

To: European Commission

Luxembourg, 2 August 2011

Re: Consultation on a new European regime for Venture Capital (the “Consultation”)
ALFI lobbyist registration number: 6182372280-83

Introduction

ALFI and LPEA are pleased to provide a common response to the Consultation.

ALFI represents the Luxembourg investment management and fund industry. It counts among its membership asset management groups from various horizons and a large variety of service providers.

According to the latest CSSF (Commission de Surveillance du Secteur Financier) figures, on 31 May 2011, there are 3,749 undertakings for collective investment in Luxembourg (UCITS and non-UCITS), representing 13,186 active compartments and a total, in terms of net asset value (“NAV”), of EUR 2.219,208 billion.

In the non-UCITS fund arena, two types of fund are included in the CSSF statistics, namely the UCI Part II funds (619 funds, NAV EUR 212 billion) and the SIF funds (1,266 funds, NAV EUR 225 billion). While these funds do include significant numbers of the traditional alternative investment segments, namely hedge funds, private equity funds and real estate funds, Luxembourg also supports a wide variety of other investment strategies in its funds, including (but not limited to) microfinance, socially responsible investment, commodities, infrastructure, carbon credits, renewable energy, islamic finance, wine, art, timber, agriculture, distressed debt, shipping, aircraft leasing, etc. In addition, the SICAR venture capital/private equity regime and some non-regulated legal arrangements under Luxembourg corporate law may also partly fall under the scope of the AIFMD.

The LPEA represents the interests of all actors that shape or serve the PE value chain in Luxembourg, which include:

- fund managers of PE focused investment vehicles;
- institutional or non-institutional investors in PE;
- service providers to the PE industry.

The mission of LPEA is threefold:

- towards its members: represent and promote the interest of Private Equity and Venture Capital (“PE”) players based in Luxembourg;
- towards Luxembourg: support government and private initiatives to enhance the attractiveness of Luxembourg as an international hub for carrying out PE business and/or servicing the PE industry in all its dimensions;
- towards the EVCA and other relevant international PE industry bodies: represent the interests of the members of the LPEA and the industry as well as Luxembourg as a place of doing PE business.

We thank the European Commission for the opportunity to participate in this Consultation.

Response to the Consultation

We have carefully considered the questions raised in pages 7 to 17 (Box 1 to 14) and our responses are herewith attached.

Box 1

- a) Do you think that encouraging Member States to a process of mutual recognition of venture capital funds, based on the direct enforcement of the Treaty freedoms, could facilitate the cross-border activity of these funds?
- b) Do you believe that the main impediment preventing cross-border venture capital fundraising and investments is
- * the absence of a passport for activities under the AIFMD thresholds;
- or
- * the fact that the AIFMD is not tailored to venture capital in general?
- c) Is a targeted modification of AIFMD rules for venture capital or a standalone initiative in this area the more appropriate tool to increase venture capital activities? Please specify.
- d) From your experience, could you provide concrete examples where you encounter additional administrative or regulatory hurdles when raising or investing funds across the EU?
- e) Do you believe that an initiative on cross-border operations of venture capital could contribute to eliminating the cross-border tax problems encountered and if so, how?
- f) How could a possible passport for venture capital operators facilitate targeted tax incentives in favour of cross-border venture capital investments?

- a) **Do you think that encouraging Member States to a process of mutual recognition of venture capital funds, based on the direct enforcement of the Treaty freedoms, could facilitate the cross-border activity of these funds?**

This path has already been foreseen following the publication of the Expert Group Report on removing obstacles to cross-border investments by venture capital (VC) funds in March 2007. In the report, mutual recognition is mentioned as one possible solution to remove obstacles to cross-border investments by VC funds. However, four years later, it does not seem that this mutual recognition took place. Further, in 2009, the Commission services noted that this process had not yet contributed to a reduction of the fragmentation of the VC markets. Therefore, another route needs to be explored.

- b) **Do you believe that the main impediment preventing cross-border venture capital fundraising and investments is**
* **the absence of a passport for activities under the AIFMD thresholds; or**
* **the fact that the AIFMD is not tailored to venture capital in general?**

Generally speaking, the above mentioned Expert Group Report made it clear that the main issues for VC funds operating cross-border were related to the cost of structuring funds insofar that it would avoid permanent establishment in multiple jurisdictions, as well as the requirement to receive authorization in multiple jurisdictions, thereby increasing operating costs.

Extensive literature exists on the fact that AIFMD is not tailored to VC funds. In particular, no lighter regime that could apply to small and medium VC managers while granting them access to the passport for their funds under the AIFMD has been foreseen. The “opt-in” approach contained in the Directive would impose an excessive cost burden to VC funds and their managers. Gaining access to a passport under a lighter regime should nevertheless be welcomed by the industry as it will improve the access to funding even though it does not tackle the main issue identified by the Expert Group.

In any case, assessing the impact of the lack of a passport for activities under the AIFMD on cross-border fundraising and investment is currently not possible. This is due to the fact that the AIFMD passport will only become available to EU managers for their EU funds from the final date of the transposition period of the Level 1 Directive, i.e. in mid-2013.

- c) **Is a targeted modification of AIFMD rules for venture capital or a standalone initiative in this area the more appropriate tool to increase venture capital activities? Please specify.**

Increasing VC activities can be best achieved by designing a distinct regime for VC, which could be the topic of a separate piece of legislation. This approach would, in addition, give time to appropriately consult with various stakeholders without being caught by the AIFMD own deadlines.

d) From your experience, could you provide concrete examples where you encounter additional administrative or regulatory hurdles when raising or investing funds across the EU?

These issues have been extensively covered in the aforementioned Expert Group Report which clarifies that no single market for VC did exist in Europe, therefore making it unnecessarily complicated for VC funds to invest outside their home country. Some of the examples mentioned stress the need for separate registration or establishment in each Member State on the supply side, or the difficulty to access equity financing from innovative or high-growth funds on the demand side. The same applies to fundraising as a result of lack of aligned legal, regulatory and tax frameworks. ALFI/LPEA fully support these findings.

e) Do you believe that an initiative on cross-border operations of venture capital could contribute to eliminating the cross-border tax problems encountered and if so, how?

Answer to this question has been the subject of a second report on removing tax obstacles to cross-border Venture Capital Investments released in 2009. One of the main reasons identified for the EU VC market working below its potential was the lack of cohesion between the 27 tax systems across the EU which can lead to double taxation (Double Taxation Conventions may exist but often complex commercial structures used in VC are not always accommodated by such DTCs), tax treatment uncertainties (risk of creating a layer of taxation at the level of the management of the funds) and administrative obstacles. As a result, VC tends to be restricted to domestic markets rather than operating cross-border. The report specifically considered and proposed solutions to a number of taxation issues which arise where VC is operating cross-borders within the EU (for a summary, please refer to pages 2 and 3 of the report). ALFI/LPEA fully support these findings.

f) How could a possible passport for venture capital operators facilitate targeted tax incentives in favour of cross-border venture capital investments?

Please refer to e).

Box 2

- a) Do you agree with this approach? If not, what alternative approach would you suggest? Could you then briefly outline the pros and cons of such an alternative?
- b) Do you consider such a voluntary regime to have any major cost implications for the key stakeholders? (Investors, competent authorities, venture capital business). Please specify.
- c) Based on your experience, could you provide qualitative and/or quantitative assessment of potential cost savings that the European 'Passport' would bring about?
- d) What information should the manager provide to the competent authority?
- e) What option would you favour: registration with the national authority or with ESMA? Alternatively, ESMA could hold a European register of venture capital managers and funds with the information provided by national authorities. Would you favour this solution?

a) Do you agree with this approach? If not, what alternative approach would you suggest? Could you then briefly outline the pros and cons of such an alternative?

ALFI/LPEA welcome a voluntary registration regime for managers of Venture Capital investment structures (hereafter a “Manager”).

This regime should benefit any entity managing third party funds or companies, as well as to any internally-managed structures engaging in Venture Capital investments. To that effect, the concept of ‘internally-managed’ should also be recognised in the context of this regime.

b) Do you consider such a voluntary regime to have any major cost implications for the key stakeholders? (Investors, competent authorities, venture capital business). Please specify.

Costs involved will depend on the scope of requirements imposed on the Manager (please see item d) below). In consideration of the characteristics of the Venture Capital entities, these should be kept as limited as possible.

c) Based on your experience, could you provide qualitative and/or quantitative assessment of potential cost savings that the European 'Passport' would bring about?

Economies of scale may be achieved if Managers could freely distribute units across the European Union. In addition, a directive on Venture Capital may ease the development of an EU expertise which could prove beneficial to both, the industry and investors, as regards the costs incurred by the Managers and other actors involved, and thus indirectly by the investors.

As qualitative examples of cost savings, we can mention: a single set of requirements for registration and ongoing monitoring as well as simplified investment structures.

d) What information should the manager provide to the competent authority?

ALFI/LPEA take the position that the requirements should be focused on the reputation and the experience of the persons who effectively conduct the business of the Manager.

Managers would inform the competent authority of their home Member State (please see item e) below) on the structures under management.

Managers willing to benefit from the fundraising passport should provide the competent authority with internal organisational information (e.g. rules on conflicts of interest), and, to a lesser extent, with financial-related information. In this regard, initial capital or own funds requirements should not be imported as such from Directives 2009/65/EC or 2011/61/EU but rather be lowered.

**e) What option would you favour: registration with the national authority or with ESMA?
Alternatively, ESMA could hold a European register of venture capital managers and funds with
the information provided by national authorities. Would you favour this solution?**

ALFI/LPEA favour a registration with the authority of the home Member State of the Manager. Home Member State of the Manager means the Member State in which the Manager has its registered office.

The ESMA would consolidate a list of Managers duly approved by national authorities of the 27 Member States.

Box 3

a) Do you agree with this approach? If not, what alternative approach would you suggest?

b) What should be the content and timeframe of the notification?

Should the notification cover both, the places where the manager intends to invest in SMEs, and the places where it intends to raise funds?

c) Do you consider such a procedure to have any major cost implications for the key stakeholders? (Investors, competent authorities, venture capital business). Please specify.

a) Do you agree with this approach? If not, what alternative approach would you suggest?

We believe that this approach is consistent with the objective of this consultation to create a "light" system of regulation for VC funds.

Any notification regime to be implemented should foresee a single notification to the manager's home state supervisory authority as multiple notifications would in terms of cost and benefit outweigh any benefits to the VC market.

ALFI/LPEA thus suggest that any notification process be aligned as much as possible with the UCITS/AIFMD notification processes as multiple standards will create additional burden to industry stakeholders and regulators alike.

In addition, we believe that a register of VC Managers and the funds they manage at national and possibly at ESMA level (with feeds being provided by national regulators only) and accessible via the Internet, will meet the transparency requirement adequately.

b) What should be the content and timeframe of the notification?

Should the notification cover both, the places where the manager intends to invest in SMEs and the places where it intends to raise funds?

For an investor, SME, or local regulator, the main due diligence necessary when dealing with a VC Manager is to check that they comply with the European Regime, which can be ascertained by consulting the VC Manager's Home Member State national register or, if implemented, the proposed ESMA register.

For more in-depth due diligence, investors, who will be professional investors, will review the fund documentation with their legal advisors.

The aforementioned national and possibly ESMA registers should contain sufficient information to identify VC managers, their place of business, and the funds that they manage and should be updated as significant information changes.

Given that national and European Law does not generally require in advance disclosure of an intention to invest in SMEs in EU Member States, we cannot see why such a requirement should be introduced by the European VC regime.

The concerns which led to the inclusion of market exposure information in the AIFMD were related to systemic risk. By virtue of the limited size of VC funds, the SMEs that they invest in and the limited / absence of leverage in the financing models for this industry, systemic risk considerations are not relevant in this niche.

c) Do you consider such a procedure to have any major cost implications for the key stakeholders? (Investors, competent authorities, venture capital business). Please specify.

VC funds are typically distributed among a limited target audience of professional and high-net-worth investors, and even with a passport, VC funds are likely to target only a limited number of countries.

A requirement to notify other Member States in advance will create an administrative burden disproportionate to its benefits, at the level of the VC Fund Manager and national regulator. The costs of such administration will logically be passed on to investors.

However, the creation of a national or pan-European register accessible on the internet will provide interested parties with a cost-efficient means to check if VC Managers are registered, which should meet the aims of this initiative adequately.

Box 4

- a) Do you agree with this approach? If not, and in case you believe venture capital should be accessible to retail investors, what kind of measures would you recommend to ensure their protection?
- b) What are the restrictions (if any) on participation of retail investors in your country within the fund structures used for venture capital investments

a) Do you agree with this approach? If not, and in case you believe venture capital should be accessible to retail investors, what kind of measures would you recommend to ensure their protection?

Certain categories of individual investors should be authorised to invest in venture capital funds. Business angels, for instance, play a key role in venture capital and should be allowed to continue to invest in venture capital funds.

Under the AIFM Directive, all investors who are not professional investors within the meaning of the MiFID are considered as retail investors. Under MiFID, there are two categories of professional investors: per se professional investors and those who may opt up to professional investor status. Individuals (including high net-worth individuals) can only be considered as professional investors under the opt-up process. The opt-up process under the MiFID has clearly been drafted with the provision of the investment services in mind. It is unclear how this process would work to assess the eligibility of an investor willing to invest in a VC fund. One of the three criteria to be taken into consideration to assess the expertise and knowledge of a client/investor under this opt-up process is that the client/investor must have "carried-out transactions of significant size, on the relevant market, and at an average frequency of 10 per quarter over the previous four quarters". What "market" should be taken into consideration in the context of a proposed investment in a venture capital fund? Requesting that the client/investor has invested in at least 10 different venture capital funds (or non UCITS funds in general) per quarter over the previous four quarters would be completely disproportionate. The process also implies the obligation to give to investors that request to be treated as professional investors "a clear written warning of the protections and investor compensation rights they may lose". It is unclear what this would entail in the context of an investment in a fund.

In order to fully meet the EU policy goals it may not be appropriate to simply exclude all types of "retail" investors from the benefits of the contemplated new regime. "Business angels" should be able to continue to play their role and we do not see a good reason to exclude high net worth individual investors, experienced investors. Further alignment between investor interests and the persons conducting the investment activities must be permitted and hence such conducting persons should be able to invest themselves in the relevant vehicles.

Therefore an appropriate regime – and crucial for the industry - could be to permit access to institutional investors, professional investors (as defined under MiFID) and to such other investors who are in a position to meet a (high) minimum investment threshold and/or to provide independent and reliable assessment of their financial expertise. Moreover, such a flexible approach with regards the investors base would enable current practice whereby GPs

(i.e. The physical persons) are required to invest in the fund (at least in Europe) to continue. A strict application of MiFID would potentially make this impossible.

b) What are the restrictions (if any) on participation of retail investors in your country within the fund structures used for venture capital investments?

In Luxembourg, regulated Venture Capital funds can be established:

- as investment companies in risk capital (*sociétés d'investissement en capital à risque*, **SICARs**) subject to the law of 15 June 2004 on the SICAR, as amended (the **SICAR Law**); or
- as specialised investment funds (**SIFs**) subject to the law of 13 February 2007 on SIFs, as amended; or
- as undertakings for collective investment (**UCIs**) subject to part II of the law of 17 December 2010 on UCIs (the **UCI Law**) (**Part II UCIs**).

Shares or units issued by SICARs or SIFs are strictly reserved for investment by investors falling in any of the following three categories:

- (i) Institutional investors
- (ii) Professional investors within the meaning of MiFID
- (iii) Any other investor (including an individual investor) who:
 - (A) confirms in writing that he/she/it is a well-informed investor; and
 - (B) either:
 - invests (or commits to invest) a minimum of EUR125,000 in the SICAR/SIF; or
 - obtains a certificate delivered by a credit institution within the meaning of Directive 2006/48/EC, an investment firm within the meaning of Directive 2004/39/EC or a management company within the meaning of Directive 2001/107/EC certifying his/her/its expertise, experience and capacity to adequately appraise an investment in the SICAR/SIF.

The directors (*dirigeants*) and all other persons involved in the management of a SICAR/SIF may invest in the respective SICAR/SIF.

Box 5

- a) Do you agree with this approach? If not, what alternative approach would you suggest?
- b) Do you agree with the need to require an annual report for each fund?
- c) Do you agree that the annual report should reflect the annual financial accounts and a report of the activities of the financial year?
- d) Do you agree with the obligation to audit the financial information of the annual report?
- e) What reporting requirements/obligations exist within the fund structures used in your country for the purpose of venture capital investments? Would you consider that the proposed information requirements would constitute a significant administrative burden? Please specify.
- f) Do you think that more information requirements should be imposed on venture capital managers? If so, please specify

a) Do you agree with this approach?

Yes, overall, we agree with the proposed approach whereby VC managers would be subject to limited reporting requirements so as to avoid unnecessary burdens, and in any case to no such reporting requirements as those stipulated under the AIFMD. VC funds in particular – and even more so than PE funds – should not be required to disclose commercially sensitive information. The objective should be to provide the investors of the respective fund with sufficient reliable information so that they can follow the activities and financial performance of the fund, as well as compare such performance with other funds. Producing an annual report including the annual financial accounts and a report of the activities of the financial year for each fund would fulfill this objective.

Regarding who should be a recipient of that information, we believe that the distribution of the annual report and the report of activities should be restricted to the investors and to authorities.

It should however be noted that the applicable legislation in many European countries will oblige the venture capital funds to file annual accounts with the public company register. Such accounts might need to be established according to the local applicable GAAP that might be different from the fund's accounting rules used for the above accounts and might also require different disclosures. Consequently, the Commission should think about whether such local rules should be accommodated to the special needs of venture capital funds, as otherwise existing local requirement might jeopardize the objective of the Staff Working Paper of avoiding unnecessary reporting burden.

b) Do you agree with the need to require an annual report for each fund?

Yes, this is widely accepted as a minimum requirement in terms of governance and transparency to investors.

c) Do you agree that the annual report should reflect the annual financial accounts and a report of the activities of the financial year?

Yes. The report of activities should at least give a brief overview of the key financial metrics and key information regarding the evolution of business of all/the most important investee companies.

d) Do you agree with the obligation to audit the financial information of the annual report?

Yes, we agree; in order to provide investors with some basic confidence, we favor the fact that the financial information should be audited. Moreover, this is widely accepted as a minimum requirement in terms of governance and providing reliable information to investors.

e) What reporting requirements/obligations exist within the fund structures used in your country for the purpose of venture capital investments?

Private Equity funds set up under the forms of SICARs and SIFs are required to produce an annual audited report, which includes annual financial accounts and a report of the activities of the financial year and which is to be submitted to the regulator.

f) Would you consider that the proposed information requirements would constitute a significant administrative burden? Please specify.

In Luxembourg, required reporting obligations for VC funds are broadly in line with the above principles. One specific requirement is that investments are reported at Fair Value (SICAR, SIF). This makes the information provided to investors more transparent, more reliable, and better comparable. However, for VC funds, this requirement may seem less appropriate given the fair valuation models typically retained for VC investments which imply a high level of judgment and therefore potentially more uncertainty. Therefore, we would recommend that flexibility is maintained so that valuation principles can be defined in the fund rules agreed between the manager and the investors.

No other information requirements should be imposed on VC managers as they would not bring any additional relevant transparency element, while potentially cause substantial additional costs to be incurred.

Box 6

- Do you think there is a need to specify any operating condition for venture capital entities? If yes, what would you consider as sufficient EU level framework for venture capital managers in this area and what level of compliance cost would this entail?
- Do you think that it should be specified that venture capital entities should comply with rules of conduct when dealing with their investors? If yes, to what extent?
- Do you think that it should be specified that venture capital entities should comply with specific organisational requirements? If yes, to what extent?
- Do you think that it should be specified that the persons effectively conducting the business should have good repute and experience? If yes, to what extent?
- Do you think that it should be specified that the significant shareholders should be suitable? If yes, to what extent?

- **Do you think there is a need to specify any operating conditions for venture capital entities? If yes, what would you consider as sufficient EU level framework for venture capital managers in this area and what level of compliance costs would this entail?**

Operating conditions for venture capital entities should indeed be partly aligned with those applicable to AIFMs under the AIFM Directive. The following ones should especially be replicated:

- article 13 of the AIFM Directive;
- the identification, prevention, management and monitoring of conflict of interest set out under article 14 of the AIFM Directive.

On the contrary, the following should be adjusted to the more specific requirements applicable to venture capital funds:

- risk management processes;
- liquidity management processes. In this respect, one should note that these requirements are not applicable to unleveraged closed-ended alternative investment funds.

▪ Do you think that it should be specified that venture capital entities should comply with rules of conduct when dealing with their investors? If yes, to what extent?

Venture capital entities should comply with rules of conduct when dealing with their investors. Rules set out under article 12 of the AIFM Directive enable a high-level of investor's protection without binding venture capital managers in a way that would be detrimental to the effectiveness of decisions-making. In particular, venture capital entities should act honestly, with due skill, care and diligence, and fairly in conducting their activities. Further, they should act in the best interests of the fund or the investors of the fund they manage.

The reference to the integrity of the market in article 12 of the AIFM Directive would, however, be irrelevant for venture capital entities since they invest in unlisted companies. Their investment has thus no impact on the market and its integrity, especially when no leverage is used.

▪ Do you think that it should be specified that venture capital entities should comply with specific organizational requirements? If yes, to what extent?

Human and technical resources of venture capital entities should be appropriate and adequate for the proper management of the fund. We believe that the following requirements can be considered as appropriate and adequate in the context of venture capital entities: sound administrative and accounting procedures, control and safeguard arrangements for electronic data processing, and adequate internal control mechanisms including, in particular, rules for personal transactions by employees or for the holding or management of investments in order to invest on its own account.

▪ Do you think that it should be specified that the persons effectively conducting the business should have good reputation and experience? If yes, to what extent?

It is important that the persons effectively conducting the business of the venture capital entity have good reputation and experience especially in relation to the investment strategies pursued by the funds managed by the venture capital entity. The name of these persons, their track record, education, prior experience and proof of honorability should be communicated to the competent authorities. This will foster quality for venture capital European entities.

- **Do you think that it should be specified that the significant shareholders should be suitable? If yes, to what extent?**

Only the significant shareholders of the managers should be the object of this scrutiny.

Box 7

- a) Do you agree with this approach? If not, what alternative approach would you suggest?
- b) Is it convenient to specify in the legislative proposal the legal forms that the venture capital funds might adopt?
- c) Is there any other aspect relating to the legal form of the venture capital entities that the proposal should take into account?

a) Do you agree with this approach? If not what alternative approach would you suggest?

ALFI/LPEA supports the approach that managers shall be free to choose between the available legal regimes in the various Members States. The choice of legal forms will permit managers to choose the most appropriate legal or corporate forms available for legal, regulatory and tax purposes. Investor and manager preferences may vary. The tax treatment (i.e., transparent or opaque), as well as the legal structuring flexibility (i.e., corporate entity, partnership arrangement, trust or co-proprietor arrangement, etc...), are essential considerations and cannot be reduced to a single common denominator.

b) Is it convenient to specify in the legislative proposal the legal forms that the venture capital forms might adopt?

No, for the reasons mentioned under a) above, managers and investors should remain free to choose between all available corporate and legal forms or other arrangements, be they self-managed or externally managed.

c) Is there any other aspect relating to the legal form of the venture capital entities that the proposal should take into account?

No, this is already today dealt with and addressed in the available legal regimes and corporate/legal forms available in the Member States.

Box 8

- a) What, if any, investment criteria determine your existing national fund structures used for purposes of venture capital investments?
- b) Do you think it is worth specifying any investment rules for venture capital funds? If yes:
- c) Do you think there is a need to define a compulsory investment percentage of assets that the venture capital fund should invest in SMEs? If yes, what compulsory investment percentage would you propose and how should it be calculated?
- d) Do you agree with the need to envisage a flexible application of the principle described?

a) What, if any, investment criteria determine your existing national fund structures used for purposes of venture capital investments?

None of the existing venture capital structures in Luxembourg provide for any specific investment criteria, except for the following laid down in the SICAR law:

- Generally speaking, risk capital under the SICAR law is characterised by the concurrent gathering of two elements, namely a high risk and an intention to develop the target entities. The intention to develop the target entities is deemed to be inherent per se in the contribution of capital to entities in view of their launch or their listing on a stock exchange.
- The concept of “risk capital” notably refers to venture capital and private equity financings.
- Venture capital usually refers to capital contributed to newly launched undertakings (start-ups) or entities active in sectors with high development potential.
- The concept of private equity is to be construed in the broad sense. Private equity bears an inherent risk which is notably the risk due to lack of liquidity. It may be described, as opposed to listed securities, as an investment in a non-listed private company, often of a relatively limited size and a significant level of risk.

b) Do you think it is worth specifying any investment rules for venture capital funds? If yes:

As a general rule, investment focus and restrictions to be found in governing documents of (venture capital) funds are the result of one or more of the following: the market opportunity, the promoter’s (GPs) skills and track record, and negotiations between the GP and investors (LPs).

Experience has shown that setting additional investment rules by law or regulation (a) may lead to conflicts with typical investment situations that venture capital funds encounter, and (b) may not be entirely aligned with the objective of optimization of returns for the funds’ investors (whether public or private).

Consequently, it is ALFI’s and LPEA’s view that preferably investment rules should not be specified by law or other regulation.

c) Do you think there is a need to define a compulsory investment percentage of assets that the venture capital fund should invest in SMEs? If yes, what compulsory investment percentage would you propose and how should it be calculated?

See response under b). If, however, a compulsory SME investment percentage was to be considered, ALFI/LPEA are of the opinion that such threshold should be no higher than 50 % to a maximum of 2/3rd.

The basis for calculation should be “committed capital”, or - more adequately – “investable capital” (such amount to be calculated as commitment less (estimated) operating cost over the life of the fund).

d) Do you agree with the need to envisage a flexible application of the principle described?

See response under b) and c) above. ALFI/LPEA are of the opinion that flexibility is a key attribute and needs to be defined such that:

- The rules apply only at the time of initial investment;
- There are margins set for exceeding such thresholds;

Also, for completeness and further illustration, it should be ensured that:

- Venture capital funds can provide financing (whether seed or expansion capital) to SMEs independent of the capital structure of the targets;
- Expansion capital financing is possible, which may include financing of targets that are themselves above the SME thresholds, at least within certain limits (e.g. no more than x % above or that meet at least one of the criteria);
- Investments in non-EU SMEs (and non-SMEs) are possible;
- SMEs (and non-SMEs) qualify for investment independent of the target's age (i.e. years since incorporation);
- Buyout transactions shall be permitted, which means that either the fund will take a majority position and/or acquires a position through a secondary transaction, at least as part of a financing transaction.

Box 9

- a) How do your national rules capture (if at all) the definition of venture capital funds?
- b) Should the temporary nature of the venture capital investment activity in SMEs constitute a criterion that should be reflected?
- c) Do you think it should be specified any temporal limit (minimum and maximum) to the participation of the venture capital fund in the capital of the SME (i.e., from at least 2 to 10 years)?
- d) Are there any other means of finance that venture capital funds provide to SMEs that should be reflected (e.g. loans)?
- e) Do you think that there is a need to specify that the manager should be actively involved in the development, growth and success of the SME? Or should the passive investment in an SME also be considered by the proposal as venture capital investment?
- f) What other criteria would you consider appropriate to capture the venture capital activity?

a) How do your national rules capture (if at all) the definition of venture capital funds?

Venture capital is not explicitly defined by Luxembourg law. The law of 15 June relating to the Investment Company in Risk Capital (SICAR) defines risk capital as the “direct or indirect contribution of assets to entities in view of their launch, development or listing on a stock exchange. CSSF Circular 06/241 however gives further guidance on the notion of risk capital and indicates that it includes venture capital, understood as “the capital put at the disposal of newly launched undertakings (start-up) or those active in sectors with high development potential”.

For the purpose hereof, the concept of Venture Capital investments should refer to the investments in unlisted SMEs within the meaning of the Commission Recommendation 2003/361/EC in view of their launch and, or alternatively, their development whereas the bulk of capital invested be in the form of equity.

b) Should the temporary nature of the venture capital investment activity in SMEs constitute a criterion that should be reflected?

See answer c) below.

c) Do you think there should be specified any temporal limit (minimum and maximum) to the participation of the venture capital fund in the capital of the SME (i.e., from at least 2 to 10 years)?

As indicated in the Report of Expert Group on removing tax obstacles to cross-border Venture Capital Investments, the investment in a typical venture capital fund is generally done on a long-term basis, i.e. between 3 to 7 years. It is difficult to use such indication as a criterion because venture capital funds will have to be recognized as such before the criterion can be met. The nature (and quality) of investment activity should thus not depend on specific temporal limits that may prove hard to define. However, trading-related activities, as well as any type of investment whose return result from successive short-term profits, should be excluded.

d) Are there any other means of financing that venture capital funds provide to SMEs that should be reflected (e.g. loans)?

The venture capital industry often invests in companies through various instruments with a view to ensuring that returns will not be adversely impacted by taxation at the level of the investment vehicles. The investment will thus often take the form of an equity portion, together with quasi-equity contributions, loans, and even options. Defining venture capital by reference to specific securities will not properly encompass the various forms of venture capital investment.

e) Do you think that there is a need to specify that the manager should be actively involved in the development, growth and success of the SME? Or should the passive investment in an SME also be considered by the proposal as venture capital investment?

Venture capital funding is not a passive funding and holding activity but requires some form of further involvement by the VC fund in the target business. Whereas such involvement does not mean that the VC fund will run the business of the underlying target, the VC fund may play an important and active advisory, mentoring or consulting role.

f) What other criteria would you consider appropriate to capture the venture capital activity?

See answer 10 b) below.

Box 10

- a) To what extent does your national regime capture the above definitions of typical venture capital strategies?
- b) Do you agree that the special rules on venture capital should only apply where funds invest in the seed, start-up, or expansion stages of SMEs? If not, do you believe that SMEs in a restructuring phase should also benefit from venture capital? What other approaches would you suggest?
- c) Would you propose other definitions to define the permitted portfolio of venture capital funds?
- d) Do you agree that venture capital funds do not/should not use leverage?

a) To what extent does your national regime capture the above definitions of typical venture capital strategies?

These terms are all covered by the more general category of risk capital as defined by the CSSF circular 06/241. These are industry terms used to reflect certain commercial situations and are not terms defined by local law.

b) Do you agree that the special rules on venture capital should only apply where funds invest in the seed, start-up, or expansion stages of SMEs? If not, do you believe that SMEs in a restructuring phase should also benefit from venture capital? What other approaches would you suggest?

Limiting the application of the regime to investments in seed stage, start-up stage, and expansion stage may prove difficult and might greatly limit the usefulness of the special regime for venture capital funds. While the categories are generally recognized by the industry, their application in practice for legal purposes is often a challenge that may entail a lot of discussion undermining the legal certainty in the field. One may want to use a criterion that will more broadly meet the needs of the SMEs for their development and consisting of (i) the requirement that the investment be made initially to an SME, and of (ii) the condition that this investment aims at assisting in the development of the SME.

Limiting the regime to seed, start-up and expansion stages may result in funds having to avoid some investments that could be valuable to SMEs because they do not clearly fall within the reach of the definition of seed, start-up, and expansion stage. For example, excluding replacement capital may have an adverse effect since venture capital funds often provide replacement capital and expansion capital at the same time. The concept, resulting from State Aid prohibitions, is useful for the purpose of assessing the amount of State Aid being provided, but should not be kept for the purpose of assessing whether a transaction is a venture capital transaction or not.

c) Would you propose other definitions to define the permitted portfolio of venture capital funds?

As already suggested, venture capital cannot easily be defined by reference to certain transaction types as neither the context of venture capital investment, nor its form can be pre-defined. Investment activity does, for example, often involve a number of funding rounds in the

evolution of an SME and the nature of a fund's investment is always in flux. In practice, there is no clear delineation between the investment stages described by the consultation paper. Hence, it seems more logical to define venture capital investment to include all forms of capital investment in SMEs, thereby avoiding any risk of artificiality or distortion of investment activity in the SME sector. Such a definition would best address the funding problem highlighted by the Commission and would also be consistent with Section 2 of Chapter V of AIFMD (Article 26(2)).

d) Do you agree that venture capital funds do not/should not use leverage?

No, see answers 9 d) and 10 c) above.

Box 11

- a) Do you agree with the list of entities described as not being proper investment targets for venture capital funds?
- b) If not, what types of companies would you specify as eligible investment targets?
- c) Do you think that the EU should draw inspiration from the criteria set by the SEC to define the target companies of the venture capital funds?

a) Do you agree with the list of entities described as not being proper investment targets for venture capital funds?

Subject to any restrictions attaching to retail investors, all investment activity directly or indirectly targeted at SMEs (including, for example, through a fund of funds or a feeder fund) should be included in concept of venture capital in order to promote and diversify investment in this sector for the policy reasons set out by the Commission.

b) If not, what types of companies would you specify as eligible investment targets?

See answer a) above.

c) Do you think that the EU should draw inspiration from the criteria set by the SEC to define the target companies of the venture capital funds?

Only in very general terms; the venture capital industry is much more developed in the US than in Europe. Therefore, a European framework needs to provide appropriate flexibility to enhance the chances for similar success.

Box 12

What could be an appropriate regime for third country venture capital funds?

ALFI/LPEA fully agree that an open venture capital market will be beneficial and hence third country venture capital funds should not be barred access to the EU.

In this respect one must, however, distinguish between a third country venture capital fund's ability to invest in SMEs based in the EU and the ability to market units of a third country venture capital fund to investors within the EU.

The ability to invest in SMEs based in the EU cannot be restricted by the contemplated new EU legislation but is governed by existing supra-national legislation.

The ability to market units of third country venture capital funds should, for reasons of investor protection and level playing field considerations, be subject to appropriate equivalence tests, it being understood that such test should not apply with respect to genuine reverse solicitation.

Box 13

- a) Do you agree with this approach?
- b) Would you support the first (exemption for entities below the AIFMD threshold) or the second option (exemption independently from the threshold)? Would you suggest an alternative approach?
- c) Are there any particular elements from the AIFMD that in your view should also apply to the venture capital managers?

a) Do you agree with this approach?

We agree with the approach that managers that can benefit from the contemplated new regime should be exempted from the AIFMD.

b) Would you support the first (exemption for entities below the AIFMD threshold) or the second option (exemption independently from the threshold)? Would you suggest an alternative approach?

The most suitable solution appears, to us, to be a general opt-in possibility for any managers of venture capital funds investing in SMEs, regardless of whether they are or are not above the thresholds of the AIFMD (or otherwise out of the scope of application of the AIFMD). Should the opt-in be exercised, the relevant manager will, with respect to venture capital funds investing in SMEs, be exempted from the AIFMD. In cases where the opt-in is not exercised, the AIFMD will or will not apply as determined by the AIFMD itself.

To exempt only those managers, who are below the thresholds of the AIFMD, is not practical because such thresholds may be reached at a later stage.

To exempt all managers, regardless of whether or not the thresholds are reached and regardless of whether they have or have not opted into the contemplated new regime is not suitable. In such cases, either virtually all managers of venture capital funds investing in SMEs would have to fall under the contemplated new regime - which clearly is not appropriate -, or managers that otherwise would be caught by the AIFMD could simply escape both, the AIFMD and the contemplated new regime; this would be tantamount to a simple opt-out possibility from the AIFMD.

c) Are there any particular elements from the AIFMD that in your view should also apply to the venture capital managers?

While the contemplated new regime should be autonomous, requirements from the AIFMD relating to investor protection should be transferred from the AIFMD - with possible graduation in line with the general principle of proportionality though.

Box 14

- a) Do you agree with this approach? If not, what alternative approach would you suggest?
- b) What supervisory powers should be granted to the competent authorities for the supervision of venture capital funds and managers?
- c) What type of sanctions should be envisaged?

a) Do you agree with this approach? If not, what alternative approach would you suggest?

Yes. Based on the general trend towards increased transparency and regulation, it is absolutely imperative that a regime which aims at minimizing these obligations (as imposed by the AIFMD), is effectively implemented and supervised.

For this to be possible, competent authorities have to have the necessary powers to enforce the regulations as stipulated in the proposed regime. Effective regulation and monitoring will be aided by the empowerment of respective competent authorities to penalise parties, who do not comply with the regulations. The severity of such penalties should be based on the severity of the non-compliance.

b) What supervisory powers should be granted to the competent authorities for the supervision of venture capital funds and managers?

Supervisory powers in relation to the enforcement of the proposed Venture Capital Regime should be aligned with those powers Competent Authorities have for supervision of the AIFMD (refer Chapter IX of the AIFMD).

Again, considering the current environment, the introduction of a lighter regime for Venture Capital Funds should only result in a reduction of the obligations imposed, not in a weaker enforcement of the obligations that still apply.

c) What type of sanctions should be envisaged?

Sanctions should be aligned with the severity of the non-compliance. As mentioned in paragraph b), supervisory powers of Competent Authorities should be the same as those applied under the AIFMD, which can be found in Chapter IX of the AIFM.