Channel Islands
BRUSSELS OFFICE

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On behalf of the governments and financial services regulators of the Channel Islands of Guernsey and Jersey

Response to the European Commission Consultation Document on the Review of the European Venture Capital Funds (EuVECA) and European Social Entrepreneurship Funds (EuSEF) Regulations

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About the Channel Islands

The Channel Islands ('the Islands') consist of the Bailiwicks of Guernsey and Jersey. They are British Crown Dependencies. They are not part of the United Kingdom, but the UK has ultimate responsibility for their external affairs and defence. The Islands enjoy a high degree of autonomy, including their own fiscal and judicial systems, and receive no financial subsidy from the UK or the EU. By virtue of Protocol 3 of the UK's Accession Treaty, the Islands are part of the Customs Union and within the Single Market for the purposes of trade in goods, but not services and as such are treated as "third countries" in financial services regulation. The Islands are part of the Sterling Zone and by virtue of equivalence under the EU's Wire Transfer Regulation are part of the UK's payment and clearing system.

The OECD Convention was extended to Guernsey and Jersey in 1990 and they are part of the UK for the purposes of its membership of the OECD. OECD Decisions and Recommendations apply to Guernsey and Jersey to the same extent as they do to the UK unless the contrary is specifically stated in a particular case – further details can be found on the OECD's website.

About Channel Islands Brussels Office

CIBO was established in 2011 as the joint office of the Governments of Guernsey and Jersey to promote and protect the interests of the Channel Islands in Europe. CIBO has three permanent staff, employed under Belgian employment law. Its legal status is as a Belgian not-for-profit association (fondation privée). It is accountable to, and governed by, a Board of Directors (two Directors from each Bailiwick). It takes political direction from Ministers.

Opening remarks

The Channel Islands are home to a significant and sizable funds industry whose success is founded on professionalism, regulatory leadership and a commitment to international standards and co-operation. The Channel Islands funds sector's particular expertise is in the closed ended alternative funds sector and in the marketing to professional investors only.

We have a demonstrable track record of regulatory co-operation and engagement and a demonstrable track record of success in demonstrating the application of equivalent regulatory approaches to the European Union where there is a relevant contribution by the Channel Islands to the EU markets. In the summer of 2015 ESMA's public opinion was that both Islands funds regimes were effectively equivalent under AIFMD and that there were no grounds not to extend the passport to the Islands.

We believe we have a unique perspective to provide the European Commission to assist it achieve success in its objective of making the EuVECA regime a success and a contributor to capital markets union and are therefore confining our responses to the questions concerning EuVECA.

Both Islands were pleased to respond to the European Commission's general consultation on Capital Markets Union in early 2015 and in this spirit we stand ready to provide whatever further contribution to this work the European Commission might find helpful, including attending meetings and contributing additional materials in writing, and look forward to the opportunity to play a constructive

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role in the development of a proportionate and workable framework for EuVECA funds and their managers.

General remarks/summary position

We have tried to focus our responses to the European Commission's consultation to areas where we are providing comments based on our specific expertise and experience in an attempt to support the objectives of CMU. We have tried to avoid commenting on issues on intra EU competence and thus we have deliberately left many questions blank.

The general thrust of our position can be broken down into broadly two suggestions:

- The first is to support the intention in the regulation to open up the regime to third country managers. As we said in our general CMU responses in early 2015 making access to EuVECA and EuSEF funds as broad as possible and having the broadest possible family of managers and marketers can only serve to increase the numbers of these types of fund. We believe that the rights to manage and market EuVECA and EuSEF funds should be extended to AIFMs in third countries which demonstrably operate equivalent supervisory standards – specifically those third countries to which ESMA has determined there are no obstacles to the extension of the AIFMD passport. Where third country managers are supervised according to equivalent proportionate regulatory standards there is no justification for their exclusion which undermines the openness and international attractiveness of the EU capital market and works against the objectives of CMU. Such exclusion also works against providing access of EU investors to global capital markets and global investments which in the long term would be against the EU's economic self-interest.

- The second is our belief that a relaxation of the qualifying investment criteria and qualifying portfolio company conditions would make EuVECA and EuSEF funds more attractive as it would make them easier to establish and market. In a similar vein, this argument holds for a relaxation of the limits on equity and loan stakes as this would increase the flexibility and attractiveness of such funds. Whilst the effect of relaxing the rules will broaden the range of assets beyond the core venture capital SME targeted by the original EuVECA Regulations, our view is that it would be better to achieve a flourishing funds sector of predominantly venture capital assets, rather than a sector exclusively focussed purely on venture capital which is of limited use. Our view, however, is that there is a required policy trade-off for this increased flexibility - being a mildly more robust regulatory regime.

  The current requirements in the Regulations impose limited registration requirements on the host competent authority. In the interests of investor protection and reputation, we believe that a proper authorisations process for managers of EuVECA funds is required (even though it is recognised that EuVECA funds are primarily aimed at professional investors, the requirement to maintain confidence in the EuVECA brand directly and thus indirectly continued investment in early stage European SME's, we believe, necessitates supervisory substance which is slightly greater than is currently in place in order to sustain confidence in a cross border passport). We stress we do not envisage this to be of the scale of the requirements of AIFMD, nor do we believe that for interests of financial stability, confidence or investor protection there is a need for prudential regulation (in particular) or for own funds greater than what is stipulated in the current Regulations.

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In this regard, we note that Article 7 of the Regulations sets out a principles based regime. The Channel Islands' regulatory regimes reflect this approach and have built in such principles by way of codes and rules.

Consultation response

Question 1) Should managers authorised under the AIFMD be able to offer EuVECA to their clients? Please explain

- Yes. Fund managers whose total assets under management exceed the threshold referred to in point (b) of Article 3(2) of Directive 2011/61/EU should also be able/allowed to establish, market and manage EuVECA funds. Allowing larger fund managers to participate in EuVECA funds will deepen the capital pool available for investment. Furthermore, expanding the scope of fund managers to include those that are already well regulated under Directive 2011/61/EU and have access to the AIFMD passport should not, in our view, have a negative impact on the overall objective of the EuVECA Regulations (being to give smaller fund managers access to a fund raising passport).

- Article 2(2) of the EuVECA Regulations already permits fund managers whose assets under management post fund launch exceed the threshold to continue to use the EuVECA designation in certain circumstances, and in our view, there should be little concern if the threshold is exceeded either at or following establishment of an EuVECA fund.

Question 2) Should managers authorised under the AIFMD be able to offer EuSEF to their clients? Please explain.

- Nil response

Question 3) What would be the effect of EuVECA or EuSEF managers, managing EuVECA or EuSEF funds only, continuing to enjoy the relevant passports once the total EuVECA or EuSEF assets under management, subsequent to their registration as fund managers, exceed the threshold of €500 million?

- EuVECA Assets Under Management (AUM) should be excluded from the AIFMD threshold calculation, so as to ensure that EuVECA AUM do not – on their own – trigger AIFMD registration. This would allow successful EuVECA firms to continue to grow AUM whilst being able to take advantage of the passport under a lighter touch regime, which is likely to result in greater capital invested in EuVECA funds over time as the sector grows and matures.

Question 4) What would be the effect of EuVECA or EuSEF managers, managing EuVECA and/or

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EuSEF funds, continuing to enjoy the relevant passports once their total assets under management, subsequent to their registration as fund managers, exceed the threshold of €500 million?

- See response to question 3.

Question 5) What has been the effect of setting the current threshold at €100,000?

- We have no comment other than to state that in our experience these funds are only appropriate for professional investors and elective professionals on request and that the liquidity of the underlying assets does not make them appropriate for the retail market. Thus we do not see the threshold as inappropriate.

Question 6) What effect would a reduction in the minimum €100,000 investment have on the take-up of EuVECA? If you favour a reduction, what would be an appropriate level?

- We believe that this would increase the risk of mis-selling interests in a EuVECA fund. Distribution channels can become convoluted and may not capture the right investors.

Question 7) What effect would a reduction in the minimum €100,000 investment have on the take-up of EuSEF? If you favour a reduction, what would be an appropriate level?

- See response to question six.

Question 8) How would any reduction of the minimum €100,000 investment be balanced against the need to ensure appropriate retail investor protection?

- See response to question five and six

Question 9) Are the costs relating to fund registration proportionate to the potential benefits for funds from having the passport?

- Our view is that the qualifying investment and portfolio company rules and equity/debt investment limits should be relaxed and broadened. To ensure continued adequate proportionate supervision in such a (more) flexible environment, our proposal would be to enhance the proportionate supervision registration requirements for the managers of EuVECA funds and bring those requirements closer in line with full authorisation, but short of AIFMD requirements. The supervision needs to be proportionate to the risk to give credibility the passport. Above that, we see no requirement for there to be further costs from competent authorities in host member states.

Question 10) Are the registration requirements for EuVECA a hindrance to the setting up of such

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funds in your Member State and, if so, how could this be alleviated without reducing the current level of investor protection?

- Nil response

Question 11) Are the registration requirements for EuSEF a hindrance to the setting up of such funds in your Member State and, if so, how could these hindrances be alleviated without reducing the current level of investor protection.

- Nil response

Question 12) Are the requirements for minimum own funds imposed on the managers relating to fund registration proportionate to the potential benefits for funds from having the passport?

- In relation to EuVECA Funds that have separate managers, yes we do not believe, given the illiquid nature of the asset class and the restrictions on marketing to professional investors, that there is a need for any further prudential requirements. However, in relation to self-managed EuVECA funds, we do not think there should be an "own funds" requirement; simply that they must be a going concern.

Question 13) Should the use of the EuVECA Regulation be extended to third country managers and if so, under what conditions?

- Yes making access to EuVECA and EuSEF funds as broad as possible and having the broadest possible family of managers and marketers can only serve to increase the numbers of these types of fund. We believe that the rights to manage and market EuVECA and EuSEF funds should be extended to AIFMs in third countries which demonstrably operate equivalent proportionate supervisory standards – specifically those third countries to which ESMA has determined there are no obstacles to the extension of the AIFMD passport. Where third country managers (and their funds) are supervised according to equivalent proportionate regulatory standards there is no justification for their exclusion which just undermines the openness and international attractiveness of the EU capital market and works against the objectives of CMU.

- Extension of the passport to third countries would enable EuVECA to leverage the experience of jurisdictions that possess a pre-existing track record of success in the venture capital funds sector. Investors in such funds are typically highly sophisticated and will generally consider track record and industry experience as critical when choosing to invest, and accordingly a regime which is able to leverage the existing background and experience will maximise its traction with industry in the future. Such experience would contribute in the development of this asset class to the extent that it is further developed using the EuVECA framework. In a similar vein to AIFMD and MIFID II, it is entirely reasonable to also expect third country jurisdictions not to be listed as a non-cooperative country or territory by the Financial Action Task Force (FATF) and to have in place tax information agreements that comply with the OECD Article 26 tax convention.

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Question 14) Should the use of the EuSEF Regulation be extended to third country managers and if so, under what conditions?

- See question thirteen.

Question 15) Is the current profile of eligible portfolio assets conducive to setting up EuVECA funds? In particular, does the delineation of a 'qualifying portfolio undertaking' (unlisted, fewer than 250 employees, annual turnover of less than €50 million and balance sheet of less than €43 million) hinder the ability to invest in suitable companies?

- The qualifying investment requirements as currently included in the EuVECA Regulation can make the regime unattractive and should be re-considered and made broader and more flexible.
- The narrowness of the SME definition used in EuVECA also raises issues by excluding companies that would ordinarily be considered 'small or medium' sized by fund managers and investors. Companies active in the services field, for example, may fairly rapidly reach 250 employees but from a financing perspective are still 'early stage' and looking for equity backing from venture capital or other active fund investors.
- Furthermore, the current SME definition creates significant barriers to corporate venture capital investment. This distinction between types of venture investment is not justified in practice and makes it more difficult for corporate and institutional investors to provide much needed early-stage financing to these companies.

Question 16) Does a EuVECA's inability to originate loans to a qualifying portfolio undertaking in which the EuVECA is not already invested hinder the attractiveness of the scheme for potential managers of such funds?

- See response to question 17.

Question 17) In this context, does the rule that a EuVECA can only use 30% of the aggregate capital contributions and uncalled committed capital for loan origination reduce the attractiveness of the scheme?

- The requirement that secured or unsecured loans not exceed 30% of fund commitments precludes certain managers whose strategy may involve investing a higher proportion of debt alongside equity; or discourage those who are simply unwilling to deny themselves the flexibility to find the right mix of debt and equity as circumstances and market conditions dictate. Concentrations of loan notes alongside equity are not uncommon for earlier stage investment, helping to mitigate down-side risk and offering some protection for the fund should the portfolio company become insolvent. This threshold should ideally be removed, or at least increased.

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- More generally, as the funding and financing needs of SMEs will vary over time and as the company grows there should be full flexibility allowed in the financing instruments to be used (i.e. no restriction as to the type of assets/instruments). Any limitation of finance would be contrary to the great need of flexibility of investments in SMEs and will worsen SMEs' access to finance. In particular, many small funds (and private equity funds in general) provide mezzanine capital to fund their portfolio companies. Currently, not all of such instruments are treated uniformly within the EU.

Question 18) What are the key issues or obstacles when setting up and marketing EuVECA or other types of venture capital funds across Europe?

- In terms of third countries, we believe that AIFMD member state border controls are likely to act as an obstacle until such time as the passport is fully opened up.

Question 19) What are the key issues or obstacles when setting up and marketing EuSEF or other types of social investment funds across Europe?

- See question eighteen

Question 20) What other measures could be put in place to encourage both fund managers and investors to make greater use of the EuVECA or EuSEF fundraising frameworks?

- There is a strong case for reconsidering whether the narrow focus of the EuVECA regime is appropriate and for extending this voluntary regime to all fund managers whose assets under management are below the EUR 500 million threshold, regardless of whether they are venture capital, growth/expansion or small (sub-threshold) buy-out funds. Indeed, it is not just venture capital funds that provide finance to European SMEs; a major part of financing provided to SMEs from our industry is provided by private equity funds.

- Limiting EuVECA only to venture capital funds that meet a specific set of fairly restrictive criteria automatically limits its potential take-up. It also implies a stark distinction between fund investment strategies that may not be helpful nor reflective of the needs and the experiences of either the investors or companies which they are typically looking to finance through different stages of growth.

- These small funds should be provided with a means to market across EU borders, as failure to do so undermines the objective to establish a single market for capital. Fund managers who do not need to be authorised under the AIFMD, are not likely to pose a higher degree of risk for investors than venture capital funds, and would still only enjoy a pan-EU passport to market to "professional investors" (and not to retail investors). Since development and growth finance, which is often also provided by a "buy-out" investor offering an exit to a founder, are just as important for the EU economy as start-up capital, the EuVECA regime could be extended to funds with this type of strategy.

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Question 21) What other barriers exist to the growth of EuVECA and EuSEF? Please specify. Are there other changes that could be made to the EuVECA and EuSEF regulations that would increase their up-take?

- Nil response

Question 22) What changes to the regulatory framework that govern EuVECA or EuSEF investments (tax incentives, fiscal treatment of cross-border investments) would make EuVECA or EuSEF investments more attractive?

- EuVECA funds should be exempted from the Prospectus Directive requirements where these funds are marketed only to professional and elective professional investors. However, if EuVECA funds were to issue transferable securities to the public, it would then be crucial for these funds to be caught under the Prospectus Directive, in order to give retail investors the legal protection which they need.

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Annex 1: The Finance Sectors of the Channel Islands

- The economies of Guernsey and Jersey are services based. In particular over the past 40 years both Islands have developed into important international financial centres. Financial services firms are major employers in the Islands, with over a quarter of the workforce (19,000 jobs) employed in the sector.
- The combined level of banking deposits across the Islands in September 2015 was around £215 billion and the level of funds was £443 billion. These deposits and funds are drawn into the UK and the rest of Europe largely from the rest of the world and the Islands' marketing efforts are directed at increasing this flow from the Far East, Gulf and other wealth creating countries outside of Europe.
- There are 30 licensed banks in Guernsey and 33 regulated banks in Jersey at 2015 and both jurisdictions have local deposit guarantee schemes. Many banking operations are branches or subsidiaries of parent banks based in the EU, including HSBC, BNP Paribas and Deutsche Bank.
- Although Channel Islands funds invest heavily into the UK, it is understood that much of this flows onwards into mainland Europe. Notably there are a number of Channel Islands based infrastructure funds investing in a variety of projects including renewable energy. The activities of these funds support European policy on energy security and reduction of carbon emissions. Indeed the European Commission frequently quotes that more than a third of UK Private Equity funds' investment goes to companies elsewhere in the EU. This is supplementing the significant direct investment flows from the Channel Islands' funds into the wider (non UK) European economy.
- The wider financial sector of the Channel Islands includes substantial fiduciary and specialist asset management expertise. Both Guernsey and Jersey thus act as "financial entrepôts" and are significant net providers of liquidity and investment funds to the EU economy, directly and indirectly.
- The Channel Islands' closest trading partner is the United Kingdom. Recent information shows that the majority of investment into UK funds channeled through the Channel Islands is from overseas non-European investors. In the UK, Infrastructure funds based in the Channel Islands (including a hub of renewable energy funds) assist with supporting key UK government objectives by facilitating the construction and management of key infrastructure assets across the UK.
- Non-European investors contribute approximately half of the Channel Islands investment into assets in Europe. The Channel Islands funds markets facilitate European investors in achieving their goal of obtaining exposure to global alternative assets. Channel Islands expertise in asset management acts as a mechanism to source and facilitate global investors to invest in EU assets.
- The Islands have strong links with capital markets across the globe and are the home of companies that have been the subject of significant listings on worldwide stock exchanges. Companies incorporated in the Channel Islands have had more successful initial public offerings of non-UK entities than from any other jurisdiction in the world. There are 91 Channel Islands companies among the 3,000+ companies listed on the Alternative Investment Market (AIM) of the London Stock Exchange: more than from any jurisdiction except the UK.
- The Channel Islands Securities Exchange Authority Limited provides a listing facility and a market for companies to raise capital from international investors based on a bespoke trading platform

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serving the interests both of Channel Islands' business and of issuers of specialist debt, investment funds and other equity securities from around the world.

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Annex 2: Channel Islands' Regulatory Approach

The Channel Islands are committed to ensuring their regulatory framework and practice meet international standards. They are committed participants in discussions of international standards doing so through their membership of, or association with, the following international organisations.

- The International Organisation of Securities Commissions (IOSCO) - as a member
- The International Association of Insurance Supervisors (IAIS) and the Offshore Group of Insurance Supervisors (**OGIS**) - as a member
- The Group of International Finance Centre Supervisors (GIFCS)
- The Organisation for Economic Co-operation and Development (OECD) – as part of the United Kingdom's membership.
- The Council of Europe's Committee of Experts on the Evaluation of Anti-Money Laundering Measures and the Financing of Terrorism (MONEYVAL).

Through their membership of the Group of International Finance Centre Supervisors, it works with:

- The Basel Committee on Banking Supervision (BIS)
- The Financial Action Task Force (FATF) on money laundering

The Channel Islands are also committed to international regulatory co-operation and is a signatory to the IOSCO MMoU and the IAIS MMoU. They have numerous bilateral regulatory co-operative agreements in place; and, through ESMA, MoUs covering AIFMD with 27 members of the EEA.

The Channel Islands also have a demonstrable track record of regulatory co-operation and engagement and a demonstrable track record of success in the application of equivalent regulatory approaches to the European Union where there is a relevant contribution by the Channel Islands to the EU markets. In the summer of 2015 ESMA's public opinion was that both Islands funds regimes were effectively equivalent under AIFMD and that there were no grounds not to extend the passport to the Islands.