MEMO/11/880

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Commission proposal on venture capital for small- and medium-sized enterprises (SMEs) - Frequently Asked Questions

1. What is venture capital?

Venture capital mainly comprises equity finance, i.e. taking an ownership interest in a company by buying shares or other forms of participation in the company capital, which is invested at the early stages of innovative start-up companies. Economic studies show that young start-ups that benefit from equity investors fare better than those who have to rely on debt[1].

2. Why do we need venture capital? Can banks not provide capital to SMEs?

Although banks finance 75% of the real economy in Europe, it can be very difficult for companies, especially SMEs and start-ups to access funding from banks. According to the latest survey on access to finance published today by the European Commission and the European Central Bank (see MEMO/11/879), access to appropriate sources of finance continues to be one of the most significant constraints for small businesses stifling their potential for growth.

As a result of the crisis, the situation has got even worse. According to the Commission/ECB survey, out of the SMEs who applied for bank loans over the last six months, 11% were rejected, 4% were refused because of high costs and 17% received less than they applied for. This means that one out of three businesses did not get the finance they had planned for. In addition, according to the October 2011 Bank Lending Survey (BLS) of the European Central Bank (ECB)[2], the overall net tightening of credit standards by euro area banks increased significantly in the third quarter of 2011. In particular, the net tightening of credit standards on loans to SMEs rose from 3% in the second quarter of 2011 to 14% in the third quarter. This further tightening has been ongoing since the second half of 2010.

As loans are not always easy to access, venture capital offers an alternative source of finance which allows SMEs to invest and grow.

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[1] Some of the sources:

- Venture Capital: policy lessons from the VICO project, September 30, 2011, www.vicoproject.org
- A. Robb and R. Seamans, 2011. Entrepreneurial Finance and Performance: A Transaction Cost Economics Approach
- Survey on the economic and social impact of venture capital in Europe, European Private Equity and Venture Capital Associationa, Research Paper 2002 http://www.evca.eu/uploadedFiles/Home/Knowledge_Center/EVCA_Research/Economical_Impact/EconomicImpactofVentureCapital.pdf

[2] *The euro area bank lending survey*, ECB, October 2011.

3. How does venture capital work in practice?

Venture capital provides fresh capital to generally small and young companies. Often innovative start-ups, they have a strong growth potential, but at the same time have a business model with a high level of uncertainty.

Being the equity provider, venture capital accepts more risk than, for example, banks offering loans: creditors are expected to be paid before owners in case of company's failure. Since the success of a venture capital fund's investments is directly linked to the success of the underlying companies, venture capital firms (unlike traditional debt providers) usually provide important non-financial support to these companies including consultancy services, financial advice, marketing strategy, training, etc.

Venture capital can be supplied in a number of ways including public or regional organisations, banks, corporations and their affiliates. However, in Europe, the majority of venture capital investments come from independent venture capital investors.[3] Usually structured as funds, they pool capital from a number of investors in pursuit of a defined strategy. As such, they strive to diversify the individual investor's risks by investing into carefully selected portfolio companies. These funds are usually structured as limited partnerships with a limited lifespan, usually 10 years.

Companies such as Skype, WaveLight AG, Fimasys, PassivSystems, Aluwave, BMEYE, Interinfo, Energate, Fluxome and many others would not exist today without the funding and guidance provided during their early stages by venture capitalists supported by the Competitiveness and Innovation Framework Programme (CIP, 2007-2013) and its predecessor programme.[4] This highlights that venture capital funds and investors are particularly important for start-ups and innovative companies.

4. Do EU rules on venture capital exist already?

At this stage, there are no specific EU level rules that facilitate fund-raising by venture capital fund managers. Venture capital is much more developed in some countries than in others but only nine Member States have put in place dedicated rules for venture capital. The remaining 18 countries apply general rules on company or corporate law to venture capital funds.

As a result, there is limited cross-border fundraising activity of European venture capital funds. On average, the proportion of cross-border fundraising for all types of venture capital funds has for the last four years reached only 12% (€ 2.5 billion).

At European level, Undertakings for Collective Investment in Transferrable Securities (UCITS, see IP/10/869) rules aim to provide safe products for retail investors while the recently agreed rules on alternative investment fund managers (AIFMD, see MEMO/10/573 and MEMO/10/572) target systemic risk created by complex derivatives-based investment strategies.

As a result of AIFMD, all alternative investment fund managers, including managers of venture capital funds, whose aggregate assets under management exceed €500 million will, as of July 2013, need to seek authorisation from national supervisors in the area of securities markets. A manager authorised under AIFMD can market his funds across the EU.

[3] Venture capital: policy lessons from the VICO project, September 30, 2011, www.vicoproject.org

[4] http://ec.europa.eu/enterprise/flipbook/finance_for_europe_entrepreneurs/index.html ; http://ec.europa.eu/cip/

However, the AIFMD passport is not available to fund managers that operate beneath the threshold of the AIFMD. Although, these managers can "opt-in" to the AIFMD, full compliance with all of the Directive's requirements is often more than a manager of a small venture capital fund can afford, both in terms of staff and technical resources.

5. What will today's proposal change? Main elements of the proposal:

Single Rulebook: Because of a diversity of rules per Member State, venture capital managers can face high costs and red tape in raising funds across the EU. The Commission's proposal is to simplify matters by governing the marketing of funds under the "European Venture Capital Funds" designation. Venture capital funds can earn this designation if they fulfil the following requirements:

1. It invests 70% of the capital committed by its sponsors into unlisted SMEs.
2. It provides equity or quasi-equity[5] to these SMEs.
3. It does not employ leverage (so it does not invest more capital than that committed by investors, so it is not indebted).

The home Member State regulator will only register funds that comply with the essential requirements of the framework. Once registered, the manager has access to the passport.

All funds that operate under this designation must abide by uniform rules and quality standards (including disclosure standards to investors and operational requirements) in raising funds.

Quality brand: The European Venture Capital Funds label acts as a "passport", allowing venture capitalists to market their funds across the EU and grow, while using a single set of rules. In addition, the common EU brand will make it much easier for investors throughout the EU to locate these funds. The uniform rules on venture capital investors will make sure that marketing can be tailor-made to the needs of these investor categories (such as high net-worth individuals or business angels).

Tailor-made regime: The AIFM Directive applies to funds above the threshold of €500 million, but its rules mainly target systemic risk created by complex derivatives-based instruments held by hedge funds and private equity firms. This is less suitable for typical venture capital funds. The Commission's proposal would give venture capital a regime that would be tailored to their size and interest, as well as to those of potential investors.

6. Why has the Commission chosen 70% of capital contributions as the threshold for the eligible funds portfolio?

In preparing the proposal, the Commission analysed various thresholds. A lower threshold, say 50%, would not really distinguish a European Venture Capital Fund from a private equity fund as in that scenario, 50% of the committed capital could potentially be used for private equity buyouts.

On the other hand, a 90% threshold would give the fund manager very little scope for prudent risk spreading – i.e. putting all eggs in one basket – or liquidity management. The 70% threshold is therefore a balanced approach between keeping a distinct, attractive profile investor confidence and risk spreading

[5] For example by providing an subordinated loan, which is an unsecured loan with a lower ranking in case of bankruptcy compared to senior debt (e.g. from banks).

7. Can the passport be withdrawn?

Yes, the home Member State regulator can withdraw the passport if the venture capital fund manager does not fulfil all of the above mentioned essential requirements.

8. Can the venture capital fund manager trade shares or other financial instruments?

The essential function of venture capital is to invest in equity that is directly issued by the start-up company. This is why the venture capital fund manager has to invest at least 70% of the capital received from investors into equity directly issued by SMEs. In order to enhance liquidity management and risk spreading, the fund manager is not subjected to any further limitation as to the use of the remaining 30% of the fund's capital commitments.

9. What happens once the assets managed by a venture capital fund exceed €500 million?

If the aggregate assets of a venture capital fund exceed €500 million, the manager will fall within the scope of the AIFMD and will have to seek a regular authorisation. According to the latest figures available from the European Private Equity and Venture Capital Association (EVCA), 98% of European venture capital fund managers manage a portfolio of funds that would be beneath the €500 million threshold set out in the AIFMD. Should venture capital funds become more successful in the future, the Commission will consider reviewing the €500 million threshold.

10. What happens if a manager manages both venture capital funds and other types of investment funds at the same time?

As long as the aggregate value of the assets managed in the venture capital funds does not exceed €500 million, the manager can get a passport under the new rules. The fact that he might also manage other investment funds does not count against the calculation of the venture capital threshold. Of course, the manager has to seek AIFMD authorisation if the assets managed in these other investment funds exceed €500 million.

11. Can everybody commit capital to a venture capital fund?

At this stage only professional investors and a group of traditional venture capital investors such as family offices[6] and angel investors[7] (a private investor who provides both finance and business expertise to an investee company) are eligible to invest in venture capital funds that will operate under the new rules. At a later stage, the rules may be reviewed in order to open venture capital investments to the general public.

Finally, a uniform framework for venture capital funds will channel more capital to innovative and high-growth potential companies.

[6] A private company that manages investments and trusts for a single wealthy family or multiple ones and provides services ranging from investment management and advice, accounting, tax and financial advice to educational planning or concierge services

[7] A private investor who provides both finance and business expertise to an investee company

12. How does venture capital work in other parts of the world?

The venture capital industry has its roots in the US. The US industry remains by far the largest and most mature, followed by Europe. However, the average European venture capital fund is small and far beneath the optimal size necessary for a diversified investment strategy to make a meaningful capital contribution to individual companies and thereby produce real impact. Currently, only 2% of all SME financing needs are met by venture capital in Europe compared to 14% in the US.

While the average venture capital fund in the European Union contains approximately €60 million, a U.S. counterpart has a fund size of €130 million on average.[8] Economic studies show that venture capital funds can make a real difference for the industries they invest in once their size reaches approximately € 280 million.[9] Furthermore, between 1999 and 2005, U.S. venture capital funds invested around €4 million on average in each company; whereas European funds could only muster investment volumes of €2 million on average per company.[10] Between 2003 and 2006, early-stage capital investments in the U.S. were on average €2.2 million per company while early-stage capital contributions in the EU were on average €400 000 per company.[11] Overall, the U.S. venture capital funds have consistently outperformed European ones.[12]

13. When will the new rules enter into force?

Today's proposals now pass to the European Parliament and the Council (Member States) for negotiation and adoption under the co-decision procedure. Once adopted, a regulation enters into force shortly after publication in the EU Official Journal.

More information:

http://ec.europa.eu/internal_market/investment/venture_capital_en.htm

[8] Ernst & Young, "Back to basics, Global venture capital insights and trends report 2010" and Josh Lerner, Yannis Pierrakis, Liam Collins and Albert Bravo Biosca, "Atlantic Drift - Venture Capital performance in the UK and the US, Research report June 2011, see Appendix 2: Tables,

[9] Josh Lerner, Yannis Pierrakis, Liam Collins and Albert Bravo Biosca, "Atlantic Drift - Venture Capital performance in the UK and the US, Research report June 2011, see section 4.1

[10] ibid

[11] K. Raade and C.T. Machado: Recent developments in the European private equity markets, Economic papers 319, April 2008

[12] ibid