



ADVICE TO ESMA

Securities and Markets Stakeholder Group –

Advice on Consultation Paper – Draft Technical Advice on the implementing measures of the Regulations on European Social Entrepreneurship Funds (EuSEF) and European Venture Capital Funds (EuVECA)

I. Executive summary

The objective of this paper is to provide high level advice to ESMA on the Consultation Paper – Draft Technical Advice on the implementing measures of the Regulations 346/2013 on European Social Entrepreneurship Funds (EuSEF) and 345/2013 on European Venture Capital Funds (EuVECA). ESMA is required to provide such technical advice by 30 April 2015 to the European Commission as per their request on 27 May 2014.

The SMSG very much appreciates the opportunity to comment on this consultation paper. While the four areas of advice specifically addressed by the consultation paper are in themselves relatively straightforward and largely uncontroversial the SMSG would like to call ESMA's attention to the following general key considerations when finalizing its advice:

- While both the EuVECA and EuSEF regulations and hence registrations are voluntary and not mandatory they in many cases provide the only opportunity for EU-based smaller managers of qualifying venture capital and/or social entrepreneurship funds to market these funds cross-border to European professional and semi-professional¹ investors.
- One of the main sources of equity financing for EU SMEs in their early stages of development, i.e. before becoming eligible for listing on an SME growth market or other trading venue, but after they have outgrown the friends and family stage of financing (but without yet being “bankable” as they do not generate revenue) are managers of smaller private equity and venture capital funds as well as, more recently, social impact investment funds. These managers raise funds from insurance companies, pension funds, family offices, foundations etc. across Europe, in some cases also globally, and channel these funds as equity or shareholder loans into SMEs. In parallel these managers also provide the active ownership which these young companies need in order to develop from “garage-stage” to a more professional and investable company (better governance, stronger management, stronger operations, better processes), but which operational ownership service most institutional investors are typically not themselves staffed to provide.

¹ The definition of semi-professional investor varies somewhat across the Member States but may typically encompass investing at least 100,000 EUR and signing a statement acknowledging awareness of risks involved in this type of investment.

- The sector for social investment is still emerging in Europe and lags some 30 years behind the venture capital sector in development, depth, width and maturity. Hence the importance of the Level II rules being supportive and sufficiently flexible as the sector develops, adapts and grows while catering to the EU Social Business Agenda for inclusive growth.
- As mentioned also by ESMA in its advice proportionality is important. For an absolute majority of these managers it is not an option to opt into the full AIFMD authorization in order to obtain the EU-marketing passport due to the resources required and costs involved.
- As underlined also by the current push to a Capital Markets Union and focus on encouraging market (i.e. equity) financing it is imperative to get the regimes for these new labelled vehicles right. Hence the SMSG strongly advocates a principle based approach for these Level II implementing measures. Examples provided should be viewed only as examples, ideally Annexed for ease of ongoing update, leaving sufficient flexibility and proportionality for the market to find its “level” in terms of how these funds are constituted and how they constitute their portfolios.
- As some managers have already been registered under the EuVECA and EuSEF labels and are operating in accordance with their respective current parameters, the SMSG advises ESMA to put in place so called grandfathering provisions for such registered managers.

II. Introduction

1. On 26 September 2014 ESMA published a discussion paper in order to seek stakeholders’ views on the technical advice ESMA is required to provide by April 30, 2015 to the European Commission on the implementing measures of the Regulations 346/2013 on European Social Entrepreneurship Funds (EuSEF) and 345/2013 on European Venture Capital Funds (EuVECA).
2. The input from stakeholders will help ESMA in the development of the final technical advice to be drafted. ESMA has invited for comments on the consultation paper to be submitted until 10 December 2014.

III. General remarks

3. The introduction of the AIFMD (implemented since July 22, 2014) implies that all non-UCITS managers of funds (e.g. real estate, hedge, venture capital, private equity, social entrepreneurship, art, forests, wine etc) now have to be authorized² or registered in order to manage and market their funds across the EU, even if only to institutional investors.
4. Prior to the AIFMD, this type of fund offering/marketing by venture capital, private equity and social entrepreneurship fund managers was mainly done by following the national so called private placement

² Different thresholds apply to registered AIFMD managers. When the funds they manage are closed-ended and unleveraged (as is typical for venture capital, private equity and social entrepreneurship funds) and total less than 500 MEUR in assets under management (AUM) then such managers are only subject to registration. Otherwise the general threshold below which registration only applies is below 100 MEUR in AUM; most social investment fund managers manage far less than 100 MEUR – on average 13.8 MEUR.

rules – which are not rules in themselves, but rather the exemptions granted under the Prospectus Directive (limited numbers of qualified investors approached etc).

5. While the full AIFMD authorization also provides those managers with a so called EU-marketing passport, the smaller sub-threshold managers have to rely on these private placement regimes, or, if they qualify, can apply for the EuVECA or EuSEF registration and labels. In theory these managers can also subject themselves to a full AIFMD authorization by opting in, but for smaller fund managers the costs involved and administrative burdens imposed by the full AIFMD are disproportionate and unmanageable.
6. As many Member States have as a result of the national implementation of the AIFMD de facto tightened their private placement rules - basically closing their borders to smaller non-domestic funds - it is for example today, in many cases impossible for a Swedish venture capital fund manager to be able to market its fund to German institutional investors.
7. Many EU-based venture capital, private equity and social entrepreneurship funds are currently excluded from being able to use the EuVECA and EuSEF regulations/labels as already the Level 1 text imposes a number of restrictions on e.g. what constitutes a qualifying investment (types of financial instruments that can be used and % of company 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 – max 250 employees and either turnover of max 50 MEUR or a balance sheet of max 43 MEUR).
8. One of the main sources of equity financing for European small and medium sized companies (as per the SMSG definition in our SME financing paper (ESMA 2012 SMSG 59)) in their early stages of development, i.e. before becoming eligible for listing on an SME growth market or other trading venue, but after they have outgrown the friends and family stage of financing (but without yet being “bankable” as they do not generate revenue) are managers of smaller private equity and venture capital funds as well as, more recently, social impact investment funds.
9. These managers raise funds from insurance companies, pension funds, family offices, foundations etc across Europe, in some cases also globally, and channel these funds as equity or shareholder loans into these SMEs. In parallel these managers also provide the active ownership which these young companies need in order to develop from “garage-stage” to a more professional and investable company (better governance, stronger management, stronger operations, better processes), but which operational ownership service most institutional investors are typically not themselves staffed to provide.
10. Neither the US-originated Amazon, Google and Facebook; nor the EU-originated MySQL, Spotify and Skype, would be where they are today without the “intelligent and patient capital” provided to them along the way by different venture capital funds and their managers.
11. Investments into young and growing companies need to be flexible and catered to the needs of these companies, their capital providers and founding entrepreneurs, be they social or not. Too many limitations on what constitutes “qualifying” or not (and especially where investment is not necessarily linked to specific tax incentives offered), and which then in turn makes cross-border fund-raising difficult or even impossible is not in the interest of the EU nor the SMSG when promoting the single market, the financing of SMEs to foster growth and innovation across Europe as well as social inclusion.

SMSGs Advice

12. In view of the above the SMSG strongly advocates a principle based approach for all of these Level II implementing measures. Examples provided should be viewed as examples only, ideally Annexed for ease of ongoing update, leaving sufficient flexibility and proportionality for the market to find its “level” in terms of how these funds are constituted and how they constitute their portfolios.
13. As mentioned also by ESMA in its advice proportionality is important. For an absolute majority of these small managers concerned it is not an option to opt into the full AIFMD authorization in order to obtain the EU-marketing passport due to the resources required and costs involved.
14. The sector for social investment is still emerging in Europe and lags some 30 years behind the venture capital sector in development, depth, width and maturity. Hence the importance of the Level II rules being supportive, rather than restrictive as the sector develops, adapts and grows while catering to the EU Social Business Agenda for inclusive growth.
15. While not part of this consultation the SMSG would also like to point out the importance of a harmonization of tax laws across the EU for the social impact investment market to become truly cross-border. This relates both to the fund vehicles as such being seen as tax transparent (i.e. avoiding double taxation of investors) irrespective of the domicile of the respective investors as well as of the investee into which investments are made. Differences in tax deductibility for investments into SMEs in general or social investments in particular and their importance for allocating funds to the sectors should be analyzed.
16. The SMSG also notes that while it is for investors investing their own funds, like family offices or HNI, is easier to take a holistic view on risk, financial return and societal impact and any potential trade-offs, for institutional investors like pension funds to generally be able to do the same will require changes to their fiduciary duty.
17. Acknowledging the general importance of transparency and harmonized reporting for attracting investors to an asset class, the SMSG is of the view, that in consideration of the different investment strategies sought by social impact investors and the broad range of causes being addressed, as long as the EuSEF manager follows a “general type of process” (i.e. the five step process recommended by the GECES), the pre-contractual information about the methodologies that a fund will use to measure inputs, outputs and outcomes (and where at all possible also impact) can remain general.
18. The SMSG would also like to draw ESMA’s attention to the fact that the EuSEF definition of a “qualifying portfolio undertaking” is narrower than the definition of a “social enterprise” as contained in the SBI.
19. The SMSG further believes it to be important that such EuSEF definition of “qualifying portfolio undertaking” does not exclude those companies engaged in preventive measures, i.e. not necessarily addressing the already marginalized, but to broader populations as addressing the issue before it becomes a problem is typically both cheaper and more effective.

Adopted on 10 December 2014

A handwritten signature in blue ink, consisting of several overlapping loops and a final horizontal stroke with a small arrowhead pointing to the right.

Jesper Lau Hansen
Chair
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