

December 2016

## European venture capital and social entrepreneurship funds

*Impact Assessment (SWD (2016) 228, SWD (2016) 229 (summary)) of a Commission proposal for a regulation of the European Parliament and of the Council amending Regulation (EU) No 345/2013 on European venture capital funds and Regulation (EU) No 346/2013 on European social entrepreneurship funds (COM (2016) 461)*

### Background

This note seeks to provide an initial analysis of the strengths and weaknesses of the European Commission's [Impact Assessment](#) (IA) accompanying its proposal amending the 2013 regulations referred to above. The Commission's proposal was submitted on 14 July 2016 and has been referred to Parliament's Committee on Economic and Monetary Affairs (ECON). The original intention of the current regulations was to enhance the growth and innovation of small and medium-sized enterprises (SMEs) in the Union as well to enhance the growth of social undertakings in the Union. For this purpose, the co-legislators created two new investment fund frameworks – the European venture capital funds (EuVECA) and the European social entrepreneurship funds (EuSEF) – aimed at small fund managers, which would invest mainly in SMEs and social undertakings respectively. These investment funds can be marketed throughout the EU and benefit from a lighter regime than, for instance, the one granted by the Alternative Investment Fund Managers Directive (AIFMD). If the current proposal is adopted in its current form it would mean that, compared to today's situation, larger managers would also be able to market EuVECA and EuSEF funds and that all managers would have the possibility to invest in larger companies. Additional proposed changes and more details are outlined below. For further information on the legislative process, including Parliament's starting position and details on the Council's compromise text, please see the parallel European Parliamentary Research Service (EPRS)' [EU Legislation in Progress](#)<sup>1</sup> briefing on the proposal. For a complementary analysis of the Commission's review, stakeholder consultations and additional elements on the views of small businesses, please see the parallel EPRS [Implementation Appraisal](#)<sup>2</sup>

### Problem definition

According to Better Regulation principles, the logical starting point for a problem definition of an IA supporting a proposal amending two regulations would be to carry out a review of their operation. The table below shows that, under the existing legislation, the Commission was requested to conduct the review of the regulations in three steps, analysing: firstly, third countries' funds; secondly, a broad range of topics; and, finally, larger investment funds.

**Table 1: Overview of review clauses in the current EuVECA and EuSEF Regulations**

	Timing	What the Commission was obliged to conduct	Pursuant to
1	By 22 July 2015	Two reviews of the possibility of allowing: - venture capital funds established in a third country to	- Art. 26(1) point (h)

<sup>1</sup> Delivorias, Angelos 'Reviving risk capital: the proposal to amend EuVECA and EuSEF', EPRS, October 2016, PE 593.493.

<sup>2</sup> Malmersjö, Gertrud, 'European venture capital and social enterprise funds', EPRS, October 2016, PE 587.351.

	Timing	What the Commission was obliged to conduct	Pursuant to
		use the designation EuVECA; - social entrepreneurship funds established in a third country to use the designation EuSEF.	EuVECA - Art. 27(1) point (f) EuSEF
2	By 22 July 2017	Two general surveys of the functioning of the rules and the experience acquired in applying them on a broad range of points, from the use of the EuVECA and EuSEF designations to opening up the funds to retail investors (see relevant Articles for a full list).	- Art. 26(1) points (a) to (g), (i) and (j) EuVECA - Art. 27(1) points (a) to (e) and (g) to (m) EuSEF
3	Starting by 22 July 2017	Two reviews of the <i>interaction</i> between EuVECA / EuSEF Regulations and other rules, in particular the AIFMD, addressing the scope of the Regulation and in particular whether it is necessary to extend it to allow for larger managers to become managers of EuVECA and EuSEF funds.	- Art. 27 EuVECA - Art. 28 EuSEF

Source: EuVECA and EuSEF Regulations; author

The IA does not make any distinction of timing in its 'Annex 5 (review clauses of the EuVECA and EuSEF Regulations)'. It states that all the items, which are summarised and grouped together, must be reviewed by 22 July 2017 (IA, p. 75). However, this does not seem to correspond to the wording of the review clauses in the current legislation (Articles 26 and 27 in EuVECA; Articles 27 and 28 in EuSEF). The IA then states that 'the Commission has decided to accelerate the planned review of 2017' (IA, p. 44), which is annexed to the IA (IA, pp. 44-74). A preliminary analysis of the review and of the IA reveals that:

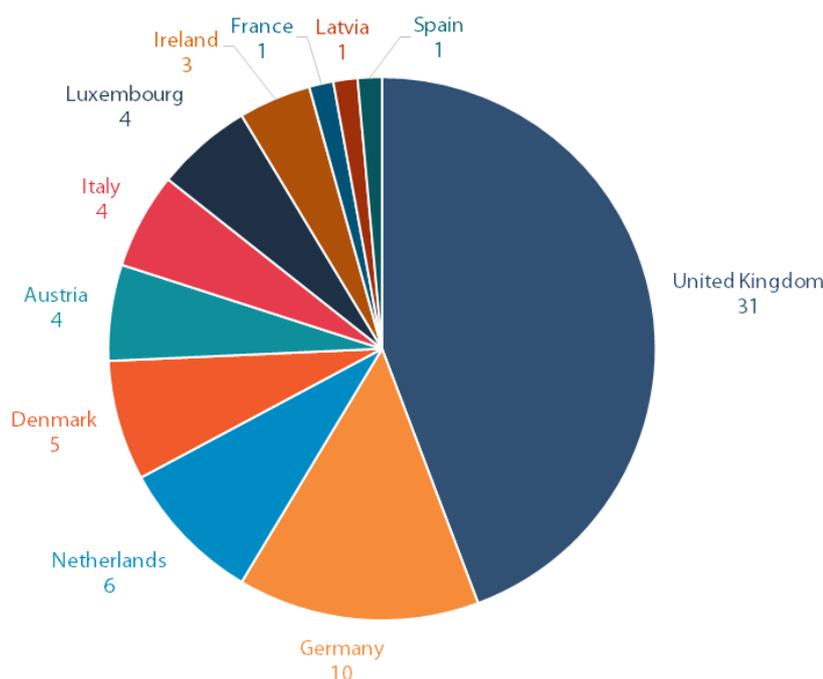
- The IA concludes that it is too early to open up the market to third countries' investment funds (see below under 'Relations with third countries' for more information).
- The review and the IA analysed some of the points listed under 2 above, such as the possible marketing to retail investors, and there are some data on the use of the EuVECA and EuSEF designations. However, neither the review nor the IA analysed in depth, for instance, the following points which are listed in the review clauses:
  - the geographical and sectoral distribution of investments undertaken by qualifying venture capital and qualifying social entrepreneurship funds: in the IA, there is a wealth of information and data on the broader venture capital funds industry in Europe, including the geographical distribution of investments, but these do not distinguish between EuVECA and non-EuVECA funds (e.g. IA, p. 129);
  - an examination of possible tax obstacles for social entrepreneurship funds and an assessment of possible tax incentives aimed at encouraging social entrepreneurship in the Union. The consultation feedback provides the opinions of some stakeholders on this issue (for instance, IA, p. 98); the IA states that tax issues are out of the scope of the analysis and that they will be dealt with by other initiatives.
- The Commission moved the analysis of the scope extension to larger managers from the review of the interaction with the AIFMD (under 3 above) to the earlier review, which is annexed to the IA (under 2 above). The IA states: 'the Commission has decided not to use the *possible option* of combining this review with the broader review of the Alternative Investment Fund Managers Directive (AIFMD) planned to start in 2017' (IA, p. 4, emphasis added). However, the review of the interaction between EuVECA/EuSEF on the one hand, and the AIFMD on the other, does not seem to be an option, but rather an obligation. According to Art. 27 of the EuVECA Regulation and Art. 28 of the EuSEF Regulation, it should have started only after the previous review on the functioning of the rules.

In short, the review does not seem to follow completely the rationale behind the review clauses in the current regulations, which wanted the Commission to analyse first third countries, then the functioning of the rules, and only at a later stage the possible opening up to larger managers.

Moving from the process to the content, the IA identifies two main problems in need of possible EU action: the 'low take-up and assets under management [that are] below expectations' (IA, p. 15) and the 'lack of cross-border business' (IA, p. 18). According to the Commission, these problems apply to both frameworks, but particularly to the EuSEF one. In examining the data provided to substantiate these two problems, the following observations can be made.

The Commission states that in April 2016 there were 70 EuVECA funds (IA, p. 16). As the EuVECA Regulation has applied since 22 July 2013, these funds were set up in the EU only in less than three years. In relative terms, looking at the broader venture capital industry, beyond EuVECA, the IA reports that between 2011 and the third quarter of 2015 (hence, a period of almost five years) there were 316 new venture capital funds in Europe, including Norway and Switzerland (IA, p. 39 and 118). In terms of expectations, the IA, referring to the previous 2011 IA accompanying the Commission proposal for the current regulations, states that 'EuVECA was targeted with raising [cross-border] €4.2 billion'. The IA does not provide data on cross-border capital raised and assets under management of EuVECA funds, stating that these data are not publicly available (IA, p. 16). However, the €4.2 billion target seemingly referred to a 'long-term stable scenario that can be achieved after *two decades* of relatively open cross-border capital markets' (2011 EuVECA IA<sup>3</sup>, pp. 60-61, emphasis added). In the short-term, which was not defined in more precise terms back in 2011, and might, therefore, have been more than three years, the target in the intermediate scenario was approximately €1 billion lower. The 2011 EuVECA IA went on to state that 'Progress [in boosting the average size of European venture capital funds] will necessarily be incremental and... will take several years to come to fruition.' (2011 EuVECA IA, p. 61). The 2011 IA recalled that the average life span of a venture capital fund is 10 years and used this time span to measure the increase in assets under management. Among the useful data provided in the 2016 IA is the list of EuVECA funds by home Member State. This list is summarised in the graph below and shows that the industry is still mainly based in a limited number of countries.

**Graph 1: EuVECA funds by home Member State**



Source: Commission IA (pp. 144-149) based on data as of April 2016; author

<sup>3</sup> SEC(2011), 1515

As far as EuSEF are concerned, the IA states that in April 2016 there were four EuSEF funds with total assets under management of €32 million, a result which is considered 'clearly... disappointing' (IA, p. 16). While the figures are lower than the ones provided for EuVECA, the IA also says that the size of the social investment market is estimated to be approximately 10 % of the size of the venture capital one (IA, p. 111). It also reports that social funds, beyond EuSEF, have on average €14 million of assets under management, compared with €70 million of assets under management for venture capital broadly speaking (IA, p. 23). Therefore, the two markets seem to be different and the EuSEF funds each have on average €8 million of assets under management after less than three years. The 2011 Commission IA on the proposal expected an increase in the potential investor base by at least 15 % to 18 %, by including wealthy individuals among the investors ([2011 EuSEF IA](#)<sup>4</sup>, p. 54). The present IA does not explain whether these targets have been met, but stakeholders stated that the inclusion of some retail clients is an incentive of the two regulations compared to the AIFMD (IA, p. 100).

In sum, it seems to be too early to evaluate the problems identified, and some relevant data referring specifically to EuSEF and EuVECA funds are missing. The need to push quickly for an even stronger support for EuVECA and EuSEF is stated, but leaves some unanswered questions. At first sight, it appears that different conclusions could be drawn using the same data provided in the IA.

Moving to the causes of the problems, the IA acknowledges that other factors, which are out of the scope of the analysis, play a major role in determining the success of these funds. These include tax incentives - which should have been analysed for EuSEF funds, according to the EuSEF review clauses - and an essential driver for demand, the 'propensity for investors to be more closely involved in early stage businesses and social ventures' (IA, p. 5).

The focus is therefore on issues which reflect the views expressed in the consultations: that is, the fact that larger managers are not allowed to run EuVECA and EuSEF; that managers of EuVECA must currently invest mainly in SMEs, and that non-professional investors must currently invest at least €100 000 in one fund. The IA devotes quite a lot of attention to the 'considerable total costs' of these funds (IA, p. 11) and provides some evidence in this regard. However, the IA gives less attention to the benefits. In the public consultation, views were evenly split on this point. Seven industry organisations considered that the costs relating to fund registration were proportionate to the potential benefits of marketing and managing funds across the EU, using what are known as 'passporting' rights, whereas seven other organisations took the opposite stance (IA, pp. 86-87). According to the IA, the cost issues appear to be related to divergences in the application of the rules among Member States, for instance on the interpretation of the 'sufficient own funds' which managers must hold, as well as on registration processes and administrative requirements.

## Objectives of the legislative proposal

The overall objective stated in the IA is to 'increase investments into venture capital and social enterprises via EuVECA and EuSEF funds' (IA, p. 21). There is, therefore, a shift compared to the declared purpose of the existing regulations, which was to enhance the growth and innovation of small and medium-sized enterprises (SMEs) in the Union, as well to enhance the growth of social undertakings in the Union (respectively recital 13 of EuVECA Regulation and recital 16 of EuSEF Regulation). As the IA notes that, after just three years, it is still too early to judge whether the objectives of the regulations have been met (IA, p. 10), it might perhaps have been appropriate to provide a time-dependent objective in the IA.

The *specific* objectives stated in the IA are to 'make it easier for managers to run EuVECA and EuSEF and attract more investors' and to 'facilitate operations and decrease costs for EuVECA and EuSEF funds' (IA, p. 21). These objectives are related to the problems identified, even though they do not entirely reflect the need to 'increase the take-up and assets under management' and to 'increase cross-border business of EuVECA and EuSEF funds', which were identified as the main problems in the IA.

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<sup>4</sup> SEC(2011) 1512

The *operational* objectives (IA p. 21) are to: 1) remove limitations for larger managers to manage EuVECA and EuSEF funds and dual registration requirements; 2) strike the right balance between the need to have a light touch regime and a sufficient level of investor protection; 3) streamline the rules for marketing and managing the funds.

## Range of options considered

Based on this framework, the IA considered some options related to the following areas: 1) fund managers; 2) investment assets; 3) investors, and 4) fund costs. The Commission's preferred course of action is highlighted in bold. The range of investment assets is analysed only for EuVECA, as it is deemed 'sufficiently broad' for EuSEF (IA, p. 25, footnote 33).

### 1. Fund managers

1. No policy change: only fund managers whose portfolios are below €500 million can manage and market EuVECA and EuSEF;
2. **Allow AIFMD-authorised managers (whose portfolio exceeds €500 million) to manage and market EuVECA and EuSEF;**
3. Exempt EuVECA and EuSEF managers from the AIFMD authorisation requirement if they exceed the AIFMD €500 million threshold.

### 2. Investment assets (for EuVECA only)

1. No policy change: SMEs, i.e. non-listed companies of up to 250 employees, with annual turnover of no more than €50 million or annual balance sheet of no more than €43 million (current qualifying portfolio criteria);
2. **Permit investments in small mid-caps, i.e. non-listed companies of up to 499 employees;**
3. **Permit investments in SMEs listed in SME growth market, i.e. listed SMEs with a market capitalisation of less than €200 million;**
4. **Permit follow-on investment in firms that exceed the qualifying portfolio criteria.**

### 3. The investor base

1. **Do nothing: professional investors; non-professional investors with a €100 000 minimum investment;**
2. Reduce the € 100 000 minimum investment without investor protection safeguards;
3. Reduce the € 100 000 minimum investment with investor protection safeguards.

### 4. Fund costs

1. No policy change: leave Member States flexibility to interpret EuVECA and EuSEF requirements (e.g. sufficient own funds, as well as current administrative requirements and registration processes);
2. Guidelines or recommendations for more consistent application of the EuVECA and EuSEF Regulations;
3. **Explicit clarifications in the EuVECA and EuSEF Regulations to avoid burdensome administrative processes and additional measures (including fees imposed by host Member States) and non-proportionate requirements imposed by home Member States.**

This is an IA where the choice of the options analysed in depth seems rather narrow. An initial assessment of the analysis backing the IA's choices reveals that for:

- *Fund managers*: the IA concludes that AIFMD-authorised managers (whose portfolio exceeds €500 million) should be allowed to manage and market EuVECA and EuSEF. According to the existing review clauses, the Commission should have analysed this issue in the context of the review with the interaction with the AIFMD, to be started by 22 July 2017, after having analysed other issues.

- *Investment assets*: reading the [opinion](#) of the Commission's Regulatory Scrutiny Board (RSB), one can conclude that the three selected options (2, 3 and 4) were originally presented as one single measure in a draft version of the IA report. The Board requested they be split (Opinion, page 2). Although the recommended improvement has been implemented, the options have almost invariably the same expected impacts, are equally effective and efficient, and are all selected in the IA (IA, table 4, pp. 29-30). Therefore, in practice, the IA does not present a wide range of alternatives to the status quo.

## Scope of the Impact Assessment

The IA provides an analysis of all options for their *economic* impacts, focusing on the expected more direct effects on the financial industry. It acknowledges that it is too early to measure and analyse economic impacts on SMEs and social businesses, as data are not available. Despite the acknowledgement, this approach appears to be an analytical flaw, as the declared purpose of the regulations is to enhance the growth and innovation of SMEs and the growth of social businesses. *Social* impacts, including those on employment, are not analysed either. The geographical distribution of the investments made by EuVECA and EuSEF funds, requested in the current review clauses, is not analysed.

## Subsidiarity / proportionality

The IA checks the regulatory options in the light of the principle of subsidiarity. It argues that Member States cannot modify the regulations individually (necessity test), and that the EU can better solve the limitations in, and divergences of, application of the EuVECA and EuSEF regulations across Member States (test of European added value) (IA, p. 20). No national parliaments had issued a reasoned opinion raising subsidiarity concerns by the deadline of 17 October 2016.

The proportionality of the options retained by the Commission is briefly analysed, the IA arguing that they 'strike the right balance between public interest, protection of investors, safety and trust considerations as well as related costs' (IA, pp. 36-38). The reasoning is the same for both EuSEF and EuVECA funds.

## Budgetary or public finance implications

The IA states that there are no costs for the EU budget (IA, pp. 37-38). The two months' registration deadline and the right of appeal before the courts introduced by the proposal, but not analysed in the IA, might at first sight entail some costs for Member States. According to the proposal, the home State's competent authority must inform the fund manager of whether their EuSEF or EuVECA fund have been registered no later than two months after the managers have provided the required information. Refusal to register must be substantiated and is subject to a right of appeal before the courts. The deadline is in line with the reasoning that there are divergences in the registration processes among competent authorities. According to the Explanatory Memorandum of the proposal, the right of appeal is in line with the Charter of Fundamental Rights, namely with the right to remedy and to a fair trial (Section 3. Fundamental rights).

## SME test / Competitiveness

The regulations currently in force are aimed at enhancing the growth and innovation of small and medium-sized enterprises (SMEs) in the Union - for EuVECA - and the growth of social undertakings in the Union - for EuSEF. The IA notes that opening up the market to larger companies than SMEs has advantages and disadvantages. It states: 'There is a risk that by diluting the [SME] focus, some EuVECA funds may well focus on larger entities, where the risk of investment may be lower... [and which] are more likely to have access to other sources of capital' (IA, p. 27). The IA concludes, however, that it is likely that 'SMEs would receive a smaller proportion of funding from a considerably larger pool of investment in funds that are more attractive to investors' (IA, p. 29). The IA conveys the message that opening up the definition of eligible assets is in line with the commercial interests of the financial industry associations which took part in the consultation (IA, p. 134). The nature of the opinion of non-financial businesses, including SMEs, is less clear.

## **Simplification and other regulatory implications**

The 2011 IAs on EuVECA and EuSEF noted that these investment frameworks were complementary to that of the Alternative Investments Fund Managers Directive (AIFMD). Therefore, even though the AIFMD is analysed in the IA, it is unclear why the review has taken place before the one planned for the AIFMD in 2017, and not at the same time, as requested in the existing review clauses.

## **Relations with third countries**

As stated above, according to the review clauses contained in the current regulations, the Commission was requested to carry out, by 22 July 2015, a review of the possibility of allowing third country fund managers to use the EuVECA and EuSEF labels. The IA provides some basic information on this issue. Namely, the consultation feedback provides elements for and against this possibility (IA, pp. 91-92). The IA concludes by saying that, during a technical workshop held on 27 January 2016, after the public consultation, 'there was consensus that it is too early to open the frameworks to foreign managers' (IA, p. 102). Regarding the global context, the IA notes that the EU venture capital industry lags behind the US one.

## **Quality of data, research and analysis**

By the Commission's own admission, the 'review of whether the initial objectives of the Regulations have been met is both early, and as a result, partial. It therefore considers only limited evidence at this stage.' (IA, p. 10). The same reasoning seems to apply to the IA as whole. The IA is based on sound knowledge of the financial industry and on data by public authorities – such as ESMA – and academics, but mainly industry figures. An important source of data is the trade and business association which is registered in the Transparency Register as [Invest Europe - the Voice of Private Capital](#). These data provide ample evidence about the overall situation of private equity, venture capital and social investment funds in Europe and elsewhere. However, less evidence is provided in the IA specifically on EuSEF and EuVECA funds, which are the funds targeted by the proposal. The structure of the IA is otherwise clear and facilitates the consideration of the Commission's reasoning by the co-legislators.

## **Stakeholder consultation**

According to the IA, the stakeholders affected by the problem to be solved and by the proposed regulatory solutions are:

- managers of EuVECA and EuSEF funds; large AIFMD-authorized managers;
- investors in EuVECA and EuSEF funds;
- social undertakings; SMEs, mid-caps, SMEs on SME growth markets and other companies listed on SME growth markets which are not SMEs.

Two visions appear to co-exist in the IA. According to the Annex 'Who is affected by the initiative and how', all of these stakeholders would be winners and the proposal does not seem to have any disadvantage for any of them (IA, p. 43). Elsewhere in the IA, potential expected advantages and drawbacks, for instance for SMEs, are highlighted (see 'SME test/Competitiveness' above). The Commission has run at least two online public consultations on EuVECA and EuSEF, each lasting more than the mandatory minimum of 12 weeks. Industry associations and private companies have provided most of the responses to the main public consultation (IA, p. 80). 'Practitioners, supervisors and other stakeholders interested in offering these funds' attended a technical workshop held on 27 January 2016 (IA, p. 99). Overall, a genuine attempt to gather an input seems to have been made, but the voice of non-financial businesses, including SMEs, does not come across clearly in the IA.

## **Monitoring and evaluation**

The IA provides relevant indicators to be monitored and used in a future evaluation. However, these are not taken up in the proposal. The indicators identified are the number of large managers managing EuVECA and EuSEF funds; assets under management, administration and marketing costs of both fund frameworks, and

capital raised and investment undertaken by EuVECA funds. It is unclear if and when the issues listed in the review clauses of the existing regulations, and which were not analysed in the current review, will be analysed. These issues include, for instance, the geographical and sectoral distribution of investments undertaken by qualifying venture capital and social entrepreneurship funds (See 'Problem definition' for more details). One assumption applied in the IA, which could be used in the ex-post evaluation, is that 50 % of all venture capital and social investment funds in the EU would be EuVECA and EuSEF (IA, p. 39).

## Commission Regulatory Scrutiny Board

The Regulatory Scrutiny Board analysed a draft version of this IA report on 12 May 2016 and issued a [positive opinion](#) on it. Even though some RSB recommendations appear to have been addressed in the final version, two questions raised by the Board on the timing of the initiative nevertheless still seem to be relevant, namely: 'on which ground is the take up of the funds assessed to be low at this early stage? Why should the review take place now and why will it not be undertaken in the context of the subsequent review exercises like the review of the Alternative Investment Fund Managers Directive (AIFMD)?'

## Coherence between the Commission's legislative proposal and IA

The legislative proposal of the Commission follows the recommendations expressed in the IA.

## Conclusions

This initial appraisal concludes that the Commission's impact assessment is based on sound knowledge and on relevant data relating to the investment funds industry. However, the evidence regarding specifically the two fund frameworks under review - European venture capital funds and European social entrepreneurship funds - is, by the IA's own admission, limited. The IA and the review attached to it do not cover all the points listed in the review clauses of the two regulations, for instance the geographical and sectoral distribution of investments undertaken specifically by EuVECA and EuSEF funds. At first sight, it appears that different conclusions could be drawn using the same data provided in the IA, for instance regarding the low take-up and lower than expected performance of the funds. The range of options analysed in depth seems rather narrow. Finally, the purpose of the existing regulations is to enhance the growth of small and medium-size enterprises and of social businesses. The IA states that it is too early to judge whether these objectives have been achieved and excludes this issue from the scope of the analysis. Even so, an initial analysis of the public consultations undertaken shows that, despite the absence of more concrete evidence, a greater effort could have been made to integrate the voice of non-financial businesses, including SMEs and social enterprises, within the IA.

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*This note, prepared by the Ex-Ante Impact Assessment Unit for the European Parliament's Committee on Economic and Monetary Affairs (ECON), analyses whether the principal criteria laid down in the Commission's own Better Regulation Guidelines, as well as additional factors identified by the Parliament in its Impact Assessment Handbook, appear to be met by the IA. It does not attempt to deal with the substance of the proposal. It is drafted for informational and background purposes to assist the relevant parliamentary committee(s) and Members more widely in their work.*

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