

IMPACT OF THE PROPOSED AIFM DIRECTIVE ON VENTURE CAPITAL

Europe's venture capital industry has been a constructive and engaged stakeholder in the AIFM Directive process from the start, and accepts the principle of enhanced EU-level regulation for the industry. Our engagement has been focused on ensuring appropriate and proportionate rules, that do not unnecessarily harm access to finance for companies, while creating a European Single Market for this industry.

However, at this point in the process, the venture industry finds the evolution of the dialogue negotiations extremely concerning, specifically, but not exclusively, referring to the compromise proposals being produced by the European Commission which go beyond the Directive texts adopted by the Council and the European Parliament.

The industry believes that the specifics of venture capital are not being sufficiently taken into account, and as a result venture capital managers risk seeing themselves subjected to inappropriate, disproportionate and irrelevant rules with regards to their investment activities, which aim to support the creation, growth and development of companies in order to create long-term value.

This paper sets out the venture capital industry's main concerns regarding the proposed compromises and describes how some of the provisions therein could have unintended negative consequences for venture capital, SMEs and other innovative companies.

Lack of consistency

The venture industry believes there is a lack of consistency between some of the proposed AIFMD provisions and other initiatives of the European Commission in the field of SMEs, access to finance and facilitating cross-border investments.

For example, the EU Strategy 2020 identified making "an efficient European venture capital market a reality" as a priority to achieve and has put a lot emphasis on attracting institutional investors to fund innovation in Europe and facilitating cross-border investments.

Also the Competitiveness Council at the end of May 2010 recognised the importance of our industry. In its statement, the Council explicitly asked efforts to be devoted to "create favourable conditions to foster a growing and robust European venture capital market", and invited the Commission "to explore the need for improved cross-border venture capital investment acting especially in the early stages" and "to assess the effectiveness of technology-oriented exchange regulated markets, such as the Alternative Investment Market (AIM), in stimulating innovation and entrepreneurship in the EU", with such assessment paying particular attention to "the role they play in providing a source of capital funding for high growth companies".

Scope and Tailoring

Under the European Commission's latest compromise proposal, AIFM managing unleveraged AIF, without redemption rights during a period of five years, and with cumulative AIF under management of below EUR 500 million, would be exempted from the AIFM Directive. As such, they would not be able to benefit from the rights granted under Articles 33 and 34 unless they choose to opt-in under this Directive. Such an opt-in regime would mean compliance with the entire Directive.

The venture industry is against the European Commission's approach to introduce such a partial exemption, as it would deprive venture capital of a fair tailored regime and would lead to imposing even to small venture capital funds the full set of provisions foreseen for large hedge funds (full

depository, valuation and capital requirements) when they decide to opt-in to benefit from the internal market passport.

A venture capital fund investing in early-stage businesses would face major outlay for entirely useless advisory services such as independent valuation and depository. Furthermore, capital requirements for venture funds and funds investing in SMEs that do not present any risks will just mean less money to be invested in European start-ups and SMEs.

The venture industry considers such an approach to be in significant contradiction with other European Commission initiatives in the field of SMEs and access to finance, and more broadly, with the objectives of the EU to support SMEs and to develop venture capital funding for young innovative companies.

Disclosure

Under the European Commission's latest compromise proposal, disclosure obligations would be triggered by an acquisition of 'control', rather than by acquisitions of 10%, 20% or 30% of the voting rights. Control would be defined as 50% of the voting rights in non-listed companies and 30% in listed companies. Companies with less than 250 employees and an annual turnover not exceeding EUR 50 million, and/or an annual balance sheet total not exceeding EUR 43 million (EU SME definition) would be exempt.

However, another compromise on portfolio company disclosure is circulating, which lowers the threshold for 'controlling influence' to 10% and would only exempt companies with less than 50 employees. Also the disclosure requirements go a lot further than the Commission's proposed compromise.

The industry continues to believe that venture-backed portfolio companies should not be subject to more stringent requirements than any other issuer or non-listed company receiving private investment other than by an AIFM in order to ensure a level playing field.

The disclosure requirements are discriminatory and would shatter the level-playing field for vulnerable, high-potential businesses, placing them at a disadvantage to competitors. This is particularly disadvantageous for later-stage venture-backed businesses that very often face fierce competition from much larger rivals, capable of exploiting innovative ideas and ultimately damaging value and exit opportunities.

Obliging venture-backed companies to disclose board-level, commercially-sensitive information without any reference to a level playing field or company law, puts a particular onerous burden on them in terms of both a competitive and an administrative capacity, rendering it unattractive to entrepreneurs to use venture capital as a means to fund growth.

Furthermore, several proposed disclosure requirements imply a major change to EU social law, and contradict principles and provisions of European and national company law.

The venture industry would like to stress the importance of reasonable disclosure requirements, both with regards to the content and to the types of companies they apply to. EU legislators are responsible for the full economy and must take their responsibility by avoiding undue burden for SMEs.

Finally, the industry would like to reiterate that for non-listed companies, controlling influence is reached when 50% or more of the voting rights is secured, and that it is inappropriate to apply to non-listed entities thresholds that are defined for quoted companies (10%, 20%, 30% or 50%) where shareholding is usually spread across a large number of investors.

Capital adequacy in target companies

While the venture industry recognizes the need to ensure a correct application of the Second Company Law Directive which protects companies and their liquidity, it is extremely concerned about the proposal for a fixed duration of investment in a company (lock-in period).

Not only would this affect the level playing field between investors, but it will also eliminate the opportunity of entrepreneurs and SMEs to raise venture capital over a number of funding rounds, thus calibrating the amount of capital raised to the need of the company at any particular time of its development. Important late stage or pre-IPO funding rounds would become impossible under the suggested lock-in period.

Third countries

Venture capital is about raising money worldwide to invest locally. Around 60% of European venture capital funds come from outside the EU and we should not have these sources of finance put at risk by having our trading partners feel they are being treated unfairly.

There also continues to be a major risk for European institutional investor returns, if undue restrictions are imposed regarding their ability to invest in funds outside the EU.

Access of and to non-EU funds is important for the continuous supply of European companies with capital from outside Europe and for European investors and their asset allocation strategy.

The European economy cannot afford depriving its funds and companies of resources coming from cooperative third countries, nor preventing its investors from diversifying their risks by taking stakes in other regions of the world.

EU innovative companies need capital to grow and long-term shareholders which can commit themselves to their daily management with the determination to develop an effective corporate strategy. Therefore:

- It is key that the third country regime does not alienate Europe's major trading partners to take a defensive and protectionist stance on bilateral investment with Europe, at a time when such investments are badly needed in the wake of the financial crisis, as this would lead to inward investment into Europe's economies and SMEs being inhibited or slowed down.
- It is important that the third country rules do not damage the returns of Europe's pension funds and institutional investors, and do not restrict the freedom of European investors to invest in AIFs outside the EU, as that would threaten the competitiveness of the European venture capital industry vis-à-vis its North-American and Asian equivalents.