

An aerial photograph of a desert landscape, showing a series of parallel ridges and valleys. A bright yellow diagonal line cuts across the upper right portion of the image. On the left side, there is a vertical white bar composed of many thin, parallel lines of varying lengths, creating a textured, barcode-like appearance.

European venture capital  
and social entrepreneurship  
funds proposed



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# 1. Executive Summary



In December 2011, the European Commission issued two proposals to create new EU regulatory frameworks and labels (designations) for investment funds investing primarily in small and medium sized enterprises (SMEs):

- ▶ Regulation on European venture capital funds
- ▶ Regulation on European Social Entrepreneurship Funds

The proposed European regimes would be available to managers of collective investment undertakings (CIUs)<sup>1</sup> established in Europe falling below the Alternative Investment Fund Managers (AIFM) Directive €500 million threshold<sup>2</sup>, and which comply with a number of investment and organizational requirements.

They aim to build sustainable and innovative businesses in Europe through access to adequate funding by granting registered managers of such funds a passport so that they can efficiently raise funds cross-border in Europe. The passport would allow them to market qualifying European funds to suitably qualified investors throughout the EU from mid 2013 under the designations of respectively:

- ▶ “European venture capital fund”
- ▶ “European Social Entrepreneurship Fund” (EuSEF)

The two new regimes are voluntary. If a manager opts not to meet the requirements of one of the regimes and benefit from one of the passports, the Regulations do not apply and existing national rules and general EU rules continue to apply.

<sup>1</sup> Collective Investment Undertaking (CIU) means an undertaking which raises capital from a number of investors with a view to investing it in accordance with a defined investment policy for the benefit of those investors and which does not require authorization pursuant to the UCITS Directive (Directive 2009/65/EC).

<sup>2</sup> Article 3(2)(b) of Directive 2011/61/EU. Article 3 lays down the requirements to be met by managers of alternative investment funds whose assets under management do not meet the thresholds of the AIFM Directive.



## 2. Supporting venture capital and social business in Europe

Europe's 23 million SMEs provided 80 percent of all new jobs in Europe in the past five years and contribute significantly to European growth<sup>3</sup>.

However, compared to the US, venture capital currently plays a minor role in the financing of SMEs.

The objective of the European venture capital funds proposal is to unlock the potential for venture capital funds to finance SMEs and thereby support European growth.

Social businesses are a growing sector with substantial potential, already representing ten percent of all European businesses and employing over 11 million of paid employees<sup>4</sup>.

The objective of the EuSEF is to create a framework to stimulate investment in social businesses.

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<sup>3</sup> Source: European Commission.

<sup>4</sup> Idem.

### 3. Key provisions of the proposed regimes

Most of the provisions of the proposed regimes are similar, with the main exception of those on qualifying investments and some of the transparency requirements (particularly relating to the social impact of EuSEFs).

#### Qualifying European venture capital funds

Qualifying “European venture capital funds” are CIUs which invest at least 70% of their aggregate capital contributions and uncalled committed capital in “qualifying investments”. “Qualifying investments” include equity and quasi-equity instruments<sup>5</sup> which meet one of the following criteria:

- ▶ Issued by a qualifying portfolio undertaking and acquired directly by the qualifying venture capital fund from the qualifying portfolio undertaking
- ▶ Issued by a qualifying portfolio undertaking, or an undertaking which holds a majority stake in the qualifying portfolio undertaking acquired by the qualifying venture capital fund, in exchange for an equity instrument issued by the qualifying portfolio undertaking

A “qualifying portfolio undertaking” must, at the time of investment, be an SME - i.e., have less than 250 employees and must have either a turnover not exceeding €50 million or an annual balance sheet not exceeding €43 million. Furthermore, it must not be listed on a regulated market.

#### Qualifying European Social Entrepreneurship Funds

Qualifying EuSEFs are CIUs which invest at least 70% of their aggregate capital contributions and uncalled committed capital in “qualifying investments”. “Qualifying investments” go beyond equity and quasi equity instruments and include:

- ▶ Equity instruments which meet one of the following criteria:
  - ▶ Issued by a qualifying portfolio undertaking and acquired directly by the qualifying EuSEF from the qualifying portfolio undertaking
  - ▶ Issued by a qualifying portfolio undertaking, or an undertaking which holds a majority stake in the qualifying portfolio firm acquired by the qualifying EuSEF, in exchange for an equity instrument issued by the qualifying portfolio undertaking

- ▶ Securitized and un-securitized debt instruments issued by a qualifying portfolio undertaking
- ▶ Shares or units in one or several EuSEFs
- ▶ Medium to long-term loans granted to qualifying portfolio undertakings
- ▶ Any other type of participation in qualifying portfolio undertakings

A “qualifying portfolio undertaking” must, at the time of investment, be a small and mid-sized undertaking<sup>6</sup> (but not a CIU) which must not be listed on a regulated market. Furthermore it must meet all the following criteria:

- ▶ Have the achievement of measurable, positive social impacts as a primary objective in accordance with its articles of association, statutes or any other statutory document establishing the business, where either:
  - ▶ The undertaking provides services or goods to vulnerable or marginalized persons
  - ▶ The undertaking employs a method of production of goods or services that embodies its social objective
- ▶ Use its profits to achieve its primary objective instead of distributing profits and has in place predefined procedures and rules for any circumstances in which profits are distributed to shareholders and owners
- ▶ Be managed in an accountable and transparent way, in particular by involving workers, customers and stakeholders affected by its business activities

#### Use of leverage

The manager of the qualifying European fund must not employ any method to increase the exposure at the level of the fund, such as borrowing, issuing debt obligations, providing guarantees. As an exception, the fund may borrow a short period to provide liquidity between a capital call and receipt of committed capital from investors.

<sup>5</sup> Any instrument whose return is predominately based on profits or losses of the qualifying portfolio undertaking and which is unsecured in the event of default.

<sup>6</sup> i.e., an undertaking which either has an annual turnover not exceeding €50 million, or an annual balance sheet not exceeding €43 million. Note that the definition does not refer to any number of employees, and therefore qualifying portfolio undertakings do not have to be SMEs.

## Regulation of the manager

The manager of the qualifying European funds must be a legal person whose regular business is managing at least one qualifying European fund, established in the EU and subject to registration under the AIFM Directive<sup>7</sup>. The assets of the portfolios of qualifying European funds managed by the manager must not exceed €500 million. The manager may also manage funds other than qualifying European funds.

## Conduct of business

The managers of qualifying European funds are required to meet conduct of business requirements including:

- ▶ Act with due skill, care and diligence in conducting their activities
- ▶ Apply appropriate policies and procedures for preventing malpractices
- ▶ Conduct their business activities so as to promote the best interests of the qualifying European funds they manage, the investors in those qualifying European funds, and the integrity of the market
- ▶ Apply a high level of diligence in the selection and ongoing monitoring of investments in qualifying portfolio undertakings
- ▶ Possess adequate knowledge and understanding of the qualifying portfolio undertakings they invest in
- ▶ Identify and avoid conflicts of interest and, where they cannot be avoided, manage and monitor and disclose those conflicts of interest in order to prevent them from adversely affecting the interests of the qualifying European funds and their investors and to ensure that the qualifying European funds they manage are fairly treated
- ▶ Have sufficient own funds and employ adequate and appropriate human and technical resources
- ▶ In the case of EuSEF managers, employ, for each EuSEF, procedures to measure and monitor the extent to which the qualifying portfolio undertaking invested in by the EuSEF achieve the positive social impact that they are committed to.

## Eligible investors

The managers of qualifying European funds may market the units and shares of their qualifying European funds exclusively to investors who are professional clients<sup>8</sup> or who have requested to be treated as professional clients. They may also market to other investors where a number of conditions are met, including the following:

- ▶ The investor commits to invest a minimum of €100,000
- ▶ The investor has stated in writing, in a separate document from the contract to be concluded for the commitment to invest, that he/she is aware of the risks associated with the envisaged commitment or investment

- ▶ The qualifying European fund manager undertakes an assessment of the expertise, experience and knowledge of the investor and is reasonably assured, in light of the nature of the commitment or investment envisaged, that the investor is capable of making his/her own investment decisions and understanding the risks involved and that a commitment of this kind is appropriate for such an investor.

## Marketing

The managers of qualifying European funds wishing to use the respective designations - "European venture capital fund" and "European Social Entrepreneurship Fund" - to market their qualifying European funds are required to apply for registration with the competent authority of their home Member State. The application must include:

- ▶ The identity of the persons who effectively conduct the business of managing the qualifying European funds
- ▶ The identity of the qualifying European funds whose units or shares shall be marketed and their investment strategies
- ▶ Information on the arrangements made for complying with the requirements of the Regulation
- ▶ A list of Member States where the European funds manager intends to market each qualifying European fund.

When the competent authority of their home Member State grants registration, the registration provides the manager with a passport allowing it to market its qualifying European funds under the designation "European venture capital fund" or "European Social Entrepreneurship Fund" throughout the EU.

Immediately after the registration of a qualifying European fund manager, the competent authority of the manager's home Member State is required to notify this to Member States listed by the qualifying European fund manager in its application file as target countries for marketing.

## Transparency

The managers of qualifying European funds are, for each qualifying European fund required to:

- ▶ Provide investors with information before they invest including:
  - ▶ The identity of the manager and any other service providers, and a description of their duties
  - ▶ A description of the investment strategy and objectives of the qualifying European fund, including a description of the types of the qualifying portfolio undertakings and other assets in which the qualifying European fund may invest, the techniques it may employ, and any applicable investment restrictions

<sup>7</sup> Article 3(3)(a) of Directive 2011/61/EU.

<sup>8</sup> As defined in Section I of Annex II to the Markets in Financial Instruments (MiFID) Directive (Directive 2004/39/EC).

- ▶ In the case of EuSEFs:
  - ▶ The positive social impact being targeted by the investment policy of the EuSEF, including where relevant, projections of such outcomes, and information on past performance in this area
  - ▶ The methodologies to be used to measure social impacts
  - ▶ A description of the assets other than qualifying portfolio undertakings and the process and the criteria which are used for selecting these assets (other than cash or cash equivalents)
- ▶ A description of the risk profile of the qualifying European fund and any risks associated with the assets in which the fund may invest or investment techniques that may be employed
- ▶ A description of the qualifying European fund's valuation procedure and of the pricing methodology for the valuation of assets
- ▶ A description of how the remuneration of the manager is calculated
- ▶ A description of all fees, charges and expenses and of the maximum amounts thereof which are directly or indirectly borne by investors
- ▶ Where available, the historical performance
- ▶ In the case of EuSEFs: the business support services and the other support activities the EuSEF manager is providing or arranging in order to facilitate the development, growth or in some other respect of the qualifying portfolio undertakings, or, explanation of the fact that such services or activities are not provided
- ▶ A description of the procedures by which the qualifying European fund may change its investment strategy or investment policy, or both
- ▶ Make available an audited annual report to the competent authority no later than six months of the end of the financial

year, and make it available to investors on request. Minimum content requirements apply to EuSEF annual report, in so far as investments into social businesses raise specific transparency issues. Therefore the annual report of an EuSEF shall at least include:

- ▶ Details of the overall social outcomes achieved by the investment policy and the method used to measure these outcomes
- ▶ A statement of any divestments related to qualifying portfolio undertakings
- ▶ A description of whether divestments in relation to the other assets of the EuSEF which are not invested into qualifying portfolio undertakings, occurred on the basis of processes and criteria which are used for selecting such assets and which are disclosed to investors
- ▶ A summary of the activities the EuSEF has undertaken in relation to the qualifying portfolio undertakings in terms of business support services and other support activities

#### Application

The Regulations would be directly applicable in all EU Member States without national transposition. The Commission proposes that the Regulations apply from 22 July 2013, coinciding with the date of application of the AIFM Directive.

Member States are required to lay down effective, proportionate and dissuasive sanctions and administrative measures applicable to breaches of the provisions of the Regulations. Additional implementing ("level 2") measures and technical standards are also foreseen, clarifying some provisions.

## 4. Conclusion

Provided these proposed texts are adopted in a timely manner by the European institutions, these regimes would enter directly into force in all EU member states alongside the AIFM Directive.

We welcome the development of the proposed regimes which are complementary to the AIFM Directive. They will entitle smaller managers anywhere in Europe to opt-in to a regime providing them with a passport to raise capital across Europe based on a registration and subject to minimum regulatory requirements.

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