Issues in the Industry. Recent developments in European Venture Capital and equity investment regulations

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Speculators, Hedge Funds and Bankers are amongst the usual scapegoats in any financial crisis. The answer of the political system is, of course, to regulate the culprits ostensibly in order to avoid a repetition of the crisis. The recent recession named as the biggest after the Big Depression of 1928 is no exception. It is therefore no surprise that the EU has decided to regulate what had been left unregulated for many many years until now.

The first UCITS (Undertakings for Collective Investment in Transferable Securities) Directive was adopted in 1985 and is now in its 3rd avatar. Throughout Europe it is reported that nevertheless € 6,8 trillion are invested in this kind of Undertakings.

On Nov. 11, 2010 the European Parliament adopted the Alternative Investment Fund Managers (AIFM) Directive. It is expected to enter into force within 2011, while members states will have to harmonise their domestic laws within 24 months from its entry. Predictably it had a lot of bad publicity. However reading carefully the Directive one can see that there are good news and bad news in it. The main bad news is that the Directive regulates any fund that is not a UCITS (ΟΣΕΚΑ in Greek) from any country in the world if it wishes to market itself or even to invest in the EU. In other words it regulates any fund whatsoever that invests in non-transferable securities. However, there is no definition about what are "non transferable securities" in the definitions, nor about what is a "collective investment undertaking" (Article 3, Definitions). For example if a Bank establishes a fund with three of its private banking clients to invest in a specific company which is in need of restructuring by retiring its existing debt and converting it into shares, would that fall under the definition?

The good news is that only larger funds need be concerned (over 100 m. €, or even 500 m € if they do not use leverage <u>and</u> do not allow redemptions in the first five years). The further good news is that the Directive mostly imposes as a legal obligation what in fact was until now common practice. Thus for example the Directive imposes on AIFM to "act honestly with due skill, care and diligence", to *"act in the best interests of the AIF it manages" etc. (Art. 9). However there are some more significant requirements: the prospectus must disclose if any investor has preferential treatment, to identify conflicts of interest. Risk management systems must be put in place and in particular liquidity management systems. There must be "an appropriate, documented and regularly updated due diligence process when investing on behalf of the AIF, according to the investment strategy, the objectives and risk profile of the AIF (Art. 11, par. 3(a)).*

The Directive also imposes the existence of a third party independent valuator who will "establish the value of assets acquired <u>and</u> the value of the shares and units of the AIF" at least once a year. This was a task usually carried by the fund itself. As to the valuation rules there are left for the home state of the AIF or for the instrument of incorporation of the AIF itself. Obviously there is not much certainty in this requirement.

The AIF must have a depositary who must be a regulated bank and an independent chartered auditor. In respect of the audit, the Directive does not specifically say which rules will apply (national or international financial reporting standards).

Lastly the AIFM must provide extensive information to its investors as well, report to the competent authorities of its home members state.

All in all, I do not think that any self respecting venture capital fund did not already comply with these requirements. What has now changed is that the funds must also comply with a lot of regulatory disclosures, reporting requirements to investors and competent authorities etc. This will be a burden to smaller funds which would want to obtain the EU passport to market themselves. I would recommend that a specific person be given that particular task in order to avoid any issues. If the venture capital fund does comply it has freedom to invest and market itself throughout the EU with the appropriate label on is prospectus.

In the last part of this short attempt to address current legal issues I would like to touch upon some more mundane but possibly interesting matters :

1. *Exit from funds is a hot topic nowadays. Many who have invested would like to exit from their commitments and ideally get back their investments. Unless there are specific redemption rules, which are very rare in venture capital funds, this is exceedingly difficult. Standard fund rules specify that that if one fails to pay further cash calls, he or she will forfeit his initial investment and still be liable. An attack on the fund managers or grounds of incompetence, lack of due diligence, inordinate risk taking etc will have to be brought at great expense (most likely in the High Court of London) and with little hope of success.*

2. *Transfer of assets from one fund to the next is also very topical. It happens that some funds are unfortunate enough to have reached their term when the market is in a slump. The assets still in the fund however may in the eyes of the managers be quite valuable given time. Investors could agree to become direct shareholders in the investee company but most would not like the hustle and they should all unanimously agree. A sale of the investee company to another fund is a possibility, but if the buying fund is run by the same managers, then they would face issues when considering the valuation and the price of the transfer. I would not easily recommend it. A last resort would be to sell to some or a majority of the investors but again there are issues of valuation.*
3. *A third interesting topic these days, is the question of the valuation of the investment of the shares or units in the fund itself. Under IFRS the investor company could keep in its books the investment in the fund at the valuation stated by the managers, unless it has reasons to doubt it. The managers usually apply EVCA valuation rules which in a bad market do not freely give credit to good companies, while may be overvaluing bad companies. The managers more often than not will be very cautious about what they report. Consequently, the audited statements of the fund will usually underestimate the value of the investments and therefore this underestimated value will be reflected back in the books of the company. The result is that the investing company will report losses in their Profit and Loss Statement on investments which have prospects of regaining their value. When they do, the appreciation will not however appear on the Profit and Loss Statement but will accrue to the equity of the Balance Sheet.-*