Submission

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CREATING LASTING VALUE

On behalf of the Public Affairs Executive (PAE) of the
EUROPEAN PRIVATE EQUITY AND VENTURE CAPITAL INDUSTRY

10 December 2014

To **European Securities and Markets Authority**

Re **Response to the Consultation Paper on ESMA's Technical Advice to the European Commission on the implementing measures of the Regulations on European Social Entrepreneurship Funds and European Venture Capital Funds**

Table of Contents

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Introduction

The Public Affairs Executive ('PAE') of the European Private Equity and Venture Capital industry welcomes the opportunity to respond to the ESMA Consultation on the Level 2 implementing measures of the Regulations on EuSEF and EuVECA (the 'Consultation').

For many years, the EVCA has been an engaged interlocutor with ESMA and other European institutions, following closely the different discussions and initiatives affecting the European private equity ('PE') and venture capital ('VC') industry. In particular, the EVCA has been a consistent and firm supporter of the EuVECA Regulation, believing it to be a valuable mechanism to facilitate cross-border fundraising and thereby to allow smaller fund managers to raise capital from experienced investors freely throughout the EU without having to meet the disproportionate costs of authorisation (and administrative burdens) under the Alternative Investment Fund Managers Directive (AIFMD).

We write on behalf of the representative national and supranational European private equity and venture capital ('PE/VC') bodies. Our members cover the whole investment spectrum, including the institutional investors investing in a broad range of PE/VC funds, as well as the PE/VC firms raising such funds and the venture capital arms of European corporates. Our members invest in the full life-cycle of unlisted companies, from high-growth technology start-ups, to the largest global buyout funds turning around and growing mature companies, and thus we speak on behalf of the entire European PE/VC industry, investors as well as managers.

In this response, we have focused solely on those aspects of the Consultation which are of particular importance to the private equity and, in particular, the venture capital industry. As such, we have provided answers to the section and questions dealing with the implementing measures for the EuVECA Regulation (Sections 3.1 to 3.5 and corresponding Questions 9 and 10), but not to those dealing with EuSEF managers.

We stand ready to provide whatever further contribution to this work ESMA might find helpful, including attending meetings and contributing further materials in writing.

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Consultation response

Before moving into the specific questions raised in the Consultation dealing with conflicts of interest for EuVECA managers, the EVCA would like to share some general and high-level comments we believe are worth considering and taking into account within the context of this Consultation.

1. An important point is the **principle of proportionality**, i.e. the fact that policies must be appropriate to the size and organisation of the EuVECA manager and the nature, scale and complexity of its business.

   This is recognised and referred to in paragraph 2 of the section dealing with 'Advice on the steps to identify, prevent, manage, monitor and disclose the conflicts of interest' (paragraph 36, page 19 of the Consultation):

   "Similarly to the case of EuSEF, the mandate of the Commission notes that EuVECAs are managed by entities below the threshold in Article 3(2) of the AIFMD, and are therefore simpler structures with less opportunity for confronting many of the conflicts of interest foreseen in Article 14 of the AIFMD and Articles 30 to 37 of the AIFMD Level 2 Regulation. Since the EuVECA qualifying portfolio undertakings are likely to be small in scale and therefore have limited resources, the Commission invites ESMA to take into account the principle of proportionality in the advice, and avoid being burdensome for both the qualifying portfolio undertakings and the EuVECA managers."

   This is a **critical point**, and it could be made even clearer and more explicit that the other points of the advice are to be applied in light and on the basis of this overarching principle.

2. More generally, the EVCA would like to stress that the approach should focus on **higher-level principles-based rules**, with detailed examples included for illustrative purposes.

3. Any Level 2 measures should be **principles-based, outcomes-focused and not unduly prescriptive** so as to avoid the imposition of disproportionate requirements on smaller delegates, or the imposition of requirements with which compliance is practically impossible. **If the final implementing measures are unduly restrictive, the EuVECA Regulation together with the tightening seen across Europe of the so-called private placement regimes risks further limiting access to equity financing for SMEs.**

4. Indeed, one of the main sources of equity financing for EU SMEs in their early stages of development (i.e. during that period when they have: outgrown the friends and family stage of financing; are not yet generating sufficient income to secure bank financing; but still cannot secure equity financing from the public markets through an IPO) are these very private equity and venture capital managers. These managers raise funds from investors like insurance companies, pension funds, family offices and foundations across Europe, and in some cases also globally, and channel such funds into these SMEs. They also provide the active ownership which these young companies need in order to professionalize their business out of the "garage-stage" (e.g. governance, management, operations, processes)

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and thus grow, expand and develop, but which most institutional investors are typically not themselves staffed to provide.

5. However, cross-border marketing by sub-threshold funds has, post-AIFMD, become increasingly difficult due to the tightening of the so-called national "private placement" rules. With the exception of a few Member States where rules have remained unchanged, sub-threshold funds are encountering obstacles in many jurisdictions where they want to register for marketing.

   For many sub-threshold funds, the EuVECA (and/or EuSEF) label(s) are (becoming) the only way they can market themselves across EU Member States. But many EU-based venture capital funds are already excluded from the EuVECA Regulation/label as it imposes a number of restrictions on, for example, what constitutes a qualifying investment (types of financial instrument that can be used and participation acquired) and what constitutes a qualifying portfolio company into which such qualifying investment is to be made (e.g. only SMEs as per the EU state aid definition – a maximum of 250 employees and either a turnover of maximum EUR 50 million or a balance sheet of maximum EUR 43 million).

6. If the intention is to develop a true single market for venture capital (thus facilitating growth, innovation as well as social inclusion across the EU), changes to the policy framework may be needed. While sub-threshold funds in theory of course could go to non-EU jurisdictions like the US, the Middle East and Asia to raise funds they are very unlikely to have the resources or capacity for this. For EU investors interested in committing capital to venture capital it pushes them to be more domestic-market oriented in their asset allocation, which is contrary to the goals of the EU single market and works against risk diversification.

Section 3 'Level 2 measures on conflicts of interest of EuVECA managers'

Q.9: Do you agree with the proposed approach?

7. As a starting point, the EVCA would like to stress that **it is inherent in the venture capital model that there are safeguards against conflicts of interest**. These safeguards have been developed over many years as a result of engagement between sophisticated and active institutional investors and managers seeking to raise capital. Features of the industry include co-investment by the manager or staff of the manager in investments, and profit sharing mechanisms and other conflicts management mechanisms negotiated with investors in the fund documentation. In particular, incentives and returns to the manager (and investment executives) are dependent on actual realised returns to investors, as opposed to notional accounting profits.

8. In addition, to ensure also on an ongoing basis that conflicts of interests are properly dealt with, it is typical that PE/VC funds operate an investor advisory committee (consisting of representatives of investors), the main purpose of which is to be consulted on, and to advise the manager on, all conflicts of interest. The role and remit of investor advisory committees are set out in a fund's constitutional document. Investor advisory committees have been a

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long-established feature of the PE/VC industry and were originally created for the very purpose of requiring the manager to refer all conflicts of interest to it, so enabling investors to be aware of and be consulted on such matters. Whilst we recognise that the regulatory exhortation is always to introduce structural measures to mitigate and manage conflicts such that they do not result in a material risk of damage to the interests of the fund or investors, some conflicts can only be managed through disclosure and informed consent.

9. **Conflicts issues are also a key focus for investors**. Conflicts of interest management is typically a topic for due diligence undertaken by or on behalf of potential investors. Where controls such as those described in paragraphs 7 and 8 above are missing, they are often negotiated into the fund terms by the investors as a condition of their investment.

10. Private equity and venture capital fund managers' conflicts management arrangements are very carefully negotiated by investors in the fund documentation. The fund documentation typically contains various **restrictions aimed at avoiding conflicts of interest** between the investors and the general partner/manager, e.g. ensuring that all co-investment is performed on a pro rata basis in all investments (i.e. that there is no cherry-picking) and restricting other investment activities and other business activities of key team members etc.

11. Against this background, the EVCA does not have any major concerns of principle with Section 3.3 'Proposed approach' and Section 3.4 'Advice on the Level 2 measures on conflicts of interest of EuVECA managers' of the Consultation.

12. However, there are a couple of **general concepts** we would like to highlight and we believe should continue to be taken into account for the further development and finalisation of the Technical Advice and the actual Implementing Measures:

    - There is a clear need to ensure that **different treatment of investors is acceptable** if there is an **objective** reason for it. In other words, treating investors *fairly* does not always necessarily require all investors to be treated *identically*. For example, some firms may have ERISA investors, US investors caught by "dealing with the enemy act" and/or other regulatory or legal constraints in their statutes, and these investors may for these reasons need to be treated differently from others. Also some public EU investors may require a different treatment (e.g. they need to be excluded from certain investments as a requirement of the mandates they have been given).

    - There should be **sufficient flexibility for each manager** to identify its own conflicts of interest and to determine its own conflicts of interest policies. Procedures to protect against conflicts of interest in the alternative investment sector **cannot be generalised**, but should be **tailored to different AIF business models**. Supervision under the EuVECA regime should provide fund managers with a sufficient level of discretion (within certain parameters) as to how to plan and constitute their conflicts of interest policies and processes.

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Specific text comments

13. We believe there is an incorrect reference in the ESMA Consultation paper. Page 21, point 6 refers to Article 14 of the EuVECA Regulation while we think it should rather refer to Article 13 as Article 13 deals with investor reporting and Article 14 with reporting to competent authorities in connection with registration. Point 6 should thus read as follows:

    "6. The EuVECA manager shall decide whether to include this disclosure in the information that it has to provide to investors in accordance with Article 13 of Regulation (EU) N. 345/2013, of 17 April 2013, on European Venture Capital Funds."

14. Point 7 on page 21 deals with voting rights:

    "The EuVECA manager shall develop adequate and effective strategies for determining when and how any voting rights held in the EuVECA portfolio are to be exercised, to the exclusive benefit of the EuVECA concerned and its investors.(...)"

    The EVCA would like to suggest that this provision may be **disproportionate** in the context, and will confuse some EuVECA managers and give rise to unnecessary cost of formalising voting policies. In the context of investment in a private small or medium sized enterprise, it is almost inconceivable that the EuVECA manager would manage two or more funds invested in the same company which did not have aligned interests. Venture capital firms will by definition exercise their voting rights in order to ensure that the strategy they invested in is followed. Any residual risk that this could happen would be addressed by the overarching obligation to identify, mitigate and manage conflicts of interest.

15. We believe there is an incorrect reference in point 8 on page 22, which refers to paragraph 6. We believe this reference should rather be to paragraph 7. Point 8 should thus read:

    "8. The EuVECA manager shall make available to the investors on demand a summary description of the strategies and details of the actions taken on the basis of the strategies referred to in paragraph 7."

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About the PAE

The Public Affairs Executive (PAE) consists of representatives from the venture capital, mid-market and large buyout parts of the private equity industry, as well as institutional investors and representatives of national private equity associations (NVCAs). The PAE represents the views of this industry in EU-level public affairs and aims to improve the understanding of its activities and its importance for the European economy.

About EVCA

The EVCA is the voice of European private equity.

Our membership covers the full range of private equity activity, from early-stage venture capital to the largest private equity firms, investors such as pension funds, insurance companies, fund-of-funds and family offices and associate members from related professions. We represent 650 member firms and 500 affiliate members.

The EVCA shapes the future direction of the industry, while promoting it to stakeholders such as entrepreneurs, business owners and employee representatives.

We explain private equity to the public and help shape public policy, so that our members can conduct their business effectively.

The EVCA is responsible for the industry's professional standards, demanding accountability, good governance and transparency from our members and spreading best practice through our training courses.

We have the facts when it comes to European private equity, thanks to our trusted and authoritative research and analysis.

The EVCA has 25 dedicated staff working in Brussels to make sure that our industry is heard.

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