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EuVECA – Eureka?

A study on Private Equity fundraising via new EU regulation

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Summary

During 2013 a new EU regulation (345/2013) on European Venture Capital Funds (EuVECA) was carried out to simplify matters for AIFMs when marketing funds throughout the EU. Such AIFMs earlier had to comply with the full legislation of the AIFMD, which is an expensive process. Marketing in this context means the process of raising capital from professional and non-professional investors. The capital raised is subsequently invested in accordance with a set investing policy.

The regulation sets a standard of rules for an AIFM to qualify for usage of the EuVECA designation in its fund marketing. It also classifies particular investment undertakings as qualifying or non-qualifying. The fund shall at all times have a certain percentage of qualifying investments in its portfolio, which is expressly stated in the regulation.

The regulation has however not been applied to its intended extent. To date, there are only 45 registered EuVECA funds throughout the EU, six of which are based in Sweden. I have tried to identify what has caused these problems, and identified a great lack of knowledge. Both legal advisors and Venture Capitalists are largely unwitting of the regulation's existence, and common practice is still to register AIFs under the full legislation of the AIFMD.

In addition to this, I have examined if the regulation has potentially been inadequately promulgated, based on the second of Fuller's eight principles of morality of law. Finally, I have presented a few possible solutions for the regulation to be applied more extensively. One way is to amend the wording of the regulation, explicitly allowing more AIFMs to use it, and classifying more investments as qualifying. Furthermore, the national implementations of the AIFMD could refer to the regulation in chapters relevant to registration and marketing of AIFs. I also believe the regulation would

benefit from being communicated more efficiently to the relevant people. Exactly through what channels of marketing this should be done is beyond the scope of my knowledge, but I am of the view that the regulation would be more widely applied if communicated directly to law firms and Private Equity firms.

Sammanfattning

År 2013 infördes en ny EU-förordning (345/2013) med avsikten att underlätta marknadsföring av riskkapitalfonder (s.k. EuVECA-fonder) inom unionen. Tidigare behövde alternativa investeringsfonder, som alltså lyder under LAIF och därmed AIFMD, registreras och marknadsföras under omfattande tillsyn och höga avgifter. Marknadsföring syftar i sammanhanget på kapitalresning från såväl professionella som icke-professionella investerare, och det resta kapitalet är sedan föremål för att investeras i enlighet med en fastställd investeringspolicy.

Den nya förordningen ställer upp olika krav på hur en fondförvaltare kvalificerar sig för att få använda EuVECA-beteckningen vid marknadsföring av sin fond. Förordningen klassar vissa investeringar som kvalificerade och andra som okvalificerade. Det ska vid var tid råda ett förhållande mellan kvalificerade och okvalificerade investeringar, vilket också framgår av förordningens artiklar.

Problemet med förordningen är att den inte har tillämpats i särskilt stor utsträckning. I skrivande stund finns endast 45 registrerade EuVECA-fonder i hela EU, varav sex är registrerade i Sverige. Jag har därför försökt identifiera vad detta beror på, och kommit fram till att det finns en stor kunskapsbrist på området. Både advokater och riskkapitalister är i stor uträkning helt ovetande om förordningens existens, och branschpraxis är fortfarande att registrera AIFer under AIFMDs fulla registrerings- och redovisningskrav.

Utöver detta har jag undersökt om förordningen möjligen brister ur ett rättssäkerhetsperspektiv och diskuterar Fullers åtta kriterier för att en lags eller rättssystem existens ska kunna hävdas. Särskilt det andra kriteriet om promulgation, alltså bekantgörande genom offentligt anslag, har diskuterats.

Slutligen presenterar jag potentiella lösningar på hur förordningen skulle kunna få större spridning. Man skulle kunna ändra lagtexten till att explicit omfatta fler typer av fondförvaltare och investeringar, samt hänvisa till förordningen i nationella implementeringar av AIFMD. Utöver detta tycker jag att förordningen bör kommuniceras bättre till de som berörs av den. Exakt genom vilka markandsföringskanaler detta skulle ske är bortom min vetskap, men att förordningen skulle få större spridning om den kommunicerades direkt till advokatbyråer och riskkapitalbolag är troligt.

Preface

My first three years of legal studies in Lund have been both challenging and interesting. As the programme offers courses ranging from Legal Theory to Commercial Law, I believe it to be a good education regardless of one's choice of career to pursue.

During the summer of 2015, I was employed as a Summer Associate at the Swedish law firm Wigge & Partners. My first task, which followed me throughout the internship, was to investigate the fairly new EU regulation about European venture capital funds, in order to later advise a client on the matter. I was constantly faced with questions to be answered by the relevant competent authority, which seldom had any answers. Needless to say, I wanted to research the subject further, and decided it to be the focus of this Bachelor Thesis.

I would like to thank my supervisor Johan Adestam for providing me with different perspectives and methods of explanation. Your feedback and help has been highly valuable. I would also like to thank my family and friends for always supporting and inspiring me. Thank you!

I have written this essay in order to educate others and myself. Therefore, should you have any queries regarding this Thesis, the regulation as such or questions about how to register a EuVECA fund, do not hesitate to contact me at christian@solvell.com.

Lund, December 2016

Christian Sölvell

Abbreviations

AIF	Alternative Investment Fund
AIFM	Alternative Investment Fund Manager
AIFMD	Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010
AUM	Assets under management
CMU	Capital Markets Union
ELTIF	European Long-Term Investment Funds
ELTIF regulation	Regulation (EU) 2015/760 of the European Parliament and of the Council of 29 April 2015 on European long-term investment funds
EP	European Parliament
ESMA	European Securities and Markets Authority
EU	The European Union
EuSEF	European Social Entrepreneurship Funds
EuSEF regulation	Regulation (EU) No 346/2013 of the European Parliament and of the Council of 17 April 2013 on European social Entrepreneurship funds
EuVECA	European Venture Capital (Fund)
EuVECA regulation	Regulation (EU) No 345/2013 of the European Parliament and of the Council of 17 April 2013 on European venture capital funds

EVCA	European Private Equity and Venture Capital Association
FI	Sweden's Financial Supervisory Authority
IPO	Initial Public Offering
LAIF	The Swedish Alternative Investment Funds Managers Act (Lagen (2013:561) om alternativa investeringsfonder)
LBO	Leveraged Buyout
PE	Private Equity
SME	Small and medium-sized enterprises
SVCA	Swedish Private Equity and Venture Capital Association
VC	Venture Capital

1 Introduction

1.1 Background

So far during the 21st century, around 90 % of total venture capital investments in the EU have been made in only eight member states; Sweden, Denmark, Finland, the UK, Germany, the Netherlands, France and Spain. Such investments are almost exclusively made by registered AIFs complying with the AIFMD. These face heavy regulatory demands, and raising money, i.e. marketing such funds, is an expensive process. Due to this, and the fact that venture capital investments are seen as drivers of innovation and expansion, it seemed natural to create a new legal framework to simplify marketing of AIFs throughout the EU.¹

As of 22 July 2013, these needs were addressed through the regulation on European Venture Capital funds. By registering a fund under the “EuVECA” designation, the fund manager obtains a passport to market its fund in the EU without having to comply with different national regulations on AIFs. This in turn is thought to provide new sources of financing for SMEs.²

The regulation is part of the European Commission’s plan to create a “Capital Markets Union”. The main goal of the CMU is to form a harmonised infrastructure for capital mobilisation, and thus create opportunities for expansion, new jobs as well as new opportunities for investors and savers.³⁴

¹ European 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*, 2016/0221, p. 3.

² Regulation (EU) No 345/2013, Recitals 1–2 .

³ European Commission, *Capital Markets Union – Accelerating Reform*, Brussels, 2016, p. 2.

The European Commission has estimated that 98 % of all PE firms in the EU manage funds below the €500MM threshold, and therefore could be eligible for usage of the EuVECA designation.⁵ Despite this, there have only been six registered EuVECA funds in Sweden to date, and 45 in the EU.⁶⁷ Due to this, I found the subject worth researching.

1.2 Purpose and question formulation

The purpose of this essay is to outline key issues related to the EuVECA regulation, and why it has not been used to its intended extent. I will employ a critical perspective when analysing potential issues, questioning the legitimacy and rationale of the regulation. After working with the regulation in practice, and realising several of its shortcomings (from my point of view), my premise in this essay has been that the regulation is flawed. The European Parliament and the European Commission may perhaps be of a different view, although they have carried out public consultations in order to amend the regime.

Questions to be discussed are the following:

- What are the different purposes of the regulation?
- What are the limitations to the regulation, i.e. why has it not been used to its intended extent?
- What may be potential solutions to the limitations?

⁴ European Commission, *Action Plan on Building a Capital Markets Union*, Brussels, 2015, p. 7.

⁵ Matheson Asset management and Investment Funds team, *Briefing Note: The European Venture Capital Fund and European Social Entrepreneurship Fund Regulations*, 16 June 2015, available from Matheson, (accessed 22 November 2016).

⁶ EuVECA funds registered in Sweden: Bridge 140 AB, CCP Investment AB, eEquity AB, eEquity III AB, Goldcup 9877 AB and MVI Fund I AB.

⁷ As of 16 November 2016.

1.3 Method and materials

1.3.1 General on method and materials

In this Thesis I have employed the legal dogmatic method, i.e. examined legal issues through interpreting existing sources of law.⁸⁹ I have also provided potential solutions to these problems in line with *Lex ferenda* to provide my view on how the EuVECA regulation could be amended. Issues in this case consist of problems related to the regulation, originally brought to my attention by my former colleagues, and later myself. To date, I have not found a single book covering the regulation. Neither are there any cases where AIFMs of registered EuVECA funds have been parties in disputes related to the regulation. Due to this, a lot of my sources have been articles, background documents, preparatory work as well as different legislations, complemented by opinions and thoughts of people relevant to the scope of the regulation.

I have applied a Rule of Law perspective in my analysis of shortcomings of the regulation. Because of the general lack of knowledge, I have decided to focus on public promulgation, which is the second of Lon L. Fuller's eight principles of legality.¹⁰

1.3.2 Interviews

My initial thought was to present a survey result regarding the EuVECA regulation. I later realised the limited knowledge of the regulation, and my hopes of creating a quantifiable result through a survey slowly faded.

⁸ A. Peczenik, *Juridikens allmänna läror*, 2005, p. 33 ff.

⁹ A. Peczenik, *Juridikens teori och metod*, 2005, p. 249 ff.

¹⁰ L.L. Fuller, *The Morality of Law*, rev. ed., New Haven, Connecticut, Yale University Press, 1969, p. 39.

However, if one aims to present a qualitative determination on a certain matter, a more suitable way is often to hold qualitative interviews.¹¹ Due to the fact that my goal partly was to determine the success of the EuVECA regulation, I decided to formulate questions and discuss the regulation with a few people instead. I spoke to people active within Private Equity, Legal Services and Venture Capital Associations.

The limited amount of interview material proved to be too insufficient to draw conclusions for my questions, other than that the regulation is highly unknown amongst practitioners who could benefit from it. Due to this, I have decided not to present a section of interview results, but rather include some answers in the text body. I have also decided to anonymise my interviewees prior to publicising this essay, to avoid singling them out. Instead, should you want to examine the material, I suggest you contact me through my details listed in the Preface above.

There are different approaches to formulating interview questions. These will also vary depending on what type of interview is to be conducted.¹² Given the small number of registered EuVECA funds in Sweden, I decided to merely ask lawyers for potential drawbacks they had identified with the regulation, if any. For people active within PE, or PE/VC Associations, I asked if they had encountered the regulation at all, and if not, what this could be due to.

1.4 Limitations

Having worked with the regulation in Sweden, and therefore having been in contact with FI, I have decided to limit this Thesis to analysing it from a Swedish perspective. However, the regulation has not been very successful in other member states either, hence the problems could be related to the

¹¹ A. Lantz, *Intervjumetodik – den professionellt genomförda intervjun*, Lund, Studentlitteratur, 2000, p. 34.

¹² *Ibid.*, p. 56.

regulation as such, and not the lack of knowledge of competent authorities. My conclusions should therefore, for the most part, hold true in all member states, although my disclaimer is that they are drawn from a Swedish perspective.

Alongside the EuVECA regulation, a nearly identical regime was created for so-called EuSEFs.¹³ A EuSEF differs from a EuVECA fund in the sense that it should primarily invest to create positive social impact throughout the EU. Another regulation related to the CMU is the ELTIF regulation.¹⁴ It addresses ELTIFs, thereby focusing on the long-term timeframe of investments.

While the regulations are closely related, especially considering their relatively unsuccessful results, it would be beyond the scope of this essay to discuss them all. I have therefore decided to merely focus on PE fundraising and thus the EuVECA regulation. Because the regulations differ in ways, this should also avoid some confusion for the reader.

1.5 Disposition

The following Thesis is split into five main sections, where the subsequent section presents an introduction to the field of PE. The introduction is held short, and is probably only relevant for readers who have never heard of PE.

Section three provides a briefing on the EuVECA regulation as a whole, and outlines the criteria that make a registered AIFM qualified to use the designation. It also presents a thorough walk-through of potential implications with the regulation, specifically focusing on the way in which investments have to be made.

¹³ Regulation (EU) No 346/2013 of the European Parliament and of the Council of 17 April 2013 on European social entrepreneurship funds.

¹⁴ Regulation (EU) 2015/760 of the European Parliament and of the Council of 29 April 2015 on European long-term investment funds.

Section four, again, concludes a few of the drawbacks to the regulation. A Rule of Law perspective is applied, with focus on public promulgation, to examine if the regulation could have been announced more efficiently.

The fifth and last section includes my analysis and conclusions to the questions relevant to the Thesis (see Section 1.2). It also contains a few proposals of change, both to the regulation and the nationally implemented acts related to the AIFMD. The section therefore provides, according to me, solutions to how the current regulation could be improved in order for it to be widely applied amongst relevant practitioners.

2 Introduction to Private Equity

2.1 Definitions related to PE

For readers inexperienced in the field of PE, the following sections should provide some guidance. I will try and sort out the most relevant concepts in order for you to better understand this Thesis. If a sentence containing technical terms is difficult to understand, remember to check back to the list of abbreviations. Let us start by assessing definitions and how to classify them.

The definitions in the field of PE may vary somewhat depending on whom you ask. Several definitions can also be misleading. While the term Venture Capitalist¹⁵, frequently used by the mass media, implies a person only active within VC, many (including myself) would also consider it applicable to an employee of a buyout firm or a private business angel. The term Venture Capitalist, as used in this essay, refers to anyone investing in privately held companies and practicing an active ownership.¹⁶ Furthermore, I have heard several explanations of what a VC firm actually does versus a buyout firm. One arguable point of view is that VC firms only invest in early-stage companies, and that buyout firms only invest in mature companies. This could be the only way, if any, to differ the activities from each other. The following figure attempts to outline different characteristics of the activities, and how my definitions group them together.

¹⁵ *Swedish: Riskkapitalist.*

¹⁶ M. Nyman, J. Lundgren and CC. Rösiö, *Private equity- och venture capital-investeringar*, Vällingby, Elanders Sverige AB, 2012, p. 17.

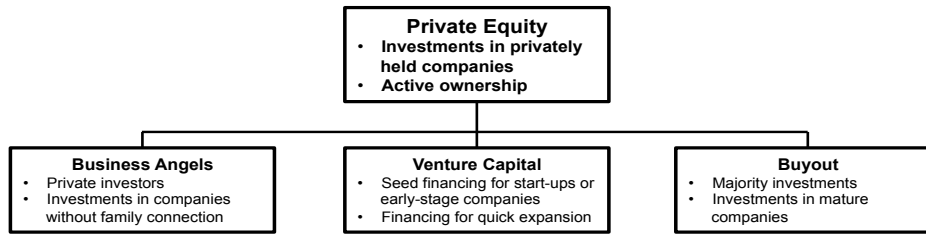


Figure 1. The different business areas are linked together by the generic term "Private Equity". Note: Business Angels are not relevant for the scope of this Thesis, but merely mentioned to educate the reader.

I will henceforth use the term "PE" as a definition for both VC and buyout activities, and "PE firms" for firms engaged in either or both activities. Due to the fact that they both invest in privately held companies, and because their fund structures share great similarities, I have decided to group them together. These designations correspond to those used by the SVCA and EVCA.¹⁷¹⁸ Remember, a "Venture Capitalist" can be active in either VC or buyout activities, meaning such a person operates in the field of PE through a PE firm with my definitions. PE firms will most commonly be referred to as AIFMs for the purpose of this essay. This should be made obvious in the following section.

2.2 Briefly about Private Equity activities

PE firms create empty funds, which act as pooling platforms to gather investors' money. By investing raised capital, actively participating in the operations of its investments and monitoring the fund's performance, the typical PE firm acts as a sort of fund manager. PE firms have to be registered as AIFMs under the AIFMD, or national implementations of the directive in the respective member state. Due to the fact that business angels are not entitled to raise funds by using the EuVECA regulation, this category of investors will not be discussed further.¹⁹

¹⁷ SVCA, <http://www.svca.se/om-private-equity/>, (Accessed 17 November 2016).

¹⁸ EVCA, <http://www.investeurope.eu/about-private-equity/private-equity-explained/>, (Accessed 17 November 2016).

¹⁹ M. Nyman, J. Lundgren and CC. Rösio, *Private equity- och venture capital-investeringar*, Vällingby, Elanders Sverige AB, 2012, p. 30.

The term “buyout” refers to a purchase of a target company’s shares, to the extent that the buyer gains controlling interest in the target company. If such an acquisition were to be made with the use of leverage, e.g. a bank loan, the transaction would be labelled a leveraged buyout (LBO). PE firms generally hold their investments for three to five years, and the so-called “exit” is made by either selling the company to another PE firm (secondary buyout), by selling the company to an industrial buyer (which may benefit from synergies) or by floating the company in an IPO. The latter refers to an offering of the company’s shares, turning a private company public.²⁰

²⁰ L. Siming, *Private Equity and Advisors in Mergers and Acquisitions*, Gothenburg, Intellecta Infolog, 2010, p. 111.

3 Regulation of EuVECA funds

3.1 Introduction to the EuVECA regulation

Increased accountability and transparency became the centre of discussions when the AIFMD was introduced in 2011.²¹ The Directive was carried out to create a comprehensive and harmonised supervisory and regulatory framework for managers of AIFs in the EU. An AIF is defined as a collective investment undertaking of the closed-ended type, which raises capital from a number of investors, and subsequently invests it in accordance with a defined policy in order to benefit its investors.^{22,23} An AIFM is the legal person whose regular business is to manage such AIFs.²⁴

Managers of registered AIFs face fairly heavy regulatory demands. There is, however, a distinction made between larger and smaller AIFs. In order for an AIFM to market its fund, i.e. raise capital, in other EU countries than its home member state, it earlier had to comply with the full regulations of the AIFMD, regardless of whether it was above or below the €500MM threshold. Yearly costs for AIFMs complying with the full regulations have been estimated to around €250.000, where the majority is derived from risk and compliance needs and continuous reporting requirements.²⁵ Partly due to this, the EuVECA regulation was created. Funds below the threshold may now be marketed in the EU without having to comply with the rigorous legislation of the AIFMD. The costs of registering a EuVECA fund vary

²¹ B. Leleux, H. van Swaay and E. Megally, *Private Equity 4.0: Reinventing value creation*, John Wiley & Sons Ltd, 2015, p. 23.

²² Directive 2011/61/EU of the European Parliament and of the Council, Article 4.1(a) i-ii.

²³ Directive 2009/65/EC of the European Parliament and of the Council, Article 3(a) and Article 5.

²⁴ Directive 2011/61/EU of the European Parliament and of the Council, Article 4.1(b).

²⁵ KMG Capital Markets, *Report On The High Costs of AIFMD Compliance*, available through <https://www.kmgcapitalmarkets.com/index.php/news/item/58-the-high-costs-of-aifmd-compliance>, 2013, p. 1.

between member states, but as of 2016, the costs for registering a Swedish EuVECA fund are SEK 38.000.²⁶ The EuVECA regime is a regulation of the EU, meaning it is to be directly applied in all member states, and there is no need for member states to individually pass laws on the matter. One could say the EuVECA designation acts as a direct passport for marketing of smaller AIFs. Managers of EuVECA funds furthermore gain access to “non-professional investors” throughout the EU, able and willing to invest at least €100.000, aiding the process of fundraising and making it possible for individuals to invest in funds.²⁷²⁸

It is important to understand the term “marketing” in the context of the EuVECA regulation. The regulation defines marketing as:

“A direct or indirect offering or placement at the initiative of the manager of a qualifying venture capital fund, or on its behalf, of units or shares of a venture capital fund it manages to or with investors domiciled or with a registered office in the EU.”²⁹

The regulation however, does not provide any clear line of demarcation between marketing and reverse solicitation, the latter meaning investors themselves seeking to find funds to invest in. An investment relationship between investors and an AIFM may be recurring, if for example the AIFM’s earlier performance has been satisfactory. In this case, a new fund may not have to be marketed as a previous fund. This problem first arose with the AIFMD, where AIFMs became unsure on how to communicate with potential investors. Lawyers assisting AIFMs often took a conservative approach, and sometimes even warned their clients against distributing

²⁶ Finansinspektionen, <http://www.fi.se/Tillstand/Avgifter/Fonder-och-vardepapper/>. Accessed 20 November 2016.

²⁷ Regulation (EU) No 345/2013, Article 2.1(a).

²⁸ Regulation (EU) No 345/2013, Article 6.1(a).

²⁹ Regulation (EU) No 345/2013, Article 3(i).

business cards to investors. To avoid being unsure, it is therefore always easier to presume a fund is marketed when it raises capital.³⁰

3.2 Eligibility criteria for usage of the EuVECA designation

3.2.1 General

To point out every single criterion a fund manager must meet to be eligible to use the EuVECA designation, would be beyond the scope of this essay. I will, however, mention the most important.

Firstly, we find certain prerequisites. As mentioned, the AIF's total AUM has to be below the €500MM threshold. Secondly, the fund may never be leveraged.³¹ This does not mean a fund employing LBO strategies is exempt from using the EuVECA designation, despite using leverage in its acquisitions. The debt financing is almost always employed in a later stage, e.g. in a newly founded company responsible for the actual acquisition, leaving the original fund unlevered.³² The manager has to be established within the EU, and its fund has to be registered at the competent authority in the country of establishment (in Sweden, FI).³³

The most central points for a qualifying fund relate to how investments are made. There is a list of criteria that make up a “qualifying investment”, and the AIFM should have an intention to invest at least 70 % of the fund's total capital in such investments. In addition to this, so-called “non-qualifying investments” may never exceed 30 %. This is often, quite misleading,

³⁰ B.Prew, *AIFMD: The ongoing challenge with reverse solicitation*, 7 April 2015 (April 2015 Issue), Available from INDOS Financial and Hedge Fund Intelligence, (accessed 21 November 2016).

³¹ Regulation (EU) No 345/2013, Article 3.2(b).

³² Nyman, Lundgren and Rösiö, 2012, p. 69–70.

³³ Regulation (EU) No 345/2013, Article 2.1(b)–(c).

referred to as the 70/30 relationship.³⁴ Due to the fact that they are two separate criteria for a qualifying EuVECA fund, I will hereinafter refer to them as the “70 criteria” and the “30 criteria” (see Section 3.2.3 below).

3.2.2 Qualifying investments

A qualifying investment is typically a purchase of equity instruments issued by qualifying portfolio undertakings. Other financial instruments are accepted as well, however, a purchase of issued or existing shares of qualifying portfolio undertakings would probably be the most common scenario.³⁵ Companies regarded as qualified portfolio undertakings have to meet certain standards. Below follows a list of the most important criteria laid out by the regulation. Again, the list is not complete, but states the most relevant points.

In order for a portfolio undertaking to be qualifying, it has to:

- be a privately held company;
- have less than 250 employees; and
- have less than or equal to €50MM annual turnover *or* have less than or equal to €43MM in total assets.

The portfolio undertaking may not be an investment fund, a credit institution, an insurance company or a financial holding company. If a portfolio undertaking should fail to comply with any of these criteria, it would not be considered qualified. However, recall that an AIFM only has to have an intention to invest at least 70 % of the funds total capital in qualified investments, meaning the regulation provides space for non-qualifying investments as well.³⁶

³⁴ D. Höppner, *EuVECA Essentials: an introduction to the European Venture Capital Fund Regulation*, Brussels, European Private Equity and Venture Capital Association, 2014, p. 7.

³⁵ Regulation (EU) No 345/2013, Article 3(e) i–iv.

³⁶ Regulation (EU) No 345/2013, Article 3(d) i–iv.

The first three criteria (privately held, employee count and turnover or asset thresholds) make up the definition of an SME as defined by the European Commission.³⁷ All in all, virtually all target SMEs for smaller PE firms are qualifying portfolio undertakings. Investment funds, credit institutions etc. are seldom target companies for PE firms. Despite this, some firms *may* want to invest in such businesses, and one could ask why the regulator has limited the choice of target companies at all. This may limit the EuVECA regulation's overall attractiveness. To grant PE firms free choice of investments, while still using the EuVECA designation, is part of a change proposal made by the EVCA. The proposal is currently under review by the European Commission.³⁸

3.2.3 Qualifying fund

Regardless of what companies an AIFM targets; it has to comply with the 70 criteria and 30 criteria if it wants to market a fund as a EuVECA fund. It should be the fund manager's intention to invest at least 70 % of the EuVECA fund's total aggregate capital in qualifying investments. The excess cash (i.e. funds not invested), as well as all relevant fees, charges and expenses, are not included in the calculation. Such fees may be the registration fee or costs for adding countries to your marketing list (currently SEK 28.000 and SEK 4.000 respectively, paid to FI if established in Sweden).^{39,40}

³⁷ European Commission, *Commission Recommendation of May 6 2003*, Title I, Article 2.

³⁸ EVCA, *Response to the European Commission Consultation Document on the Review of the European Venture Capital Funds (EuVECA) and European Social Entrepreneurship Funds (EuSEF) Regulations*, 2015, p. 20.

³⁹ When registering a EuVECA fund, the AIFM must provide the relevant authorities with a list of countries intended for marketing of the EuVECA fund. Adding countries to this list is associated with additional costs.

⁴⁰ Finansinspektionen, <http://www.fi.se/Tillstand/Avgifter/Fonder-och-vardepapper/>. Accessed 18 November 2016.

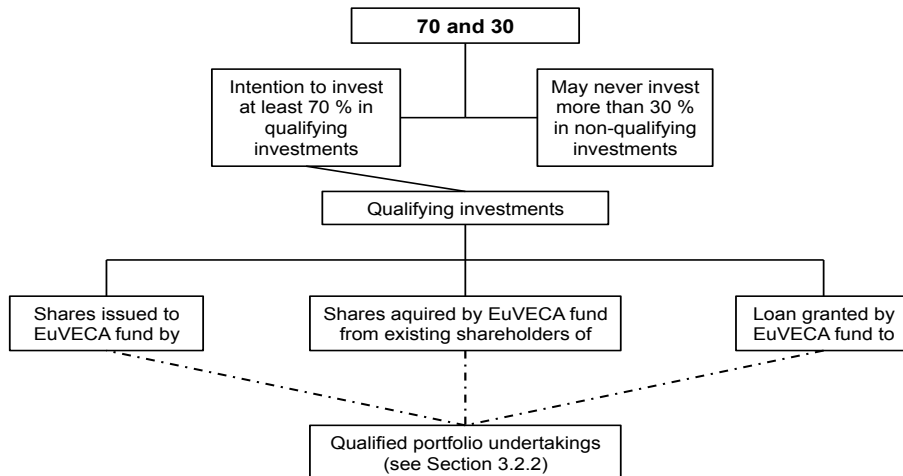


Figure 2. Essentials of the 70 criteria and the 30 criteria.

The 30 criteria for non-qualifying investments is seen as a *continuous requirement*, meaning there should never be more than 30 % of the EuVECA fund’s total capital invested in non-qualifying investments.⁴¹ This provision is somewhat vague with respect to cash received from realisations of investments. One could argue these are investible assets, but they could also be seen as excess cash. If they were to be seen as the latter, the 30 criteria would be affected. Assume the following situation of Fund A.

	Total capital	Excess cash	Qualifying	Non-qual.	Percentage
Year 1	100	0	70	30	70/30
Year 2	100	10	60	30	≈ 67/33

Table 1. In year 1, Fund A satisfies the 30 criteria. Assume the values of investments have not grown at all in the first year. In year 2, the manager of Fund A decides to sell a qualifying investment for €10MM, which is now held as cash. Recall that cash is not taken into consideration when calculating the percentages. Thus, the non-qualifying investments have now exceeded the 30 % barrier and no longer satisfies the 30 criteria.

As mentioned, the EuVECA regulation states it should be the AIFM’s *intention* to invest 70 % of the fund’s aggregate capital in qualifying investments. It is unclear how strict this rule is. In reality, an AIFM could probably simply state its intention to invest a minimum of 70 % in qualified

⁴¹ D. Höppner, *EuVECA Essentials: an introduction to the European Venture Capital Fund Regulation*, Brussels, European Private Equity and Venture Capital Association, 2014, p. 5.

investments when registering its fund. However, since the 30 % barrier explicitly is a continuous requirement, I felt obligated to clarify my take on these unclear formulations. My interpretation is that the 30 criteria only has to hold true at the time of investment, and is therefore *not* an on-going requirement in that sense. The phrase “on-going” would therefore allude to the total capital raised in the fund, and not take either performance over time or realisation of investments into account. The order in which investments are made, would probably not be of relevance either. If the first investment made would be classified as non-qualified, and therefore account for 100 % of total investments, I highly doubt the relevant competent authority would take any measures. However, no registered EuVECA fund has yet been exempt from using the designation, why we find ourselves with little guidance on the matter. Reasons for disqualifying a EuVECA fund could also vary between member states, since the supervision of EuVECA funds is left to the national competent authorities.

4 Limitations to the regulation

4.1 Intention vs reality

The primary intention with the EuVECA regulation has been to streamline the capital markets within the EU. However, as mentioned above, the EuVECA regulation has not been applied to its intended extent. This may partly be due to unclear formulations, and partly due to a lack of knowledge. Confusion around some provisions has even left competent authorities unsure in some situations. For example, adding countries to your marketing list (mentioned in Section 3.2.2) implies an extra cost of SEK 4.000 per country.⁴² However, by listing every member state of the EU in your marketing list from the beginning, one can evade this extra cost. There is no explicit rule that the countries listed have to be intended targets for marketing, or that a fund actually has to be marketed there. When I asked FI about this matter, they simply had no answer. However, they did not see a problem with my suggestion of registering all countries at once. My recommendation to someone registering a EuVECA fund would therefore be to write down all member states on its marketing list, thus avoiding additional costs on this matter in the future. There is no expressed penalty in the regulation for doing so.

The purpose with the regulation has furthermore been to simplify matters for only VC activities, not buyout activities. This intention is explicitly stated in the recitals of the regulation.⁴³ However, AIFMs operating within buyout have managed to register EuVECA funds as well. I would therefore deem a fund active within buyout to be just as appropriate as a VC fund to use the designation.

⁴² Regulation (EU) No 345/2013, Article 15(b).

⁴³ Regulation (EU) No 345/2013, Recital 11.

4.2 Rule of law perspective

In his 1964 novel "The Morality of Law", Lon L. Fuller listed eight principles of legality. According to Fuller, these are requirements that have to be met to a sufficient degree, in order for a legal system to exist. These requirements are also applicable on individual statutes, and dictate that laws should be (1) generally formulated, (2) publicly promulgated, (3) in prospective terms, (4) in clear and intelligible language, (5) free of contradictions, (6) in a form that citizens can abide by, (7) sufficiently constant through time and (8) administered congruently with their language as announced.⁴⁴

Public promulgation is deemed necessary for efficacy when passing new laws, but there is also a moral side to it. It is seen as morally objectionable for states to pass laws that have not been publically promulgated to a sufficient degree. A fair consideration has to be made whether enough information of newly established laws has been notified to the public, or if the law should be considered invalid. How orthodoxically these principles are to be applied remains somewhat unclear to me. Famous legal philosophers such as Hart, Dworkin, Cohen, Hughes and Summers have all treated Fuller's eight principles as mere "oughts". According to Fuller himself, the principles are not just principles of efficacy, nor to be treated as mere "oughts", but rather determinants of whether new laws should be considered valid or not.⁴⁵

In modern constitutional states, I believe one would struggle to claim passed laws invalid due to insufficient public promulgation simply because one has not heard of the law. This is probably the case for EU regulations as well.

⁴⁴ L.L. Fuller, *The Morality of Law*, rev. ed., New Haven, Connecticut, Yale University Press, 1969. Fuller has extended discussions of each criterion from pp. 46–90.

⁴⁵ R.S. Summers (General Editor: William Twining), *Lon L. Fuller – Jurists: Profiles in Legal Theory*, Stanford, California, Stanford University Press Library, 1984, p. 39.

Nevertheless, the public promulgation may in this case have been insufficient to a certain extent, and is therefore interesting to discuss.

Although the regulation has become effective through its public announcement, the field intended to benefit from it is relatively narrow. The fact that so few AIFMs have decided to register EuVECA funds could indicate that they simply do not know it exists, and thus have not received the proper information. Of course, this could be related to implications other than public promulgation, e.g. legal advisors of AIFMs withholding information to secure recurring revenues of assisting their clients under full regulations of the AIFMD. I would however be careful in drawing such a conclusion, since there by contrast lies a prestige for legal advisors in knowing and providing the latest information for improving their clients' operations. I would not be conservative in actually deeming the public promulgation of the regulation insufficient. The lack of knowledge has to derive from something, and my conclusion is that it is mostly due to shortcomings on the promulgation matter, i.e. it could definitely be improved (this conclusion is further discussed in Section 5).

4.3 Amending the regulation

As a response to national competent authorities being unsure of certain points in the regulation, ESMA published a Q&A Report on 11 November 2014. In short, the questions asked foremost regarded managers above the €500MM threshold, registration and marketing.⁴⁶ The following was concluded by ESMA.

Firstly, an AIFM subsequently exceeding the €500MM threshold in its funds may still set up new EuVECA funds, as long as these are below the threshold. Secondly, if the AIFM is not already registered as an AIF within

⁴⁶ ESMA, *ESMA publishes updated EuSEF and EuVECA Q&A*, 11 November 2014, <https://www.esma.europa.eu/press-news/esma-news/esma-publishes-updated-eusef-and-euveca-qa>, (accessed 8 December 2016).

its Member State, it has to be registered at its competent authority twice, i.e. firstly in accordance with the AIFMD, and secondly with the EuVECA regulation. Recall that the EuVECA regulation is used to simplify matters for already registered AIFMs. Finally, ESMA concluded that AIFMs managing EuVECA funds are also eligible to market other regular AIFs.⁴⁷

The main focus of the 2015 Consultation on EuVECA funds was to potentially amend the regulation in favour of larger AIFMs. Associations, companies and individuals were from 30 September 2015 until 6 January 2016 asked to provide the European Commission with change proposals. The consultation was created jointly for change proposals on the EuVECA regulation and the EuSEF regulation, and most responses regarded the EuSEF regulation. Responses to the EuVECA regulation foremost regarded the same questions discussed in the ESMA Q&A, why I have decided to not include any answers in this Thesis.

⁴⁷ ESMA, *Questions and Answers – Application of the EuSEF and EuVECA Regulations*, ESMA/2014/1354, 11 November 2014, available from European Securities and Markets Authority, (accessed 9 December 2016).

5 Analysis and conclusion

5.1 Problematisation

So far, we have looked at different operations associated with the EuVECA regulation, what qualifies a fund to be eligible to use the designation, and general purposes of the regulation. Important to note is that the purposes have not always been in line with the actual outcome. For example, we realised the fact that whilst traditional buyout firms have not been intended to benefit from the regulation, they most certainly can. Neither has it created new sources of financing for SMEs throughout the EU considerably, due to the small number of funds registered.

What first caught my attention with the regulation was that something had stopped it from being applied thoroughly, and that the common practice for PE firms to date has continued to be to register traditional AIFs under the AIFMD, even when they fall below the threshold and otherwise meet the eligibility criteria. The following sections constitute my modest attempt to answer why this has been the case and provide reasonable solutions.

5.2 Not applied to its intended extent – lack of knowledge

After speaking to people active within PE, PE associations and Law firms, I realised the vast lack of knowledge on the regulation. It has also been brought to my attention that Swedish PE firms have gained access to non-professional investors through LAIF. This is really only of importance to smaller PE firms, which only seek funding in their respective member states. As soon as marketing in other member states is carried out, the AIFM has to comply with either the full legislations of the AIFMD or market its fund under the EuVECA regulation.

As mentioned in Section 1.1, only 45 EuVECA funds have been registered in the EU since 2013. The lack of knowledge has been discussed in Section 4.2, and has puzzled me throughout the writing of this essay. How can a legislation on such an important matter have been overlooked by both legal advisors and Venture Capitalists? When suggesting a usage of the EuVECA designation to Venture Capitalists who could benefit from it, i.e. Venture Capitalists managing funds below the threshold and investing in qualifying investments according to a set investing policy, I have simply been given the answer that they outsource such help from legal advisors in regulatory teams. Quite why they have not been informed of the regulation is beyond my understanding.

5.3 Solutions

One way to enhance the general knowledge of the EuVECA regulation in Sweden could be to refer to it in LAIF. Chapters related to registration of smaller AIFs for marketing within Sweden could easily be reformulated to simply mention the EuVECA regulation. This should clarify the fact that a smaller AIFM could be entitled to raise funds throughout the entire EU. This solution was first suggested to me by one of my interviewees, a lawyer active in the regulatory team of a Swedish law firm, and I believe it to be highly efficient. Of course, a similar measure could be taken in all member states in their implementations of the AIFMD.

Another solution could be to let all investments be qualifying. Quite why the regulator has decided to merely benefit VC activities (which did not succeed entirely, see Section 4.1) and limit the choice of investments, is beyond my comprehension. The same goes for the reasoning behind the 30 criteria. To let PE firms invest in whatever they desire could increase the attractiveness of the regulation. Furthermore, since the intention to only benefit VC activities has not proven successful, I suggest the 11th Recital to be amended and explicitly include traditional buyout activities. I specifically remember

reflecting on that Recital when aiding a client on the registration, and since there was never an explicit prohibition to register a buyout funds, I agreed with my colleagues to instead focus on the core criteria of the threshold and investments.

Due to the fact that the European Commission wants to fulfil its goals in creating a CMU, it would seem natural to market the EuVECA regulation more thoroughly, specifically informing lawyers and other practitioners of it. This is in line with an effective public promulgation from a Rule of Law perspective, as discussed earlier. The same perspective is relevant in the context of predictability. Whilst the supervision of EuVECA funds is left to national competent authorities in member states, the regulation could easily be amended to give examples of what exactly disqualifies a EuVECA fund from using the designation, and not leave this up to national authorities to decide. This could create a more harmonised set of rules with, again, increased predictability across the member states.

5.4 Closing remarks

After criticising the EuVECA regulation throughout the essay, I should perhaps express my enthusiasm for it. I advocate the objective of the CMU and its strive for European economic growth. I therefore think the idea to simplify matters for smaller fund managers is very clever. I do, however, see problems with the execution of the regulation. Could it perhaps be a question of people knowing about the regulation, but being careful with applying it, since other fund managers have continued to register regular AIFs under the AIFMD? Probably not. The regulation is associated with substantially lower costs and should be attractive, in my opinion, to most smaller AIFMs. Not *all*, due to the limitations of qualifying investments and because individual investing policies vary amongst AIFMs. Of course, since the common practice for PE firms has been to continue registering AIFs under the AIFMD, a new regulation could be seen as complicated to adapt

to. If, however, Venture Capitalists of smaller AIFs were informed of the regulation, I believe many would find it attractive.

I also believe it is safe to say the regulation was not entirely finished when it was launched. It lacks guidance in many situations, which can be a common problem when completely new laws are passed. The on-going consultation of the amending of the regulation could perhaps clarify certain points. However, the problem of public promulgation remains.

As the regulation is under renegotiation after the public consultation, I foremost hope it is amended to allow all investments of AIFMs to be qualified, i.e. let EuVECA funds invest in whatever they desire. On a national level, I would welcome the member states' individual implementation acts of the AIFMD to refer to the regulation in chapters relevant to registering and marketing AIFs, in order to inform relevant people of the regulation's existence.

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