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Nothing ventured nothing gained: How the EU can boost growth in small businesses and start-ups

Apostolos Thomadakis

Abstract

Venture capital can be vital to innovative and growth-oriented start-ups and small businesses in need of external capital. Since July 2013, when the Regulation on European Venture Capital Funds (EuVECA) came into force, it has not had much success or attracted much attention. European venture capital funds are far from being systemically relevant and suffer from multiple supply-side failures and structural weaknesses; namely a lack of private-sector investors; fragmentation; small fund size; limited access to international money; low investment interest; low current and expected performance; and a big funding gap with the US. The Commission's proposed changes to the existing regulation, published 14 July 2016, includes an extension of the range of managers eligible to market and manage EuVECA, an increase in the range of companies that EuVECA can invest in, and simplified registration and cross-border marketing of EuVECA. These proposals will now be discussed in the European Parliament and the EU Council. This paper argues, however, that they fail to address three important issues that could further boost financing: the extension of the EuVECA Regulation to third-country managers, the reduction of the €100,000 entry ticket without further compromises on investor protection, and harmonisation of rules on managing requirements. Finally, it discusses measures that facilitate access to financing for start-ups and SMEs: i) common/harmonised legislation, ii) harmonisation of tax treatment, tax rates and tax relief processes, iii) promotion of social/impact investment, iv) bridging early-stage ecosystem to secondary markets and v) improved training and support to bring more investors on board.

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1. Introduction

The EU's decision to create a Capital Markets Union (CMU) to mobilise capital across the region means that Europe is now ready to address issues of regional competitiveness, growth and jobs. Indeed, financing growth and innovation is one of the focal points of the Commission's Green Paper,[1] which advocates expanding the pool of both investible assets and potential investors. Once the CMU is put in place Europe is likely to be better off than it is today in terms of cross-border capital markets.

Small- and medium-sized enterprises (SMEs) and start-ups are the backbone of the European Union's economic development, yet they find it difficult to access finance and boost their growth. Since the global financial crisis, bank lending has become scarce and entrepreneurs have to take risks and look for new sources of money. Moreover, given the volatility of the stock market and the zero- to negative-returns delivered by the bond market (safe haven), alternative investments (e.g. small cap) become a more attractive and necessary option. One of these alternative investments is venture capital (VC).

Venture capital has been a key source of finance for commercialising radical innovations.[2] Unlike other forms of external finance, a key feature of VC is that it facilitates the provision of funding to start-up firms, despite the huge risks associated with unproven technologies or inventions. Since start-ups with new technologies rarely have internal cash flow to draw upon and are too risky to obtain debt finance, they critically depend on the provision of VC for their survival.

With the aim of promoting investment in start-ups and SMEs, opening up new areas of growth and moving towards an innovation-led economy, the Regulation on European Venture Capital Funds (EuVECA) came into force in July 2013. The Regulation aims to support young and innovative firms by investing in privately held undertakings with an annual turnover of less than €50 million (or an annual balance sheet of less than €43 million) and fewer than 250 employees. Since July 2013, the facilities have been available to fund managers with a total value of assets under management of €500 million or less, and can be marketed across the European Economic Area (EEA) – composed of the EU member states plus Iceland, Liechtenstein and Norway – to both professional and non-professional investors who commit a minimum of €100,000 to the fund.

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[1] See European Commission (2015a).

[2] The focus of this paper is on VC that the European Commission (2012) defines as "investment in unquoted companies by investment funds (venture capital funds) that, acting as principals, manage individual, institutional or in-house money and includes early-stage and expansion financing, but not replacement finance and buy-outs. Strictly defined, venture capital is a subset of private equity…" On the other hand, private equity (PE) can be defined as a form of medium- to long-term equity investment in private companies not listed on the stock exchange.

Even though the EuVECA Regulation has had some initial success and is starting to be accepted by the market, the very small number of applications[3] and the speed with which the text was produced have exposed a number of issues, including a lack of knowledge and understanding of the way the venture capital industry operates. Against this background, the European Commission published a consultation on the review of the EuVECA Regulation in September 2015, which led to a proposed amendment in July 2016.

Taking this latter action as its point of departure, this paper is organised as follows. Section 2 analyses the supply-side failures and structural weaknesses of EuVECA, while section 3 addresses the current limitations of the EuVECA Regulation. Section 4 describes the Commission's proposed amendments to the Regulation; section 5 calls for further action; section 6 offers some long-term policy recommendations and section 7 concludes.

2. The venture capital market

The venture capital industry has a longstanding commitment to encourage and facilitate long-term investment. As recognised by the European Commission (2013) in its Green Paper on Long-term financing of the European economy, and given the longer time horizons of their business models, institutional investors (insurance companies, pension funds, mutual funds and endowments) represent suitable providers of long-term financing. Total assets under management (AuM) in Europe increased by 9% in 2013 and 15% in 2014, to reach an estimated €19 trillion at the end of 2014. This brought the ratio of AuM to aggregate European GDP to 124% of GDP at the end of 2014.[4]

2.1 Lack of private-sector investors

Despite this large amount of available capital, European innovation continues to be faced with a lack of private-sector investors in venture capital. Many private investors/Limited Partners (LPs) no longer invest in the European VC asset class due to the associated higher risks and lower performance returns. Start-ups and early-stage growth firms have yielded poor returns, which has deterred the private sector from returning to this asset class.

On the other hand, the supportive tax environment for individual investors, such as business angels and other high-net worth investors, provides a powerful incentive for early-stage investors, but also considerably reduces the real downside on an investment. These tax 'benefits', however, should only aim to encourage investment and change the risk profile of start-ups and are not meant to be a tool to reduce the tax burden of wealthy individuals.

In response to private investors withdrawing from the market, the public sector stepped in to maintain the availability of risk-capital financing during the global economic and financial crises. According to Invest Europe/PEREP_Analytics data (Figure 1), in 2015, government agencies contributed 31% of the funds raised, followed by funds of funds and other asset managers (22%), corporate investors (14%), and family offices and private individuals (12%).

On an aggregate basis between 2007 and 2015, the share of total funds raised by pension funds, insurance companies and banks fell from 32% to just 11% in 2015. Over the same period, contributions by government agencies grew considerably. While in 2007 government agencies accounted for 14% of investment in European venture capital, by 2015 their share had increased to 31% of venture funding.

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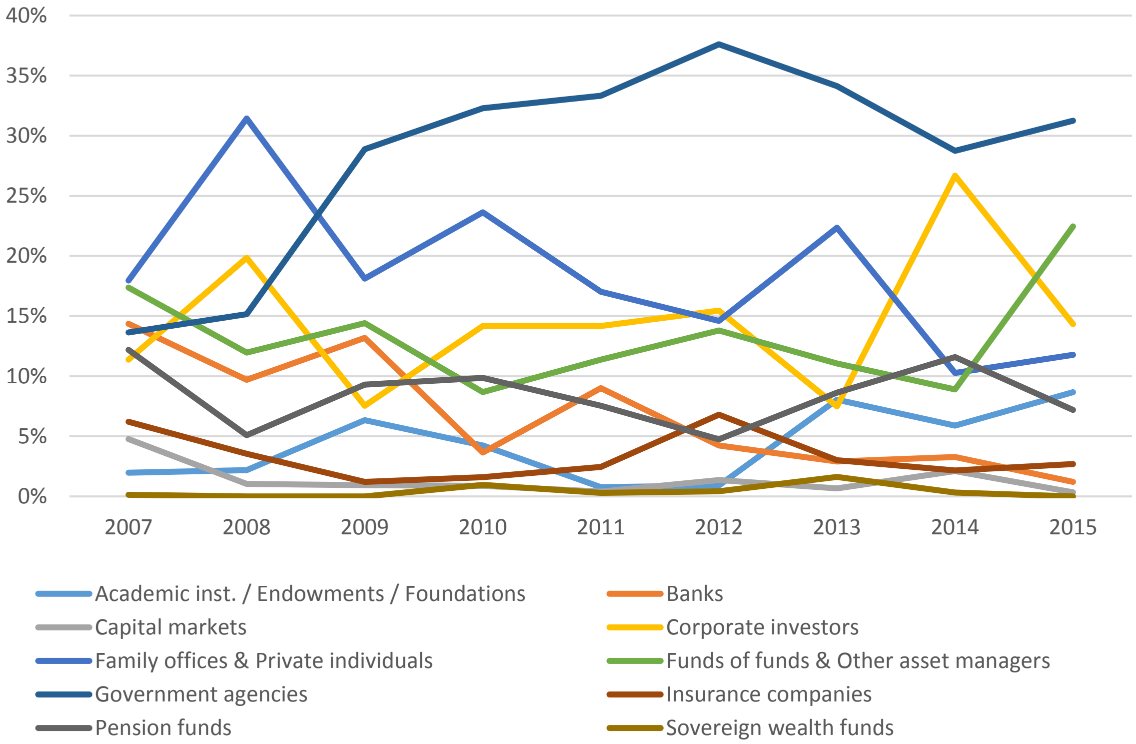
[3] In July 2016, 70 EuVECA funds had been notified to the European Securities and Markets Authority (ESMA). However, the register contains only 20 such funds (11 in Germany, five in Ireland, two in Spain, and one in France and Latvia). Moreover, the number of registrations per year is decreasing: one registration in 2013, nine in 2014, seven in 2015 and only three in 2016 (as of late November).

[4] Asset Management in Europe, 8th Annual Review, EFAMA.

Figure 1. Venture capital - Funds raised by type of investor (% of total amount)



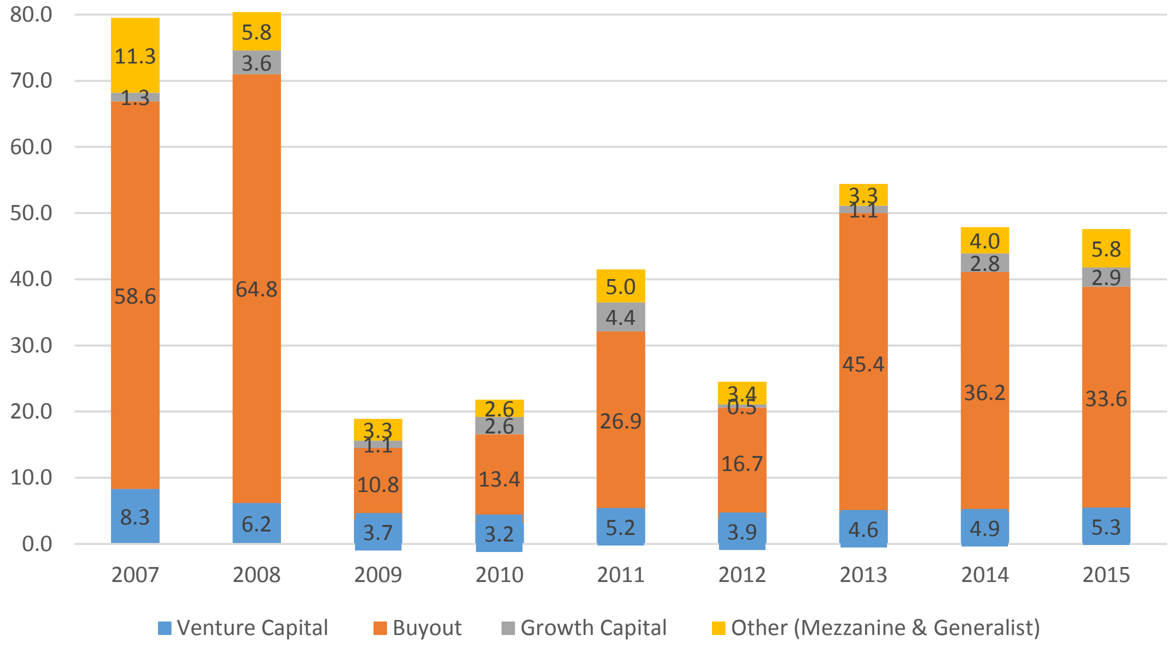
Source: Author's calculations based on Invest Europe/PEREP_Analytics data.

2.2 Fragmentation

This trend towards increased reliance on public-sector investment could be exacerbated in the coming years as new prudential regulation comes into effect.[5] Institutional investors will be under pressure to reduce their investments in long-term, illiquid investments, and commitments to private equity are also likely to be affected. As a consequence, venture capital, as the smallest part of the private equity industry and the one that is most willing to back more innovative (and thus riskier) European companies, is in danger of being cut out entirely from the asset allocation strategies of banks, insurance companies and occupational pension schemes. Data for 2015 show that venture capital, in comparison with other asset classes, accounted for only €5.3 billion (11.2%) in terms of fundraising and €4 billion (8.4%) in terms of investments (Figures 2 and 3).

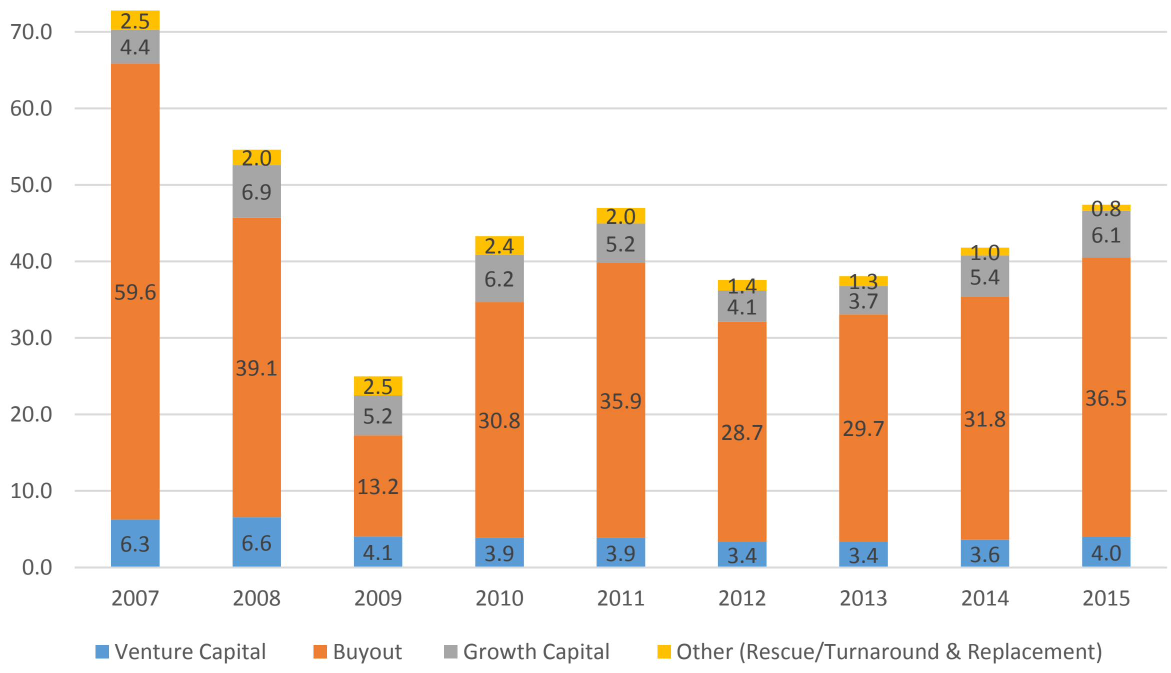
[5] The European Commission's legislative proposals include: i) a framework for simple, transparent and standardised securitisation, ii) new prudential calibrations for banks in the Capital Requirements Regulation (CRR), iii) an adjustment to the Solvency II legislation to make it easier for insurers to invest in infrastructure and European Long-Term Investment Funds (ELTIFs), iv) a framework for a pan-European covered bond market and v) the European Venture Capital (EuVECA) and European Social Entrepreneurship Funds (EuSEF) Regulations.

Figure 2. Incremental amounts raised by type of fund (€ billion)



Source: Author's calculations based on Invest Europe/PEREP_Analytics data.

Figure 3. Amount of equity investment by type of fund (€ billion)

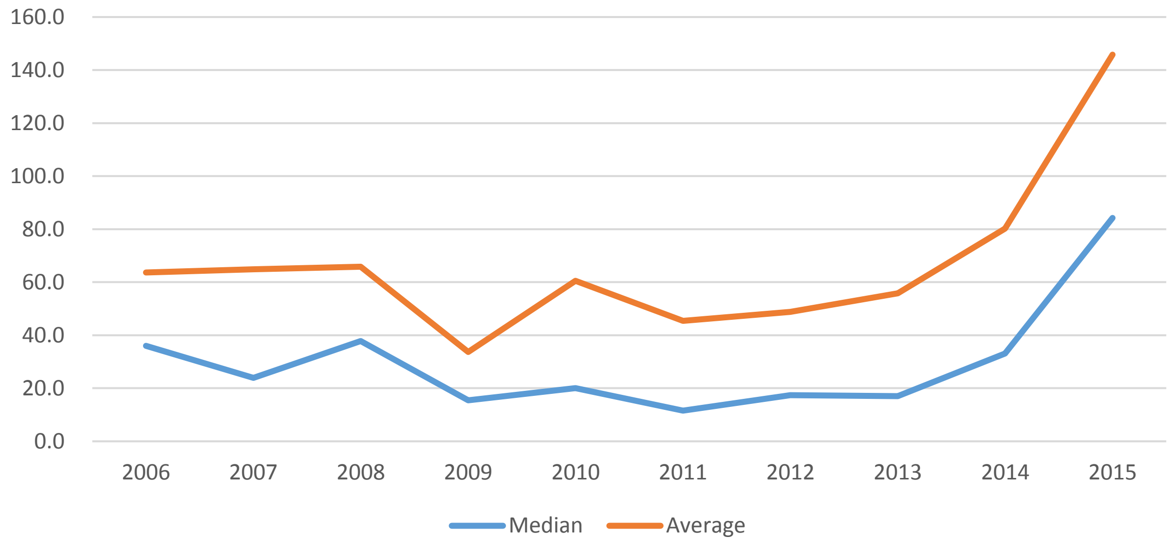


Source: Author's calculations based on Invest Europe/PEREP_Analytics data.

2.3 Fund size

While the European venture capital fund was relatively small until 2013, things have changed significantly since 2014 (Figure 4). Between 2006 and 2013, the average size of European VC funds was €55 million and the median fund size only amounted to €18.7 million; 50% of all European venture capital funds were smaller than €18.7 million. On the other hand, in 2014-15 the average size increased to €113 million, while the median to €59 million.[6]

Figure 4. Median and average EU VC fund size (€ million)



Source: Author's calculations based on PitchBook 2Q 2016 European Venture Industry Report.

2.4 Access to international money

Due to their small fund size, however, it is difficult for venture capital managers to raise capital outside of Europe and to take advantage of a more general geographic shift in the sources of long-term institutional private capital. Latest data from the European Investment Fund (EIF) – one of the biggest providers of risk capital, in particular of VC to young and innovative European start-ups – show that the fundraising volumes backed by the EIF in 2014 amount to 45% of the overall volumes collected by European VC investors. Similarly, the investment activity backed by EIF represented 41% of total investment in Europe in 2014.[7] From figures 5 and 6 it is evident that European venture capital does not have access to large pools of international capital.

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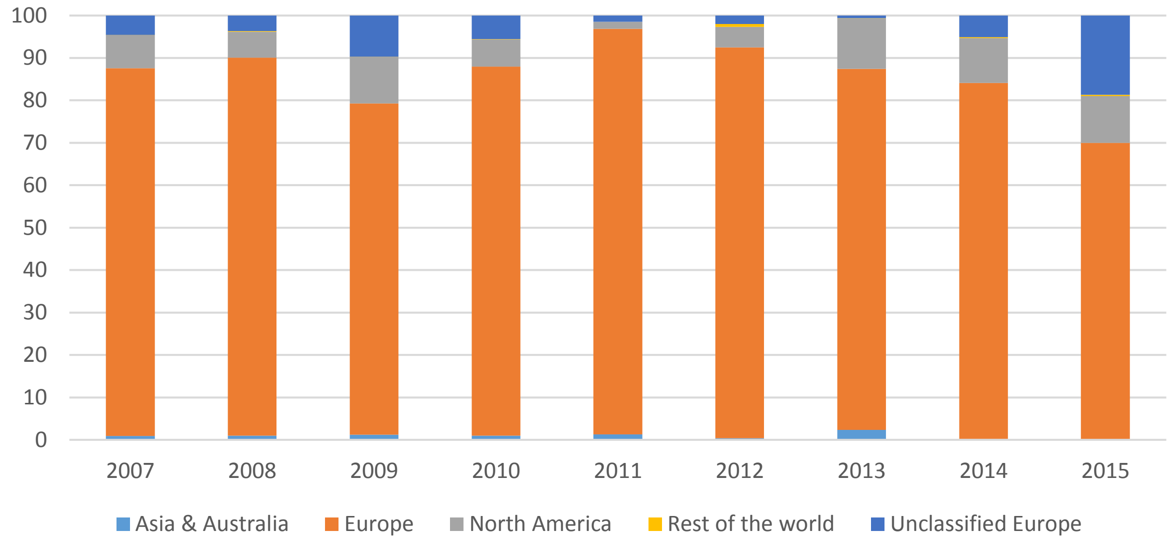
[6] This increase is largely attributed to the EuVECA Regulation that came into force on 22 July 2013 and aimed to encourage investments by VC funds in small and innovative firms in order to boost economic growth.

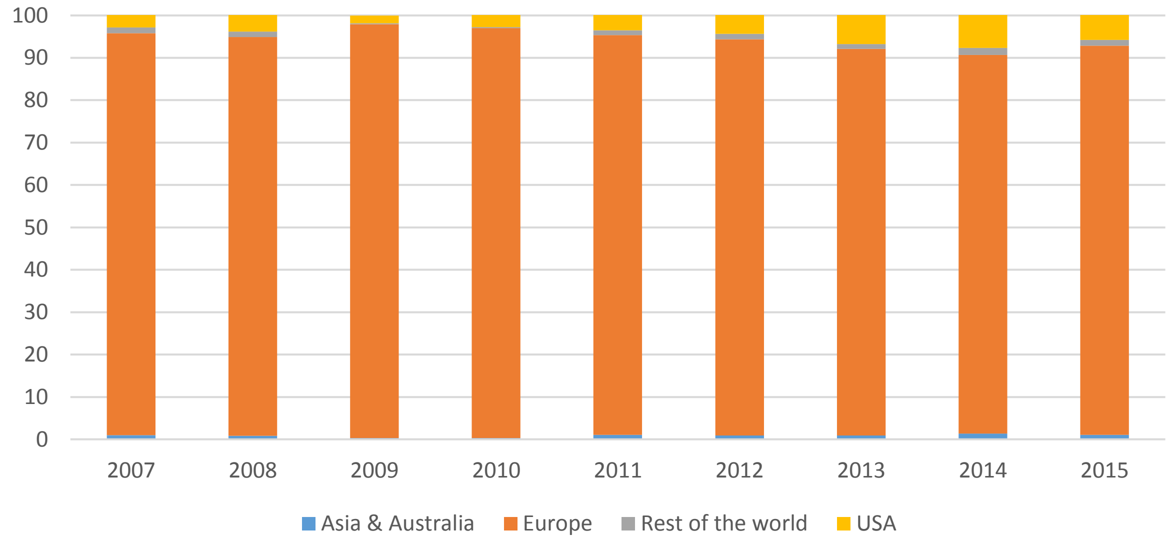
[7] These numbers correspond to early stage and later stage fundraising activity, as well as seed and start-up stage investment, respectively, EIF (2016).

Figure 5. EU VC fundraising by source of fund (% of total amount)



Source: Author's calculations based on Invest Europe/PEREP_Analytics data.

Figure 6. EU VC investment by region (% of total amount)



Source: Author's calculations based on Invest Europe/PEREP_Analytics data.

2.5 Level of investment interest

International investors have gradually lost interest in European venture capital. Data from the Global Private Equity Barometer[8] show that when compared to other private equity investment options, European VC is perceived as one of the least favourable private equity sectors to invest in.

[8] Colles Capital's Global Private Equity Barometer provides an overview of worldwide trends in private equity, based on the plans and opinions of institutional investors in private equity (limited partners) based in North

The winter 2013-14 edition of the survey anticipated that investors will scale back their exposure to European VC and large buyout investments (due to higher risk) over the next two-to-three years, while small and mid-market buyout transactions will offer the best private equity opportunities. In particular, 35-40% (5-10%) of LPs planned to decrease (increase) their new commitments in EU VC, and 30-35% of LPs to increase their exposure to small and mid-market buyout funds.

The picture from the latest survey (summer 2016) is similar, even though the magnitude of investors planning to decrease their EU VC exposure has now moderated (7%). In particular, LPs are planning to maintain their exposure to VC and to build their exposure to small and mid-market buyout funds, growth capital and private debt over the next two-to-three years. Finally, investors are pursuing similar strategies for North American and European private equity, as can be seen from Table 1.

Table 1. LP investment strategies for North American and European PE over the next 2-3 years (% of respondents)

	North America	Europe
Large buyouts	-21% / +10%	-17% / +13%
Mid-market buyouts	-5% / +42%	-5% / +36%
Small buyouts	-4% / +41%	-6% / +32%
Growth/expansion capital	-4% / +26%	-6% / +26%
Venture capital	-7% / +11%	-7% / +8%
Private debt/credit	-8% / +27%	-5% / +24%

Source: Author's calculations based on Global Private Equity Barometer, summer 2016.

2.6 Current and expected performance

The low level of interest for European VC observed in the early years is reflected in the low returns that LPs' private equity portfolios have generated since their inception; low returns not only compared to other EU private equity investment options, but also to international VC investments (Table 2). Seventy-five percent of LPs have received annual returns (net of fees and carried interest) of more than 11% from European buyouts, while only 43% of them are from European VC. Furthermore, 57% of LPs achieved net annual returns of less than 10% by investing in EU VC, compared to 40% and 37% of LPs investing in Asia-Pacific and North American VC, respectively.

Table 2. Annual net returns across LPs' PE portfolios since their inception (% of respondents)

		< 10%	11-20%	> 20%
Buyout	North American	13	85	2
	Asia-Pacific	27	73	0
	European	25	74	1
Venture	North American	37	53	10
	Asia-Pacific	40	52	8
	European	57	43	0

Source: Author's calculations based on Global Private Equity Barometer, summer 2016.

Regarding annual net return expectations from their PE portfolios, 54% of LPs expected the European VC to deliver returns of less than 10% over the next three-to-five years. Moreover, they anticipated that buyout transactions in Europe would offer the best private equity opportunities, as almost 80% of LPs

America, Europe and Asia-Pacific (including the Middle East). In the 19th edition of the Barometer 113 private equity investors participated, while in the 24th edition (summer 2016) 110 investors.

expect annual returns in the range of 11-20%. The low forecasted performance of EU VC is evident, not only within the European private equity market, but also across international markets (Table 3).

Table 3. LPs' forecast net annual returns from PE in the next 3-5 years (% of respondents)

		< 10%	11-20%	> 20%
Buyout	North America	10	87	3
	Asia Pacific	29	66	5
	Europe	15	79	6
Venture	North America	24	64	12
	Asia Pacific	42	51	7
	Europe	54	40	6

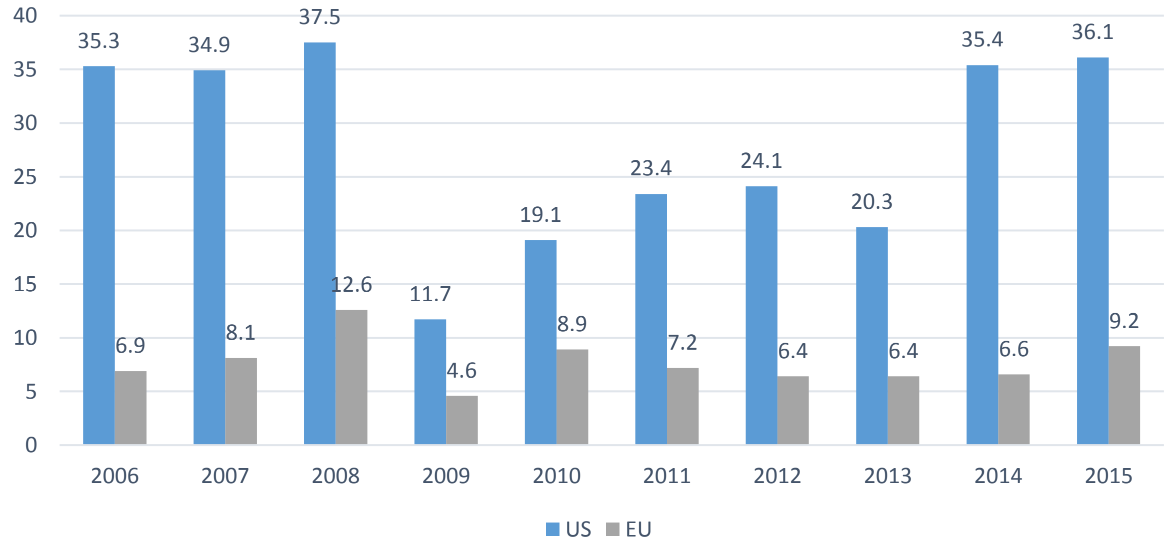
Source: Author's calculations based on Global Private Equity Barometer, winter 2015.

2.7 Funding gap with the US

It is evident that European venture capital needs to access more international institutional investors who have a potentially higher risk appetite and access to additional pools of capital. Lately, however, we see that US institutional limited partners are increasingly among the largest investors in European venture capital funds and fastest-growing European tech firms.

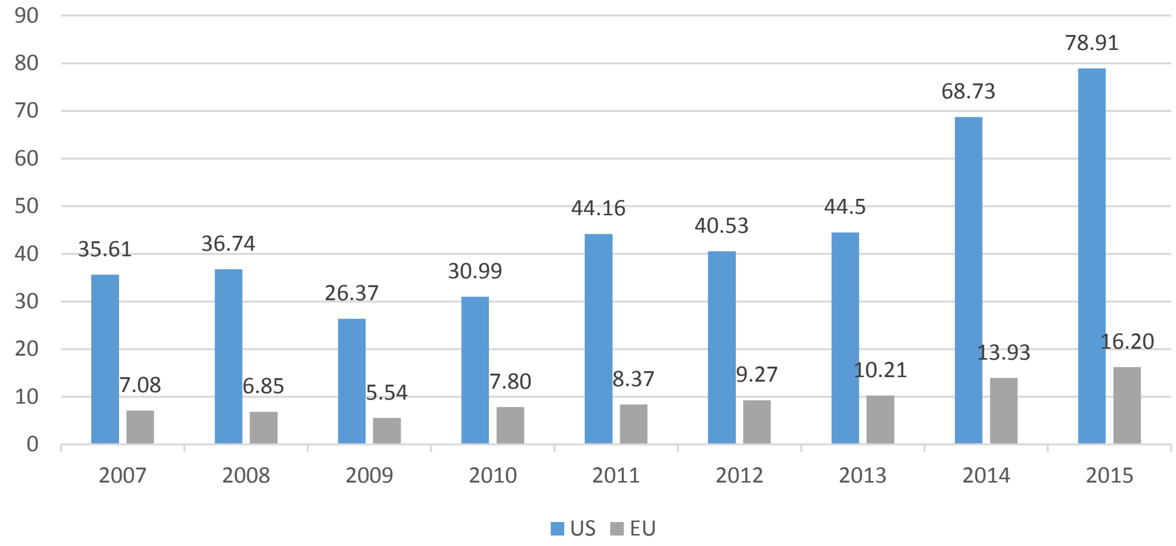
The global economic and financial crisis had a major impact on the level of VC deal flow in both the EU and the US. American VC fundraising has recovered more quickly, however, as shown in Figure 7. Venture capital fundraising in Europe has been weak, averaging 29% of the amount raised in the US since 2006. Moreover, the total annual activity (investment) in the US VC industry ($79bn in 2015) is significantly greater than in Europe ($16bn in 2015). Even though the total size of European VC market in 2015 increased by 16.3% compared to 2014, venture capital investment in Europe averages 21% of the amount raised in the US since 2006 (Figure 8).

Figure 7. US-EU VC fundraising (capital raised, $B)



Source: Author's calculations based on PitchBook's 3Q 2016 US Venture Monitor and PitchBook's 2Q 2016 European Venture Industry Report.

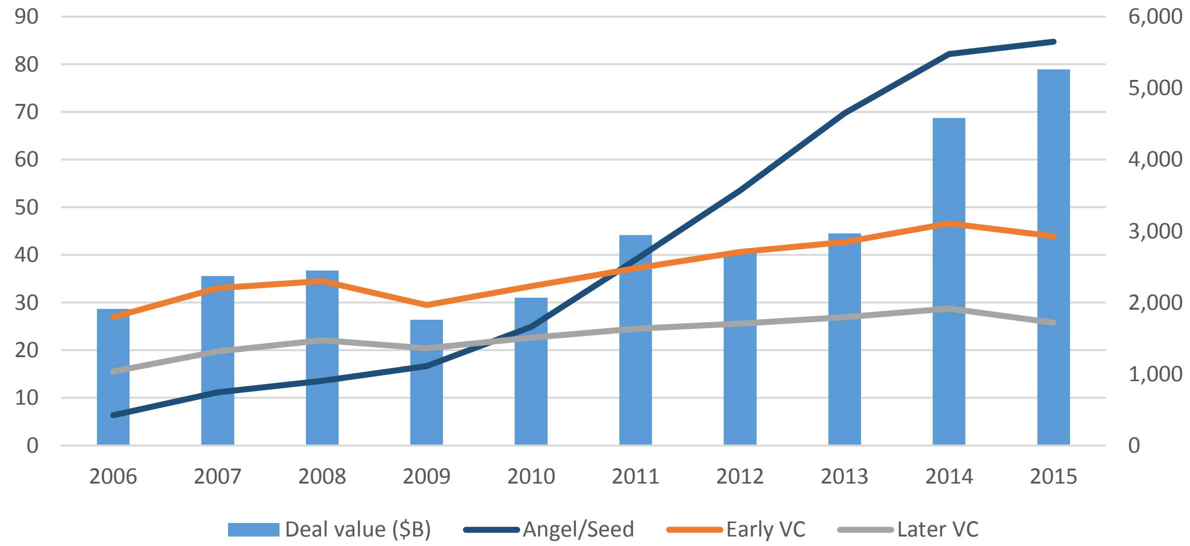
Figure 8. US-EU VC activity (deal value, $B)



Source: Author's calculations based on PitchBook's 3Q 2016 US Venture Monitor and PitchBook's 2Q 2016 European Venture Industry Report.

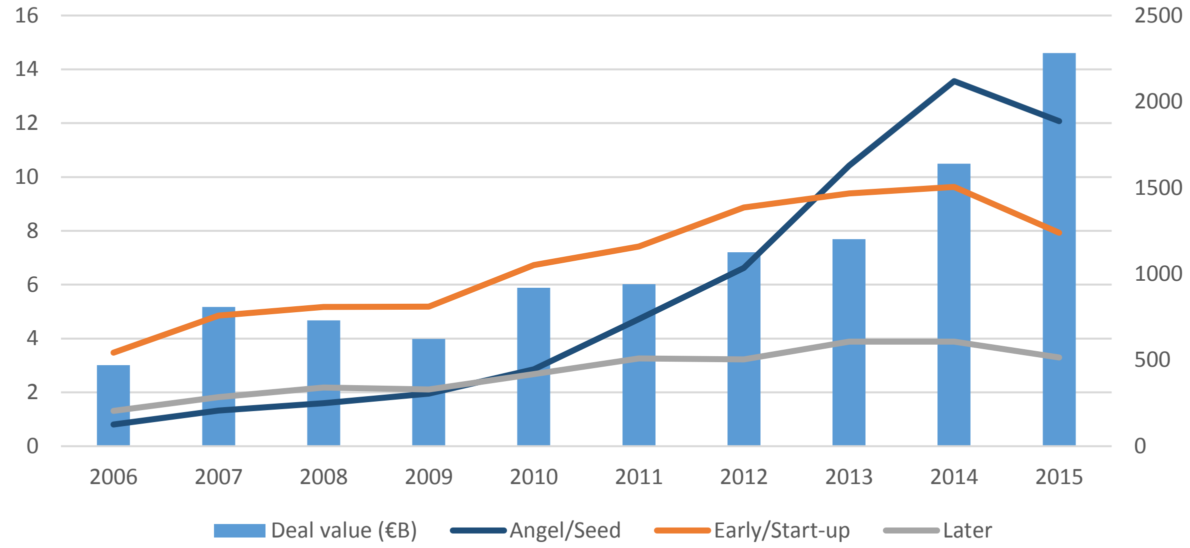
Comparing the evolution in VC activity overall and by stage of development in Europe and the US, we observe that while angel/seed activity has significantly lagged behind the number of early and late stage deals, the number of angel/seed deals has grown considerably during the economic recovery (figures 9 and 10). Yet, the time at which this change occurred, and the volume of deals closed differ on the two continents. For the US the angel/seed activity overcame the early VC activity in 2011, while for the EU it was two years later, in 2013. The number of deals closed in the EU in 2015 (3,541 thousands) accounts only for the 35% of deals closed in the US (10,293 thousands).

Figure 9. US VC activity by stage of development ($B)



Source: Author's calculations based on PitchBook's 3Q 2016 US Venture Monitor and PitchBook's 2Q 2016 European Venture Industry Report.

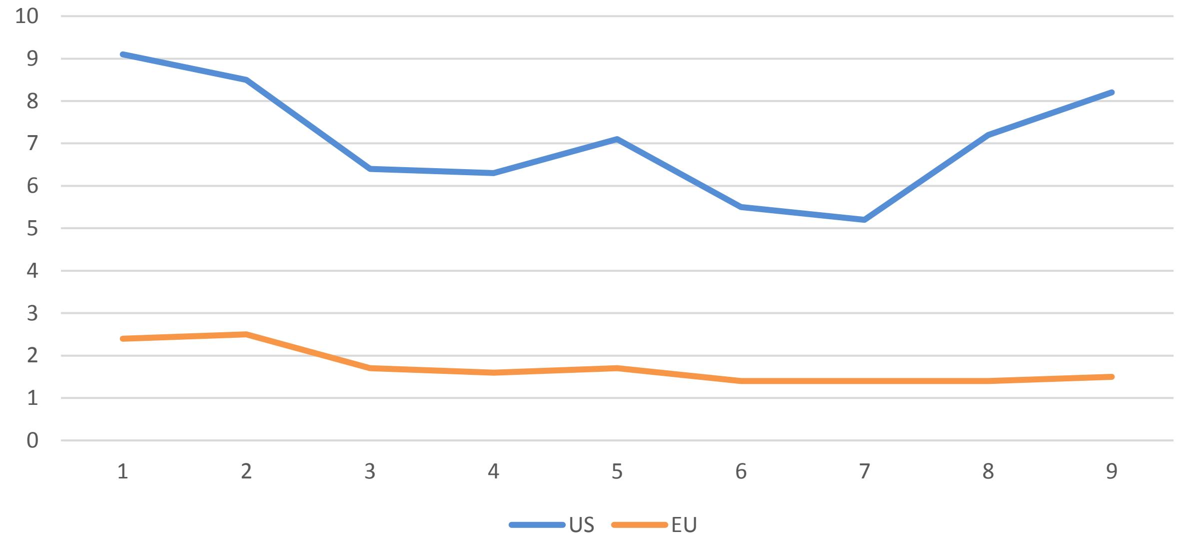
Figure 10. EU VC activity by stage of development (€B)



Source: Author's calculations based on PitchBook's 3Q 2016 US Venture Monitor and PitchBook's 2Q 2016 European Venture Industry Report.

Another important difference between the US and EU venture capital markets is the funding distribution. We consider whether funding is spread more thinly in Europe than in the US by looking at average amounts invested by company. Figure 11 shows that although European funds invest much less in aggregate than in the EU, they support many more companies (conditional on the amount invested). While the average investment in the US between 2007 and 2015 was $45.2bn by almost 6,500 companies, in Europe 3,330 companies invested only $5.87bn.

Figure 11. US-EU VC average investment per investee company ($M)



Source: Author's calculations based on PitchBook's 3Q 2016 US Venture Monitor and Invest Europe/PEREP_Analytics data.

3. Limitations of the current EuVECA Regulation

The first limitation of the current EuVECA Regulation regards the €500 million threshold of the manager's portfolio. At present, if the aggregate assets of a venture capital fund exceed €500 million, the manager falls within the scope of the AIFMD and has to seek a regular authorisation under AIFMD. This means that the manager can continue to use the EuVECA label, but not the marketing and management passports (known as 'limited grandfathering').

The second limitation concerns the types of companies a EuVECA is allowed to invest in. Currently, the EuVECA can only invest in unlisted SMEs, companies with fewer than 250 employees and an annual turnover of less than €50 million. But this provision has been regarded as narrow and restricted, and contradicts the Commission's primary focus to undertakings that are: i) very small, ii) at the initial stage of their corporate existence, and iii) display strong potential for growth and expansion.

The third limitation has to do with certain EU member states' strict requirement that funds managers pay additional fees to markets in their jurisdictions, even with the EuVECA passport. This practice acts as a barrier to Capital Markets Union and in particular to the Commission's effort to spread venture capital funds more evenly across the EU, as well as to eliminate differing registration fees without sacrificing the level of investor protection.

The fourth limitation relates to the cross-border activity of EuVECA. Venture capital funds located in larger European countries, where there are pools of capital from a local investor base, can often raise funds without the EU-wide passport. But in smaller member states, with fewer domestic investors, barriers[9] to cross-border fundraising will tend to keep them small and reliant on public money. As a result, entrepreneurs and innovators running start-up and scale-up businesses in that vicinity may struggle to obtain the funding they need for their business to survive. They will therefore look outside Europe to secure funding from investors in other locations, for example the USA. This might carry the risk that whole businesses leave Europe to follow capital.

The fifth limitation concerns the minimum investment threshold of €100,000. Even though the 'entry ticket' was introduced to ensure consumer protection, it is now regarded as being prohibitively high, particular by managers interested in investing in social entrepreneurship funds. Moreover, the fact that in some member states domestic funds with similar profiles are marketed with a lower minimum investment threshold (in France, for example, the minimum investment is €30,000 provided other fund-related requirements are met), can partially explain the low investor participation (due to the higher risk), as well as the concentration of VC managers in only few member states.

Finally, another important fact is that the EuVECA Regulation came into force on the same day as the AIFM Directive. Yet while the latter triggered immediate actions and reactions across the EU, the former appeared to attract little interest. Indeed, as everybody was focusing on the long-awaited AIFM Directive, it seems that only a few paid attention to EuVECA. This is even more surprising if we consider that one of the key points of EuVECA Regulation was to lower the high entry threshold applicable to AIFM by adjusting the regulatory requirements for qualifying VC fund managers. It seems that the benefit of full EU marketing access with lower standards, compared to the AIFM Directive, wasn't enough to attract the attention of managers.

This lack of interest shows that there are fewer VC managers than policymakers might have thought or hoped for. Or that VC managers do not operate in a cross-border environment, at least not yet, as the analysis showed. Moreover, EU VC fund managers have fewer assets under management than their USA counterparts, for example, and thus only operate locally or regionally.

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[9] For instance, discriminatory tax treatment and varying national requirements on the marketing of funds and fees for cross-border notifications.

4. The Commission's proposed changes to the EuVECA Regulation

To address the first four limitations of the current EuVECA Regulation, in July 2016 the Commission proposed to: i) extend the range of managers eligible to market and manage EuVECA; ii) increase the range of companies that can be invested in by EuVECA; and iii) make the registration and cross-border marketing of these funds easier and cheaper.

i) Extend the range of managers eligible to market and manage EuVECA

Allows managers of collective investment undertakings authorised under the Alternative Investment Fund Managers (AIFM) Directive that manage portfolios of qualifying venture capital funds to use the EuVECA designation/label in relation to the marketing of those funds in the EU. Access to the EuVECA fund designation would then be extended to authorised AIFM managing assets of over €500m. The AIFM would have to register the EuVECA funds and comply with specific provisions under the respective Regulation.[10]

ii) Increase the range of companies that can be invested in by EuVECA

Expands the range of qualifying investments permitted under the EuVECA Regulation to allow investment in small mid-caps and small and medium-sized enterprises listed on SME growth markets. In particular, EuVECA would be permitted to invest in larger companies, including unlisted companies with fewer than 500 employees and SMEs listed on growth markets with a market capitalisation of less than €200m.

iii) Make the registration and cross-border marketing of EuVECA easier and cheaper

Prohibits competent authorities of host member states from imposing fees and other charges relating to the cross-border marketing of EuVECA. Streamlines the registration process by smoothing and improving the communication between manager and competent authority, as well as eliminating duplicative registration. Finally, a successful registration under the EuVECA regulation renders a second registration under the AIFM Directive.

5. What still needs to be done on the EuVECA Regulation

i) Reduce the entry ticket without sacrificing investors' protection

Regarding the fifth limitation, the Commission decided to maintain (for the time being) the entry ticket of €100,000. Two further options were under consideration: i) to reduce the €100,000 minimum investment without restrictions, or ii) to reduce the €100,000 entry ticket and introduce investor protection safeguards. Even though reducing the entry ticket would permit EuVECA funds to be marketed to a broader range of investors, the current investor safeguard[11] would not be regarded as proportionate to the new investors' potentially lower financial literacy and ability to absorb losses. In that case additional safeguards to strengthen retail investor protection would be required.

However, as some respondents suggested during the European Commission (2016) Impact Assessment, one possible solution to these additional safeguards would be to look at the European Long Term Investment Funds (ELTIF) Regulation. In particular, this Regulation demands that ELTIF managers: i) always have a depository to keep assets safe, ii) comply with rules on spreading assets to prevent too

[10] These provisions include: i) the 30% threshold for non-qualifying investments ii) the rules on eligible investors and iii) specific disclosures to investors and notifications.

[11] The current safeguard entails a statement in writing that the retail investor is aware of the risks associated with the investment in EuVECA.

much money going into one asset, iii) use derivatives to manage currency risks in relation to assets they hold, and not for speculation, iv) obey limits on the amount they can borrow.[12]

Moreover, given the long-term nature of the assets that ELTIF managers invest in, 70% of the capital should be invested in more or less clearly defined long-term assets. In addition, the ELTIF manager has to ensure that a retail investor with a portfolio of up to €500,000 does not invest an aggregate amount exceeding 10% of his/her portfolio in ELTIF, provided that the initial amount invested in one or more ELTIF is not less than €10,000. These or some of these requirements would seem to fully serve the purpose of lowering the minimum investment.

ii) Extend passporting rights to third country managers

Another point of criticism, where the Commission decided not to take action, is the possibility of VC funds established in non-EU countries being allowed to use the EuVECA designation. Given the global nature of capital markets and the need for the CMU to fit within a global framework, as acknowledged in the Green Paper, a key objective is to attract global capital into Europe.

As this paper showed, Europe's private equity and venture capital market is much smaller than that in the US. The EU should therefore not block itself off from the external expertise and investment by restricting EuVECA to managers established in the EU. It is right that the EuVECA should be a European regulated and domiciled fund but non-EU managers with the necessary expertise and available capital should be able to establish an EuVECA and invest internationally (not just in the EU) according to their sector-specific expertise.

Needless to say, non-European managers should have to meet the same eligibility criteria as European ones, so as to ensure a level playing field. The right to manage and market EuVECA should be extended to AIFMs in third countries which demonstrably operate equivalent (or proportionate) supervisory standards – specifically those third countries to which ESMA has determined there are no obstacles to the extension of the AIFMD passport. In addition, a general principle of reciprocity should apply to third country managers, meaning that they should bear all the administrative burdens of being EU registered (not only regulatory but reporting, taxation, etc.).

Another important aspect of market access to third country managers concerns the UK and Brexit. Given that there are around 25 UK EuVECA managers, their loss will be felt when the UK leaves the EU – unless British negotiators are able to secure continued access. Even if the UK joins the EEA or is able to negotiate a bespoke deal ensuring access to the single market, the UK will acquire 'third country' status under relevant directives such as the AIFMD, EuVECA, MiFID and UCITS. This will restrict the passporting rights that authorised UK firms currently enjoy under those directives.[13] One way or another, continental European investors will not want to lose access to (or from?) UK venture funds. Unfortunately, the type of agreement the UK will secure depends more on politics than economics.

iii) Harmonise rules on marketing requirements

In many member states, rules on marketing requirements are neither easily available nor understandable. It has been argued (AFG, 2016) that many texts can apply, which are often included in laws and regulations that are lengthy and not available in a language customary in the sphere of international finance. As a result, managers who market their funds on a cross-border basis find it difficult to identify and understand local requirements. Thus, the cost of research and compliance with local requirements is sometimes significant.

Better coordination at EU level, in particular between ESMA and National Competent Authorities (NCAs) regarding the harmonisation of marketing rules and requirements, is of great importance. For

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[12] ELTIF managers can invest in: i) unlisted companies needing long-term capital (transport, energy, hospitals, schools, etc.) ii) certain listed small and medium sized enterprises (SMEs), iii) real assets iv) intellectual property and other intangible assets v) EuVECA, and European Social Entrepreneurship Funds (EuSEF).

[13] Although there are still opportunities to use passports even if the UK does not continue to benefit from single market access generally.

example, it would be helpful if a publication of all marketing rules – such as legal, tax and other practical information (e.g. regulatory fees) in the marketing regimes – applying in each jurisdiction, was easily and freely available to fund managers. Moreover, the agenda should also include a set of common guidelines and standards on the scope of marketing activities.

6. Policy recommendations for the long term

The main obstacle to the introduction of the CMU is understanding the real problems facing start-ups and SMEs, and convincing member states and national authorities that markets are now global and that their firms will gain tremendously from accessing a common pan-European capital market. This will be achieved by common legislation on equity, debt crowdsourcing and fund raising. In an era where ideas, people, money and goods are mobile and move rapidly, legislation should also be governed by common harmonised European rules. But if heavy-handed regulation is accompanied by industry consolidation, the result may be fewer market players rather than a wider choice of assets for a broader range of investors.

In an effort to make cross-border VC investment easier, the tax treatment, tax rates and tax relief processes should be harmonised across member states. Since the Commission's Consultation paper (EC, 2012) on the direct problems linked to cross-border VC investment, nothing has happened. The issues are multiple and not only range from the lack or difficulty of access to tax treaties (e.g. difficulty in refund of withholding taxes (WHT), difficulty in qualifying for tax relief in the country where the tax treaty access is granted), but also to the need of investor tax reporting in other member states or tax discrimination between resident and non-resident investment funds.[14] Any initiative[15] that attempts to simplify the whole process and resolve these impediments to the cross-border distribution of funds should be warmly welcomed.

Moreover, like start-ups and SMEs, social enterprises face obstacles in accessing financing. As banks are reluctant to provide finance (except against collateral) because of these firms' business models, it is imperative that public-private partnerships be allowed to flourish. The Commission's effort to offer new opportunities for market participants to raise and invest capital in social enterprises throughout Europe in a more simplified way, have not been fruitful. The introduction of the European Social Entrepreneurship Funds (EuSEF) Regulation was not as successful as anticipated given that only four funds registered so far, with all registrations in 2014 (three in Germany and one in France).[16]

With the EuSEF Regulation the focus is on enterprises whose corporate aim is to have a positive social impact and address social objectives, rather than simply maximise profit. For social impact investing, more flexible legal structures are needed that accommodate the hybrid nature of the social enterprise and the matching blended financing that goes with it. But investors should also think more long term, rather than expecting short-term returns ('patient capital').

Furthermore, the connection between early-stage funding with start-ups and SMEs is of great importance, and the link to the secondary markets should be the next big priority. Crowdfunding, for

[14] For example, in many cases investment funds do not have direct access to reduced WHT rates available under tax treaties, or the time and costs of recovery of WHT in many cases act as an obstacle to VC managers that want to invest in states other than those of their residence, where they are normally taxed at a low level or exempt from corporate tax.

[15] For example, imposition of an EU wide limit on the WHT rate equal to the 15% rate foreseen in double tax treaties, or even the abolishment of WHT.

[16] Moreover, given the higher costs of running socially driven funds, high registration and marketing fees are a considerable extra burden for EuSEF. For instance, an EuSEF manager provided the following breakdown of registration costs: €40,000 (external costs), €25,000 (legal advice), €14,000 (costs related to the NCA and ESMA), €50,000 (estimation of costs supported by the fund management internally) and €130,000 (internal and external arising from post-registration obligations (e.g. ESMA reporting via special interface)). Source: European Commission (2016).

example, is a great development for start-up capital, but without secondary markets, there is no exit strategy and capital remain inaccessibly.

Finally, another hurdle to overcome is inefficient matchmaking platforms between projects and investors. On-boarding more investors (both early-stage and impact) requires better training and support. This is especially true for impact investing, which is a relatively new area where lagging and discontinuity in the investment value chain is more noticeable.

7. Conclusion

While some commentators argue that access to finance for SMEs is improving and others argue that it is not, we are all conscious that there is still much to be done to ensure improved access to finance, better alternative sources of finance, and better-educated SMEs on how to access that finance.

Venture capital plays a determining role in stimulating entrepreneurship and young companies, but the current EuVECA systems are hampered by imperfections. European venture capital funds are far from being systemically relevant and suffer from multiply supply-side failures and structural weaknesses. This paper argues that the main problems are the: i) lack of private-sector investors, ii) fragmentation, iii) small find size, iv) limited access to international money, v) low investment interest, vi) low current and expected performance, and vii) the big funding gap with the US.

The proposed reform of existing EuVECA legislation aims to improve the situation by extending the range of managers eligible to market and manage EuVECA, increasing the range of companies that can receive EuVECA investment, and making the registration and cross-border marketing of EuVECA easier and cheaper. Next steps forward should be: further broadening of the population of managers that can run EuVECA (third country managers); strengthening of passporting arrangements; harmonisation of rules on managing requirements; and better blending of public and private money available to private managers.

Finally, even with Brexit, it makes a lot of sense to drive the CMU forward. CMU without the UK might take longer to construct, but that makes the need for progress even more urgent. Given the big ‘known unknown’ of the nature of the relationship the UK will have with the EU, it is necessary to make sure that the flow of capital within Europe continues.

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