
HUNGARIAN VENTURE CAPITAL AND PRIVATE EQUITY ASSOCIATION

VENTURE CAPITAL AND PRIVATE EQUITY INDUSTRY POSITION PAPER

Over the past several decades venture capital and private equity funds and fund managers have become an important part of the global financial system. During the past two decades these financial intermediaries have also played an increasingly important role in the Hungarian economy. During that period, over 3 billion US Dollars were invested through them in more than 400 Hungarian enterprises.

However, venture capital and private equity has not reached its full potential in Hungary yet. Only 0.2% of the Hungarian enterprises benefit from venture capital or private equity funding.

The HVCA believes that, through the joint efforts of the venture capital and private equity industry and the Hungarian government, the access of Hungarian enterprises to venture capital and private equity funding could be significantly increased. This in turn could significantly contribute to economic growth, increasing employment and improving Hungary's competitiveness.

This is particularly the case at a time when it is increasingly difficult and expensive for businesses to obtain traditional bank financing.

Increased venture capital and private equity investments are also likely to result in the creation of additional jobs within the Hungarian venture capital and private equity industry itself, which would in turn also contribute to the growth of the Hungarian economy.

The purpose of this position paper is to identify some of the areas where the Hungarian government could help in strengthening the role of venture capital and private equity in the economy, and contains proposals on the following topics:

- tax issues;
- business incubation programs; and
- the institutional regulation of Hungarian venture capital funds and fund-managers.

These proposals were prepared by the Strategic and Legislative Working Group of the HVCA with the assistance of **Primus Capital, Ernst & Young Advisory Ltd., Mazars, BDO Hungary Consulting Kft., Faludi Wolf Theiss Attorneys at Law, Allen & Overy Budapest Law Office, Siegler Weil Gotshal Law Office, CMS Cameron McKenna Law**

Office, Récicza White & Case LLP Law Office and **Szecskay Law Office**, whom the HVEA would like to thank for their efforts.

In addition to the proposals contained in this position paper, the legislative working group of the HVCA has taken upon itself the task of continuously reviewing and commenting upon the legal environment affecting the venture capital and private equity industry (such as company law, civil law and capital markets law). As part of that effort, in March 2012 the working group provided comments on the Draft New Civil Code, which comments are available on our website as a separate document.

Miklós Bethlen

Chairman of the Hungarian Venture Capital and Private Equity Association

21 May, 2012

(This Position Paper is an updated version of the original version thereof submitted to the Ministry of National Economy on 10 November 2011 and the updated version thereof submitted to the Ministry of National Economy in March 2012.)

INTRODUCTION

A BRIEF INTRODUCTION TO VENTURE CAPITAL AND PRIVATE EQUITY

Venture capital and private equity, as a new form of financial intermediation, emerged during the decades following the Second World War. The term “private equity” refers to the fact that these intermediaries invest in equity interests in privately held companies, i.e., companies not listed on a stock-exchange. The term “private equity” is widely used to refer to funds and fund managers focusing on more mature companies, which have been operating successfully for a number of years. The term “venture capital” in turn is used to refer to funds and fund managers focusing on businesses that are in their early stages.

In general, the business model is the following:

- a fund-manager collects funds from institutional investors (or from high net worth individuals or family offices) in a venture capital or private equity fund;
- these funds will then be invested in shares or other equity interests in privately held companies, in accordance with the fund’s investment policies. These companies are referred to as the “portfolio companies” of the fund;
- the investment will take the form, either in whole or in part, of a capital increase, and the amount of the capital increase will then be used to fund the desired objectives of the portfolio company (e.g., product development and marketing, start-up of line production, covering operating costs until profitable operation is achieved or the implementation of the company’s growth-strategy);
- the fund will realize a return on its investment if, thanks to the fund’s capital investment and the fund manager’s expertise and active involvement, the portfolio company operates successfully during the investment period (typically 3 to 5 years) and, as a result, the portfolio company’s valuation is increased, enabling the fund to sell its shares at a profit either to a new investor by way of a trade sale or to the public by way of an initial public offering of shares (IPO);
- as the return on the fund’s investment is realized by way of the sale of its shares in the portfolio company, the amount of such return will not be paid by the portfolio company (as in the case of debt financing), but will be paid by the new investor(s) as part of the purchase price paid by them for the fund’s shares in the portfolio company;
- following the sale of the fund’s shares in the portfolio company, the fund manager distributes the sale proceeds (less transaction costs and the fund manager’s share of the proceeds) to the fund’s investors;

- the investors of the fund do not make any contributions to the fund at the time the fund is set up, contributions to the fund are made only when the fund invests in a portfolio company. At the time the fund is set up, the investors of the fund will make a commitment to contribute the necessary funds if and when an investment is made.

When enterprises need external financing to achieve their objectives, venture capital and private equity investments offer a favourable alternative to bank financing. Even businesses which would normally not have access to bank financing due to their high risk profile (typically early stage businesses) can gain access to funds through these channels. More mature businesses which have difficulty obtaining bank financing (e.g., because all of their assets have been tied up as security for existing bank financing) or would just find it burdensome to finance repayments on additional loans, can also benefit from private equity and venture capital funding.

Recently, banks have significantly reduced or are aiming to reduce lending, while interest rates are on the rise. Under such conditions there is an ever growing need for alternative channels of funding such as venture capital and private equity. An increase in venture capital and private equity investments could also significantly contribute to the fulfilment of the Hungarian government's objectives of job creation and economic growth.

THE ROLE OF VENTURE CAPITAL AND PRIVATE EQUITY IN THE HUNGARIAN ECONOMY

As regards the annual volume of venture capital and private equity investments in terms of percentage of annual GDP, during the past 20 years Hungary has been in a reputable position not only within the CEE region but also among the EU member states. During this period, venture capital and private equity funds invested close to 4 billion US Dollars into more than 400 Hungarian enterprises.

However, so-called buyout transactions have accounted for about two thirds of the total volume of those investments, which were aimed at the acquisition of shares in mature companies that have been operating profitably for several years. The volume of investments in early and expansive stage companies was significantly lower. Only about 30% of the total volume of investments was directed at companies in the expansive stage and less than 5% at early stage companies.

This is also reflected by the fact that over the last two decades slightly more than 10% of the total volume of venture capital and private equity investments came from funds focusing on early stage companies. The remaining close to 90% was invested by private equity funds focusing on more mature companies with greater economic strength.

As for the number of transactions, companies in the expansive stage were targeted by the largest number of venture capital and private equity investments: such investments accounted for almost 60% of Hungarian transactions. Nearly a third of transactions involved early stage companies. Buy-out deals represented approximately 10% of transactions by number.

The seeming discrepancy between transaction numbers and volume is due to the fact that – naturally – the earlier the stage an enterprise is in, the smaller the amount necessary for it to get to the next stage.

In terms of investments into early and expansive stage (and especially early stage) companies, Hungary has one of the lowest volumes in Europe. The number of Hungarian companies that have received venture capital or private equity funding is less than 0.2 per one hundred.

It is interesting to note that a substantial percentage of the amounts invested in early stage businesses originates from investors with a Hungarian governmental background. Transactions made by investors with a Hungarian governmental background account for about 50% of the total number of venture capital and private equity transactions, while in terms of volume they represent 17.5%.

The situation has been improved by the appearance of investments by venture capital funds utilizing (mainly) EU funding through the JEREMIE program, giving an impetus mainly to early stage businesses by providing alternative financing sources in a market where the availability of debt financing is limited.

According to the data provided by Magyar Vállalkozásfinanszírozási Zrt. (MV Zrt.), the funding intermediary of the JEREMIE program, until the end of 2011 HUF 12,2 billion worth of investments were decided upon by fund managers, and agreements were entered into with 44 companies, meaning that the average equity invested per company was HUF 277 million. Following the launch of the program, almost one year had to pass before investments could commence, but beginning with 2011 the amount of equity invested has risen steadily. This is in great part due to the fact that fund managers needed this time to establish the network necessary for finding good projects.

However, the funds available under the JEREMIE program are limited. So far 8 fund managers were able to receive HUF 31.5 billion worth of funds through the MV Zrt., and were able to collect a total of HUF 13 billion on top of that in additional investments. In the next planned JEREMIE program it will be possible to apply for a further HUF 28.5 billion as repayable EU grants through MV Zrt., which, together with private investments, could total HUF 41 billion in new funds.

In our view, the growth of venture capital and private equity investments and increased access for Hungarian businesses to this source of funding would be very important for the Hungarian economy. This could be best achieved by providing appropriate incentives to market participants in the private sector and the improvement of market conditions.

FURTHER OPPORTUNITIES FOR HUNGARY IN RELATION THE PRIVATE EQUITY AND VENTURE CAPITAL INDUSTRY

In addition to the positive economic effects of encouraging venture capital and private equity investments in Hungary, we would also like to point out a further opportunity for Hungary in respect of the global venture capital and private equity industry.

In order to maximize the benefits to their investors, global venture capital and private equity fund managers utilize fund and investment structures that normally include

companies and fund entities incorporated in Luxembourg, The Netherlands, Cyprus, Malta or countries outside the European Union. The key considerations in designing such structures are tax efficiency and regulatory flexibility that ensure that the returns of the fund can be maximized and the requirements of the investors and the fund manager can be adequately addressed.

Given the huge size of the global venture capital and private equity industry, there is a significant opportunity for Hungary in making the use of Hungarian companies and fund entities attractive to the global market players by creating a more favourable tax and regulatory environment. If global industry players were to use Hungarian elements at least to some extent in their fund and transaction structures, that could result in the creation of many Hungarian jobs as well as significant additional tax revenue for Hungary.

SUMMARY OF PROPOSALS

The following is a brief overview of the proposals set out in this position paper. Our detailed proposals are set out in the subsequent sections of this position paper.

TAXATION

In order to encourage investments in venture capital and private equity assets and make Hungarian fund and investment structures attractive to international venture capital and private equity players, we propose the following actions in respect of taxation:

- extension of the advantages of notified shareholdings to private investors;
- making tax equalization available to private investors in relation to investments in venture capital funds;
- permitting the use of corporate entities' development reserves for investments in venture capital and private equity assets;
- reducing the minimum holding threshold in respect of notified shareholdings of corporate entities from 30% to 10%;
- introducing the concept of tax groups for the purposes of corporate income taxation;
- making asset sales that constitute the sale of a business exempt from VAT;
- introducing corporate income tax concessions for young and innovative enterprises; and
- reducing social security contributions in relation to research and development staff employed by young and innovative enterprises.

BUSINESS INCUBATION

In order to bridge the current gap between the abundance of Hungarian intellectual capital and the lack of adequate business skills among the people producing such intellectual capital, we propose that the government introduce a scheme to facilitate the establishment of business incubators with the help of government and private sector funding. Such a scheme would help remove the single biggest obstacle to the commercialization of Hungarian innovations.

INSTITUTIONAL REGULATION OF VENTURE CAPITAL FUNDS AND FUND MANAGERS

We are proposing a number of changes to the regulations governing the establishment and operation of Hungarian venture capital funds and fund managers. Our proposals are aimed at making such regulations less burdensome and thereby removing the competitive disadvantages that Hungarian venture

capital funds and fund managers are facing vis-à-vis foreign funds and fund managers under the current regulatory environment. Our proposals are as follows:

- Hungarian venture capital fund managers should be permitted to raise funds without the use of a registered securities broker;
- The requirement for the contribution of funds to Hungarian venture capital funds upon their establishment should be abolished;
- The requirement for regulatory approval of the fund management rules of Hungarian venture capital funds should be abolished;
- The investment restrictions applicable to Hungarian venture capital funds should be relaxed;
- A public register of Hungarian venture capital funds should be created and the right of representation of venture capital funds should be clearly regulated;
- The rules relating to the termination of Hungarian venture capital funds should be clarified;
- The statutory definition of venture capital fund management activities should be clarified;
- The legal basis for the payment of fund managers' fees should be clarified;
- The reporting obligations with respect to Hungarian venture capital funds should be simplified and made more cost efficient; and
- The regulation of voting by unit holders of venture capital funds who have not yet paid in all of their commitments to the fund should be simplified.

PROPOSALS FOR IMPROVING THE TAX ENVIRONMENT

INTRODUCTION

There are certain tax solutions that could make Hungary's tax system more attractive to those wishing to invest in venture capital and private equity funds and for financing/holding structures applied to venture capital and private equity investments.

Below we provide a summary of:

- the taxation considerations that currently constrain the investments of venture capital and private equity investors in Hungary and how a more attractive framework may be created to encourage such investments in Hungary
- how a more attractive environment could be created for venture capital and private equity funds and fund-managers in Hungary for investments in innovative businesses; and
- how the creation, development and profitable operation of young innovative enterprises could be encouraged.

1. EXTENSION OF THE ADVANTAGES OF NOTIFIED SHAREHOLDINGS TO PRIVATE INVESTORS

ISSUE

Currently, the advantages relating to notified shareholdings are available to corporate investors only. The current rules¹ require a 30% minimum shareholding and a minimum holding period of 1 year in order for the related exemption from corporate income tax to apply.

Long-term investments by private individuals are subject to favourable tax rates if the income is deemed to be income resulting from a long-term investment². In the case of income from long-term investments, the rate of the personal income tax (hereinafter: PIT) can be reduced to 10% or 0% subject to the holding period of the relevant asset (3 or 5 years). However, such favourable tax rules do not apply to investments in venture capital funds.

PROPOSAL

In light of the foregoing, we propose the introduction of the concept of notified shareholding in relation to the taxation of private individuals within the framework of the Personal Income Tax Act.

As regards the minimum shareholding threshold, we propose that, in the case of private individuals, this be reduced to 10% be applied. In our view, the 30% threshold

¹ Act LXXXI of 1996 on Corporate Tax and Dividend Tax

² Section 67/B of Act CXVII of 1995 on Personal Income Tax

that applies to corporate investors is not suitable for private individuals, since investments into SMEs are high-risk, especially in the case of start-up companies and companies focussing on innovative new technologies.

Private individuals could be required to report such shareholdings to the tax authorities and, therefore, the involvement of a broker would not be necessary.

CONCLUSION

Making income from the sale of shareholdings by private individuals exempt from personal income tax would, indirectly, result in the availability of additional funds to SMEs, which would promote innovation and, thereby, the creation of new obs.

2. MAKING TAX EQUALIZATION AVAILABLE TO PRIVATE INVESTORS IN RELATION TO INVESTMENTS IN VENTURE CAPITAL FUNDS

ISSUE

Under the current personal income tax rules, tax equalization is available only in the case of controlled capital market transactions. Under the tax equalization rules, net losses can be deferred to subsequent tax years.

PROPOSAL

We propose that the availability of tax equalization be extended to long-term investments in venture capital funds. Taking into consideration the high risks involved in such investments, we propose that losses realized on such investments be permitted to be taken into account in determining the tax base.

The managers of venture capital funds must keep track of the changes in the identity of their investors and, therefore, would be in a position to provide their investors with annual certificates regarding their investment in the fund.

CONCLUSION

The foregoing measures could significantly reduce the tax burden on private individuals investing in venture capital funds, which could serve as a counterbalance to the high risks involved in such investments, thereby encouraging such investments and increasing the funds available to SMEs.

3. ALLOWING THE USE OF DEVELOPMENT RESERVES FOR INVESTMENTS INTO VENTURE CAPITAL AND PRIVATE EQUITY ASSETS.

ISSUE

Investments into Hungarian venture capital funds could be made more popular among companies if the value of their investments could reduce their corporate income tax base to a certain extent in the year the investment is made and in preceding years.

PROPOSAL

This objective could be reached if investor companies were permitted to use part of their development reserves for the purposes of investing into the units of Hungarian

venture capital funds. It would also be beneficial if, upon the sale of such investments, the difference between the book value of the investment and the proceeds of the sale would be regarded as a tax-free capital gain.

CONCLUSION

In our view, such measures would give Hungarian venture capital funds access to substantial additional funds, and would thereby increase the funds available to them for investment.

4. REDUCING THE MINIMUM HOLDING THRESHOLD IN RESPECT OF NOTIFIED SHAREHOLDINGS

ISSUE

In order to reduce the risks involved in investing in innovative, early stage companies, venture capital investors would typically acquire a less than 30% stake in a company. For this reason investors in such companies are usually unable to benefit from the tax benefits related to notified shareholdings.

PROPOSAL

Therefore, in order to encourage venture capital investments into innovative, early stage companies, it would be necessary to amend the corporate income tax legislation relating to notified shareholdings, so that in the case of certain investments the shareholding threshold for notified shareholdings is reduced to 10%.

CONCLUSION

This measure would help to ensure that higher risk companies (primarily SMEs) are able to obtain funding and thereby create new jobs

5. THE RECOGNITION OF TAX GROUPS FOR CORPORATE INCOME TAX PURPOSES

ISSUE

Hungary could become more attractive to foreign investors if it was possible for groups of companies to consolidate their corporate income tax base within a tax group.

PROPOSAL

One possible way of consolidating the tax base would be to enable the subsidiaries of Hungarian domiciled holding companies to deduct losses incurred by their holding company from their corporate income tax base.

CONCLUSION

This would make Hungary attractive to foreign investors as a location for their holding companies.

6. MAKING THE SALE OF A BUSINESS EXEMPT FROM VAT

ISSUE

Under current Hungarian legislation, the sale of assets comprising a business is subject to VAT in the same way as a sale of individual assets. However, in several European jurisdictions (e.g. the UK) the sale of a business is exempt from VAT if certain conditions are met. This puts Hungary at a competitive disadvantage.

PROPOSAL

Making the sale of a business exempt from VAT would improve the cash-flow of potential acquirers of lines of business of Hungarian companies, and would free such potential acquirers and companies of the administrative burden of having to put a value on each individual asset that is subject to a business sale transaction. To that end, we recommend that Hungarian VAT legislation be amended in line with the relevant European Union VAT legislation.

CONCLUSION

If a sale of assets comprising a business were exempt from VAT, investors buying a business would not have to finance the VAT that is currently payable on the constituent assets of the business. This would make it easier for such potential buyers to finance the purchase price of their investment. This would make it easier for venture capital funds to exit their investments at the end of their envisaged investment horizon, which, in turn, would likely increase the returns of venture capital funds on their investments and thereby make investments in venture capital funds more attractive to investors.

7. SPECIAL TREATMENT OF YOUNG INNOVATIVE ENTERPRISES

ISSUE

Under the relevant EU legislation, companies that are less than 6 years old and spend at least 15% of their revenues on research and development are considered young and innovative enterprises. The European Commission regards the young and innovative nature of an enterprise as one of the necessary requirements for that enterprise's eligibility for state aid. This is in line with the increased use of EU resources for research, development and innovation. Young and innovative enterprises are likely to contribute to the modernization the economy, the creation of new jobs and economic growth. There is no special scheme in place under Hungarian law for helping young and innovative enterprises.

PROPOSAL

Hungarian legislation should more precisely specify local eligibility criteria.

Since most of the enterprises concerned are small or micro enterprises, any incentive scheme should be kept simple so that it does not put any significant administrative burden on the enterprises concerned. Under the current tax regime, certain tax concessions are available in relation to research and development related

expenses³. We propose that the rules of eligibility for such tax concessions be simplified and the scope of such tax concessions be made broader as follows:

- Introducing local tax concessions for young and innovative companies in the first five years of their operation:

We propose that young and innovative companies be exempted from local taxes in the first three years of their operation and that their local tax base be reduced by 50% in the 4th and 5th years of their operation. This would be a simple tax cut that would not place any significant administrative burden on the taxpayer. The local municipalities concerned would be compensated for the revenues lost by the creation of new jobs locally, as young and innovative companies typically employ a large number of research and development personnel.

- Reducing social security contributions in relation to the research and development expenditure of young and innovative enterprises:

Young and innovative companies are likely to be small and micro enterprises, presumably with cash-flow problems. In order to help such companies develop, we propose that the salaries of the research and technical employees of these companies be exempt from the social security contributions payable by the employer.

- Broadening the availability of tax losses for the purposes of offsetting against the corporate income tax base

We propose that young and innovative companies be permitted to offset their carried forward tax losses against 100% (as opposed to the current 50% limit) of their corporate income tax base without time limitation. This would improve the cash flow of young and innovative companies in their first years of profitability by permitting them to fully offset the significant amount of tax losses that such companies typically incur during their research and development phase against the profits that they make once their investments into R&D finally pay off.

CONCLUSION

The proposed measures would promote research and development activity in Hungary thereby creating new jobs.

³ Corporate Tax Act Section 7 (1) t), (17), (18); and 22 (9), (10)

PROPOSAL FOR A BUSINESS INCUBATION PROGRAM

INTRODUCTION

As can be seen from the previous parts of this position paper, the role of private equity and venture capital needs to be strengthened, primarily in the case of early stage businesses.

Private equity and venture capital could play the most significant role in relation to early stage innovative businesses focusing on new products or business solutions, as the risk profile of such businesses usually makes them ineligible for bank financing.

The launch of such innovative businesses is greatly hindered by the lack of business incubation services in Hungary. By helping them to adapt to market conditions, business incubation services would enable early stage innovative companies to access the venture capital funding needed for their development.

The business incubators currently existing in Hungary are unable to fulfil this “bridging” function. Therefore, there is a huge gap between the expectations of the available venture capital funds (the JEREMIE funds) and the business skills of early stage innovative enterprises seeking venture capital funding.

In this chapter we would like to canvas the framework of a Business Incubator Program (“BIP”) that, with the help of venture capital, would be capable of filling this gap.

THE BUSINESS INCUBATOR PROGRAM

The main objective of the BIP would be to create a market based incubation industry capable of developing, in a business sense, the early stage innovative enterprises that are produced en-masse by universities and research centres, thus making them capable of raising the venture capital needed for their growth.

The BIP would provide initial (seed) capital for small and micro enterprises in need of venture capital funding, as well as the business skills necessary for raising venture capital at a later stage of their life cycle. This could solve one of the biggest problems of Hungarian innovation financing.

The BIP would thus contribute to the achievement of the following objectives:

- increasing the number of innovative and micro enterprises relying on Hungarian intellectual property that are capable of dynamic growth and international success;
- the creation of new jobs by raising development capital for innovative early stage enterprises;
- using Hungarian intellectual capital to secure a competitive advantage by developing the business skills of inventors and innovators.

HOW TO ACHIEVE THESE OBJECTIVES?

The BIP would be based on the cooperation of government backed entities and venture capital and private equity market players. Through this scheme the government would indirectly contribute to helping enterprises through the high-risk business innovation phase of their life-cycle that follows the initial research phase.

In the framework of the program, business incubators would be set up in the form of venture capital funds, which would function as financial intermediaries and – through their fund managers – business knowledge banks. The government would also contribute to the funding of these incubators either by investing into the incubator fund or by providing refundable subsidies, in each case following a tender process. By utilizing such public and private funding, these incubator funds would:

- conduct the business and technological screening and selection of R&D projects based on a standardized methodology;
- enable enterprises to progress to the next stage of their life cycle (e.g., the stage where they can access venture capital or private equity funding) within a relatively short time (i.e., in a matter of months) through the provision of seed capital;
- develop the business skills of founders through an accredited mentoring network;
- provide bespoke management training to founders.

The incubator funds would provide seed-capital to early stage enterprises utilizing innovations derived from the Hungarian higher education system or the private sector, which:

- are in the industries given R&D priority by the New Széchenyi Plan (Automotive/Transportation/Logistics, Healthcare, Information Technology, Energy/Environment/Clean Technology);
- have market-ready R&D results in their possession; or
- intend to implement a brand new business idea.

THE NATURE AND EXTENT OF GOVERNMENT PARTICIPATION

Government funding would be provided either as an investment into the incubator fund or in the form of a refundable subsidy to the fund. The funds provided by the government would be repaid from the sale of the incubator fund's stake in its portfolio companies, within 4 to 7 years of the start of the incubation period.

The incubator funds could apply for government funding of HUF 1.5 to 3 billion, of which no more than HUF 60 million could be invested in each portfolio company.

During the implementation of the program, a certain minimum percentage of the funds contributed to the incubator funds would have to originate from the private sector as required by EU regulations pertaining to own funds. In order to encourage this, a tax concession would need to be offered as described under the taxation related proposals above.

The business incubator funds would be required to pre-screen at least 200 R&D enterprises and make 10 to 30 seed capital investments during their planned 3 year investment period.

CONCLUSION

Thanks to the hundreds of billions of HUF of R&D funding made available in the past decade through university and operative programs, there is a great number of Hungarian innovations that are waiting to be commercialized. However, the lack of business skills on the part of the institutions, workshops, inventors and the founders of early stage enterprises has become a bottle-neck for the venture capital and private equity funding of innovative Hungarian businesses. The Business Incubator Program would provide a solution to this problem.

PROPOSALS FOR A LEGAL FRAMEWORK FOR IMPROVING THE COMPETITIVENESS OF HUNGARIAN VENTURE CAPITAL FUNDS AND FUND MANAGERS

INTRODUCTION

Recent research in the EU shows that the growth of venture capital and private equity investments goes hand in hand with GDP growth. Investments in SMEs at an early stage in particular have a significant effect on economic growth.

The consultation paper of the Internal Market Directorate of the EU Commission entitled "A New European Regime for Venture Capital" points out that venture capital is an important alternative source of funding for SMEs, in particular SMEs that intend to grow and develop through R&D. It also mentions that, in order for European SMEs to become more competitive, more effort needs to be made to make venture capital funding more accessible.

A pre-requisite to this effort is the creation of a regulatory framework which is consistent with the features of the venture capital industry. In Hungary, the current institutional regulation of venture capital funds is based on the business model and institutional regulation of retail investment funds. However, since the current regulation was adopted, even the regulation of non-venture capital investment funds has been changed to recognize the distinction between retail and non-retail funds.

Private equity and venture capital funds operate as strictly non-retail funds, and are only available to sophisticated (usually institutional) investors with a high level of risk tolerance. Therefore, it is necessary to review the regulatory framework of Hungarian venture capital funds (including in relation to the regulation of fundraising, governance, and investment restrictions) and to reduce the administrative burdens relating to the monitoring and reporting requirements in relation to portfolio companies. The recent changes to the regulation of non-retail investment funds could serve as an example for this (as an interim step leading up to the forthcoming implementation of AIFMD in 2013).

Thanks to the JEREMIE program, there are now over 15 venture capital fund-managers in Hungary, which, collectively have accumulated a significant amount of experience in the practical application of the regulations relating to venture capital funds. Our proposals are based on experience.

We note that our proposals would not only help Hungarian private equity and venture capital investment to grow (thereby promoting the success of Hungarian enterprises), but would also contribute to making the regulation of venture capital funds and fund managers competitive at a European and global level, thus making Hungarian venture capital fund and fund manager entities attractive to global venture capital and private equity players in structuring their funds and investments. This could lead to the creation of many new Hungarian jobs and a significant increase in Hungarian tax revenues.

PROPOSALS

SIMPLIFYING FUNDRAISING RULES

Fund managers should be allowed to raise funds directly, without the use of an intermediary

It is a recurring issue that under the Capital Market Act (CMA) venture capital fund managers are not permitted to undertake the private placement of the units of the venture capital funds that they manage. Currently fund managers have to use a licensed securities broker for that purpose. However, this is no longer a requirement for non-retail non-venture capital investment funds.

Other countries, including the Anglo-Saxon countries and Luxembourg (in respect of SICAR funds) do not prescribe the use of a licensed broker for this purpose. The Hungarian requirement is unjustified, since units of venture capital funds are placed exclusively with sophisticated (mostly institutional) investors by a fund-manager that is licensed by the regulator. The current regulation significantly increases the cost of fundraising and places an unnecessary administrative burden on venture capital fund managers trying to raise funds. This unnecessary requirement reduces the returns of Hungarian venture capital funds and thereby puts Hungarian venture capital funds and fund managers at a competitive disadvantage.

We propose the following:

- venture capital funds should not be subject to the CMA's requirements with respect to the offering of securities (the same way as the Prospectus Directive does not apply to the units of venture capital funds); or
- at the very least, venture capital fund managers should be allowed to directly place the units of the venture capital funds managed by them to investors that comply with the general private placement requirements.

The current Hungarian rules are not supported by any of the Prospectus Directive, UCTIS IV and the AIFM Directive. Consequently, Hungarian venture capital funds and fund managers are at a significant competitive disadvantage to similar foreign funds and fund managers.

Investors in venture capital funds could be adequately protected by applying the Luxembourg SICAR model, based on which the regulations could stipulate that units of venture capital funds can only be placed with corporate investors or individuals with the necessary expertise and knowledge (e.g. institutional investors and high net worth individuals). This group of investors would generally correspond to the group of investors to whom private placements can be made under the CMA.

CONTRIBUTION OF A VENTURE CAPITAL FUND'S REGISTERED CAPITAL

In the standard international venture capital and private equity model, the fund's investors will not be required to make contributions to the fund at the time the fund is established, and will only undertake a commitment to contribute funds if and when the fund-manager calls upon them to do so in accordance with the fund's bylaws, in which case they will contribute funds in proportion to their respective shares in the

fund's capital. Such calls for payment are typically made when the fund is about to make an investment, as approved by its investment committee, in order to fund the investment and related transaction costs.

At the same time, in this model, if the fund obtains liquidity (e.g., from the sale of an investment or from dividends paid by a portfolio company), the fund-manager will promptly pay such proceeds to the fund's investors (after deducting transaction costs and carried interest), in proportion to their respective shares in the fund's capital.

This ensures that the returns on the fund's investments are maximized. Funds that are uninvested (or invested in bank deposits or government bonds) yield far below the investors' return expectations and significantly reduce the fund's returns.

However, Hungarian regulations require that at least 10% but no less than HUF 250 million of the fund's registered capital be paid in upon subscription of the fund's units, with the remaining amount payable within 6 years from the establishment of the fund.

This requirement puts Hungarian venture capital funds and fund managers at a competitive disadvantage, since it significantly reduces the potential returns of Hungarian venture capital funds in comparison to foreign venture capital funds that are not subject to such a requirement.

Moreover, this requirement is not justified by any investor or creditor protection or other public policy considerations. Venture capital fund units cannot be placed with retail investors (they can only be issued by way of a private placement), and venture capital funds may not carry on any commercial or other business activities, which could result in them incurring trade debts (i.e., any creditors to venture capital funds will have lent money to the fund being fully aware of the risks involved). Since both the fund's investors and possible creditors are sophisticated, typically institutional, investors having the necessary expertise to assess the risks involved, the rules relating to the payment of the fund's registered capital are superfluous.

SIMPLIFICATION OF THE REGULATIONS RELATING TO THE OPERATION OF VENTURE CAPITAL FUNDS

- **The requirement to have the fund's management rules approved by the regulator should be replaced by an advance notification requirement**

According to the current regulation, the fund's management rules must be approved by the PSZÁF. As venture capital fund units are available only to institutional and highly experienced private investors that are less in need of protection in this respect and can evaluate the risks relating to the fund's management rules, a requirement to notify the PSZÁF would be sufficient.

This would be consistent with the current rules of the CMA relating to the private placement of securities. Since under the provisions of the CMA venture capital fund units may be issued only in the framework of a private placement, a more strict regulation in respect of venture capital funds cannot be justified. We note that the regulations relating to non-retail investment funds also do not prescribe the approval of the fund's management rules by the regulator.

- **The investment restrictions applicable to venture capital funds should be relaxed**

Under the current regulations, the temporary current assets of venture capital funds, which have already been called from investors but have not yet been invested into a portfolio company, or which originate from the sale of a portfolio company but have not been distributed to the investors yet, may only be invested in government bonds or bank deposits.

This restriction should be relaxed so as to allow such temporary current assets to be invested in other liquid assets (as accepted by the fund's investors in accordance with the fund's management rules), similarly to what has been done under the UCITS IV Directive in respect of non-retail investment funds.

Based on the UCITS IV Directive it would also be necessary to permit investment funds to invest in venture capital funds and, accordingly, venture capital funds should be permitted to invest in investment funds, as investment fund units are considered to be liquid assets.

We also propose the relaxation of the remaining rules relating to investments and lending in accordance with the investment criteria accepted by the fund's investors.

By abolishing the current restrictions relating to investments and lending, investors in venture capital funds would be able to freely agree with the fund manager and among each other upon the rules applicable to investing and lending by the fund in accordance with their commercial preferences. As we have already mentioned, in the case of venture capital funds both investors and potential creditors are sophisticated, typically institutional, investors, who have the necessary expertise for the assessment of risks, as well as the financial resources necessary to undertake such risks.

It follows that restricting the ability of investors and fund managers of venture capital funds to freely agree upon all aspects of their funds is not justified, and such unnecessary restrictions put Hungarian venture capital funds and fund managers at a competitive disadvantage.

- **A public register of venture capital funds should be created and the right of representation of venture capital funds should be clearly regulated**

In order to ensure the security of transactions, we recommend that a public register of Hungarian venture capital funds and their managers be maintained by the PSZÁF. This register would contain information as to which venture capital fund is managed by which fund manager.

We also propose that the CMA include a provision clearly stating that the authorized representative of the fund's registered fund manager is entitled to represent the fund vis-à-vis third parties.

- **The rules applicable to the termination of funds should be clarified**

The current provisions of the CMA with respect to the termination of venture capital funds are unclear and contradictory at times, despite the fact that venture capital

funds can only be established for a definite term. Therefore, it is necessary to simplify and clarify these rules, as well as to speed up the relevant procedures.

Pursuant to the CMA, after the assets of the venture capital fund are sold off and after the prescribed deadline has expired, a termination report must be prepared by the fund manager. According to the CMA the termination report has to be prepared after the PSZÁF has decided upon the termination of the fund. However, the CMA also provides that the PSZÁF will decide upon the termination of the fund following receipt of the termination report. This is a circular provision which is impossible to comply with.

The rules relating to the satisfaction of the fund's creditors are also inconsistent. According to the CMA, the fund's creditors may submit their claims within thirty days of the publication of the notice of the fund's termination, while the fund-manager may already commence the distribution of the fund's assets to its unit holders ten days after such notice is published. Therefore, it is possible for the venture capital fund manager to distribute the assets of the fund among the fund's unit holders on e.g. the 11th day after the date the termination notice is published, so that no funds would remain available for the satisfaction of any creditor claims filed on e.g., the 15th day, as by then all assets would have been distributed among the unit holders.

We propose that the above inconsistent provisions be amended as follows:

- We propose that the tasks related to the termination of the fund be primarily carried out by the fund-manager or by a non-profit company set up by the PSZÁF in accordance with the Act on Credit Institutions.
- The assets of the fund would have to be sold within 18 months, which period could, on a single occasion, and with the approval of the PSZÁF, be extended by 6 months.
- The fund manager would be required to publish the date of the termination of the fund within two days from the receipt of the PSZÁF's decision on the termination of the fund.
- The fund's creditors would be required to submit their claims to the fund-manager within 30 days from the date of such publication.
- Those of the securities held by the fund that are listed on a regulated market could be distributed among the unit holders by a simple majority decision.
- Once all assets have been sold and the creditors have been satisfied, a termination report would have to be prepared and sent to the PSZÁF and the unit holders within 5 days.
- Thereafter, the fund-manager would be required to distribute the available funds to the unit holders within a 10 day period, provided that the PSZÁF has struck the fund from its register.
- Upon the termination of the venture capital fund the PSZÁF would be required to strike the fund from its register on the day after its receipt of the termination report if the fund has positive equity.

- We also propose the publication of a special notice that would contain information on the commencement of payments and the termination of the fund.
- The proceeds of the sale of the fund's assets remaining after the payment of the fund's debts would be distributed among the unit holders pro rata to their share in the fund's registered capital.

In the event that the fund's equity is negative, the fund's termination would be carried out by a non-profit organization established by the PSZÁF in accordance with the Act on Credit Institutions. Following the sale of the fund's assets and the receipt of the sale proceeds, this non-profit organization would pay out creditors' claims in accordance with the relevant provisions of the Bankruptcy Act.

CLARIFICATION OF THE REGULATION OF VENTURE CAPITAL FUND-MANAGERS

- **The definition of venture capital fund management activities should be clarified**

It would be important to clarify exactly what activities are included in venture capital fund management and related advisory activities, so that such activities can be clearly distinguished from activities regarded as investment services under the Investment Services Act.

The detailed regulations of the UCTIS IV Directive could serve as a model for this as adapted to the venture capital investment model, e.g. in relation to (i) the offering/placement/sale/marketing of fund units, (ii) investments in portfolio companies and portfolio management and (iii) administrative and advisory services in connection with the fund's assets (including portfolio companies).

It would be necessary to modify the current regulations so that venture capital fund-managers be able to provide investment advisory services in relation to portfolio companies and potential target companies.

In addition to the foregoing, as we have already mentioned, it is a constant problem that the sale of venture capital fund units is not regarded as a venture capital management activity and, therefore, a securities broker licensed under the Investment Services Act needs to be formally appointed for that purpose. As a possible solution, we have proposed that this be included in the statutory definition of venture capital fund management activities.

- **The legal basis for the payment of fund managers' fees should be clarified**

The definition of fund management activities also needs to be clarified so as to determine the services in respect of which the fund manager may charge management or advisory fees to the fund and/or to actual or potential portfolio companies.

- **Reporting obligations should be made more simple and cost efficient**

In relation to reporting obligations it would be useful if:

- reports would have to be prepared in English only if that is what the fund's investors agree upon (e.g. because none of them is Hungarian), particularly given that English is one of the languages officially used by the PSZÁF;
- it would be possible for the funds and fund-managers to keep their accounting records exclusively in accordance with IFRS if that is what the fund's investors agree upon;
- a 45-60 day deadline would be introduced in relation to the quarterly reporting obligation, so that the reports can contain information that is relevant to the quarter immediately preceding the date of the report, as presently, due to the lack of time, such reports do not provide information with respect to the quarter immediately preceding the date of the report but only with respect to the quarter preceding that quarter.

SIMPLIFICATION OF VOTING WITH TEMPORARY UNIT CERTIFICATES

The current rules regarding the issuance of and voting with fund units raise technical issues with respect to investor voting until full payment of the unit holders' financial commitments, which payments are called by the fund-manager to fund the fund's investments.

We propose that the current regulations be made more precise by providing that, upon registration with the regulator, venture capital funds issue a certificate of the fund's units certifying the total registered value of each unit holder's units as long as the total value of the units is not paid in full. The amount paid by the unit holder would be shown on the certificate if the certificate is issued in paper form or on the document specified by the CMA if it is issued in dematerialized form.

In the case of any further payments a new certificate would have to be issued, which would show the full amounts contributed by the unit holder both as a figure and as a percentage of the total commitment. In this way, unit holders could exercise their voting rights in the proportions indicated on such certificates until full payment of their units.