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COMMUNITY GUIDELINES ON STATE AID TO PROMOTE RISK CAPITAL INVESTMENTS IN SMALL AND MEDIUM-SIZED ENTERPRISES

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1 INTRODUCTION

1.1 Risk capital as a Community objective

Risk capital relates to the equity financing of companies with perceived high-growth potential during their early growth stages. The demand for risk capital typically comes from companies with growth potential that do not have sufficient access to capital markets, while the offer of risk capital comes from investors ready to take high risk in exchange of potentially above-average returns from the equity invested.

In its Communication to the Spring European Council, *Working together for growth and jobs – A new start for the Lisbon strategy*¹, the Commission has recognised the insufficient level of risk capital available for start-up, innovative young businesses. The Commission has taken initiatives, like the Joint European Resources for Micro- to Medium Enterprises (JEREMIE) which is a joint initiative of the Commission and the European Investment Fund to tackle the lack of risk capital for small and medium-sized enterprises in some regions. Building on the experience gained with the MAP financial instruments, the Commission has proposed a High Growth and Innovative SME Facility (GIF) under the Competitiveness and Innovation Programme (CIP), which is currently being adopted and will cover the period 2007-2013. The Facility will increase the supply of equity to innovative SMEs by investing at market terms into venture capital funds focused on SMEs in their early stages and in the expansion phase.

The Commission addressed the issue of risk capital financing in its Communication on “Financing SME Growth- Adding European Value” adopted on 29/06/06 (COM 2006-349). The Commission has also stressed the importance of reducing and redirecting State aids to address market failures in order to increase economic efficiency and to stimulate research, development and innovation. In this context, the Commission has undertaken to reform the State aid rules *inter alia* with the aim of facilitating access to finance and risk capital.

In fulfilment of its commitment, the Commission published the “State Aid Action Plan - Less and better targeted State aid: A roadmap for State aid reform 2005-2009” (“SAAP”) in June 2005². The SAAP has highlighted the importance of improving the business climate and facilitating the rapid start-up of new enterprises. In this context, the SAAP announced the review of the Communication on State aid and risk capital (“SARC”)³ to tackle the market failures affecting the provision of risk capital to start-ups and young, innovative small and medium-sized enterprises (“SMEs”), in particular by increasing the flexibility of the rules contained in the SARC.

¹ COM (2005)24, 2.2.2005.

² COM(2005) 107 final – SEC(2005) 795, 7.6.2005.

³ OJ C 253, 21.8.2001, p. 3.

While it is the primary role of the market to provide sufficient risk capital in the Community, there is an ‘equity gap’ in the risk capital market, a persistent capital market imperfection preventing supply from meeting demand at a price acceptable to both sides, which negatively affects European SMEs. The gap concerns mainly high-tech innovative and mostly young firms with high growth potential. However, a wider range of firms of different ages and in different sectors with smaller growth potential that cannot find financing for their expansion projects without external risk capital may also be affected.

The existence of the equity gap may justify the granting of State aid in certain limited circumstances. If properly targeted, State aid in support of risk capital provision can be an effective means to alleviate the identified market failures in this field and to leverage private capital.

These guidelines replace the SARC by setting out the conditions under which State aid supporting risk capital investments may be considered compatible with the EC Treaty. The guidelines explain the conditions under which State aid is present in accordance with Article 87 (1) of the EC Treaty and the criteria that the Commission will apply in the compatibility assessment of the risk capital measures in accordance with the provisions of Article 87 (3) of the EC Treaty.

1.2 Experience in the field of State aid to risk capital

These guidelines have been prepared in the light of the experience gained in the application of the SARC. Comments from public consultations of Member States and stakeholders on the revision of the SARC, on the State aid Action Plan and on the Communication on State aid to innovation⁴ have also been taken into account.

The experience of the Commission and the comments received in the consultations have shown that the SARC has generally worked well in practice, but also revealed a need to increase the flexibility in the application of the rules and to adjust the rules to reflect the changed situation of the risk capital market. In addition, experience has shown that for some types of risk capital investments in some areas it was not always possible to fulfil the conditions set out in the SARC, and, as a result, risk capital could not be adequately supported with State aid in these cases. Furthermore, experience has also shown a low overall profitability of the aided risk capital funds.

To remedy these problems, these guidelines adopt a more flexible approach in certain circumstances so as to allow Member States to better target their risk capital measures to the relevant market failure. These guidelines also set out a refined economic approach for the assessment of the compatibility of risk capital measures with the Treaty. Under the SARC the authorisation of schemes was already based on a relatively sophisticated economic analysis focussing on the size of the market failure and the targeting of the measure. Hence, the SARC already reflected the key focus of a refined economic approach. However, some fine-tuning was still needed in respect of some of the criteria to ensure that the measure better target the relevant market failure. In particular, the guidelines contain elements to ensure that profit-driven and professional investment decisions are strengthened in order to further encourage private investors to co-invest with the State. Finally, an effort has been made to provide clarity where the experience with the SARC has shown that this was needed.

⁴ COM 2005 (436) final, 21.9.2005.

1.3 The balancing test for State aid supporting risk capital investments

1.3.1 The State Aid Action Plan and the balancing test

In the SAAP the Commission underlined the importance of strengthening the economic approach to State aid analysis. This translates into a balancing of the potential positive effects of the measure in reaching an objective of common interest against its potential negative effects in terms of distortion of competition and trade. The balancing test, as outlined in the SAAP, is composed of three steps, the first two relating to the positive effects and the last one to the negative effects and the resulting balance:

- (1) Is the aid measure aimed at a well-defined objective of common interest, such as growth, employment, cohesion and environment?
- (2) Is the aid well designed to deliver the objective of common interest, that is does the proposed aid address the market failure or other objective?
 - (i) Is State aid an appropriate policy instrument?
 - (ii) Is there an incentive effect, i.e. does the aid change the behaviour of firms and/or investors?
 - (iii) Is the aid measure proportional, i.e. could the same change in behaviour be obtained with less aid?
- (3) Are the distortions of competition and effect on trade limited, so that the overall balance is positive?

The balancing test is equally relevant for the design of State aid rules and for the assessment of cases falling within their scope.

1.3.2 Market failures

On the basis of the experience gained in applying the SARC, the Commission considers that there is no general risk capital market failure in the Community. It does, however, accept that there are market gaps for some types of investments at certain stages of enterprises' development. These gaps result from an imperfect matching of supply and demand of risk capital and can generally be described as an equity gap.

The provision of equity finance, in particular to smaller businesses, presents numerous challenges both to the investor and to the enterprise invested in. On the supply side, the investor needs to make a careful analysis not merely of any collateral being offered (as is the case of a lender) but of the entire business strategy in order to estimate the possibilities of making a profit on the investment and the risks associated with it. The investor also needs to be able to monitor that the business strategy is well implemented by the enterprise's managers. The investor finally needs to plan and execute an exit strategy, in order to generate a risk-adjusted return on investment from selling its equity stake in the company in which the investment is made.

On the demand side, the enterprise must understand the benefits and risks associated with external equity investment to pursue the venture and to prepare sound business plans to secure the necessary resources and mentoring. Owing to a lack of internal capital or the collateral needed to obtain debt funding and/or a solid credit history, the enterprise may face very tight funding constraints. In addition, the enterprise must share control with an outside investor, who usually has an influence over company decisions in addition to a portion of the equity.

As a result, the matching of supply and demand of risk capital may be inefficient so that the level of risk capital provided in the market is too restricted, and enterprises do not obtain funding despite having a valuable business model and growth prospects. The Commission considers that the main source of market failure relevant to risk capital markets, which particularly affects access to capital by SMEs and companies at the early stages of their development and which may justify public intervention, relates to imperfect or asymmetric information.

Imperfect or asymmetric information may result notably in:

- (a) Transaction and agency costs: potential investors face more difficulties in gathering reliable information on the business prospects of an SME or a new company and subsequently in monitoring and supporting the enterprise's development. This is in particular the case for highly innovative projects or risky projects. Furthermore, small deals are less attractive to investment funds due to relatively high costs for investment appraisal and other transaction costs.
- (b) Risk aversion: investors may become more reluctant to provide risk capital to SMEs, the more the provision of risk capital is subject to imperfect or asymmetric information. In other words, imperfect or asymmetric information tends to exacerbate risk aversion.

1.3.3 Appropriateness of the instrument

The Commission considers that State aid to risk capital measures may constitute an appropriate instrument within the limits and conditions set out in these guidelines. However, it must be borne in mind that risk capital provision is essentially a commercial activity involving commercial decisions. In this context, more general structural measures not constituting State aid may also contribute to an increase in the provision of risk capital, such as promoting a culture of entrepreneurship, introducing a more neutral taxation of the different forms of SME financing (for example new equity, retained earnings and debt), fostering market integration, and easing regulatory constraints, including limitations on investments by certain types of financial institutions (for example, pension funds) and administrative procedures for setting up companies.

1.3.4 Incentive effect and necessity

State aid for risk capital must result in a net increase in the availability of risk capital to SMEs, in particular by leveraging investments by private investors. The risk of "dead-weight", or lack of incentive effect, means that some enterprises funded through publicly supported measures would have obtained finance on the same terms even in the absence of State aid (crowding out). There is evidence of this happening, although such evidence is inevitably anecdotal. In those circumstances public resources are ineffective.

The Commission considers that aid in the form of risk capital satisfying the conditions laid down in these guidelines ensures the presence of an incentive effect. The need to provide incentives depends on the size of the market failure related to the different types of measures and beneficiaries. Therefore different criteria are expressed in terms of size of investment tranches per target enterprise, degree of involvement of private investors, and consideration of notably the size of the company and the business stage financed.

1.3.5 Proportionality of aid

The need to provide incentives depends on the size of the market failure related to the different types of measures, beneficiaries and development stage of the SMEs. A risk capital measure is well-designed if the aid is necessary in all its elements to create the incentives to provide equity to SMEs in their seed, start-up and early stages. State aid will be inefficient if it goes beyond what is needed to induce more risk capital provision. In particular, to ensure that aid is limited to the minimum, it is crucial that there is significant private participation and that the investments are profit-driven and are managed on a commercial basis.

1.3.6 Negative effects and overall balance

The Treaty requires the Commission to control State aid within the Community. This is why the Commission has to be vigilant in order to ensure that measures are well targeted and to avoid severe distortions of competition. When deciding whether to authorise the grant of public funds for measures designed to promote risk capital, the Commission will seek to limit as far as possible the following categories of risk:

- (a) the risk of "crowding out". The presence of publicly supported measures may discourage other potential investors from providing capital. This could, over the longer term, further discourage private investment in young SMEs and thus end up widening the equity gap, while at the same time creating the need for additional public funding;
- (b) the risk that advantages to the investors and/or investment funds create an undue distortion of competition in the venture capital market relative to their competitors that do not receive the same advantages;
- (c) the risk that an oversupply of public risk capital for target enterprises not invested according to a commercial logic could help inefficient firms stay afloat and could cause an artificial inflation of their valuations, making it all the less attractive for private investors to supply risk capital to these firms.

1.4 Approach for State aid control in the area of risk capital

Provision of risk capital funding to enterprises cannot be linked to the traditional concept of "eligible costs" used for State aid control, which relies on certain specified costs for which aid is allowed and the setting of maximum aid intensities. The diversity of possible models for risk capital measures devised by Member States also means that the Commission is not in a position to define rigid criteria by which to determine whether to authorise such measures. The assessment of risk capital therefore implies a departure from the traditional way in which State aid control is carried out.

However, since the SARC has proved to work well in practice in the area of risk capital, the Commission has decided to continue and thereby ensure continuity with the SARC approach.

2 SCOPE AND DEFINITIONS

2.1 Scope

These guidelines only apply to risk capital schemes targeting SMEs. They are not intended to constitute the legal basis for authorisation of an ad-hoc measure providing capital to an individual enterprise.

Nothing in these guidelines should be taken to call into question the compatibility of State aid measures which meet the criteria laid down in any other guidelines, frameworks or regulations adopted by the Commission.

The Commission will pay particular attention to the need to prevent the use of these guidelines to circumvent the principles laid down in existing frameworks, guidelines and Regulations.

Risk capital measures must specifically exclude the provision of aid to enterprises:

- (a) in difficulty, within the meaning of the Community guidelines on State aid for rescuing and restructuring firms in difficulty⁵;
- (b) in the shipbuilding⁶, coal⁷ and steel industry⁸.

These Guidelines do not apply to aid to export-related activities, namely aid directly linked to the quantities exported, to the establishment and operation of a distribution network or to other current expenditure linked to the export activity, as well as aid contingent upon the use of domestic in preference to imported goods.

2.2 Definitions

For the purposes of these guidelines, the following definitions shall apply:

- (a) **"equity"** means ownership interest in a company, represented by the shares issued to investors;
- (b) **"private equity"** means private (as opposed to public) equity investment in companies not listed on a stock-market, including venture capital, replacement capital and buy-outs;
- (c) **"quasi-equity investment instruments"** means instruments whose return for the holder (investor/lender) is predominantly based on the profits or losses of the underlying target company, are unsecured in the event of default. This definition is based on a substance over form approach;

⁵ OJ C 244, 1.10.2004, p. 2.

⁶ For the purpose of these Guidelines, the definitions laid down in the Framework on State aid to shipbuilding OJ C 317, 30.12.2003, pages 11-14, apply.

⁷ For the purpose of these Guidelines, 'coal' means high-grade, medium-grade and low-grade category A and B coal within the meaning of the international codification system for coal laid down by the United Nations Economic Commission for Europe.

⁸ For the purpose of these Guidelines, the definition laid down in Annex I in the Guidelines on national regional aid for 2007-2013 (OJ C 54, 04.03.2006, p. 13-45) applies.

- (d) **“debt investment instruments”** means loans and other funding instruments which provide the lender/investor with a predominant component of fixed minimum remuneration and are at least partly secured. This definition is based on a substance over form approach;
- (e) **“seed capital”** means financing provided to study, assess and develop an initial concept, preceding the start-up phase;
- (f) **“start-up capital”** means financing provided to companies, which have not sold their product or service commercially and are not yet generating a profit, for product development and initial marketing;
- (g) **“early-stage capital”** means seed and start-up capital;
- (h) **“expansion capital”** means financing provided for the growth and expansion of a company, which may or may not break even or trade profitably, for the purposes of increasing production capacity, market or product development or the provision of additional working capital;
- (i) **“venture capital”** means 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;
- (j) **“replacement capital”** means the purchase of existing shares in a company from another private equity investment organisation or from another shareholder or shareholders. Replacement capital is also called secondary purchase;
- (k) **“risk capital”** means equity and quasi-equity financing to companies during their early-growth stages (seed, start-up and expansion phases), including informal investment by business angels, venture capital and alternative stock markets specialised in SMEs including high-growth companies (hereafter referred to as investment vehicles);
- (l) **“risk capital measures”** means schemes to provide or promote aid in the form of risk capital;
- (m) **“Initial Public Offering” (“IPO”)** means the process of launching the sale or distribution of a company’s shares to the public for the first time;
- (n) **“follow-on investment”** means an additional investment in a company subsequent to an initial investment;
- (o) **“buyout”** means the purchase of at least a controlling percentage of a company’s equity from the current shareholders to take over its assets and operations through negotiation or a tender offer;
- (p) **“exit strategy”** means a strategy for the liquidation of holdings by a venture capital or private equity fund according to a plan to achieve maximum return, including trade sale, write-offs, repayment of preference shares/loans, sale to another venture

capitalist, sale to a financial institution and sale by public offering (including Initial Public Offerings);

- (q) **”small and medium-sized enterprises”** (“SMEs”) means small enterprises and medium-sized enterprises” within the meaning of Commission Regulation (EC) No 70/2001 of 12 January 2001 on the application of Articles 87 and 88 of the EC Treaty to State aid to small and medium-sized enterprises Commission Regulation (EC) 364/2004⁹ or any regulation replacing that regulation.
- (r) **”target enterprise or company”** means an enterprise or company in which an investor or investment fund is considering investing;
- (s) **“business angels” means** wealthy private individuals who invest directly in young new and growing unquoted business (seed finance) and provide them with advice, usually in return for an equity stake in the business, but may also provide other long-term finance;
- (t) **“assisted areas” means** regions falling within the scope of the derogations contained in Article 87(3)(a) or (c) of the EC Treaty;

3 APPLICABILITY OF ARTICLE 87(1) IN THE FIELD OF RISK CAPITAL

3.1 General applicable texts

There are already a number of published Commission texts which provide interpretation on whether individual measures fall within the definition of State aid and which may be relevant to risk capital measures. These include the 1984 communication on government capital injections¹⁰, the 1998 notice on the application of the State aid rules to measures relating to direct business taxation¹¹ and the notice on the application of Articles 87 and 88 of the EC Treaty to State aid in the form of guarantees¹². The Commission will continue to apply these texts, when assessing whether risk capital measures constitute State aid.

3.2 Presence of aid at three levels

Risk capital measures often involve complex constructions devised to promote risk capital because the public authorities create incentives for one set of economic operators (investors) in order to provide finance to another set (target SMEs). Depending on the design of the measure, and even if the intention of the public authorities may be only to provide benefits to the latter group, enterprises at either or both levels may benefit from State aid. Moreover, in most cases the measure provides for the creation of a fund or other investment vehicle which has an existence separate from that of the investors and the enterprises in which the investment is made. In such cases it is also necessary to consider whether the fund or vehicle can be considered to be an enterprise benefiting from State aid.

⁹ OJ L 10, 13.1.2001, p. 33; Regulation as amended by Regulation (EC) 364/2004 (OJ L 63, 28.2.2004, p. 22).

¹⁰ Bulletin EC 9-1984, reproduced in "Competition law in the European Communities", Volume IIA, p. 133.

¹¹ OJ C 384, 10.12.1998, p. 3.

¹² OJ C 71, 11.3.2000, p. 14.

In this context, funding with resources, which are not State resources within the meaning of Article 87.1 of the EC Treaty, is considered to be provided by private investors. This is, in particular, the case for funding by the European Investment Bank and the European Investment fund.

The Commission will take into account the following specific factors in determining whether State aid is present at each of the different levels¹³.

Aid to investors. Where a measure allows private investors to effect equity or quasi-equity investments into a company or set of companies on terms more favourable than public investors, or than if they had undertaken such investments in the absence of the measure, then those private investors will be considered to receive an advantage. Such advantage may take different forms, as specified in section 4.2 of these guidelines. This remains the case even if the private investor is persuaded by the measure to confer an advantage on the company or companies concerned. In contrast, the Commission will consider the investment to be effected *pari passu* between public and private investors, and thus not to constitute State aid, where its terms would be acceptable to a normal economic operator in a market economy in the absence of any State intervention. This is assumed to be the case only if public and private investors share exactly the same upside and downside risks and rewards and hold the same level of subordination, and normally where at least 50 percent of the funding of the measure is provided by private investors, which are independent from the companies in which they invest.

Aid to an investment fund, investment vehicle and/or its manager. In general, the Commission considers that an investment fund or an investment vehicle is an intermediary vehicle for the transfer of aid to investors and/or enterprises in which investment is made, rather than being a beneficiary of aid itself. However, measures such as fiscal measures or other measures involving direct transfers in favour of an investment vehicle or an existing fund with numerous and diverse investors with the character of an independent enterprise may constitute aid unless the investment is made on terms which would be acceptable to a normal economic operator in a market economy and therefore provide no advantage to the beneficiary. Likewise, aid to the fund's managers or the management company will be considered to be present if their remuneration does not fully reflect the current market remuneration in comparable situations. On the other hand, there is a presumption of no aid if the managers or management company are chosen through an open and transparent public tender procedure or if they do not receive any other advantages granted by the State.

Aid to the enterprises in which investment is made. In particular, where aid is present at the level of the investors, the investment vehicle or the investment fund, the Commission will normally consider that it is at least partly passed on to the target enterprises and thus that it is also present at their level. This is the case even where investment decisions are being taken by the managers of the fund with a purely commercial logic.

In cases where the investment is made on terms which would be acceptable to a private investor in a market economy in the absence of any State intervention the enterprises in which the investment is made will not be considered as aid recipients. For this purpose, the Commission will consider whether such investment decisions are exclusively profit-driven,

¹³ It should, however, be noted that guarantees granted by the State in favour of investments in risk capital are more likely to include an element of aid to the investor than is the case with traditional loan guarantees, which are normally considered to constitute aid to the borrower rather than to the lender.

linked to a reasonable business plan and projections as well as to a clear and realistic exit strategy. Also important will be the choice and investment mandate of the fund's managers or the management company as well as the percentage and degree of involvement of private investors.

3.3 De minimis amounts

Where all financing in the form of risk capital provided to beneficiaries is *de minimis* within the meaning of Commission Regulation (EC) No 69/2001 of 12 January 2001 on the application of Articles 87 and 88 of the EC Treaty to de minimis aid¹⁴ and Commission Regulation (EC) No 1860/2004 on the application of Articles 87 and 88 of the EC Treaty to de minimis aid in the agriculture and fisheries sectors¹⁵, then it is deemed not to fall under Article 87(1) of the Treaty. In risk capital measures the application of the *de minimis* rule is made more complicated by difficulties in the calculation of the aid and also by the fact that measures may provide aid not only to the target enterprises but also to other investors. Where these difficulties can be overcome, however, the *de minimis* rule remains applicable. Therefore, if a scheme provides public capital only up to the relevant *de minimis* threshold to each enterprise over a three-year period, then it is certain that any aid to these enterprises and/or the investors is within the prescribed limits.

4 ASSESSMENT OF THE COMPATIBILITY OF RISK CAPITAL AID UNDER ARTICLE 87(3) (C) OF THE EC TREATY

4.1 General principles

Article 87(3)(c) of the Treaty provides that aid to facilitate the development of certain economic activities may be considered to be compatible with the common market where such aid does not adversely affect trading conditions to an extent contrary to the common interest. On the basis of the balancing test set out in section 1.3, the Commission will authorise a risk capital measure only if it concludes that the aid measure leads to an increased provision of risk capital without adversely affecting trading conditions to an extent contrary to the common interest. This section sets out a set of conditions under which the Commission will consider that aid in the form of risk capital is compatible with Article 87(3)(c).

Where the Commission is in possession of a complete notification which shows that all the conditions laid down in this section are met, it will try to make a rapid assessment of the aid within the time limits laid down in Council Regulation (EC) No 659/1999 of 22 March 1999 laying down detailed rules for the application of Article 93 of the EC Treaty¹⁶. For certain types of measures which do not fulfil all the conditions set out in this section, the Commission will undertake a more detailed assessment of the risk capital measure as set out in detail in section 5.

Where there is also aid at the level of target enterprises and the provision of risk capital is linked to costs which are eligible for aid under another regulation or framework or other guidelines, that text may be applied to consider whether the aid is compatible with the common market.

¹⁴ OJ L 10, 13.1.2001, p. 30

¹⁵ OJ L 325, 28.10.2004, p.4

¹⁶ OJ L 83, 27.3.1999, p.1.

4.2 Form of aid

The choice of form of an aid measure lies in general with the Member State and this applies equally to risk capital measures. However, the Commission's assessment of such measures will include whether they encourage market investors to provide risk capital to the target enterprises and are likely to result in investment decisions being taken on a commercial (that is, a profit-driven) basis, as further explained in section 4.3.

The Commission believes that the types of measure capable of producing this result include the following:

- (a) constitution of investment funds ("venture capital funds") in which the State is a partner, investor or participant, even if on less advantageous terms than other investors;
- (b) guarantees to risk capital investors or to venture capital funds against a proportion of investment losses, or guarantees given in respect of loans to investors/funds for investment in risk capital, provided the public cover for the potential underlying losses does not exceed 50% of the nominal amount of the investment guaranteed;
- (c) other financial instruments in favour of risk capital investors or venture capital funds to provide extra capital for investment;
- (d) fiscal incentives to investment funds and/or their managers, or to investors to undertake risk capital investment.

4.3 Conditions for compatibility

To ensure that the incentive effect and the necessity of aid as set out in section 1.3.4 are present in a risk capital measure a number of indicators are relevant. The rationale is that State aid must target a specific market failure for the existence of which there is sufficient evidence. For this purpose, these guidelines lay down specific safe-harbour thresholds relating to tranches of investment in target SMEs in their early stages of business activity. Furthermore, so that aid is limited to the minimum necessary, it is crucial that aided investments into target SMEs are profit-driven and are managed on a commercial basis. The Commission will consider that the incentive effect, the necessity and proportionality of aid are present in a risk capital measure and that the overall balance is positive where all the following conditions are met.

Measures specifically involving investment vehicles will be assessed under section 5 of these guidelines and not under the conditions in this section.

4.3.1 Maximum level of investment tranches

The risk capital measure must provide for tranches of finance, whether wholly or partly financed through State aid, not exceeding EUR 1.5 million per target SME over each period of twelve months.

4.3.2 Restriction to seed, start-up and expansion financing

The risk capital measure must be restricted to provide financing up to the expansion stage for small enterprises, or for medium-sized enterprises located in assisted areas. It must be

restricted to provide financing up to the start-up stage for medium-sized enterprises located in non-assisted areas.

4.3.3 Prevalence of equity and quasi-equity investment instruments

The risk capital measure must provide at least 70% of its total budget in the form of equity and quasi-equity investment instruments into target SMEs. In assessing the nature of such instruments, the Commission will have regard to the economic substance of the instrument rather than to its name and the qualification attributed to it by the investors. In particular, the Commission will take into account the degree of risk in the target company's venture borne by the investor, the potential losses borne by the investor, the predominance of profit-dependent remuneration versus fixed remuneration, and the level of subordination of the investor in the event of the company's bankruptcy. The Commission may also take into account the treatment applicable to the investment instrument under the prevalent domestic legal, regulatory, financial, and accounting rules, if these are consistent and relevant for the qualification.

4.3.4 Participation by private investors

At least 50% of the funding of the investments made under the risk capital measure must be provided by private investors, or for at least 30% in the case of measures targeting SMEs located in assisted areas.

4.3.5 Profit-driven character of investment decisions

The risk capital measure must ensure that decisions to invest into target companies are profit-driven. This is the case where the motivation to effect the investment is based on the prospects of a significant profit potential and constant assistance to target companies for this purpose. This criterion is considered to be met if all the following conditions are fulfilled:

- (a) by measures with significant involvement of private investors as described in section 4.3.4, providing investments being invested on a commercial basis (that is, only for profit) directly or indirectly in the equity of the target enterprises; and
- (b) by the existence of a business plan for each investment containing details of product, sales and profitability development and establishing the ex ante viability of the project; and
- (c) by the existence of a clear and realistic exit strategy for each investment.

4.3.6 Commercial management

The management of a risk capital measure or fund must be effected on a commercial basis. The management team must behave as managers in the private sector, seeking to optimise the return for their investors. This criterion is considered to be present where all the following conditions are fulfilled:

- (a) there is an agreement between a professional fund manager or a management company and participants in the fund, providing that the manager's remuneration is linked to performance and setting out the objectives of the fund and proposed timing of investments; and
- (b) private market investors are represented in decision-making, such as through an investors' or advisory committee; and

(c) best practices and regulatory supervision apply to the management of funds.

4.3.7 Sectoral focus

To the extent that many private sector funds focus on specific innovative technologies or even sectors (such as health, information technology, biotechnology) the Commission may accept a sectoral focus for risk capital measures, provided the measure falls within the scope of these guidelines as set out in section 2.1.

5 COMPATIBILITY OF RISK CAPITAL AID MEASURES SUBJECT TO A DETAILED ASSESSMENT

This section applies to risk capital measures which do not satisfy all the conditions laid down in section 4. A more detailed compatibility assessment based on the balancing test outlined in section 1.3 is necessary for these measures due to the need to ensure the targeting of the relevant market failure and due to the higher risks of potential crowding-out of private investors and of distortion of competition.

The analysis of compatibility of the measures with the Treaty will be based on a number of positive and negative elements. No single element is determinant, nor can any set of elements be regarded as sufficient on its own to ensure compatibility. In some cases their applicability, and the weight attached to them, may depend on the form of the measure.

Member States will have to provide all the elements and the evidence they consider useful for the assessment of a measure. The level of evidence required and the Commission assessment will depend on the features of each case and will be proportionate to the level of market failure tackled and to the risk of crowding out private investment.

5.1 Aid measures subject to a detailed assessment

The following list of types of risk capital measures not complying with one or more of the conditions set out in section 4 will be subject to a more detailed assessment given the less obvious evidence of a market failure and the higher potential for crowding out of private investment and/or distortion of competition.

(a) Measures providing for investment tranches beyond the safe-harbour threshold of EUR 1.5 million per target SME over each period of twelve months

The Commission is aware of the constant fluctuation of the risk capital market and of the equity gap over time, as well as of the different degree by which enterprises are affected by the market failure depending on their size, on their stage of business development, and on their economic sector. Therefore, the Commission is prepared to consider the authorisation of risk capital measures providing for investment tranches exceeding the threshold of EUR 1.5 million per enterprise per year provided the necessary evidence of the market failure is submitted.

(b) Measures providing finance for the expansion stage for medium-sized enterprises in non-assisted areas

The Commission recognises that certain medium-sized enterprises in non-assisted areas may have insufficient access to risk capital even in their expansion stage despite the

availability of finance to enterprises having a significant turnover and/or total balance. Therefore, the Commission is prepared to consider the authorisation of measures partly covering the expansion stage of medium-sized enterprises in certain cases provided the necessary evidence is submitted.

(c) Measures providing for follow-on investments into target companies that already received aided capital injections to fund subsequent financing rounds even beyond the general safe-harbour thresholds and the companies' early-growth financing

The Commission recognises the importance of follow-on investments into target companies that already received aided capital injections in their early stages to finance financing rounds even beyond the maximum safe-harbour investment tranches and the companies' early-growth financing up to the exit of the initial investment. This may be necessary to avoid dilution of the public participation in these financing rounds while ensuring continuity of financing for the target enterprises so that both public and private investors can fully benefit from the risky investments. In these circumstances and taking into account the specificities of the targeted sector and enterprises, the Commission is prepared to consider the authorisation of follow-on investment provided the amount of this investment is consistent with the initial investment and with the size of the fund.

(d) Measures providing for a minimum participation by private investors below 50% in non-assisted areas or below 30% in assisted areas

In the Community the level of development of the private risk capital market varies to a significant extent in the various Member States. In some cases, it might be difficult for the State to find private investors, and therefore the Commission is prepared to consider the authorisation of measures with a private participation below the thresholds set out in section 4.3.4 if Member States submit the necessary evidence. This problem may be even greater for risk capital measures targeting SMEs in assisted areas. In these cases there may be an additional shortage of capital available for them given their remote location from venture capital centres, the lower population density, and the increased risk-aversion of private investors. These SMEs may also be affected by demand-side issues such as the difficulty in drawing up a viable, investment-ready business proposition, a more limited equity culture, and particular reluctance to lose management control as a result of venture capital intervention.

(e) Measures providing seed capital to small enterprises which may foresee (i) less or no private participation by private investors, and/or (ii) predominance of debt investment instruments as opposed to equity and quasi-equity

The market failures affecting enterprises in their seed stage are more pronounced due to the high degree of risk involved by the potential investment and the need to closely mentor the entrepreneur in this crucial phase. This is also reflected by the reluctance and near absence of private investors to provide seed capital, which implies no or very limited risk of crowding-out. Furthermore, there is reduced potential for distortion of competition due to the significant distance from the market of these small-size enterprises. These reasons may justify a more favourable stance of the Commission towards measures

targeting the seed stage, also in light of their potentially crucial importance to generate growth and jobs in the Community.

(f) Measures specifically involving an investment vehicle

An investment vehicle may facilitate the matching between investors and target SMEs for which it may therefore improve the access to risk capital. In case of market failures related to the enterprises targeted by the vehicle, the vehicle may not function efficiently without financial incentives. For instance, investors may not find the type of investments targeted by the vehicle attractive compared to investments of higher tranches of investments or investments in more established enterprises or more established market places, despite a clear potential for profitability of the target enterprises. Therefore, the Commission is prepared to consider measures specifically involving an investment vehicle provided the necessary evidence for a clearly defined market failure is submitted.

(g) Costs linked to the first screening of companies in view of the conclusion of the investments, up to the due diligence phase (“scouting costs”)

Risk capital funds or their managers may incur ‘scouting costs’ in identifying SMEs, prior to the due diligence phase. Grants covering part of these scouting costs must encourage the funds or their managers to carry out more ‘scouting’ activities than would otherwise be the case. This may also be beneficial for the SMEs concerned, even if the search does not lead to an investment, since it enables those SMEs to acquire more experience with risk capital financing. These reasons may justify a more favourable stance of the Commission towards grants covering part of the scouting costs of risk capital funds or their managers, subject to the following conditions: The eligible costs must be limited to the scouting costs related to SMEs mainly in their seed or start-up stage, where such costs do not lead to investment, and the costs must exclude legal and administrative costs of the funds. In addition, the grant must not exceed 50% of the eligible costs.

5.2 Positive effects of the aid

5.2.1 Existence and evidence of market failure

For risk capital measures envisaging investment tranches into target enterprises beyond the conditions laid down in section 4, in particular those providing for tranches above EUR 1.5 million per target SME over each period of twelve months, follow-on investments or financing of the expansion stage for medium-sized enterprises in non-assisted areas as well as for measures specifically involving an investment vehicle, the Commission will require additional evidence of the market failure being tackled at each level where aid may be present before declaring the proposed risk capital measure compatible. Such evidence must be based on a study showing the level of the ‘equity gap’ with regard to the enterprises and sectors targeted by the risk capital measure. The relevant information concerns the supply of risk capital and the fundraising capital, as well as the significance of the venture capital industry in the local economy. It should ideally be provided for periods of three to five years preceding the implementation of the measure and also for the future, on the basis of reasonable projections, if available. The evidence submitted could also include the following elements:

- (a) development of the fundraising over the past five years, also in comparison with the correspondent national and/or European averages;

- (b) the current overhang of money;
- (c) the share of government aided investment programs in the total venture capital investment over the preceding three to five years;
- (d) the percentage of new start-ups receiving venture capital;
- (e) the distribution of investments by categories of amount of investment;
- (f) a comparison of the number of business plans presented with the number of investments made by segment (amount of investment, sector, round of financing, etc.).

For measures targeting SMEs located in assisted areas, the relevant information must be supplemented by any other relevant evidence proving the regional specificities which justify the features of the measure envisaged. The following elements may be relevant:

- (a) estimation of the additional size of the equity gap caused by the peripherality and other regional specificities, in particular in terms of total amount of risk capital invested, number of funds or investment vehicles present in the territory or at a short distance, availability of skilled managers, number of deals and average and minimum size of deals if available;
- (b) specific local economic data, social and/or historic reasons for an underprovision of risk capital, in comparison with the relevant average data and/or situation at national and/or Community level as appropriate;
- (c) any other relevant indicator showing an increased degree of market failure.

Member States may resubmit the same evidence several times provided that the underlying market conditions have not changed. The Commission reserves the right to question the validity of the submitted evidence.

5.2.2 Appropriateness of the instrument

An important element in the balancing test is whether and to what extent State aid in the field of risk capital can be considered as an appropriate instrument to encourage private risk capital investment. This assessment is closely related to the assessment of the incentive effect and the necessity of aid, as set out in section 5.2.3.

In its detailed assessment, the Commission will take particular account of any impact assessment of the proposed measure which the Member State has made. Where the Member State has considered other policy options and the advantages of using a selective instrument such as State aid have been established and submitted to the Commission, the measures concerned are considered to constitute an appropriate instrument. The Commission will also assess evidence of other measures taken or to be taken to address the 'equity gap' notably ex post evaluations and both supply and demand side issues affecting the targeted SMEs, to see how they would interact with the proposed risk capital measure.

5.2.3 Incentive effect and necessity of aid

The incentive effect of the risk capital aid measures plays a crucial role in the compatibility assessment. The Commission believes that the incentive effect is present for measures meeting all the conditions in section 4. However, as for the measures covered in this section the presence of the incentive effect becomes less obvious. Therefore, the Commission will also take into account the following additional criteria showing the profit-driven character of investment decisions and the commercial management of the measure, where relevant.

5.2.3.1 Commercial management

In addition to the conditions laid down in 4.3.6 the Commission will consider it positively that the risk capital measure or fund is managed by professionals from the private sector or by independent professionals chosen according to a transparent, non discriminatory procedure, preferably an open tender, with proven experience and a track record in capital market investments ideally in the same sector(s) targeted by the fund, as well as an understanding of the relevant legal and accounting background for the investment.

5.2.3.2 Presence of an investment committee

A further positive element would be the existence of an investment committee, independent of the fund management company and composed of independent experts coming from the private sector with significant experience in the targeted sector, and preferably also of representatives of investors, or independent experts chosen according to a transparent, non discriminatory procedure, preferably an open tender. These experts would provide the managers or management company with analyses of the existing and the expected future market situation and would scrutinise and propose to them potential target enterprises with good investment prospects.

5.2.3.3 Size of the measure/fund

The Commission will consider it positively where a risk capital measure has a budget for investments into target SMEs of a sufficient size to take advantage of economies of scale in administering a fund and the possibility of diversifying risk via a pool of a sufficient number of investments. The size of the fund should safeguard a likelihood of absorption of the high transaction costs and/or to finance the latter, more profitable financing stages of target companies. The size of the risk capital measure will be considered positively also taking into account the sector targeted, and provided the risks of crowding-out private investment and distorting competition are minimised.

5.2.3.4 Presence of business angels

For measures targeting seed capital, in view of the more pronounced level of market failure that can be perceived in this phase, the Commission will consider positively the direct or indirect involvement of business angels in investments in the seed stage. In such circumstances, it is therefore prepared to consider the authorisation of measures which may foresee a predominance of debt instruments, including a higher degree of subordination of the State funds and a right of first profit for business angels or higher remuneration for their provision of capital and active involvement in the management of the measure/fund and/or of the target enterprises.

5.2.4 Proportionality

Compatibility requires that the aid amount is limited to the minimum necessary. The way to achieve this aspect of proportionality will necessarily depend on the form of the measure in question. However in the absence of any mechanism to check that investors are not overcompensated, or a measure where the risk of losses is borne entirely by the public sector and/or where the benefits flow entirely to the other investors, the measure will not be considered proportionate.

The Commission will consider that the following elements positively influence the assessment of proportionality as they represent a best-practice approach:

- (a) **Open tender for managers.** A transparent, non-discriminatory open tender for the choice of the managers or management company ensuring the best combination of quality and value for money will be considered positively, as it will limit the cost (and possibly aid) level at the minimum necessary and will also minimise distortion of competition.
- (b) **Call for tender or public invitation to investors.** A call for tender for the establishment of any “preferential terms” given to investors, or the availability of any such terms to other investors. This availability might take the form of a public invitation to investors at the launch of an investment fund or investment vehicle, or might take the form of a scheme (such as a guarantee scheme) which remained open to new entrants over an extended period.

5.3 Negative effects of the aid

The Commission will balance the potential negative effects in terms of distortion of competition and risk of crowding-out private investment against the positive effects when assessing the compatibility of risk capital measures. These potentially negative effects will have to be analysed at each of the three levels where aid may be present. Aid to investors, to investment vehicles and to investment funds may negatively affect competition in the market for the provision of risk capital. Aid to target enterprises may negatively affect the product markets on which these enterprises compete.

5.3.1 Crowding-out

At the level of the market for the provision of risk capital, State aid may result in crowding out private investment. This might reduce the incentives of private investors to provide funding for target SMEs and encourage them to wait until the State provides aid for such investments. This risk becomes more relevant, the higher the amount of an investment tranche invested into an enterprise, the larger the size of an enterprise, and the later the business stage, as private risk capital becomes progressively available in these circumstances.

Therefore, the Commission will require specific evidence regarding the risk of crowding-out for measures providing for larger investment tranches in target SMEs, for follow-on investments or for financing of the expansion stage in medium-sized enterprises in non-assisted areas or for measures with low participation by private investors or measures involving specifically an investment vehicle.

In addition, Member States will have to provide evidence to show that there is no risk of crowding-out, specifically concerning the targeted segment, sector and/or industry structure.

The following elements may be relevant:

- (a) the number of venture capital firms/funds/investment vehicles present at national level or in the area in case of a regional fund and the segments in which they are active;
- (b) the targeted enterprises in terms of size of companies, growth stage, and business sector;

- (c) the average deal size and possibly the minimum deal size the funds or investors would scrutinise;
- (d) the total amount of venture capital available for the target enterprises, sector and stage targeted by the relevant measure.

5.3.2 Other distortions of competition

As most target SMEs are recently established, at the level of the market where they are present, it is unlikely that these SMEs will have significant market power and thus that there will be a significant distortion of competition in this respect. However, it can not be excluded that risk capital measures might have the effect of keeping inefficient firms or sectors afloat, which would otherwise disappear. Furthermore, an oversupply of risk capital funding to inefficient enterprises may artificially increase their valuation and thus distort the risk capital market at the level of fund providers, which would have to pay higher prices to buy these enterprises. Sector specific aid may also maintain production in non-competitive sectors, whereas region-specific aid may build up an inefficient allocation of production factors between regions.

In its analysis of these risks, the Commission will examine, in particular, the following factors:

- (a) overall profitability of the firms invested in over time and prospects of future profitability
- (b) rate of enterprise failure targeted by the measure;
- (c) maximum size of investment tranche envisaged by the measure as compared to the turnover and costs of the target SMEs;
- (d) overcapacity of the sector benefiting from the aid.

5.4 Balancing and decision

In the light of the above positive and negative elements, the Commission will balance the effects of the risk capital measure and determine whether the resulting distortions adversely affect trading conditions to an extent contrary to the common interest. The analysis in each particular case will be based on an overall assessment of the foreseeable positive and negative impact of the State aid. For that purpose the Commission will not use the criteria set out in these guidelines mechanically but will make an overall assessment of their relative importance.

The Commission may raise no objections to the notified aid measure without entering into the formal investigation procedure or, following the formal investigation procedure laid down in Article 6 of Regulation (EC) No 659/1999, it may close the procedure with a decision pursuant to Article 7 of that Regulation. If it adopts a conditional decision pursuant to Article 7 (4) of Regulation (EC) No 659/1999 closing a formal investigation procedure, it may in particular attach the following conditions to limit the potential distortion of competition and ensure proportionality:

- (a) if higher thresholds of investment tranches per target enterprise are foreseen, it may lower the maximum amount proposed per investment tranche or set an overall maximum amount of finance per target enterprise;
- (b) if investments in the expansion stage in medium-sized enterprises in non-assisted areas are foreseen, it may limit investments predominantly to the seed and start-up

- stage and/or limit the investments to one or two rounds and/or limit the tranches to a maximum threshold per target enterprise;
- (c) if follow-on investment is foreseen, it may set specific limits to the maximum amount to be invested into each target enterprise, to the investment stage eligible for intervention, and/or to the period during which aid may be granted, having also regard to the sector concerned and to the size of the fund;
 - (d) if a lower participation of private investors is foreseen, it may require a progressive increase of the participation of private investors over the life of the fund, having particular regard to the business stage, the sector, the respective levels of profit-sharing and subordination, and possibly the localisation in assisted areas of the target enterprises;
 - (e) for measures providing seed capital only, it may require Member States to ensure that the State receives an adequate return on its investment commensurate with the risks incurred for these investments, in particular where the State finances the investment in the form of quasi-equity or debt instruments, the return on which should, for instance, be linked to potential rights of exploitation (for example, royalties) generated by intellectual property rights created as a result of the investment;
 - (f) require a different balancing between respective profit- and loss-sharing arrangements and level of subordination between the State and private investors;
 - (g) require more stringent commitments as regards cumulation of risk capital aid with aid granted under other State aid regulations or frameworks, by way of derogation from section 6.

6 CUMULATION

Where capital provided to a target enterprise under a risk capital measure covered by these guidelines is used to finance initial investment or other costs eligible for aid under other block exemption regulations, guidelines, frameworks, or other State aid documents, the relevant aid ceilings or maximum eligible amounts will be reduced by 50% in general and by 20% for target enterprises located in assisted areas during the first three years of the first risk capital investment and up to the total amount received. This reduction does not apply to aid intensities provided for in the Community Framework for State aid for Research and Development¹⁷ or any successor framework or block exemption regulation in this field.

7 FINAL PROVISIONS

7.1 Monitoring and reporting

Regulation (EC) No 659/1999 and Commission Regulation (EC) No 794/2004 of 21 April 2004 implementing Council Regulation (EC) No 659/1999 laying down detailed rules for the application of Article 93 of the EC Treaty,¹⁸ require Member States to submit annual reports to the Commission.

In respect of risk capital measures the reports must contain a summary table with a breakdown of the investments effected by the fund or under the risk capital measure including a list of all

¹⁷ OJ C 45, 17.2.1996, p 5.

¹⁸ OJ L 140, 30.4.2004, p. 1.

the enterprise beneficiaries of risk capital measures. The report must also give a brief description of the activity of investments funds with details of potential deals scrutinised and of the transactions actually undertaken as well as the performance of investment vehicles with aggregate information about the amount of capital raised through the vehicle. The Commission may request additional information regarding the aid granted, to check whether the conditions of the Commission's decision approving the aid measure have been respected.

The annual reports will be published on the internet site of the Commission.

In addition, the Commission considers that further measures are necessary to improve the transparency of State aid in the Community. In particular, it appears necessary to ensure that the Member States, economic operators, interested parties and the Commission itself have easy access to the full text of all applicable risk capital aid schemes.

This can easily be achieved through the establishment of linked internet sites. For this reason, when examining risk capital aid schemes, the Commission will systematically require the Member State concerned to publish the full text of all final aid schemes on the internet and to communicate the internet address of the publication to the Commission.

The scheme must not be applied before the information is published on the internet.

Member States must maintain detailed records regarding the granting of aid for all risk capital measures. Such records, which must contain all information necessary to establish that the conditions laid down in the guidelines have been observed, notably as regards the size of the tranche, the size of the company (small or medium-sized), the development stage of the company (seed, start-up or expansion), its sector of activity (preferably at 4 digit level of the NACE classification) as well as information on the management of the funds and on the other criteria mentioned in these guidelines. This information must be maintained for 10 years from the date on which the aid is granted.

The Commission will ask Member States to provide this information in order to carry out an impact assessment of these guidelines three years after their entry into force.

7.2 Entry into force and validity

The Commission will apply these guidelines from the date of their publication in the Official Journal of the European Union. These guidelines will replace the 2001 Communication on State aid and risk capital

These guidelines will cease to be valid on 31 December 2013. After consulting Member States, the Commission may amend it before that date on the basis of important competition policy or risk capital policy considerations or in order to take account of other Community policies or international commitments. Where this would be helpful the Commission may also provide further clarifications of its approach to particular issues. The Commission intends to carry out a review of these guidelines three years after their entry into force.

The Commission will apply these guidelines to all notified risk capital measures in respect of which it must take a decision after the guidelines are published in the *Official Journal*, even where the measures were notified prior to their publication.

In accordance with the Commission notice on the determination of the applicable rules for the assessment of unlawful State aid (“consecutio legis”)¹⁹, the Commission will apply the following in respect of non-notified aid:

- (a) these guidelines, if the aid was granted after their publication in the Official Journal of the European Union;
- (b) the Communication on State aid and risk capital (SARC) in all other cases.

7.3 Appropriate Measures

The Commission hereby proposes to Member States, on the basis of Article 88(1) of the EC Treaty, the following appropriate measures concerning their respective existing risk capital measures.

Member States should amend, where necessary, their existing risk capital measures in order to bring them into line with these guidelines within twelve months after the publication of the guidelines.

The Member States are invited to give their explicit unconditional agreement to these proposed appropriate measures within two months from the date of publication of these guidelines. In the absence of any reply, the Commission will assume that the Member State in question does not agree with the proposed measures.

¹⁹ OJ C 119, 22.5.2002, p. 22.