German Economic Team Belarus

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A regulatory framework for venture capital funds in Belarus

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Executive Summary

- Belarus has considerable potential through innovative start-ups. Even though the sector has grown rapidly in recent years financing constraints remain a serious obstacle, and the established banks are not suitable to meet the needs of the sector.
- The sector will therefore continue to depend on so-called business angels, and on funds raised by larger entities in foreign markets and channelled back to Belarus. The investment by foreign investment funds in Belarus is minimal at present.
- In developing a regulatory framework for financing of the innovative economy all stages of funding should be covered. There needs to be a continuity of financing that covers seed finance and early growth up to the expansion phase once a commercial concept is proven. Multiple conditions in the legal and financial market framework need to be addressed for this purpose, in particular the role of state banks and corporate governance.
- The authorities should also make an effort to develop a regulatory framework for investment funds within Belarus. This legislation should be broad, covering all stages of equity financing. Sector specific preferences for venture capital should be kept to a minimum.
- At present this legislation should rely on minimal standards developed by international organisations for emerging markets that secure disclosure and some investor protection. But only experienced investors and individuals will be active in this market and based on sound information, and the industry poses very few concerns for financial stability.
- There is no need to copy the very complex EU law for professional investors.

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1. Introduction

Investment funds, also known as collective investment schemes, are crucial intermediaries in capital market-based finance. Such funds will emerge organically as more investible capital becomes available, and companies demand finance outside their established bank relationships. Venture capital funds are a special form of such investment funds, which typically employ highly skilled investment professionals. The start-up sector in Belarus will need to draw on international expertise and capital for some time.

Yet, Belarus is well-advised to establish a sound domestic framework for such funds. This requires a good legal structure in areas such as corporate governance and intellectual property. Legislation on investment funds could be guided by international standards, and experience in the EU.

This paper sets out the role of venture capital and why the business model of such funds gives rise to very few concerns in financial stability (in section 2). Section 3 then reviews general principles in investment fund regulation, which are reflected in international standards (in Section 4) and in the EU regulation in this area (section 5). Section 6 then addresses the specific questions raised by the Working Group. Section 7 then concludes with some immediate priorities.

2. The funding of innovative companies through private equity and venture capital

A young and innovative company will depend on a variety of types of finance. At the stage of early growth seed capital will be required, which often comes from informal channels such as family and friends. Subsequently, more formal types of finance are required. So-called business angels are a key provider of finance at the seed and early growth stages, and these investors also make their industry expertise and international networks available.

Once there is a 'proven commercial concept' within the start-up company formal types of finance in collective investment funds emerge. Investment funds collect capital from institutional and private investors and hold a limited number of portfolio companies. The legal regime for such funds needs to safeguard the public interest of proper disclosure and investor protection. These concerns are paramount where listed securities are offered to retail investors.

In Belarus, legislation aimed at a sound framework for private, or unlisted, equity needs to be the priority. In many emerging markets, the development of private equity has proven to be a catalytic intermediary stage in developing a broader set of capital market-based funding sources, which is a long-term objective for Belarus. The efficiency and governance changes that the involvement of private equity investors produce within investee firms are essential for the few companies which ultimately successfully manage a public listing.

Venture capital is a sub-sector of private equity funds that is focused on innovative companies with highly variable returns. This requires specialist skills in assessing technologies that are yet to prove commercial viability.

Companies develop if there is a continuum of financing, both at early seed-capital stage and in the later expansion. Investment funds that want to engage in Belarus, whether domestic or foreign, will seek a reliable regime for all stages of company growth.

It is therefore not advisable to establish a regime that is specific to venture capital but rather build a sound investment funds law that applies to young and more mature companies. This means that the legal regime in Belarus should establish a sound investment funds law across all types of investment. There may be specific market failures for young companies, and these may be addressed through additional preferences, in particular for small companies, though the legal regime does not need to address specific industries or technologies.

2.1. The business model of private equity funds

A brief look at the business model of these investors underlines the benefits in terms of firm performance. Private equity caters to three distinct types of enterprises:

- The key target of PE investors are companies that are growing but which are capital-constrained. These companies have a proven commercial concept and a track record. Private equity investors will acquire significant stakes and take investee firms into a further growth phase, for instance by assisting in international market expansion.
- Venture capital targets highly innovative companies and remains a small, though much sought-after sub-sector of the private equity industry. Venture capital investors have developed distinct skills with regard to firms where technology is yet not ready for commercial application and returns are highly uncertain.
- Another type of PE funds are turnaround investors which target companies which may be stagnating but which have considerable inefficiencies that can be addressed through a programme of operational and financial restructuring. Investors may inject senior debt, in addition to equity.

This business model of such funds underlines that it poses only limited financial stability and this should inform regulation.

Unlike other types of investment funds, the industry does not suffer from liquidity shocks. A private equity fund collects commitments from a range of institutional and private investors. These so-called limited partners will be committed to the fund for up to ten years. This explains an unusually long investment horizon in identifying portfolio companies, and in implementing a new business plan within these companies.

Private equity funds are also actively engaged in the firm's management. The funds are best known for their restructuring of the operations in the investee company. Value is created through a programme of cost cutting and repositioning the product and company in the marketplace. This goes hand-in-hand with reforms in the governance of the firm, as managers will be subject to more stringent performance targets. The PE business model therefore encounters obstacles where poor corporate governance or other problems in the engagement of minority investors complicate operational and governance change. These are areas that should be reformed in parallel in Belarus.

There is now an extensive empirical literature that substantiates the positive effects of private equity on the investee firm's performance.[1] These effects are particularly strong when PE investors lift credit constraints, as opposed to merely focusing on operational restructuring. This was the context for the study by EBRD on the impact of private equity in emerging Europe, based on data for investee firms from over 100 funds.[2] Based on a comparison with a peer group of companies there was clear evidence that operating revenues rose more strongly in companies following a private equity investment. Overall, labour productivity increased by a third more than in a control group, suggesting that additional capital expenditure had raised operational efficiency.

2.2. Private equity and venture capital in emerging Europe

Private equity funds are backed by a wide range of institutional investors. In the EU in the four years to 2016 one third of funding was raised from pension funds, about 18 per cent from investment funds and another 12 per cent from insurance companies.[3] Limited partners have very specific mandates that

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[1] See for instance Frontier Economics (2013).

[2] EBRD Transition Report 2015: Rebalancing Finance.

[3] European Commission (2017): Mid-term review of the capital market union agenda, staff working document.

constrain the investment universe of the private equity fund, possibly shutting out non-EU countries, such as Belarus.

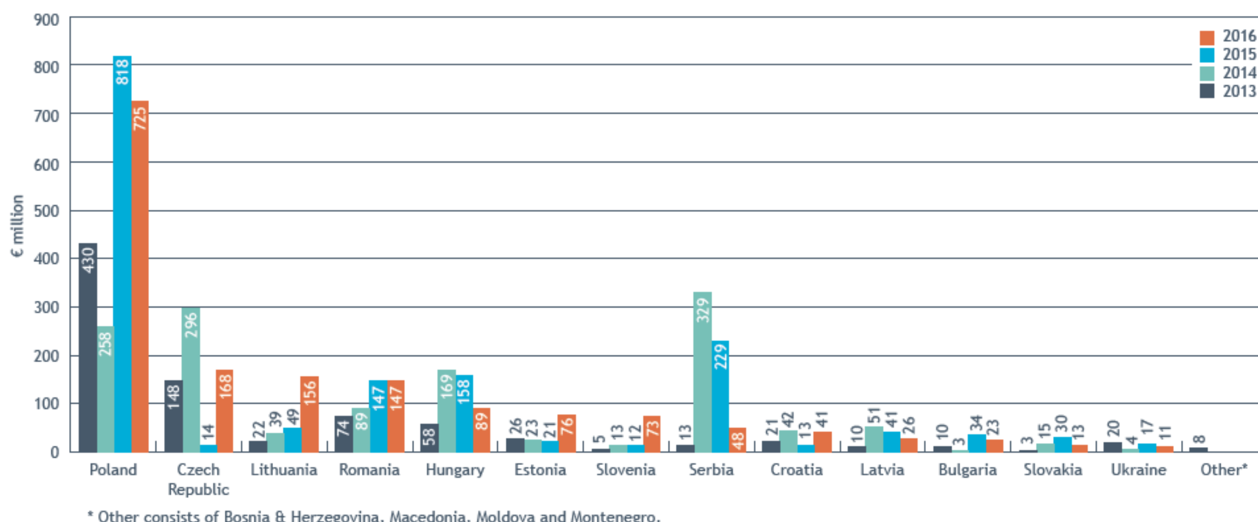
Government-owned funds account for a significant share of private equity funding in Europe, and this share is particularly large for venture capital (about 40 per cent of total investments in Europe). Fundraising by the venture fund industry is sensitive to liquidity and risk aversion in international debt markets, and consequently fell sharply in the immediate aftermath of the financial crisis.

The EU Commission presents encouraging recovery in private equity financing in Europe.[4] In the four years to 2016 the amount of capital raised by PE funds recovered to double that in the same timespan immediately after the financial crisis. The industry funded 5,900 enterprises in 2016, predominantly SMEs. The number of private equity firms has shrunk as consolidation to larger funds continued, and the industry remains largely based in the UK.

Central and eastern Europe (CEE) remains a marginal market for the European industry. The CEE share of total European fundraising is less than one per cent, and investment activity was only about EUR 1.6 billion, or 3 per cent of the total. Investments represented barely a tenth of a per cent of GDP in the region on average, which is a fifth of the same ratio in leading EU leaders such as France or the Netherlands. In the CEE Poland alone accounted for 45 per cent of the value, and a quarter of the number of enterprises funded by the industry in the region. The top five countries in the region (also including the Czech Republic, Lithuania, Romania and Hungary) accounted for 81 per cent of investments made, underlining the difficulties of smaller markets to attract the internationally diversified funds, and expend the considerable costs on market-specific due diligence (Figure 1).[5] EBRD estimated that 40,000 firms in the region could potentially be suitable targets for private equity investment, though only 2 per cent had actually become such targets.[6]

A wide variety of industries were funded, though information technology clearly stood out with roughly 21 per cent of the value of investments. The distribution by type of investment is similar to that in the rest of Europe. Given the lack of liquid local capital markets, exit options remain a significant concern for the industry, and 46 per cent by value were done through sales to other private equity firms.

Figure 1: Private equity investments in emerging Europe



Source: Invest Europe

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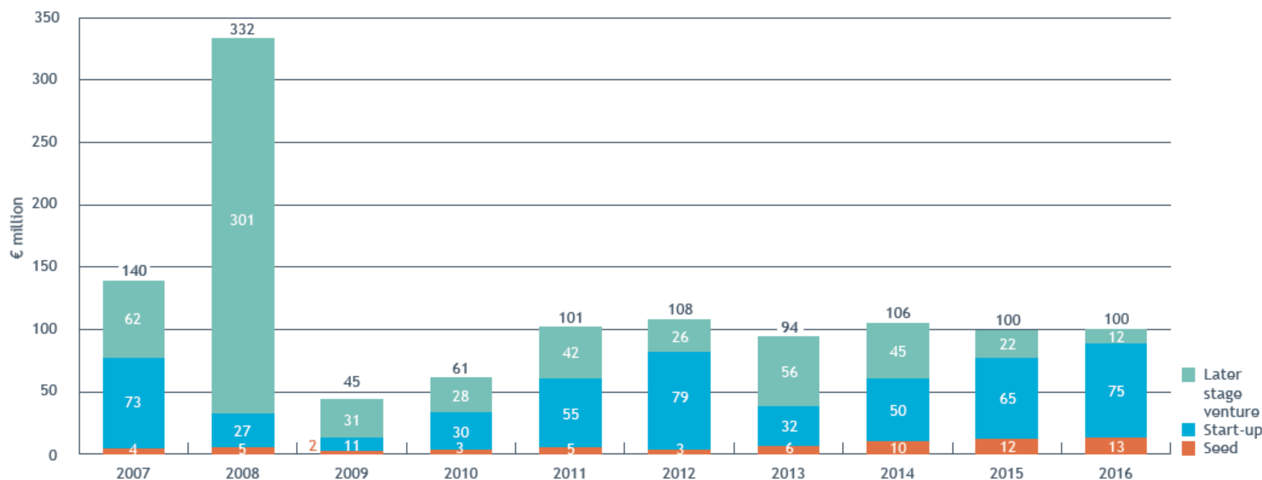
[4] EU Commission (2017).

[5] Invest Europe: CEE Private equity statistics 2016

[6] EBRD Transition Report 2015: Rebalancing Finance.

Figure 2: Venture capital investments in emerging Europe



Source: Invest Europe

3. The requirements of an investment fund law in emerging capital markets

3.1. Sound framework conditions as a condition for venture capital funds

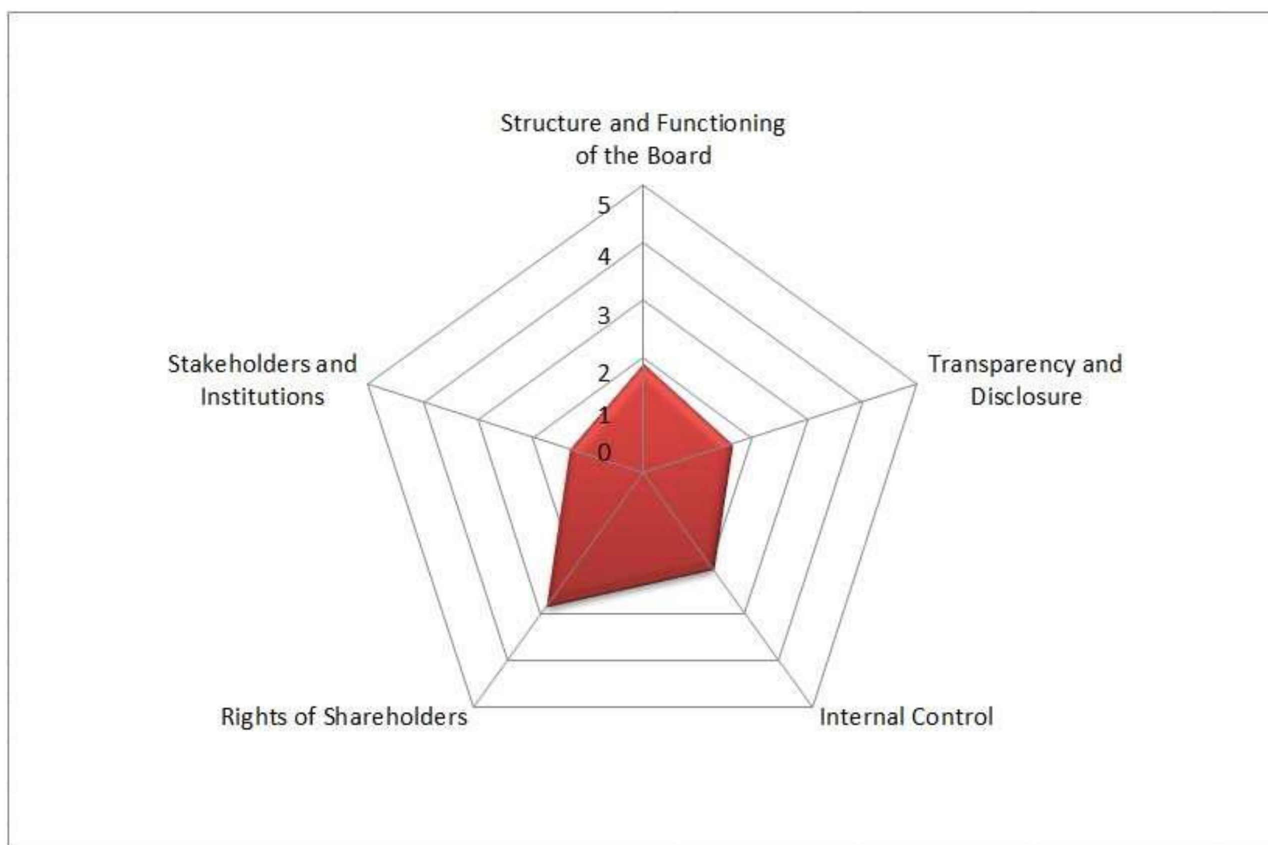
Private equity managers market their investment funds to experienced professional investors who are closely involved in setting a strategy. They normally operate with a regional investment mandate, and sometimes globally and are based in a small number of home bases. Nearly half of the European industry is located in the UK. Therefore, the regulatory and business environment in the investee's home country deeply affects their willingness to engage and subsequent investment performance.

The jurisdiction of the investee company needs to be receptive to risk capital and to the changes in governance and operations that a PE or VC fund will likely implement. This explains some of the obstacles to private equity and venture capital in emerging Europe. Key aspects such as the quality of the corporate governance regime, specifically investor protection and transparency of financial information are often inadequate.

In this regard, there is considerable scope for improvement in Belarus. An EBRD assessment of 2017 found considerable weaknesses in the key areas of the structure and functioning of boards, transparency and disclosure, and internal control. While rights of shareholders were assessed as reasonably well developed, there appears to be an urgent need to update and apply more consistently the 2007 corporate governance code in Belarus (Figure 3).[7]

[7] EBRD (2017): Corporate Governance in Transition Economies: Belarus Country Report.

Figure 3. Corporate governance legislation and practices in Belarus



Source: EBRD (2017)
Key: Very weak: 1 / Weak: 2 / Fair: 3 / Moderately Strong: 4 / Strong to very strong: 5
Note: The extremity of each axis represents an ideal score, i.e., corresponding to the standards set forth in best practices and international standards (e.g., OECD Corporate Governance Principles). The fuller the 'web', the closer the corporate governance legislation and practices of the country approximates best practices.

Poor corporate governance practices are one key reason why Belarus still ranks relatively low in investor attractiveness ratings. In one widely used ranking, Belarus is at place 97 out of 125, given particular weaknesses in investor protection and corporate governance, and labour market rigidities.[8]

The emergence of equity and venture capital funds will also depend on a number of institutions that overcome problems of information disclosure between investor and issuer, whether it is at the level of the individual company or the investment fund. Even though securities markets in Belarus are still extremely shallow and illiquid, this could include:

- Adequate skills and resources within the securities regulator (the National Bank), which will need to continually adapt laws;
- a reasonably efficient judiciary, in particular to keep in check illegal behaviour by company insiders at the cost of minority shareholders;
- good financial disclosure through independent audits;
- accounting and auditing rules that meet investors' need for reliable information, which allows accountants to expose false or misleading information;
- some professional skills among investment banking professionals and legal services;
- public disclosure of company conduct, including in the general press.[9]

[8] Groh et al. (2018), also summarised in the presentation by GET Belarus to the Belarus Development Bank.

[9] Black (2001): Legal and institutional preconditions for strong securities markets.

3.2. The regulation of investment funds

Investment funds play a crucial intermediary function in capital markets.

They provide individual investors diversification, including in assets outside the country. As they are managed by skilled professionals, investment funds provide additional protection against abuse of insider positions within investee companies. In capital markets 'self-dealing' is always a risk. This is a practice by managers or other company insiders that depletes the net worth of a firm at the expense of other investors. Given weak minority shareholder positions and ownership transparency this practice remains a risk throughout emerging Europe. Investment funds provide some safeguard against such risks.

As a source of funds and in demanding good disclosure investment funds can strengthen local capital markets. Yet, a healthy investment fund industry is likely to be the result, rather than the cause of, a strong local capital market. In particular pools of capital need to be available, and a 'track record' of successful investments needs to be demonstrated.

The purpose of an investment fund law is to protect investors against abuse of positions by fund managers, and to limit fund managers' ability for making false claims. This is reinforced by public scrutiny, including by investment analysts, rating agencies and the financial press.

At this early stage in financial market development in Belarus, an investment fund law should address only basic concerns about information disclosure and investor protection. This could allow a small number of funds to emerge, and attract capital from within Belarus, and possibly foreign funds.

3.3. Venture capital: do market failures justify a specific regime?

Venture capital is a sub-set of private equity industry, and should therefore be covered by a sound investment funds law.

Yet there are number of specific concerns. Investors in high-technology firms confront more difficult information problems as start-up companies have short histories, operate in unpredictable markets, and have uncertain growth prospects. Collateral that could be pledged in bank lending is more limited than for established firms. Protection of intellectual property is a crucial concern.[10]

Venture capital funds have developed expertise in assessing such companies. Apart from providing capital to the start-up company the venture capital financing also has a particularly deep involvement in the management of the company, and provides it a certain reputational advantage, which is of course larger for well-established international funds. Venture capital funds that originate in small local capital markets face particular hurdles in market entry, as they do not have a track record and reputation that would attract international institutional funding. This also argues in favour of supporting an investment funds industry that supports all stages of company growth.

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[10] For detailed overview of these issues and policy instruments used in advanced countries see: OECD (2015a) *Growth companies, access to capital markets and corporate* governance. OECD report to G20 Finance Ministers and Central Bank Governors; and Wilson, S. (2015): Policy lessons from financing innovative firms, OECD Science, Technology and Industry Policy Papers no. 24. For the discussion in Europe see AFME (2018): 'The shortage of risk capital for Europe's high growth businesses'.

4. General principles for the regulation of investment funds

Guidance on the design of investment fund legislation could come from the *Objectives and Principles of Securities Regulation* compiled by the International Organization of Securities Commissions (IOSCO).[11]

Belarus, as one of only two European countries, is not yet a member of IOSCO, and may want to begin preparations for membership. In the meantime, the standards could guide legislation Belarus as they are adhered to by many emerging markets in the early stages of capital market development, and would be recognised by international investors. Legislation on investment funds could be guided by Principles 24-28:

- The regulatory system should set standards for the eligibility, governance, organization and operational conduct of those who wish to market or operate a collective investment scheme.
- The regulatory system should provide for rules governing the legal form and structure of collective investment schemes and the segregation and protection of client assets.
- Regulation should require disclosure, as set forth under the principles for issuers, which is necessary to evaluate the suitability of a collective investment scheme for a particular investor and the value of the investor's interest in the scheme.
- Regulation should ensure that there is a proper and disclosed basis for asset valuation and the pricing and the redemption of units in a collective investment scheme.

While these principles are quite broad, and there seems to a recognition that regulation should be tolerant of risks that investors are prepared to accept. Principles for issuers call for accurate and timely disclosure of results, equitable treatment of all investors, and the use of internationally accepted accounting standards. Also, while there should be a clear basis for pricing and redemption of investment funds units, this does not imply that investment funds should be liquid. As pointed out above, private equity indeed has very long 'lock-in' periods for investors.

5. EU law on investment funds and venture capital

Investment law regulates the activities of asset managers who manage funds either for individual clients or as pooled investment for several investors. In the EU there is extensive legislation on the investment on behalf of individual clients where accounts are managed separately, most notably in the form of the latest Directive on financial instruments and markets (the MiFID II), and two main legal texts governing investment by retail investors, and by professional investors.

Given the present development stage of financial markets in Belarus there is no need to adhere to these very complex pieces of EU legislation. At the same time, it may be informative to examine how the **objectives of these law have been achieved**. These related originally to investor and market protection. More recently, integration within the single market in financial services, and protection of certain stakeholders, such as employees, have become more prominent.

5.1. Key elements of European investment fund law [12]

The EU law on collective investments has undergone some revisions following the European financial crisis but as it is generally regarded a success, this law has been relatively stable. It distinguishes between instruments aimed at personal or retail investors, and professional investors. The former are covered by a Directive on retail funds, the so-called *Undertakings for Collective Investments in Transferable Securities* (UCITS), which account for the bulk of European assets. This Directive has established a worldwide standard for retail investment funds that awards transparency and investor protection. Managers who are not regulated under the UCITS Directive are covered by a less stringent Directive on Alternative Investment

[11] IOSCO (2017): Objectives and Principles of Securities Regulation.

[12] This section draws largely on Zetsche, D. (2017): The Anatomy of European Investment Fund Law.

Managers (the AIFMD of 2013). This is therefore the main EU law governing professional investment, including by wealthy individuals.

AIFMD is complemented by three more flexible pieces of law: one on social entrepreneurship funds, one on long-term investment funds, and a regulation on venture capital funds (the EuVeCaR), which is aimed at closing the funding gap for innovative start-ups, and which we will examine below. All three pieces of legislation were born out of an attempt to provide more flexibility than is envisaged in the AIFMD for funding types that meet certain policy goals in the EU.

A key tenet of European investment, with long historical roots and parallels in other jurisdictions, is the separation of fund manager and its depositary. A depositary holds the fund units on behalf of the manager and thereby acts as the point of contact for the investor. As it must not benefit from the fund's performance and is subject to capital requirements it has no incentive to compromise the safekeeping of the fund units. Depositaries also provide independent monitoring of the fund managers, keeping their risk appetite in line with the mandate of the fund.

Investment managers of both retail and institutional investment are subject to extensive regulation, including on

- Licensing, relating to a 'fit and proper' test, capital requirements, and adequate business and risk organisation;
- Monitoring of operations, focusing in particular on corporate governance and remuneration, prevention of conflict of interest, and limits on leverage;
- Restrictions on the management of operational and financial risk.

In addition, both AIF managers and UCITS funds are subject to initial and periodic disclosure requirements, and, in the case of retail funds, also regulation regarding the fund itself.

5.2. The 2013 venture capital regulation as a variant on alternative investment funds

The EU has developed discrete regimes for a number of types of investment funds that suit the respective policy agendas. The 2013 regulation on venture capital is one such special regime.

The venture capital segment has attracted particular attention due to the concern that the post-crisis regulation would tighten availability of finance for SMEs.[13] A number of market failures are seen to disproportionately affect the funding of small companies, and are seen to warrant lighter regulation than is the case for professional investment managers.

Investment funds which are aimed primarily at SMEs therefore benefit from privileges under the EU's venture capital regulation (the 'EuVeCAR'). Funds that are registered under the EU regime for professional investors (the AIFMD) can opt into this more preferential regime if they are below a certain threshold size and invest more than 70 per cent of their assets into SMEs. Crucially, there is no limitation on the industry, technology or the type of innovation activity.

Managers who meet these requirements obtain a special permission to market these funds across the EU (based on a so-called passport regime), are exempt from the requirement to establish a depositary and benefit from more lenient rules on risk management, as investors are seen to be more qualified to take risks in the sector.

[13] European Commission (2017).

6. Conclusions and specific issues to be considered by the working group at the State Committee

Against this background we offer some input on the specific questions raised by the working group in the Technical Note[14] that accompanies this paper.

Legislation should facilitate investment funds which will emerge with greater liquidity in local capital and investment opportunities. Principles developed by IOSCO offer some useful guidance for legislation in early-stage capital markets. There is no need to adhere to complex European legislation.

Local investment funds will offer to investors diversification, expertise in assessing projects, and some protection against misconduct within investee firms. This is a long-term process, and local private equity funds manage only limited funds within emerging Europe. Allowing foreign funds access to Belarus, and reforming the broader regulatory conditions for this purpose, appears more promising in the short term.

Legislation should enable all forms of private equity participation by investment funds, as venture capital will only develop within an environment that is supportive of minority equity participations. Preferences granted to certain technologies or stages of innovation are unlikely to be effective. As venture capital is directed at technologies with highly uncertain commercial prospects there may however be a case for certain tax and funding preferences, as is the case in western Europe.

As these funds would not be marketed to retail investors, but only be accessible to certain well-qualified professional investors who actively take on risks, the concerns about investor protection are less prominent.

[14] Please refer to TN 04 2018.

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