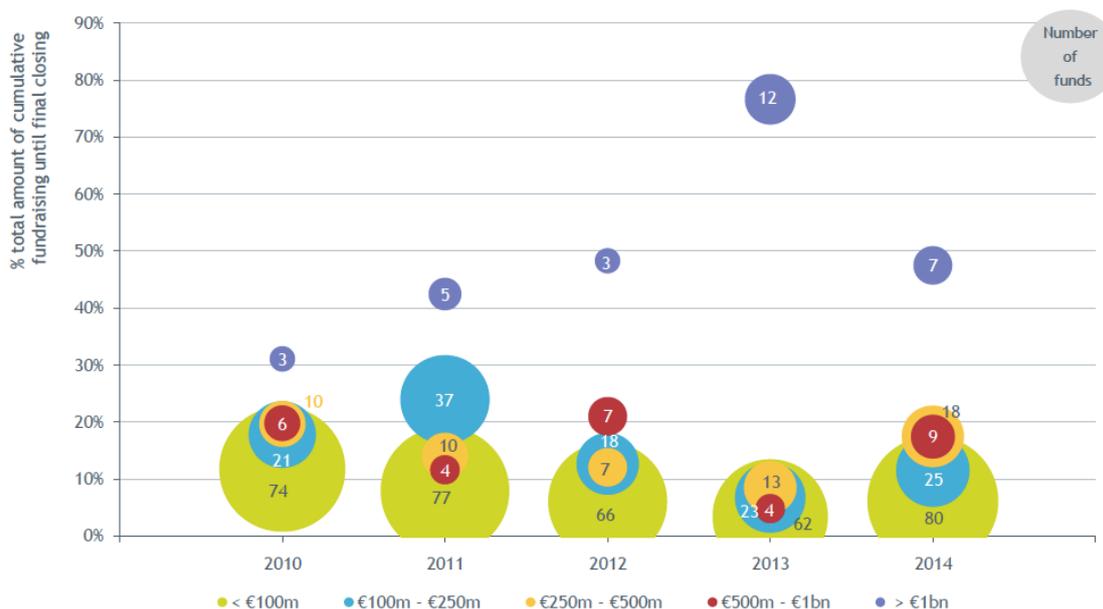
National regulators interpret the requirements for minimum own funds differently. It can be very hard for small managers to meet these requirements, especially in Luxembourg where the own funds requirements seems to amount to about EUR 125,000.

There are over 600 venture capital funds in Europe and less than 10% have a size above EUR 100 million. Recent statistics indicate that more than 60% of the number of funds raise less than EUR 100 million (often much less).

Final closing - All Private Equity - Concentration of capital



2010-2014 - Final closing during the year - Amount<sup>(1)</sup> & Number of funds<sup>(2)</sup>



Source: EVCA / PEREP\_Analytics Note: (1) The total amount raised by funds that reached a final closing in the year. Amounts from previous incremental fundraising rounds and years are aggregated to the final amount. (2) The number of funds that reached a final closing in the year. Each fund is captured only once, when the full amount has been raised.

These are an essential component of the EU innovation financing framework. Seed funds for instance are a key component of the start-up financing system. The size of these seed funds often ranges from 5 to 20m euros. These are pervasive in the US and operate under very light, one could even say, without regulatory oversight. Such funds usually operate with no more than

two people. This situation has significant implications in terms of “compliance with a regulatory burden”.

Competence should not be measured by the amount of capital – competence is a matter of relevant professional experience, education, alignment of interest, etc. Setting a high requirement for the amount of capital necessary to run an operation that intrinsically should generate sufficient fees to operate on break-even would preclude many bone fide teams from launching funds that are much needed.

Statistics from Prequin, CB Insights clearly indicate that European venture capital funds structurally raise four to five times less money than US venture capital funds.

Country	Population	VC investments per capita \$
California	38,802,500	690.68
Israel	8,238,300	412.71
US	320,000,000	147.81
EU	507,000,000	11.24

As a consequence, European ventures are structurally under financed by the same ratio. The table below (source: BrightSun) demonstrates that European companies are 50% less likely to raise a Series A than a US company. The table does not show that those who do secure a Series A in Europe only raise a fraction of the money raised in Series A in the US.

<i>Number of deals (January 2009 - August 2014) in Europe &amp; USA and percentage that attained subsequent funding</i>			
	Seed	A	B
Euro	2,537	163	37
Euro % Funded		6%	23%
USA	6,760	843	276
USA % Funded		12%	33%

The bottom-line is: it is not the time to create new entry barriers if Europe wishes to catch up on investment and support to innovative companies. Europe does not need any additional constraints, but needs more venture capital funds and more venture capital money.

It is worth noting that the same reasoning applies to own funds required for EuSEF managers, who usually manage a limited amount of assets. We think a principle of proportionality should be put in place and regulatory practices should be streamlined.

**Should third country managers be able to use the EuVECA or EuSEF designations?**

- 13) Should the use of the EuVECA Regulation be extended to third country managers and if so, under what conditions?**

ALFI and LPEA are not against 3<sup>rd</sup> country managers being given access to the EuVECA Regulation provided, as a minimum, that a member state of reference is in charge of checking compliance with the regulation. There is a need to ensure a level playing field, meaning that 3<sup>rd</sup>

country managers should in no event have easier access to the EuVECA Regulation than EEA-based managers.

Consideration should also be given to reciprocity: the extension of the passport could also create further market access for EU AIFMs into non-EU countries that are not yet broadly accessible from a European perspective. We therefore encourage the Commission to make use of this opportunity. Based on these conditions, the extension of the passport would benefit to European professional investors' choice while encouraging enhanced competition and market efficiency.

Another possibility could be to only allow 3<sup>rd</sup> country managers from countries which benefit from the AIFMD passport (as and when implemented).

**14) Should the use of the EuSEF Regulation be extended to third country managers and if so, under what conditions?**

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Another possibility could be to only allow 3<sup>rd</sup> country managers from countries which benefit from the AIFMD passport (as and when implemented).

**Should the range of eligible assets available to EuVECA funds be broadened?**

As a preliminary remark to the following three questions, ALFI regrets that the same question has not been raised with respect to EuSEF where the definition of eligible investments and the practical limitation of investments in EU social enterprises are a barrier to the take-off of the label.

**15) Is the current profile of eligible portfolio assets conducive to setting up EuVECA funds? In particular, does the delineation of a 'qualifying portfolio undertaking' (unlisted, fewer than 250 employees, annual turnover of less than €50 million and balance sheet of less than €43 million) hinder the ability to invest in suitable companies?**

At the margin, the current profile is not entirely conducive to setting up EuVECA funds because the late stage funds (Series B, C, D, E, F) now address start-ups with stellar growth rates, whose market opportunity requires them to deploy very large amounts of money (often hiring of hundreds of people), rounds of financing of EUR 100 million have become commonplace. This new trend will only accelerate. The reasons are multiple, the most fundamental being the availability of distribution platforms giving immediate, instantaneous access to over one billion people. This was not the case just five years ago. Early stage funds are not affected by the EuVECA constraints as it relates to this point.

- 16) Does a EuVECA's inability to originate loans to a qualifying portfolio undertaking in which the EuVECA is not already invested hinder the attractiveness of the scheme for potential managers of such funds?**

The limited ability of a EuVECA to originate loans to qualifying portfolio undertakings is highly problematic in light of what is market practice globally at early stage, i.e. where the volume of deals occurs. Even at later stages the problem remains. Indeed, early stage deals typically take the form of convertible notes, warrants and combinations thereof (<https://www.ycombinator.com/documents/>). And in terms of volume they can quickly amount to 80% of a fund's investments. This is NOT compliant with EuVECA, BUT this is ABSOLUTELY at the core of what venture capital funds actually do. As a result, the EuVECA Regulation misses the point. Of course, venture capital funds are equity funds so these situations are temporary and the funds eventually convert into equity, provided things go right, which is not always the case. In addition to the above, for funds using SICARs, we are unsure whether the use of intermediate holding companies impact the equation, as holding companies are typically financed 85/15 by loans.

- 17) In this context, does the rule that a EuVECA can only use 30% of the aggregate capital contributions and uncalled committed capital for loan origination reduce the attractiveness of the scheme?**

Absolutely, see our answer to question 16. No limit should be imposed in this respect for loan investments structured with equity features (equity-kickers).

### **Barriers to cross-border activity**

- 18) What are the key issues or obstacles when setting up and marketing EuVECA or other types of venture capital funds across Europe?**

Specific requests from EU Member States (beyond the requirements of the EuVECA Regulation itself, such as registration fees and requirements for the managers) currently impede the EU passport and, as a result, it does not work properly.

- 19) What are the key issues or obstacles when setting up and marketing EuSEF or other types of social investment funds across Europe?**

Specific requests from EU Member States (beyond the requirements of the EuSEF Regulation itself, such as registration fees and requirements for the managers) currently impede the EU passport which, as a result, does not work properly.

Some of the EuSEF requirements should be subject to proportionality as they are not adapted to very small structures (e.g. the reporting regime is excessively cumbersome compared to the benefits of the EuSEF passport).

EuSEFs should be allowed to finance themselves through the issue of debt obligations without a need for uncalled capital as this is a usual alternative to equity when raising capital from investors and we see no additional risk or speculation in structuring securities as debt instead of equity.

Last but not least, impact measurement remains a challenge and lacks best practices.

## Other issues

### **20) What other measures could be put in place to encourage both fund managers and investors to make greater use of the EuVECA or EuSEF fundraising frameworks?**

Consistent application and notably the absence of any form of goldplating is a prerequisite to enhance the use of the new vehicles.

Clarification is needed as to whether the EuVECA and EuSEF passports do only grant a marketing passport, or also a cross-border management passport. The wording used on page 4 (paragraph starting “In order to achieve ...”, which refers to a marketing passport only) and on page 7 (first paragraph, explicitly mentioning marketing and management passports established in these Regulations) of the consultation paper requires clarification.

Generally, national regulators need to be equipped with clear guidelines to ensure that the application processes are as short as possible. Time-to-market is key, otherwise managers will chose non-regulated vehicles which can be set up within few days.

A good way to promote the development of EuVECAs / EuSEFs could be to make them eligible under article 50 para. 2a of the UCITS directive. Communication on the value of the brands must be significantly enhanced because many managers are not even aware that they exist. When the Regulations were adopted everyone was focussing on the implementation of the AIFMD.

We also regret that the ESMA data base on EuVECA and EuSEF is not updated on a regular basis. This would help to make the labels more visible and to compare the progress on registrations in other countries.

### **21) What other barriers exist to the growth of EuVECA and EuSEF? Please specify. Are there other changes that could be made to the EuVECA and EuSEF regulations that would increase their up-take?**

The defined investment universe and investment restrictions for EuVECA / EuSEF appear to be too prescriptive and narrow to allow these vehicles to compete successfully with AIFMs, where the larger investment managers typically have the required AIFMD infrastructure in place.

Pursuant to Article 3 para. d (IV) of the EuVECA Regulation and Article 3 para. d (V) of the EuSEF Regulation, qualifying portfolio undertakings must be established within the territory of a Member State, or in a third country provided that the third country (...) has signed an agreement with the home Member State of the manager of a qualifying venture capital fund and with each other Member State in which the units or shares of the qualifying venture capital fund are intended to be marketed to ensure that the third country fully complies with the standards laid down in Article 26 of the OECD Model Tax Convention and ensures an effective exchange of information in tax matters, including any multilateral tax agreements. In practice, it is difficult for to check whether these requirements are met.

As of today, coverage of such tax conventions in emerging countries (in Africa for instance) remain low. This requirement prevents therefore managers to adopt the EuSEF structure for some of their funds (e.g. microfinance or social development projects in emerging countries).

Please also bear in mind that the same constraint could also hinder development of ELTIFs (for instance, infrastructure projects in emerging countries). We would therefore urge the

commission to review such requirements and /or to strongly encourage /support acceleration in the signature of OECD Model Tax Convention in emerging countries where the need of funding of social and infrastructure projects is important.

**22) What changes to the regulatory framework that govern EuVECA or EuSEF investments (tax incentives, fiscal treatment of cross-border investments) would make EuVECA or EuSEF investments more attractive?**

In a fund context, it is of paramount importance that funds remain tax neutral.