

Opinion of the European Economic and Social Committee on the 'Proposal for a Regulation of the European Parliament and of the Council on European Venture Capital Funds'

COM(2011) 860 final — 2011/0417 (COD)

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On 20 and 17 January 2012 respectively, the Council and the European Parliament decided to consult the European Economic and Social Committee, under Article 114 of the Treaty on the Functioning of the European Union, on the

Proposal for a Regulation of the European Parliament and of the Council on European Venture Capital Funds

COM(2011) 860 final — 2011/0417 (COD).

The Section for the Single Market, Production and Consumption, which was responsible for preparing the Committee's work on the subject, adopted its opinion on 17 April 2012.

At its 480th plenary session, held on 25 and 26 April 2012 (meeting of 26 April), the European Economic and Social Committee adopted the following opinion by 131 votes to two, with five abstentions:

1. Conclusions and recommendations

1.1 The EESC welcomes the Regulation on European Venture capital funds which proposes the establishment of a Europe-wide legal investment vehicle using a single passport to help European venture capital funds attract international investors and to facilitate access to finance by innovative SMEs. The regulation establishes uniform rules on the categories of investors, uniform requirements for the managers of collective undertakings that operate under the designation 'European Venture Capital Fund'; requirements as to the investment portfolio, investments techniques and eligible undertakings that a qualified venture capital fund may target.

1.2 The initiative comes in response to the objectives of the overall Europe 2020 strategy and the Single Market Act, to ensure that by 2012 venture capital funds established in any Member State can invest freely throughout the EU, and finance innovative EU companies and job creation in sustainable way.

1.3 The Regulation on European Venture Capital Funds is aimed at attracting international private investors, including individuals, to invest in venture capital funds based in any EU country. It is very important as the European venture capital sector is over-dependent on public funding, with more than 50 % of funding provided by public contributions. The EESC thinks that public authorities should instead focus on creating a stable regulatory framework.

1.4 The regulation establishes uniform rules on the categories of investors that are considered eligible. The proposed measures must be more flexible and address the needs of private international investors so that they can conduct cross-border investments. The EESC thinks the measures should be attractive to non-European as well as

European investors if we want the pool of available capital for European SMEs to increase.

1.5 The European venture capital fund passport is very important, in the context of prudential regulations such as Basel III, CRDIV and Solvency, for major private providers of capital to the venture capital industry: banks, pension funds and insurance companies which limit their investments in innovative SMEs considered to be high risk assets.

1.6 The EESC particularly welcomes the planned role of European venture funds in supporting jobs creation in innovative, hi-tech European SMEs. The funds whose assets under management should not exceed a threshold of EUR 500m, must dedicate at least 70 % of their aggregate capital contributions directly to SMEs, and provide equity or quasi equity finance to SMEs.

1.7 The Committee is also satisfied with uniform requirements for registration of funds all over Europe and the EU-wide marketing passport, which should facilitate cross-border investments, as well as business compliance, organisational and ethics requirements for European fund managers.

1.8 However, the EESC draws attention to several limitations, which may weaken the anticipated impact such as limiting the scope of action of the qualifying venture fund, restricting it exclusively to investments in equity and quasi-equity instruments issued directly by an undertaking (e.g. new issue of shares or other forms of participation). The EESC proposes to broaden the proposed regulation to include shares or units of others EVCFs as well as funds of funds, which may increase the total amount of capital available to SME investments.

1.9 Such limitations exclude from the scope of the regulation the possibility that a so-called fund of funds may obtain the EU-wide passport.

1.10 The EESC draws attention to the fact that the single passport does not settle the issue of tax transparency of investment vehicles, which is crucial if venture capital or private equity investments are to be carried out effectively. The problem of cross-border tax obstacles in venture capital should be examined and solutions proposed.

1.11 The EESC emphasises that the essence of an effective investment vehicle is that it should enable different types of investor to carry out joint investments, while ensuring tax optimisation, especially as regards avoiding double taxation (at issue here is the tax paid on the portfolio investment and tax on the distribution of funds back to investors in the fund).

1.12 The EESC asks for a transitional period relating to the implementation of the threshold requirements, in order to take into account different levels of income in different EU Member States.

1.13 The EESC considers that European venture capital funds should be a closed-end structure that invests at least 70 % of its aggregate capital contributions and uncalled committed capital in assets that are qualifying investments in order to ensure that their shares are not redeemable for cash or securities until they liquidate. Furthermore, European venture capital funds should be located in the European Union, as a means to prevent the establishment of funds managed by an EU manager in tax heavens for tax avoidance purposes.

1.14 The protection scheme of investors should be strengthened by the appointment of a depositary, which is responsible for ensuring the safe-keeping of assets, the monitoring of the cash flow and the oversight functions. The UCITS directive requires the appointment of a depositary for collective investment undertakings.

1.15 The EESC wishes to draw attention to the particular significance of developing use of EU funds for the venture capital market and the availability of financing for businesses in the seed and start-up phase, which are not financed by private capital on account of the level of risk involved.

1.16 The regulation's proposal to introduce a European venture capital fund passport is a step in the right direction; this proposal should be completed and fostered in order to avoid an impact that is disproportionately small compared to expectations.

2. The venture capital and private equity market in Europe

2.1 The proposed regulation of the European Parliament and of the Council was drawn up in the context of a specific assessment. The document describes the venture capital market in Europe as being weak in comparison with the

American market. The European market is significantly smaller, fragmented into a series of national markets and characterised by a lack of uniform rules. Only a few Member States have special venture capital fund regimes, with rules on portfolio composition, investment techniques and eligible investment target. This means that for capital providers such as individual clients, pension funds and insurance companies, directing investment towards venture capital is difficult and costly.

2.2 Traditionally British fund managers have raised and invested the largest share of European capital in the venture and private equity sector. The British systematically managed to raise some 30 % of funds from the market for new investments, and in 2009 they managed to raise 34 %. At the peak of the winning streak in 2007, British fund managers invested EUR 34bn, accounting for 46 % of all European investments. In the crisis year of 2009, this figure was EUR 9bn, representing almost 40 % of the market. In terms of investment, only 52 % of the EUR 9bn invested went to British firms, while most of the remaining capital was exported to other European countries.

2.3 The other main players in the European market are the biggest economies on the old continent, namely France, Germany and Italy. Their position on the market is stable; in 2009 these three countries raised some 31 % of all new capital and invested EUR 6.7bn, amounting to some 29 % of all investments. In their case, most funds are raised on national markets and remain in the country in the form of investment, which, as in the case of Italy and Germany in 2009, are supplemented by imported capital.

2.4 Major changes have also occurred in the structure of capital providers. In 2008, the main source of capital was pension funds (28 %), while the importance of banks had been gradually declining (22 % in 2000 and 7 % in 2008). In 2009, this trend was reversed and the share of banks increased to 18 %. These shifts were the result of a sudden suspension of the flow of resources from the pension fund sector, which was seeking to limit its exposure to risky assets.

2.5 An indicator of the scale of the difficulty linked to raising funds is the time required by fund managers for the final closing of a fund (i.e. to gather a notional group of investors). Between 2005 and 2007, on average no more than one year was required for this. By 2009, this process was taking 18 months, and by the first half of 2010 the figure was 20 months.

2.6 For a number of years, there has been a clear downward trend in venture capital investment in Europe: in 2009 venture investments amounted to EUR 9bn, but investments in businesses in the seed and start-up phase were only EUR 2bn. In the first three quarters of 2010, investment amounted to EUR 7 bn.

2.7 A key consequence of lower investment was the drop in the average value of investments in a single enterprise from EUR 8.8m in 2008 to EUR 4.7m one year later. Data from the first half of 2010 show that this amount subsequently increased to EUR 7.9m.

2.8 Investments are focussed on 5 sectors: in 2009 and 2010, 19 % of investments went to the sector for goods and services for business, 13 % to consumer goods, the retail trade sector and telecommunications, and 15 % was invested in the life science sector. In the case of venture capital, 65 % of investments went to the life science sector, the IT sector and the electronics and telecommunications sector.

3. Overview of the EC proposal

3.1 As a consequence of the financial crisis of 2008 and 2009, and new prudential requirements such as Basel III, CRDIV, and Solvency, the provision and extension of credit lines by banks to SMEs has decreased significantly. SMEs' search and demand for other alternative sources of finance has become pressing.

3.2 There is therefore a need to provide alternative sources of finance to SMEs. In this respect, venture capital funds can play a critical role in closing the funding gap for investment innovation. They provide equity or quasi equity funding to start-up firms and small businesses with perceived long-term growth potential, typically to finance their early market development. Contrary to private equity funds (which mainly focus on buyouts), venture capital funds invest in companies on a long-term basis, alongside entrepreneurs.

3.3 The European venture capital industry is fragmented and dispersed. This leads to a statistically significant investor's reluctance to invest in an venture capital fund (VCF). As a consequence of regulatory fragmentation, potential 'venture capital' investors such as wealthy individuals, pension funds or insurance companies find it difficult and costly to embark on channelling some of their investments toward venture capital.

3.4 The lack of financial resources that are currently directed towards venture capital is directly responsible for the sub-optimal size of the average European VCF. Venture capital, at this stage, plays a minor role in the financing of SMEs. The absence of an efficient venture capital sector leads to European innovators and innovative business ventures punching below their commercial potential. This, in turn, is negative for Europe's global competitiveness.

3.5 This significantly lowers investment potential, i.e. funds, and limits the flow of capital to small and medium-sized enterprises, especially innovative businesses. This in turn 'obliges' SMEs to be dependent on the banking sector. This situation is all the more difficult for SMEs given that, in light of new prudential regulations, banks have become significantly less inclined to finance small businesses in the early stages of their development, even innovative ones.

3.6 A thriving European venture capital market is an objective of the overall Europe 2020 Strategy. The European Commission committed in the Single Market Act ⁽¹⁾ (SMA) to ensure that by 2012 venture capital funds established in any Member State can raise capital and invest freely throughout the EU.

⁽¹⁾ http://ec.europa.eu/internal_market/smact/docs/20110413-communication_en.pdf 13 April 2011.

3.7 In its document of 7 December 2011, the Commission presented a proposal for a Regulation of the European Parliament and of the Council on European Venture Capital Funds. The gist of the proposal is the introduction in the European Economic Area of the possibility for venture capital funds to obtain so-called European fund status (passport), provided that they meet certain regulatory requirements. The passport would enable them to act freely and to raise funds in individual countries. It would ensure that investors enjoy basic security of investment, and for management companies it would lower the regulatory costs of access to individual categories of investors and markets.

3.8 The proposed Regulation addresses these problems by:

- introducing a definition of a 'European Venture Capital Fund', which includes the following essential requirements: (i) it dedicates at least 70 percent of its aggregate capital contributions to SMEs; (ii) it has assets under management in total that do not exceed a threshold of EUR 500 million; (iii) it provides equity or quasi-equity finance to these SMEs (i.e. 'fresh capital'); and (iv) it does not use leverage (i.e. the fund does not invest more capital than that committed by investors so is not indebted). Short-term borrowing should only be allowed to permit the fund to cover extraordinary liquidity needs;
- establishing uniform rules on the categories of investors that are considered as eligible to invest in 'European Venture Capital Funds'. The qualifying funds may only be marketed to investors recognised as professional investors in Directive 2004/39/EC and certain other traditional venture capital investors (such as high net-worth individuals or business angels);
- providing all managers of qualifying venture capital funds with uniform requirements for registration as well as a EU-wide marketing passport, which will allow access to eligible investors across the EU and help create a level playing field for all participants in the venture capital market;
- introducing minimum transparency, organisational and conduct of business requirements that must be complied with by the manager;

4. General and specific remarks

4.1 The proposal for a Regulation of the Parliament and the Council on European Venture Capital Funds forms part of regulatory efforts to create more favourable conditions for the way in which the venture capital market operates and to have a greater impact on SMEs. The EESC believes that this is a very good first step towards developing a European innovative and sustainable modern technologies industry, employing highly skilled, well educated European workers, acting in favour of job creation.

4.2 The EESC emphasises that the essence of an effective investment vehicle is that it should enable different types of investor to carry out joint investments, while ensuring tax optimisation, especially as regards avoiding double taxation (at issue here is the tax paid on the portfolio investment and tax on the distribution of funds back to investors in the fund). It seems that the lack of a reference to the issue of tax transparency means that there will be limited interest in the passport.

4.3 Helping institutional investors gain access to the venture market may be achieved significantly more quickly and more easily by using the fund of funds mechanism, where a significant dispersal of risk is achieved at the level of portfolio investments. Funds of Funds provide a good way to invest in venture capital for institutional investors with small allocations for venture capital or to institutional investors who have not built extensive competence in direct fund investing. According to data from the EVCA, in 2009 funds of funds were responsible for some 13.5 % of new capital allocated to venture and private equity funds, whereas throughout the 2005-2009 period this was on average 14.1 % (at the same time funds of funds were the second biggest provider of capital after pension funds).

4.4 The EESC asks for a transitional period relating to the implementation of the threshold requirements, in order to take into account different levels of income in different EU Member States.

4.5 The EESC considers that European venture capital funds should be a closed-end structure that invests at least 70 % of its aggregate capital contributions and uncalled committed capital in assets that are qualifying investments in order to ensure that their shares are not redeemable for cash or securities until they liquidate. Furthermore, European venture capital funds should be located in the European Union, as a means to prevent the establishment of funds managed by an EU manager in tax heavens for tax avoidance purposes.

4.6 The protection scheme of investors should be strengthened by the appointment of a depositary, which is responsible for ensuring the safe-keeping of assets, the monitoring of the cash flow and the oversight functions. The UCITS directive requires the appointment of a depositary for collective investment undertakings. This principle has also been integrated in the AIFM directive. In order to ensure the continuity of the Community framework, a depositary should also be appointed for the EVCFs.

4.7 The new regulation does not solve the nominal weakness of the venture capital market. There are two phenomena governing the economics of investment funds: first, the dynamic growth of the pension funds sector has prompted systematic growth in the value of capital allocated to (venture, private equity) funds by investors. However the rules governing the breakdown of investment risk in the investment portfolio mean that the optimal venture fund portfolio comprises 8-12 companies. A smaller number of investments increases the risk of the portfolio, whereas a higher number raises the costs of monitoring the portfolio. The combined effect of the growing supply of capital and the rule on optimising the portfolio inevitably leads to a steady trend towards growth in the size of the funds which in turn necessitates an increase in the value of individual investments in the portfolio company. In the end, the growth in pensions savings (long-term savings) has triggered a shift in investment away from the venture sector towards private equity.

4.8 The second phenomenon is linked to the way in which fund managers are remunerated, i.e. paid a percentage of the value of the capital managed. Such a remuneration scheme means that the bigger the fund, the bigger the value of the remuneration. This means that for a given management group it is more profitable (!) to use a private equity fund (large) than a venture fund (small), where the investment risk is considerable higher, as are the management costs. These two phenomena mean that the venture market is becoming relatively weaker (growing more slowly), because capital is inclined to go to larger funds and investments, which at the same time may suit the interests of opportunistic fund managers.

4.9 The proposed regulation is unable to mitigate these two patterns, and the EESC invites the Commission to undertake further reflections in this respect.

4.10 Investments made by executives of a venture capital fund manager when investing in the qualifying venture capital funds that they manage, proving their involvement and responsibility, should be allowed.

4.11 The EESC supports Venture Capital Funds dedicated to information society technologies, energy efficiency and renewable energy sources that can contribute to achieving the goals of the overall Europe 2020 Strategy.

4.12 The EESC welcomes the initiative to confer the power to adopt delegated acts on the Commission, and encourages the Commission to continue monitoring developments and evolutions of the Venture Capital Market.

Brussels, 26 April 2012.

The President
of the European Economic and Social Committee
Staffan NILSSON