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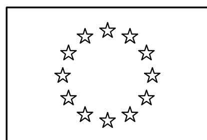

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Removing obstacles to cross-border investments by venture capital funds - Glossary and Expert group report

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COMMUNICATION FROM THE COMMISSION TO THE COUNCIL, THE EUROPEAN PARLIAMENT, THE EUROPEAN ECONOMIC AND SOCIAL COMMITTEE AND THE COMMITTEE OF THE REGIONS

Removing obstacles to cross-border investments by venture capital funds - Glossary and Expert group report

1. GLOSSARY[1]

Asset allocation

A fund manager's allocation of his investment portfolio into various asset classes* (e.g. stocks, bonds, private equity).

Asset class

A category of investment, which is defined by the main characteristics of risk, liquidity and return.

Business angels

Wealthy private individuals, who invest directly in new and growing unquoted businesses. Business angels usually provide finance in return for an equity stake in the business, but may also provide other long-term finance. This capital can complement the venture capital* industry by providing finance at an earlier stage, especially at the pre-seed and seed stage.

Buyout

A transaction in which a firm (or part of it) is acquired from the current shareholders. In a management buyout the current managers are the buyers, with the support of private equity/venture capital investors.

Capital market

A market in which long-term capital is raised by industry and commerce, the government and local authorities. Stock exchanges* are part of the capital market.

Early-stage (capital)

Financing to companies before they initiate commercial manufacturing and sales, i.e. before they are profit-generating. This includes seed* and start-up* financing.

[1] Definitions contained therein are only applied in the context of the Commission Communication "Removing obstacles to cross-border investments by venture capital funds" and are without prejudice to possible existing definitions in the Member States or Community legislation.

Eligible investors

Institutional investors who are able to act on a professional basis, and those individuals who have sufficient knowledge, skill, expertise, or financial assets to be able to take the inherent risks of VC* investing into account, and as a result are able to be treated and acknowledged on the same basis as their institutional counterparts.

Equity

The share capital of a company. Typical features of equity capital include an entitlement to profits, a proportionate share of the proceeds upon liquidation and subordination to creditors.

Exit

Liquidation of holdings by a private equity/venture capital investor. The usual ways- of doing this is by a trade sale to another company; public offering (including an initial public offering, IPO*) on a stock market; write-off of the investment; sale to another investor; or repayment of the investment (when part of the investment agreement).

Expansion capital

Financing provided for the growth of a firm. The capital may be used to finance increased production capacity, market or product development, or to provide working capital.

Fund size - The total amount of capital committed by the LPs* and GPs* of a fund.

Fundraising

The process in which private equity/venture capital practitioners raise money to create an investment fund. These funds are raised from private, corporate or institutional investors*, who make commitments to the fund which will be invested by the General Partner*.

General Partner (GP)

A partner in a partnership, e.g. in a private equity/venture capital management company, who has unlimited personal liability for the debts and obligations of the limited partnership and the right to participate in its management.

Institutional investors

Refers mainly to insurance companies, pension funds, banks and investment companies collecting savings and supplying funds to the markets, but also to other types of institutional wealth (e.g. endowment funds, foundations, etc). Usually these have substantial assets and are experienced investors.

Initial Public Offering (IPO)

Also flotation, going public. The process of launching a private company for the first time on a stock market by inviting the public to subscribe to its shares.

Limited Partner (LP)

An investor in a Limited Partnership*, who in contrast to a General Partner*, is liable for partnership obligations only to the extent of his investment. Limited partners are usually restricted from taking an active part in the management of the business of the partnership.

Limited Partnership

A legal structure that is used by most private equity/venture capital funds. A partnership is usually formed for a fixed period of time between the investors in a private equity/venture capital fund and the management company making the investments in the underlying portfolio companies. The investors have limited liability and the management company has unlimited liability. The details on management policy and profit-sharing are laid out in a partnership agreement.

Private equity

Investment by private investors taking an equity stake in companies not listed on a stock market*. Venture capital* is strictly speaking a subset of private equity, where the latter also includes replacement* capital and buyouts*.

Private equity/venture capital funds

A private equity/venture capital investment fund is a vehicle for enabling pooled investment by a number of investors in equity and equity-related securities (such as quasi-equity) of companies (investee companies). These are generally private companies whose shares are not quoted on any stock exchange*. The fund can take the form either of a company or of an unincorporated arrangement such as a limited partnership. In form, a private equity/venture capital fund can either be a company or a limited partnership: a few are quoted on stock markets.

Prudent person rule

A behaviourally-orientated standard of investment, rather than one based on quantitative criteria. The rule allows pension funds to include private equity/venture capital funds in their asset allocation according to their own needs, while respecting the risk profile of their clients. In other words, the obligation of pension managers to invest as a prudent investor would do on his own behalf, in particular by carrying out sensible portfolio diversification.

Private placement

A specific sales method for financial instruments or investments allowing the buyer and seller to conclude an investment transaction subject to an exemption from many or all of the statutory requirements that would apply in the event of a public offering. Private placement regime would not apply many of the requirements that are imposed in the event of marketing to the public - such as publication of mandatory disclosure documents, conduct of business rules, and rules on general solicitation of interest in financial transactions. In order to ensure that these exemptions from general securities law are limited to actors, who are able to transact without needing these regulatory protections, private placement regimes generally specify criteria for entities who are eligible to conclude transactions under these conditions.

Replacement capital

Purchase of existing shares in a company from another private equity investor or shareholder.

Risk capital (markets)

An EU term used to describe markets providing equity financing to a company during its early growth stages (start-up* and development*). Risk capital covers three types of financing, (1) informal investment by business angels*; (2) venture capital*; (3) stock markets specialized in SMEs* and high growth companies.

Seed capital

Financing provided to study, assess and develop an initial concept; it is the phase preceding the start-up* phase.

SME – Small and medium-sized enterprises

Under European rules a SME should have less than 250 employees, an annual turnover not exceeding EUR 50 million, and/or an annual balance sheet total not exceeding EUR 43 m.

Start-up capital

Provided to companies for product development and initial marketing. Firms may be in the process of being set up or may exist but have not sold their product or service commercially.

Stock exchange (stock market)

A market in which securities are bought and sold. Its basic function is to enable public companies, governments and local authorities to raise capital by selling securities to investors.

Tax transparency

If a venture capital vehicle is tax transparent, income accruing to the fund will be regarded for tax purposes as accruing directly to the partners or shareholders in the vehicle.

Venture Capital (VC)

Investment in unquoted companies by venture capital firms who, acting as principals, manage individual, institutional or in-house money. In Europe, the main financing stages included in venture capital are: early stage (covering seed* and start up*), and expansion*. Strictly defined, venture capital is a subset of private equity*. Venture capital is thus professional equity co-invested with the entrepreneur to fund an early stage (seed and start-up) or expansion venture. Offsetting the high risk the investor takes is the expectation of higher than average return on the investment.

2. EXPERT GROUP REPORT[2] ON "REMOVING OBSTACLES TO CROSS-BORDER INVESTMENTS BY VENTURE CAPITAL FUNDS"

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This report is based on the work of experts attending the expert group on "Removing obstacles to cross-border investments by venture capital funds", organised by Directorate-General for Enterprise and Industry of the European Commission (October 2006-March 2007). Report contains only the main points and arguments that were presented in the three meetings of the expert group. The views expressed by the national experts do not necessarily reflect the official position of the Member States they represented. The role of the Commission staff in the group was to facilitate discussions and contribute to put together the report.

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[2] Full version of the Expert group report from March 2007 can be found on: http://ec.europa.eu/enterprise/entrepreneurship/financing/docs/cross_border_investment_report_30march07.pdf

EXECUTIVE SUMMARY

Innovative firms in Europe face significant problems in accessing the funding they need to start, grow and compete on global markets since there is an equity gap for small and medium-sized companies (SMEs) in their seed, start-up and expansion stages. European SMEs indeed turn mostly to banks to obtain external finance and only in limited cases to alternative sources of financing - such as venture capital funds, but the money they get is often not sufficient. In particular venture-backed investments could fill in the equity gap.

While venture capital funds have become increasingly important, this external source of funding still remains fragile. The venture capital sector in Europe does not fully benefit from a single market and it is also less efficient and profitable than in the United States. Markets that are fragmented along national lines make cross-border investments unnecessarily complicated for venture capital funds to invest outside their home country and indirectly hinder innovative SMEs to reach economies of scale and specialisation. The venture capital industry has been urging the removal of the existing obstacles to cross-border investments within Europe so that the sector could perform better and also exploit the opportunities that are available within European SMEs.

The Commission recognises the strong entrepreneurial and innovation impetus provided by equity funding, with a particular focus on venture capital funding. The Commission launched a debate with national experts and industry stakeholders to discuss the existing obstacles to cross-border investments and possible ways to remove them as well as to encourage the development of a truly European venture capital market for SMEs.

This report describes some characteristics of national frameworks regulating local venture capital markets and summarises difficulties that practitioners reported on. It highlights that many European venture capital funds are small, operate locally and do not have resources to extend their operations outside home jurisdictions. Therefore, conditions especially for smaller funds need to be improved, since 80% of all venture capital deals represent investments into SMEs. Expert group members agreed that it is not only the size of venture capital funds that matters, it is also the size of their deals and markets in which they operate.

In a diverse European Union with now 27 sets of operating conditions, the level of development of venture capital markets varies and so do the frameworks affecting them. The group discussed the national approaches on legal, regulatory and fiscal frameworks, the lacking common understanding and missing legal certainty. These widely varying frameworks are affecting both fundraising and investing, putting additional burden on cross-border operations. While the group recognised the importance of a dynamic venture capital industry, in particular the industry stakeholders stressed that the Member States need to assess all the possible supply and demand factors that may contribute to market failures.

Apart from exchanging good practices and improving coordination between the Member States, the most reasonable way to progress in the short term would be the **mutual recognition of the existing national frameworks on venture capital funds**. Member States could take steps towards recognising venture capital funds, which are registered and operate in other jurisdictions. This would allow them to operate across borders without having to go through separate registration and regulation processes or to invest through parallel structures. The expert group recognised that it was up to the Member States to decide what would be the most suitable for them. There is a broad understanding that deeper and more efficient

European venture capital markets would unlock the innovation potential of Europeans and promote economic growth and competitiveness.

INTRODUCTION AND CONTEXT OF THE EXPERT GROUP

Innovative small and medium-sized enterprises (SMEs) can only grow if they have access to suitable forms of financing; this may often involve private equity (PE) and venture capital (VC) financing. This is not always the case in the EU, where entrepreneurs and small firms often find it difficult to get the funding they need to start and grow their business. And even if successful in obtaining external finance, the money they get is often too little. **Financing innovative SMEs** is considered by many finance providers as an unattractive activity due to high transaction costs and low returns given the risk incurred, especially at the early-stage.

However, the reluctance of investors to invest in higher risk areas, where the expected returns do not compensate for the higher risk, such as in SMEs, is not the only barrier restricting these small firms in search for funding. Fundamentally, government policies often do not sufficiently encourage investments in SMEs or create incentives for venture capital industry to invest more in small firms. As a result *it is too difficult to access equity capital in Europe*.

The success of the **Partnership for growth and jobs** depends largely on European SMEs that are the essential sources of innovation and job creation. Improved access to financing for innovative enterprises is one of the key ingredients in allowing SMEs to fulfil their potential and one concrete step would be to *lift intra-EU barriers for cross-border activity of venture capital funds*.

Recognising the strong entrepreneurial and innovation impetus provided by equity funding, extending the benefits of the **single European market** to venture capital is extremely important, as this would lead to further development and deepening of the private equity and venture capital markets. Free movement of capital is one of the four fundamental liberties of the single market and the Commission has consistently built a legislative framework and taken various supportive actions to achieve this goal.

In the Communication "*Financing SME growth – Adding European Value*"[3], the Commission outlined a set of measures to help innovative SMEs by improving access to finance, in particular at their early stages, at both EU and Member State levels. Making cross-border investments in venture capital easier was one of the key goals of this Communication and the Commission called for concrete and pragmatic steps to overcome the existing legal, regulatory and tax barriers and asked the Member States to engage with the issue.

As announced in the Communication, the Commission then launched a debate on removing obstacles for cross-border **venture capital** investments and invited national experts and stakeholders to participate in an expert group. The Commission services facilitated discussions and provided administrative support for the meetings and drafting of this report.

This **expert group aimed at** identifying for each participating country the regulatory framework affecting venture capital funds - both those domiciled in the country of investment and those domiciled elsewhere. The group served as a forum to identify the management and professional rules in different countries as well as to discuss possible common definitions.

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[3] Commission Communication of 29 June 2006 is available in all Union languages at:
http://ec.europa.eu/enterprise/entrepreneurship/financing/publications_documents.htm

Most importantly, this group aimed at finding solutions to overcome the existing obstacles for venture capital funds investing cross-borders within Europe.

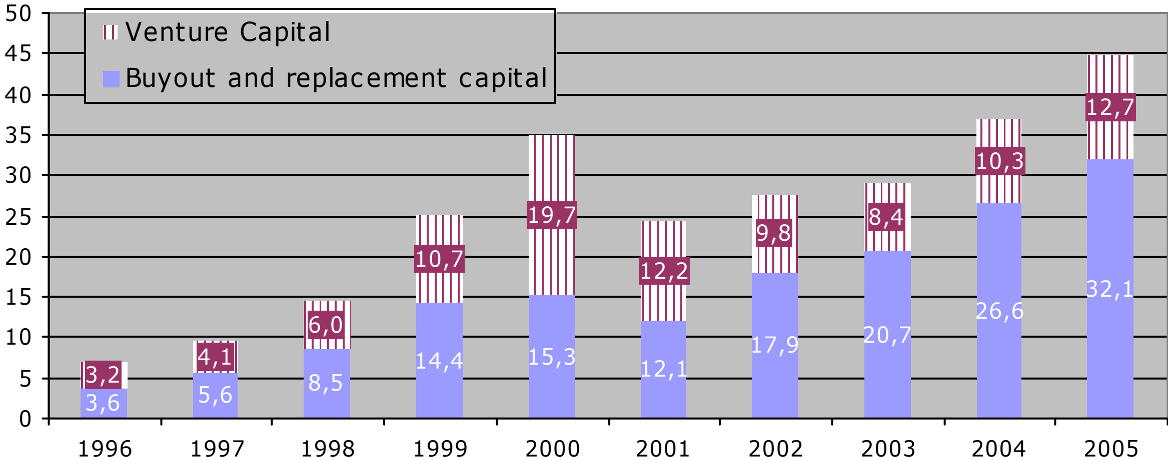
Recent trends in developing the venture capital market in Europe

8.1. Industry trends

Statistics have shown an **upward trend** in European private equity and venture capital (PE/VC) investments, notably since 2004. The buyout sector especially has been the driving force. In 2005, PE funds raised 71.8 billion EUR, up 2.5 times from 2004 levels; PE investments totalled 47 billion EUR, up 27% from 2004 and reached an all-time high (of the total amount invested, seed investments represented 0.2% by amount at 97 million EUR and 4% by number of investments; start-up investments represented 5% by amount at 2.3 billion EUR and 29% by number)[4].

Over the last ten years, European equity markets as a whole have developed markedly. Investments by European PE and VC funds increased by more than eight times from 5.5 billion EUR in 1995 to a record 47 billion EUR in 2005 (of which 34.3 billion EUR was buyout and replacement capital and 12.7 billion EUR venture capital). Within the increasing venture capital amounts, the major share continued to go to expansion capital and a smaller one to seed capital. A modest positive trend is reflected in the share of VC investments as a percentage of GDP which in 2005 amounted to 0.11% (whereas buyout investments were 0.31% of GDP). Some countries with a more open market approach also have a higher share of private equity investment as a percentage of GDP (i.e. the UK and Sweden above 1% in 2005, while the European average was around 0.4% of GDP).

Graph 1: PE/VC invested in 2005



Source: EVCA Presentation to the Expert group meeting, 24 October 2006

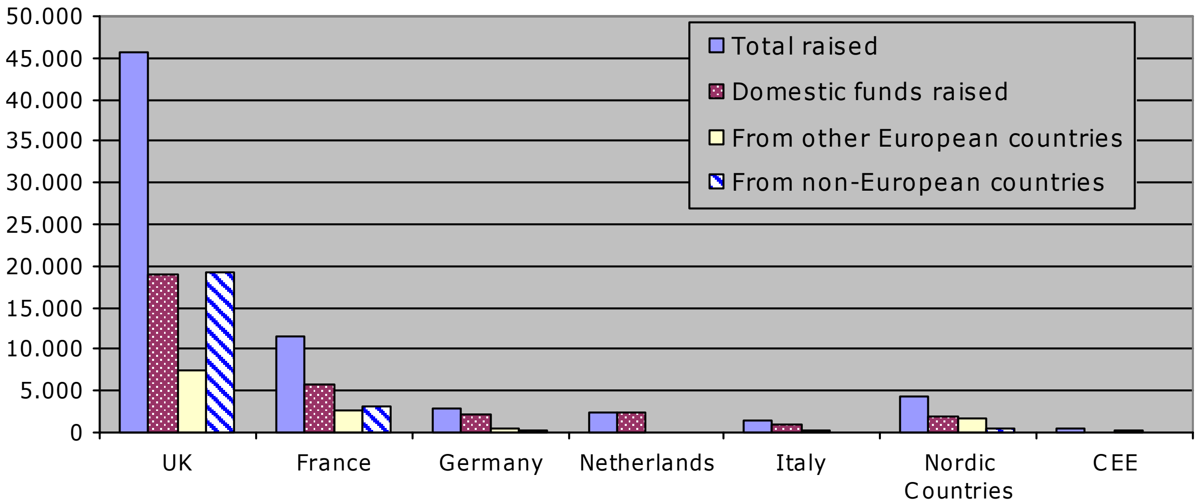
The openness of an economy is also reflected when analysing PE/VC funds raised in a country. In 2005, the UK was the leading European private equity market with almost the same level of PE/VC funds raised by non-European countries as by domestic funds; the share of funds raised from other European countries was smaller, although still much higher than in

[4] Figures from 2006 Yearbook of EVCA; Preliminary figures for 2006: http://www.evca.com/images/attachments/tmpl_8_art_227_att_1095.pdf

any other European country. The reason is that British fund structures are attracting investors. By total amounts of PE/VC funds raised, in 2005, the UK was followed by France and the Nordic countries (*as shown in Graph 2 below*).

The industry reported that the European VC industry was becoming **pan-European and globally oriented,** with a strong tendency to expand their investment focus. However, among the main reasons that VC funds would not expand their international investment focus in the next 5 years were **legal restrictions** and the **limited size of the fund**.

Graph 2: PE/VC funds raised by country in 2005



Source: EVCA Presentation to the Expert group meeting, 24 October 2006

8.2. Industry performance and economic impact

The number of companies receiving PE/VC backing was 4,995 in 1995 and 7,207 in 2005. Between 2000 and 2004, European PE and VC financed companies created 1 million **new jobs**, of which VC-backed firms created 630,000 (and buyout-financed firms created 420,000). In the period mentioned, employment grew by an annual average of 5.4%, of which 30.5% per year was the employment rate on VC-backed companies (and 2.4% annually was the employment rate in buyout-financed firms). [5]

The industry reported that VC-backed companies spend on average 45% of their total expenses **on R&D**, amounting to an average 3.4 million EUR per company per year. This averages to 50.500 EUR per employee per year and is 6-times higher as per employee expenditure of the EU-25 top 500 R&D spenders.

In Europe 78% of the total number of investments in 2005 went into companies employing less than 100 employees. Although external equity investments are a relevant option only for a very small number of SMEs, they are important **for the rapid growth of innovative firms**.

The majority of investments in Europe are **domestic** – they are made within private equity operators' home country: in 2005, 85% by number and 62% by amount of investment.

[5] Figures from EVCA Research Paper on Employment Contribution of PE and VC in Europe: http://www.evca.com/images/attachments/tmpl_9_art_129_att_953.pdf

However, according to a recent industry survey[6], European VC firms are planning to invest more cross-border, with a **primary focus in Europe**: out of 119 European VC funds surveyed, 66% indicated they intend to expand their international investment focus over the next five years and two thirds planned to expand investment into other European countries (32% of these VCs favoured Western Europe markets, 21% Central Europe and 14% in Eastern Europe). The same survey showed encouragingly that **Europe is now perceived as the preferred destination by 30%** of global venture capitalists intending to expand their investment activities. In view of this, *removing obstacles for cross-border investment becomes increasingly important.*

8.3. Venture capital markets: EU versus US

Although there has been growth in European venture capital markets in recent years, they **remain behind** the United States. Before the 1990s, venture capital investments in Europe were limited. VC investments boomed on both continents between 1995 and 2000, but the subsequent bursting of the investment bubble led to a sustained decline in investment levels both in the EU and the US. At the same time the gap between Europe and US narrowed as both the bubble boom and its burst were more pronounced in the US. However, US venture capital funds adjusted quickly to changes in market conditions and recovered much quicker (in particular those operating close to centres of activity, such as Silicon Valley) than the markets in Europe.

In relative terms in 2004[7], overall US venture capital investment amounted to 0.18% of GDP and European venture capital investment to 0.11% of GDP. When comparing these relative figures, it might seem that EU and US are converging. However, the development of European VC industry is **held back by fragmentation**, among other reasons. Whatever the reasons, the European VC markets seem **less efficient** and **less profitable** than in the US.

On average, the overall **profitability** of European VC investments looks **low**[8]. As of the end of 2003, the average internal rate of return (IRR) for five and ten year investment horizons were 2.3% and 8.3% respectively. The performance of early-stage venture investments was particularly disappointing with five and ten year investment horizon IRR as low as -1.8% and +1.3%. In the US, the picture was better, with IRRs of 22.8% and 25.4% for five and ten year investment horizons. The **performance gap** between the European and US funds was even more striking in early stage venture investing since US funds showed IRRs of 54.9% and 37% for five and ten year horizons. However, many European-based funds and foreign funds investing in European target companies are capable of delivering attractive returns to their investors and hence give a chance to innovative start-ups and new technologies being put in the market. For example, the best-performing top quarter VC funds in existence since 1980 until 2005 delivered a compounded average return of 17.1% in 2005 and 18.6% in 2004.

Although good funds can still raise money, overall these low returns act as a brake on the development of the industry. **Low returns** make, in particular, seed and start-up investments unattractive, leading to a **lack of investors** that prevents new European enterprises from reaching a size where they can attract expansion capital.

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[6] Deloitte - EVCA 2006 Global Venture Capital Survey

[7] DG ECFIN document of January 2006: Venture capital investment in Europe in 2004

[8] DG ECFIN Economic Paper, March 2006: Profitability of VC investment in Europe and the US: http://ec.europa.eu/economy_finance/publications/economic_papers/2006/economicpapers245_en.htm

Despite the volume of venture capital and private equity funding available, it is not clear that the European market is mature enough for innovative enterprises to get enough equity funding. European companies face substantial **problems in accessing finance**, while in the US more money is raised and invested.

Furthermore, European innovative companies with potential for high growth are not funded with amounts large enough and do not grow into globally competitive firms. Less seed and start-up capital is raised in Europe than in the US.

One of the key differences between EU and US markets is that Europe funds **more** VC-backed firms (7207 EU companies[9] versus 5406 US companies[10]), with **smaller amounts** than in the US. The average technology investment is around 0.9 million EUR in the EU against 6.1 million EUR in the US. This drip-feeding has various side effects, including **limiting growth potential**. The European average for seed and early start-up investment is 0.5 and 0.8 million EUR, respectively, whereas in the US the corresponding average investment is four times higher, at 1.8 and 4.0 million EUR, respectively.

American venture firms are usually characterised as committing larger sums to individual businesses, investing earlier in the lives of portfolio companies, and playing a more hands-on role in their subsequent development[11]. The result is that the US markets create a small number of rapidly growing, successful companies, as opposed to the European approach of targeting more modest returns from firms across the whole investment portfolio. In the US during the 1990s, 11 VC-backed companies returned more than 250 times their venture capitalists' original investment, whereas in Europe, only 10 venture-backed companies returned more than 20 times.

An example: a young European company is established and launches a product and gets funded by a first VC fund of approx. $5 million seed capital, but in the US it would get 3-times as much to grow into a competitive company.

Practitioners stressed that in comparison with US funds, EU funds have greater running costs and more uncertain regulatory and tax environment.

8.4. A changing environment

While within Europe differences exist between countries in the stage of development of venture capital markets (some countries have active and well performing markets, whereas in other countries venture capital industry has only recently started to develop), the **global** private equity and **venture capital industry** has succeeded in mobilising institutional investors and deploying their funds to attractive business opportunities throughout the world.

The industry is urging the removal of the existing obstacles to cross-border investments within Europe so that the sector could perform better. This need is market-driven as the European venture capital industry is globalising. Practitioners noted that in some of the larger Member States with mature venture capital markets the concept of a "country fund" has become irrelevant and it is rather a "**sector fund**" and specialisation by sector that matter; and that those sector funds need to invest across borders and raise money globally. According to

[9] Figure from EVCA 2006 Yearbook
[10] Figure from Ernst&Young, Dow Jones, Venture One; 23 August 2006
[11] EVCA 2006 Yearbook, p. 16

some national experts, however, in markets that are only just starting to develop and need public intervention to boost their growth, smaller "**country funds**" can have an important and catalytic role.

The trend in the European venture capital industry has been towards **larger funds** and this is likely to continue. However, since this industry is growing as a whole, so far there has been no indication that the industry would be heading towards concentration. On the contrary, in the short term new VC funds are likely to enter the market after the recent difficult years, which will increase the **competition** in the industry.

Furthermore, in a **diverse European Union** now with 27 Member States, differences exist not only in terms of the level of development of venture capital markets, but the diversity is reflected also in regimes regulating those markets. Nevertheless, in all countries the main goal should be supporting innovative SMEs to achieve employment and growth.

From a public policy viewpoint the venture capital sector is an important factor contributing to European competitiveness but it has worked **below its potential** in Europe. As a consequence, venture capital as a source of alternative external financing has not contributed sufficiently to improving access to finance for innovative SMEs, *facing particular problems in all European countries*, nor has it managed to reduce the existing **equity gap**.

There are both cyclical and structural reasons, but the structural ones (market fragmentation) are a more important long-term obstacle, *as summarised in this expert group report*.

The expert group members discussed whether Europe **lacks a growth culture**: it seems that neither the investee companies nor the funds are aggressive enough in pursuing growth. Given the considerations outlined above, industry expert emphasised that Europe as a whole was of the right size for developing a VC industry, whereas individual countries were not.

9. INCREASING THE CROSS-BORDER ACTIVITIES OF VENTURE CAPITAL FUNDS

Venture capital has become an essential part in generating economic growth. Active venture capital markets are important drivers of a more competitive, entrepreneurial and innovative Europe. These markets contribute particularly to creation of new jobs, and to the design and use of new knowledge and technologies.

9.1. Current situation in Europe

Currently, **a single market** for venture capital **does not exist** within Europe. Practitioners noted that the VC market is not benefiting from the same level of integration as other financial markets. Letting venture capital markets share the advantages of the single market would benefit both venture capital funds as actors on the supply side and SMEs as funding-seekers actors on the demand side:

- The increased availability of venture capital would benefit **innovative SMEs,** in particular through more seed and start-up capital. They could exploit innovations and new technologies, boost jobs and grow into competitive companies.

- **Venture capital funds** operating across borders over a wider geographical area could more easily reach economies of scale, develop a specialised sectoral expertise, raise more money, diversify portfolios and improve returns.

Innovative and high growth firms suffer from problems in raising capital, in particular in those parts of Europe where venture capital market is less developed or has only recently started to develop. Throughout the EU, fundraising and investments are concentrated in a limited number of regions, and access to suitable forms of financing for innovative SMEs is **unevenly spread across the EU**[12].

The group noted the **differences among Member States** concerning the development of equity markets, and activities on those markets as well as the size of their markets.

Some Member States have more mature and well-performing venture capital markets; some have less favourable environment but functioning markets, whereas in some Member States investment and fundraising opportunities are more limited.

Especially in the new Member States, equity markets have only recently started to develop and funds in those countries are smaller and thus need apart from more VC investors also to gain experience and knowledge.

Recent industry study[13] **benchmarking** European countries' tax and legal frameworks at levels of limited partners (investors), fund managers and investee companies grouped countries[14] in the following "country clusters":

- advanced countries: Ireland, UK;
- reform-friendly countries: France, Belgium, Spain; Luxembourg;
- progressive followers: Denmark, Austria[15], Finland;
- fading countries: Greece, Netherlands; Portugal, Italy, Hungary;
- slowing countries: Norway, Sweden, Germany;
- CEE countries (little improvement): Czech Republic, Poland, Slovakia;
- newly-added countries: Estonia, Latvia, Slovenia, Romania.

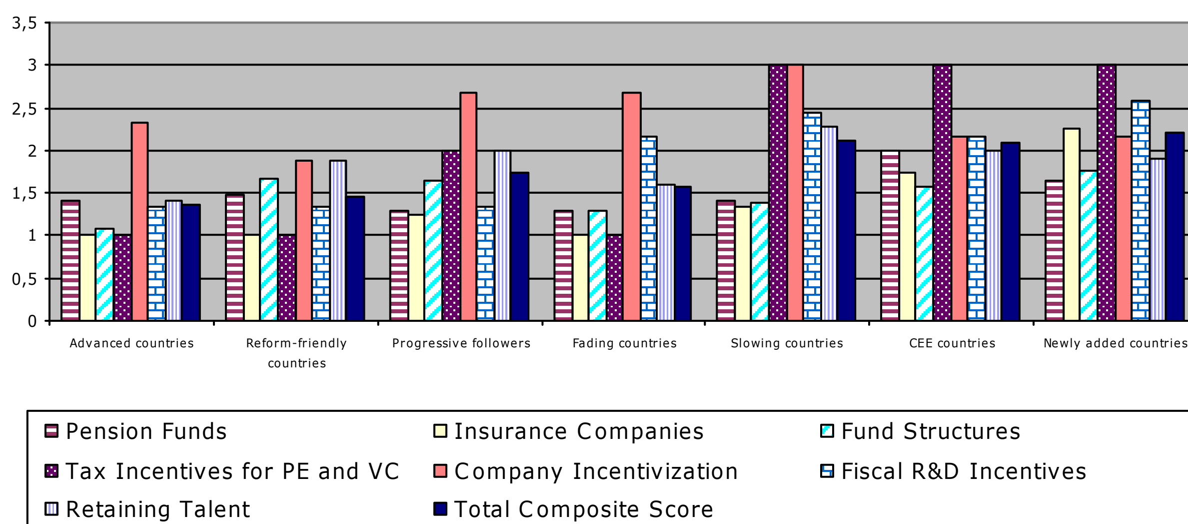
Graph 3: Benchmarking study – composite scores of listed "country clusters":

[12] Detailed information on number of VC funds in respective countries is in Annex III of the Expert group report

[13] EVCA Benchmarking study, December 2006 (cut-off date: 1 July 2006): http://www.evca.com/images/attachments/tmpl_8_art_215_att_1051.pdf

[14] Bulgaria, Cyprus, Lithuania and Malta were due to difficulties in gathering information from those countries excluded from the final EVCA Benchmarking analysis.

[15] Austrian legal form MFAG is valid only till 31 Dec 2007; its replacement could affect any subsequent ranking.



Source: EVCA Presentation to the Expert group meeting, 20 November 2006

9.2. Size matters

The European venture capital industry is very diverse in terms of fund size, capitalisation, management and investment strategies, though European VC funds do have some similarities and face similar problems.

As opposed to buyout funds, many European VC funds are relatively **small, operate locally** and do not have the resources to extend operations geographically or to new industry sectors and at the same time provide the investee companies with the support they need. Also, conditions for smaller funds need to be improved, since 80% of their deals represent investments into SMEs.

Industry experts shared the opinion that by definition venture capital is a volatile and risky business and that both the size of a VC fund and the size of VC market matter, the latter being often limited by the size of the country. In this respect the members of the expert group identified the following aspects as significant factors for investing in seed and early-stage firms as well as for a fund's investment focus and cross-border operations:

- The size of VC deals:

European VC deals are **smaller** and are not sufficient for innovative SMEs; and market fragmentation acts as a brake on seed and early-stage investments. High overhead costs hit the profitability of smaller funds especially hard, which makes them to focus more on larger underlying investments.

- The size of VC funds:

Although some European venture capital markets are maturing, they are producing only a limited number of large and successful funds. The majority of the existing VC **funds** in Europe are rather **small**, although there is a large variation[16]. Moreover, the costs and

[16] Information on the size of investment portfolio of VC funds in countries is in Annex III available at: http://ec.europa.eu/enterprise/entrepreneurship/financing/docs/cross_border_investment_report_30march07.pdf

complexities of cross border investments further disadvantage smaller funds and deter them from operating outside their own jurisdiction and thus limit their growth and specialisation potential. Furthermore, the size of a VC fund is important, not just to build international presence, but also to allow for greater risk taking inside a fund's portfolio, and to assume different but still controllable risk. Especially for specialised funds, potentially interesting investments might be mostly outside its home jurisdiction.

However, the group also noted that some smaller funds or **niche players** might operate successfully in home markets without investing beyond local borders. Nevertheless, even for those VC funds a simplified and friendly regulatory local environment could stimulate their investments.

- The size of the VC market (and the size of the country):

The **limited** size of venture capital markets in many Member States (*especially in the new Member States and where the industry has only started to build up)* makes it necessary for venture capital funds to operate across borders to achieve any sustainable size.

Funds need **a critical mass of deals** to reach economies of scale, specialise, and more easily raise funds from investment institutions. The only way that funds in smaller markets can compete is to allow them to grow easily across borders, invest in geographically wider area and encourage them to become larger, more professional funds.

The venture capital industry is no longer a marginal industry; it has become an essential ingredient. However, Europe is not yet considered as a fully viable market.

Although the number of pan-European funds has increased, this could have been more pronounced if regulatory requirements had not complicated cross-border investments.

Industry experts stressed a need for Europe to address the current market fragmentation in one or two years, otherwise the prospects for an efficient venture capital market would be diminished, with negative effects on the competitiveness of Europe.

Some experts estimated that the average size of venture-backed investment in Europe is between 1 and 5 million EUR and that VC funds alone cannot solve the problem of a lack of risk capital in Europe. In order to expand private investments, business experience as well as incentives for serial entrepreneurs are needed on the demand side. On the supply side governments need to contribute public money to the market, following established good practices in public-private-partnerships.

10. FRAGMENTATION OF THE EUROPEAN VENTURE CAPITAL MARKET

The group discussed national practices and regulatory approaches defining the environment of VC funds in Europe[17]. The participants recognised that despite the increasing importance of venture capital funding in the EU, it is **unnecessarily complicated for venture capital funds to invest in firms outside their home country.** This is a barrier for the functioning of the single market. Because venture capital funds are often liable for separate registration or establishment in each Member State, cross-border operations become both expensive and time

[17] Some examples are described in Annex III of the Expert group report.

consuming. Tax legislation, administrative rules and legal requirements - all are the responsibility of national authorities - create major barriers for funds looking to invest outside their home country.

The identified barriers to improving the integration of European VC markets:

- **On the supply side:** VC funds face obstacles when investing across borders in Europe, since they are often liable for **separate registration or establishment** in each Member State, which increases costs and time spent for fund structuring. Some larger VC funds that are nevertheless operating across EU borders have to channel investments through complex and costly **parallel vehicles** established in other countries. National regulatory frameworks could be more responsive in recognising the need for VC funds to be able to invest outside their home market without having to establish parallel structures.

- **On the demand side:** many innovative and high-growth firms face difficulties in accessing equity finance. Although external equity capital is an important source of financing only for a limited number of innovative firms, understanding its importance for growth financing is essential also for entrepreneurs. Improving entrepreneurs' **investment readiness**[18] is the necessary counterpart for improving the supply of venture capital and providing basis for a rapid expansion of high-growth firms.

10.1. Examples of barriers hampering VC investments in Europe

The group discussed the national approaches on legal, regulatory and fiscal issues that are not aligned and often do not provide legal certainty, putting additional burden on cross-border operations - affecting **both fundraising and investing**. The following example was described during the discussions - *as also shown in figure 1:*

– A venture capital fund ("VC Fund I") with an investment team based in Austria and focusing on investments in Austria and, to a lesser extent, certain neighbouring countries, was targeting investors in several jurisdictions.

– VC Fund I was first incorporated as an Austrian company limited by shares (MFAG). The reason for this is that the MFAG benefited from a favourable tax regime, provided that the MFAG invested at least 75% of its capital in Austrian companies and certain additional quantitative criteria were met. As the fund's general partner could not participate in the MFAG due to legislative restrictions, a parallel fund, constituted as an Austrian limited partnership (KG), was set up for purposes of the general partner's investment in the fund.

– The Austrian structure was not tax efficient for a number of non-Austrian investors, primarily Swiss and German, interested in participating in VC Fund I. A third parallel fund under the form of a Guernsey limited partnership was created for primarily the Swiss investors. To accommodate for the concerns of German investors facing similar tax issues as the Swiss investors but whose internal policy

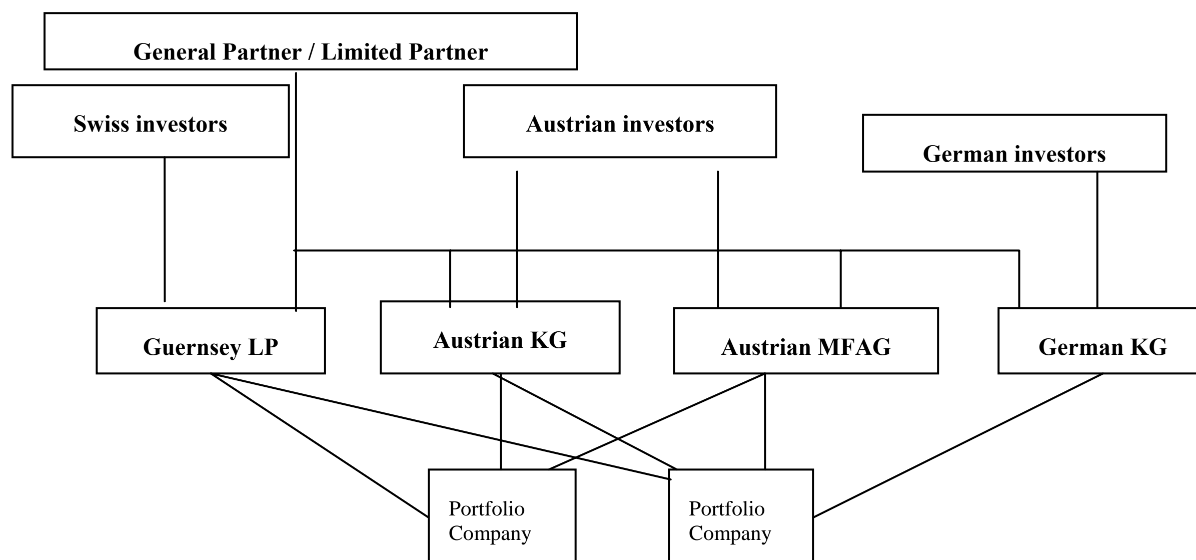
[18] The Commission organised a workshop on investment readiness – summary report is available at: ec.europa.eu/enterprise/entrepreneurship/financing/docs/financing_smes_workshops_2006/ir_summary.pdf

prohibited them from investing in offshore vehicles, a fourth parallel fund was incorporated as a German limited partnership (KG).

– The cost of the on-going management of the four parallel structures spread over three different jurisdictions during the investment period exceeded 0.4% of the total committed capital. The incremental cost, together with the high transaction costs for setting up the structure19, significantly impact the funds overall performance.

Comment: Austrian legal form "MFAG" is valid until 31.12.2007 (a new regulation is in preparation)

Figure 1: Fund structuring with parallel structures in different jurisdiction



Source: M.Leander (EIF), U.Söderholm (Andulf Advokat), Presentation to the Expert group, 20 November 2006

Various other examples from the markets demonstrated that venture capital investments can indeed be done across borders. However, the examples given illustrate hurdles that any cross-border investment has to cross. Fund managers are able to build complex structures with **parallel vehicles** and deal with them but many funds are avoiding cross-border investment because of the **complexities** and **high fund structuring costs**.

Another example showed how unaligned national regimes and a lack of a common understanding lead to complex and costly fund structures when they cater for investors from different jurisdictions investing in a variety of European countries – *as shown in figure 2*:

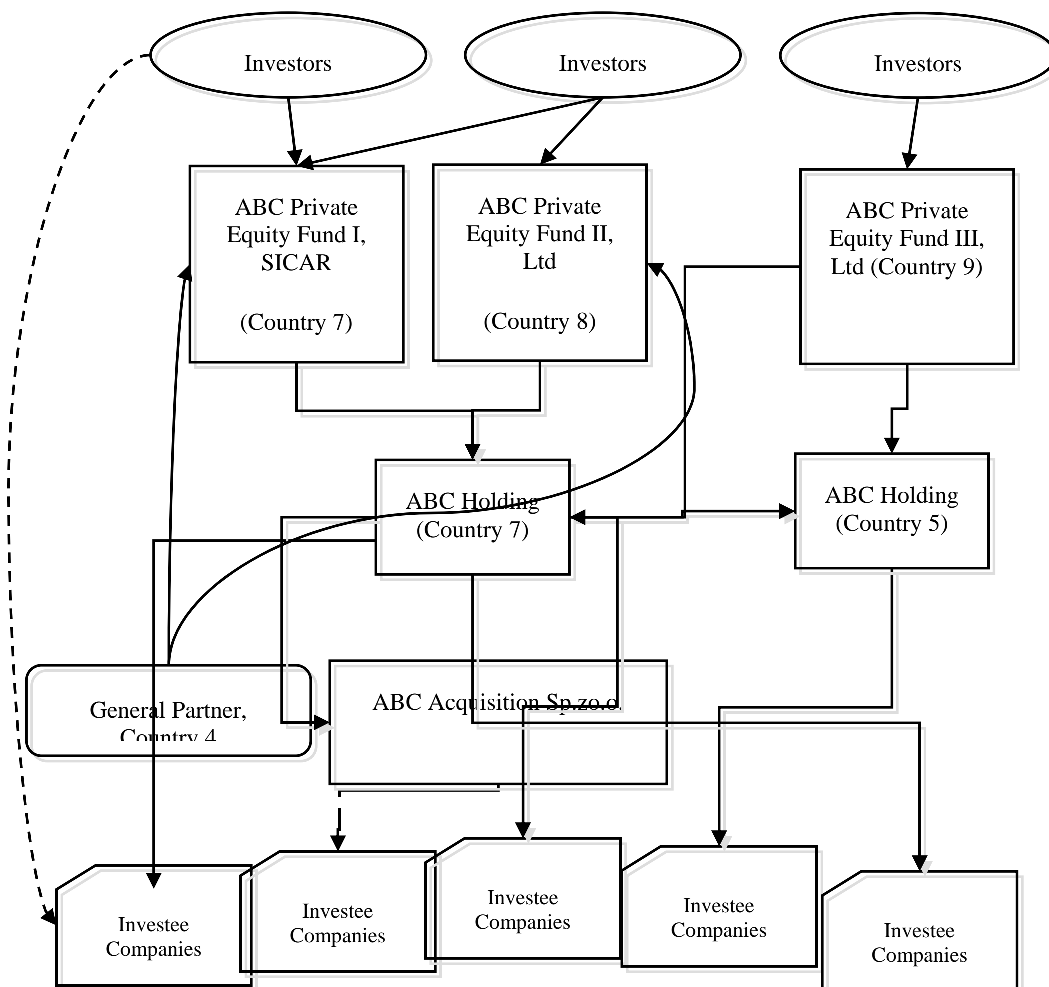
– EU Member States have adopted different treatments and practices in areas such as tax status of the available PE/VC fund vehicles, treatment of capital gains derived from PE exits, permanent establishment criteria for General Partners, private placement rules or qualified investors definition.

[19] "Typical" fund formation fees amount to 1% of total fees as a percentage of a LP's commitments over the ten-year life of a fund (from 2006 Fund Terms Advisor; Private Equity Intelligence).

- As a consequence, European fund structures often require separate vehicles per jurisdiction and category of investors, and separate vehicles per country of investing, resulting in a complex structure with several layers of vehicles.

- Costs for both setting up and administering such structures over the life of the fund, are very high, thus rendering the market **unattractive for smaller players**.

Figure 2: Fund structuring with parallel structures in different jurisdiction



Source: A.Kinsch (Ernst & Young Luxembourg), Presentation to the Expert group meeting, 19 January 2007

With reference to Figure 2, industry experts gave further examples on problems of different VC structures. In general, they concluded that fund vehicles as well as their regulatory treatment differ from one country to another. Several countries have created a working VC structure but such structures usually only fit into the environment in the respective country and work for **domestic funds only**. In many cases, a workable structure can be currently established only offshore. Besides high costs, this also creates the risk that such an offshore VC fund is functional only for a limited time.

There is no single vehicle that can meet all the requirements needed in different jurisdictions. There are some good examples, such as the Limited Partnership (LP) in the United Kingdom and "*Fond Commun de Placement à Risque*" (FCPR) in France, which attract investors to invest through LP in the UK and through FCPR in France. However, the UK LP is, *for*

example, not recognised in France and thus investors from the UK need to invest in France through intermediary vehicles).

It was noted that some regulatory frameworks are based on rules that do not fully recognise the contribution of the venture capital industry to economic well-being. This is another barrier and VC investors therefore argue for a **more stable and predictable** environment.

10.2. A variety of operating models?

The group agreed that there are also players to whom cross-border investments would not be appropriate. Some VC funds, especially **smaller funds** and **niche players** or those operating in geographically-limited areas with a developing VC market, might not consider cross-border deals at all or might have sufficient deal flow and could perform well locally.

Such funds with portfolio orientation predominantly in home jurisdiction **provide local solutions** for firms seeking equity and if there are no bottlenecks in the investment cycle that would limit later investments and exits, such funds might not need to invest internationally.

Moreover, VC funds in certain countries are so small (up to 10 million EUR) that they are **not suitable** for cross-border investments. However, experts from some smaller Member States noted that geographical limitations might lead even such "smaller" funds to operate outside their home jurisdiction.

The group noted that it is important for each Member State to have investment vehicles that are acceptable and work well in the home market first. Especially in bigger countries, the likelihood is that medium-sized VC funds (of less than 50 million EUR) will only invest in their home jurisdiction; and if they invest outside it is likely to be only in jurisdictions with a similar investment environment.

10.3. Summary of key problems and possible solutions

The most important problems that the venture capital industry is facing in practice were summarised and analysed as follows below in Table 1.

Problem	***Possible solution***
Fund raising and distribution (between investors and VC funds)	
Different national standards to determine qualified investors in private equity - VC (institutional versus private investors)	*Common EU definition for a qualified investor (for institutional and private investors)*
Different national regimes concerning where institutional investors can invest (country-specific restrictions)	*Using a prudent person rule (implementation of the prudent person rule as defined by the pension fund directive 2003/41/EC)*
Difficulties in marketing private equity and VC funds in different Member States due to different national approaches to private placement/ exemptions from public offer rules	*Common EU approach to "private placements"*
Tax neutrality (between VC funds and the country of investment)	
Complex fund structures depending on investors' home countries and investee company countries (aiming at avoiding double taxation)	*Taxation of capital gains in the home country of the investors; equal treatment of direct investors and PE investors; equal treatment of quoted and unquoted equity.*
Different rules and requirements for private equity funds to benefit from tax treaties	*Tax transparency: list of mutually recognised PE fund structures (or common criteria for Member States to determine tax transparency);* *Tax neutrality: PE funds established as limited companies (not transparent) should benefit from double taxation treaties; common requirements for benefiting from these treaties.*
Professional standards (for VC funds)	
Different local rules for valuation and reporting (increased costs and a lack of comparability)	*Encouraging use of industry self-imposed professional standards (i.e. those of EVCA)*
Problems in applying IFRS (International financial reporting standards) to PE funds: in particular the consolidation requirement	
Permanent establishment (for the general partner or fund manager)	
Risk of the general partner to have permanent establishment in the investee company country (resulting in adverse tax consequences)	*- Mutual recognition of management companies; or passport for management companies;* *- in the long term, a "passport" for a management company*

11. VARIOUS FUND STRUCTURES WITHIN THE EU

Venture capital funds can be established under various legal regimes. Some Member States have widely used solutions for locally established funds, while others might not have any appropriate legal structure or are such structures only planned. In some Member States a limited partnership structure is the most used one, but alternative corporate or similar vehicles can also be available. It should be noted that there is **no standard definition** of "limited partnership", neither a common understanding about its features.

While governments are becoming aware of the need to stimulate venture capital, the danger is that attempts to improve supply result in even more **complex** legal and tax requirements and **increased costs** for funds. At present, a fund structure aimed at fundraising and investing in different EU countries requires establishment of intermediary or **parallel vehicles**, often involving off-shore entities, and consequently results in additional costs and complexities.

Consequently, **only larger** VC funds usually set up intermediary vehicles that avoid double (or multiple) taxation of investor returns. Obtaining information about how certain jurisdictions treat funds is often time consuming and costly for venture capital funds, limiting such operations to larger funds that can absorb the overhead costs.

At present, none of the existing structures currently available in Europe is able to accommodate all types of investors from different countries, both within and from outside the EU. In this respect; the experts grouped countries as follows:

- First group: countries with specific structures to accommodate national and foreign VC investors on a tax transparent or tax-neutral basis;

- Second group: countries with specific VC structures, including some structures that are tax-exempt, but these structures are too complex and restrictive and are thus in practice virtually useless;

- Third group: countries without any rules or regulation and no structure defined in local legislation; in some cases, investment vehicles are using existing corporate structures; and in other cases, investments are possible only by using an off-shore or intermediary investment vehicle.

11.1. Examples of national venture capital markets

For the purpose of the expert group, experts reported on development of VC market and regulatory framework in their respective countries[20]. Some of the examples presented are:

- In the **United Kingdom**, the venture capital market has performed outstandingly in terms of fund raising and attracting non-UK investors. The Limited Partnership (LP) fund structure has a enabled specific regulatory and fiscally transparent framework and has also led to a wide and recognised use of an LP structure. Moreover, with regard to the regulatory framework affecting domiciled funds, the "light touch" regulatory framework as administered through its Financial Services Authority (FSA) should be pointed out. Although regulatory, it tends to operate in an enabling manner. As for non-domiciled funds, they are not very prevalent in the

[20] Detailed information on various existing structures in different countries is in Annex III of the Report

UK, probably largely because the regulatory framework around domiciled funds is enabling a light touch. The introduction of a less-enabling regulatory framework for domiciled funds would probably have the unwanted effect of pushing funds offshore.

- In **France**, the venture capital market has also preformed well. Since the 1980's, a specific legal framework FCPR (*Fonds Commun de Placement à Risque*) has enabled fiscally transparent structures (50% of unquoted companies) and the FCPR can be used for VC funds, funds of funds, buyouts. Hence, FCPR can only be registered in France and only managed by a management company which is domiciliated in France. The French legal framework cannot regard FCPR as a permanent establishment of a foregin investor and consequently there is no risk for a foreign investor to be taxed twice.

- Conditions in **Ireland** are similar to those in the UK: the LP structure is the predominant one, but a general partner (GP) in a Limited Partnership does not have to be regulated in Ireland. However, some larger VC funds have voluntarily chosen to be regulated by the Financial Services Regulator; this adds to their credibility internationally and increases their status when fund raising. Funds that are registered in Ireland can also invest abroad and they are investing mostly in the UK.

- Venture capital financing in **Luxembourg** may be provided either by regulated and supervised funds in the form of investment companies in risk capital (SICARs) created by a designated law of 15 June 2004 or by non-harmonized investment funds (UCIs) under the law of 20 December 2002 as amended relating to undertakings for collective investment or by unregulated undertakings subject to general company law. Most SICARs are operating cross-border. Securities issued by a SICAR may only be acquired by *well-informed investors* which are defined as any institutional investor, professional investor as well as any other investor who meets certain conditions (as explained in Annex III). SICARs having a legal personality the legislation does not foresee any special provisions regarding their external management by specialized or dedicated *management companies*. Moreover, in Luxembourg there is no specific legal framework applicable to *non-domiciled venture capital funds*. Foreign VC funds wishing to be active in Luxembourg have to comply with the local general legal framework. They have to make sure that in view of the type of activity and the targeted investors, a license under the financial sector legislation is not required.

- In the **Nordic region**, markets are thriving and maturing; they are open and allow a wide presence of foreign investors that are involved in biggest deals of the VC sector. - In **Denmark**, the market is relatively small with around 50 VC funds established there of about 53 million EUR on average; no specific regulatory framework exists for VC funds and LP is a widely-used structure (it is also possible to establish a Limited Partnership company under the Danish Public limited Companies Act) and tax transparency exists, what is attracting foreign investors. Danish fund structure is widely used in the region and even more commonly used are funds established in the Channel Islands.

- No specific legislation is either in force in **Sweden**, though regulatory framework exists for LP (Limited Partnership) and LLC (Limited Liability Company). The market is now maturing: an increasing number of international investors is investing in Swedish funds and some Swedish funds are based on UK Channel Islands.

- The **Norwegian** market is very open and it is relatively easy for LPs to invest into or out of. There are about 10 to 20 LPs consistently investing into PE/VC, and about 8-10 larger active VC firms as well as 5-7 PE players. There is no legislation put in place for VC/PE. Norwegian

corporations may currently receive capital gains and dividends without being taxed. Private investors are taxed. However, not many local VCs of a certain size choose to use the local structure, as the tax regime is considered unstable. Funds are typically established using a Danish structure or similarly on Jersey/Guernsey. Fund structuring is driven by international LPs need for tax transparency. Most VCs are local, but several are investing cross-border in the Nordic area and into the UK and US.

- New tax legislation has been in place in **Finland** since the beginning of 2006 treating Finnish VC funds similar as direct investors and introducing new tax treatment for VC investments, but investors have so far not taken advantage of this new Finnish structure and continued to invest either through a Danish structure or in the Channel Islands. The new Finnish Law namely requires that whenever a Finnish fund is investing abroad it has to have a permanent establishment abroad (as explained in Annex II).

- In **Germany**, no legal difference exists as regards private equity and venture capital structures. There are two main types: on the one hand, a larger number of funds using the Limited Partnership (LP) structure that is not licensed; and on the other hand, a smaller number of funds using the structure that is licensed at the state level (but not at the federal level). There is currently a debate about conditions for tax transparent funds as well as on a new law on private equity (that is to be adopted in 2007, applicable as of 2008). Funds, domiciled outside Germany, are bound by their respective national regulatory frameworks. Foreign, not domiciled PE and VC funds, operating in Germany, are organised in the legal structures of the US Delaware LP, the Dutch NV, the Luxembourg SICAR/SICAV, the French FCPR and the Swiss "Investment Company". Furthermore, Guernsey and Jersey structures are often utilised.

- The new legislation that has been in force in **Spain** since end of 2005 has turned Spanish VC market into a much more attractive and flexible environment, which has resulted in an increase of VC investments by more than 30%. The new law allows certain tax benefits (although VC funds are not really tax transparent, they are almost exempt from company tax and fully exempt from VAT; non-domiciled funds without a permanent establishment in Spain do not pay tax on profits).

- **Italy** is attracting foreign investors with a tax transparent vehicle "*Fondo Chiuso*"; and more than 50% of funds raised come from abroad. The Italian Government is also trying to expand the tax transparency to domestic investors. Domestic funds now represent about the 50% of the private equity and venture capital players and they grew in the last few years, especially due to the improvements in the regulatory framework and in the risk diversification rules.

- In **Portugal**, the venture capital market has developed and domestic funds are prevailing (only 7 out of 39 funds have some cross-border activities), despite the small size of the domestic market. The new legal framework, which is expected during the first semester of 2007, will clarify and simplify the regulatory environment, and it is likely to have a positive effect on the venture market, allowing a greater and more varied number of new players to enter in the market. Moreover, non-domiciled VC funds can operate in Portugal on the same conditions as any foreign investor. Portugal offers tax incentives for VC only when investing through VC Funds registered under the Portuguese law.

- In the **Netherlands**, VC funds are exempt from regulation. No real impediment exists for private equity, except of taxation. For fund structuring either a "BV-structure" (limited liability company) or a CV-structure (limited liability partnership; kind of a LP-structure) is

used; it is to be checked where the investor comes from, though non-domiciled funds can use the same framework as domiciled funds. Fund structuring works, but it is expensive. Moreover, cross-border activities do exist, though it is difficult to market a BV structure that is not that well-known as a LP. Cross-border activities are not that complicated because of the existing regulation but very much because of taxation. Most Dutch VC funds are locally-oriented; and it is not sure whether larger amounts of funds could be raised.

- The venture capital industry in **Austria** is young; it started to develop only a decade ago and is still developing. Currently there are 40 funds with average size of 35-50 million EUR. There is no specific regulatory framework for VC; except for one specific regulation for taxes that is not enabling tax transparency. The legal form of “MFAG” will no longer be possible after 31.12.2007 (a new regulation is being prepared).

- In most of the new Member States, venture capital markets are small and immature and have only recently started to develop (in parallel to certain governments’ incentives for public-private-partnerships in establishing VC funds) and thus no regulatory framework yet exists. **Lithuania** as well as **Estonia** might adopt new legislation in 2007. In **Latvia** and overall in the Baltic region, Nordic investors have started to invest in through local branches. VC funds registered in any other EU Member State intending to invest in Estonia have only to notify the authorities, whereas funds from third countries would need to apply for a license.

- In **Slovenia**, the market is small and immature and has also only recently started to develop. Companies can invest in venture capital, but cannot benefit from any tax relief or other tax advantages. At present, no regulatory framework has existed and current conditions are not attractive neither for domestic nor non-domestic funds. Some VC funds have been however registered locally, whereas 3 abroad (1 in the Netherlands and 2 in Austria). A new law regulating venture capital (and certain tax advantages for VC investors) is in preparation (it is expected to be adopted in mid- 2007).

- Also in **Hungary**, the VC market is rather immature. There are 20 market players, of which only 2 funds are public and 3 more funds with a direct public intervention, whereas others are foreign funds managed locally (for a representation office, the Company law applies). If a foreign fund is registered in Hungary, it needs to operate under Hungarian law (but there is currently no such example). Existing funds are concentrating on later stages and thus a gap exists in early stage investments. Changes in legislation are expected (some proposals include tax incentives for VC funds) what would allow more space for cross-border activities.

- Most of VC funds operating in **Poland** are foreign funds managed from abroad; and they can operate on the same conditions as any foreign investor. If a VC fund was managed from Poland, it would have a permanent establishment and be taxed for all profits in Poland irrespective of where the profits were generated. There are two possible domestic structures for PE/VC investment - a regulated Closed End Fund for Non-Public Assets (tax exempt) and a Polish LP equivalent (tax transparent) which is not regulated; none of the two has been widely tested in the market: the former is too expensive for small VC funds, the latter raises many tax-related problems that need solving before the structure could become viable (for instance the management company of the Polish LP is not exempt from VAT, foreign investors are understood to have a permanent establishment in Poland if they invest into a Polish LP).

- Furthermore, VC industry is almost non-existent in **Cyprus** with problems on both supply and demand side. Also in Malta, no specific regulation exists. In **Malta**, however, it is

accepted that VC funds have foreign management and currently there is no distinction between domestic and foreign VC funds, they are all considered as specialised collective schemes that can be of various structures (i.e. LP).

- In Bulgaria and Romania, no specific piece of legislation regulates local venture capital market. Some VC funds that do operate in **Bulgaria** are established elsewhere; some are, however, established locally and fall under the Company law. In **Romania**, funds with the characteristics of a venture capital funds are included in the category of non-harmonized collective undertakings.

12. FLEXIBLE REGULATORY FRAMEWORK AND ROLE OF THE PUBLIC SECTOR

While the whole group recognised the importance of a dynamic VC industry, in particular the industry stakeholders stressed that Member States need to assess all the possible supply and demand factors that may be contributing to market failures and should identify where tax and legal measures could be improved.

For example, certain well-functioning VC structures in place in some countries should be recognised also elsewhere. By reviewing their existing legislation, countries could take industry needs into consideration. Especially countries without any VC legislation could take these messages on board to develop a more favourable environment for venture capital funds to invest more in start-up companies with a high growth potential.

The group recognised that it was up to the individual Member States to decide what would be most suitable for them; these pathfinders could be countries that already have effective structures in place.

The PE/VC industry pointed out that venture capital funds have an expanding set of industry standards and a proven track record. The industry preference is for a market-driven approach to create VC-policy friendly tax and legal framework that could be used across Europe. In light of the Commission's renewed Lisbon goals of growth and jobs, and taking into account its commitment to develop financial markets in Europe, the industry has advocated taking practical steps to improve the situation and not to introduce excessive and even more complex regulatory environment.

The industry experts were arguing for a common approach by the Member States and the Commission to reduce market fragmentation:

- Member States should review their legal and administrative environment so that domestic and cross-border VC investments are **treated equally**, in particular VC funds should be able to operate without permanent establishment for tax reasons.

- Commission and the Member States should develop a good European **framework** for cross-border VC fund investments that all Member States could adopt if they wish.

Currently the Commission has no plans to legislate in the area of non-harmonised funds, the domain where private equity and venture capital belong. However, the Commission services

published White Paper on Investment Funds[21] that would serve as a basis for a proposal on European private placement regime, including for fundraising by venture capital funds.

In recognising that fund structuring becomes increasingly complex when trying to invest across borders because fundraising in two jurisdictions is almost always different, certain steps have been already taken in the Nordic region.

12.1. Example: Nordic approach to removal of obstacles to Nordic VC funds

The Nordic countries have cooperated for many years, also in promoting an innovative, competitive and knowledge-intensive Nordic business sector. In this respect, the Nordic Innovation Centre (NICe) aims at stimulating innovation into business through increased cooperation between innovation systems in the Nordic area, and at establishing a borderless Nordic region through removal of barriers hampering the free movement of innovation resources – including venture capital.

The group heard that the majority of VC funds that make investments predominantly in the Nordic region are not operating outside of the Nordic countries. Most if not all of the PE/VC funds who want to invest in Nordic enterprises are set up in the British Channel Islands. An exception is Denmark where the tax law is not an obstacle to the establishment of venture capital funds in Denmark. Most Nordic countries have today no structures that can compete successfully with foreign fund structures as they lack either of two important criteria for venture capital funds, namely favourable tax treatment and trust.

There are obstacles for VC funds to receive transnational investments in the Nordic countries. In aiming at a well-functioning common Nordic venture capital market, a recent NICe project group presented **overall Nordic recommendations**[22] - mostly related to taxation issues:

– VC funds organised as limited partnerships should be transparent in taxation:

This means that no income tax should be imposed in the country where the fund is established or where the management carries on the investment activities. Tax, if any, should only be paid in the country where the investor comes from.

– No VAT should be imposed on management services of the venture capital fund:

A VC fund pays a management fee to the company that manages this fund. As a general rule, all supplies of goods and services, such as management services, are subject to VAT. Since VC funds generally are not registered for VAT (because they do not carry on any activities subject to VAT), any VAT charged on the management fee will not be recoverable. This means that any VAT paid on the management fee may be an additional cost that in the end will be paid either by the investors or the management team.

– The risk of taxing foreign funds should be abolished by explicit regulations:

In situations where local related advisors are used or decision making takes place locally, it is currently possible that foreign VC funds are considered to have permanent establishments in target countries.

[21] White Paper on Enhancing the Single Market Framework for Investment Funds, November 2006: http://ec.europa.eu/internal_market/securities/docs/ucits/whitepaper/whitepaper_en.pdf

[22] NICe Report "Obstacles to Nordic VC funds" : http://www.nordicinnovation.net/prosjekt.cfm?Id=1-4415-210

These presented initiatives are geared towards improving the regulations for the venture capital industry in the Nordic area.

The Commission has aimed to analyse with this expert group the possibility of the Member States adopting similar solutions even on a wider basis.

An approach that would result in removal of the existing regulatory barriers could bring competitive advantages and would strengthen Nordic region within the European venture capital market.

Other countries could take similar initiatives. It might be that countries that try to expand venture capital investments would join countries that already have the cross-border investment framework in place.

13. POSSIBLE SOLUTIONS

The discussions of this expert group made it clear that structures of VC funds in Europe need to be appropriate for both domestic and foreign investors and investments. However, efforts to build up such an environment would include in practice some regulatory changes. The experts agreed that encouraging venture capital investments by creating a favourable policy environment is a task where the Commission, Member States and various industry players should cooperate to meet the challenges in improving the demand and supply of finance.

The importance of alternatives to legal solutions was emphasised, for example through exchanging best government and market practices in promoting venture capital investments. Further, there is a need to build further cooperation among national regulators. For example, to aim for a uniform approach among regulators would be useful, in particular on core principles and best supervisory practices.

Moreover, according to EVCA, there are a number of key objectives that practitioners of VC take into consideration when structuring an appropriate VC fund, and that national regulators would benefit when taking into account:

– Suitability:

A fund should be suitable for all its institutional or eligible investors (whether taxed or tax-exempt, such as pension funds) and capable of being marketed to suitable investors on a cross-border basis.

– Simplicity:

All investors like simplicity; legal and administrative clarity and certainty would facilitate cross-border investments.

– Efficiency:

Final investors and the fund itself should not be subject to economic or juridical double taxation. Tax is the main driver for complexity.

As regards institutional investors, industry experts reported that in some countries (Lithuania and Poland) pension funds are not permitted to invest in venture capital funds. In some

countries, pension funds benefit from specific fiscal exceptions. Industry experts stressed that the possibility of institutional investors to invest into VC markets should be promoted across Europe. The reason is that private equity provides an opportunity for portfolio diversification and even the prospect of higher returns when the VC industry performance improves.

The group heard examples on these issues: in Poland, for example, pension funds cannot legally invest in foreign PE/VC funds and they are not encouraged to invest into domestic funds either. Therefore the largest potential source of capital is absent from the venture capital market. Several countries still have very low legal limits for investments in venture capital by local pension funds. In general, in Europe pension funds invest almost exclusively in buyouts whereas in the US they invest heavily in venture capital.

While recognising the complexity of issues at stake, involving legal and taxation regulation in each respective country, the group proposed the following solutions:

13.1. Harmonisation at the EU level (a long-term solution)

While recognising that harmonisation of VC fund regulations at EU level would be a solution to increase cross-border VC investments, such an approach would only be possible in the long term. However, some industry experts warned that by then it might be too late to have a performing venture capital industry in Europe23.

It was also pointed out that VC industry is quite regulated in some countries and tackling the issues at stake only with a regulatory approach might cause even a more complex regulatory environment without stimulating the industry.

Therefore, a more pragmatic approach that would be possible to achieve in a shorter timeframe would be the mutual recognition of the existing national structures.

13.2. Mutual recognition

As part of the work of this expert group, a set of terms and practices applied in different countries was collected[24]. The result of the analysis is that countries differ not only in approaches used to stimulate venture capital investments but also in terms of their basic definitions. In the European Union **a common understanding** is needed in order to save time and money.

The experts took note of a report on private equity[25], which recommended that EU institutions and the Member States should take appropriate steps to arrive at mutual recognition of each other’s fiscally transparent private equity fund structures and argued for a common understanding of a private placement. The report argued for non-legislative actions that would bring about mutual recognition between Member States of existing national laws governing the marketing and sale of VC funds. It argued that this could be based on a consistent approach by Member States to rules relating to "private placements". In view of the potentially negative impacts that these differing rules may have on the functioning of the market for institutional/sophisticated investment products, the Commission has undertaken

[23] Some 10-12 years are needed for a VC fund and this is why changing regulatory environment is urgent now, otherwise any such changes might be ineffective.

[24] Extract from the questionnaire is provided in Annex III of the Expert group report.

[25] Report on PE: http://ec.europa.eu/internal_market/investment/docs/other_docs/reports/equity_en.pdf

to[26] report to the Council and Parliament on steps that need to be taken to give full effect to a **common private placement regime**.

The venture capital industry27 has advocated mutual recognition that allows for one recognised fund structure at European level and that provides the same conditions for all the fund's investors and managers. This would not preclude existing national structures being used for purely national and locally established funds.

And most importantly, the venture capital industry has urged steps to be taken towards mutual recognition of the existing national frameworks leading towards a regulatory framework that all Member States could adopt if they wish.

Achieving mutual recognition is not an easy task since Member States have different structures and legal traditions. Mutual recognition of fund structures based on existing national frameworks implies mutually acceptable levels of supervision and trust. Clearly, mutual recognition might not be immediately achievable, nor an optimal solution, but currently seems to be the most pragmatic approach available.

In a fragmented venture capital market with 27 sets of operating conditions, fund structuring becomes increasingly complex when trying to invest across borders since fundraising in two jurisdictions is always different. The group established that a fund structure aimed at investing in several Member States requires the establishment of additional intermediary or parallel vehicles, often involving off-shore entities, and consequently results in additional costs and complexities that in most cases only larger VC funds can cope with. The regulatory framework needs to be more responsive to market needs.

To achieve this, the industry has been urging for some solutions and the Commission tried to summarise the relevant ones for this expert group. In this respect, the participating experts reviewed the following "preferred" features that national authorities would need to take into consideration when reviewing the existing or adopting a new legislation or regulation.

13.3. "Preferred" features of VC funds and management companies[28]

13.3.1. "Preferred" features of a venture capital fund:

A fund should be established and registered only in its home jurisdiction and should be recognised in other Member States. It should not be liable for separate registration or establishment in each jurisdiction. National authorities should recognise that VC funds domiciled in another Member State and operating in their market are already subject to regulatory and taxation regimes in their country of residence.

In a single market Member States should not have a country-centric perspective preferring national solutions and discriminating against foreign investors. Mutual recognition of funds from other jurisdictions would lower operating costs, increase legal certainty, and reduce complexities, administration and time needed for fund raising and investing. Such an environment would increase the volume of venture capital in Europe by raising returns,

[26] White Paper on Enhancing the Single Market Framework for Investment Funds, November 2006: http://ec.europa.eu/internal_market/securities/docs/ucits/whitepaper/whitepaper_en.pdf
[27] Private Equity Fund Structures in Europe; an EVCA Tax and Legal Committee Paper, January 2006
[28] National experts' reactions are in details in Annex II of the Expert group report.

stimulating further investments, facilitating smaller funds' operations on a wider market and would thus help to achieve economies of scale upholding the competitiveness of EU for global investors.

13.3.2. "Preferred" features of a management company

VC funds that make investments across borders into other Member States should not need a permanent establishment outside its home jurisdiction. In other words, **the management company should not be liable for separate registration or establishment in each country where it invests**. With mutual recognition of VC funds from other jurisdictions (*as explained under 7.3.1.*), the same should apply for the management company of the fund. If the management company (subject to regulatory and taxation regime in the home country) could operate directly from the home country also in the investee country without being established there, costs and time required would be reduced.

If national authorities agreed on mutual recognition of fund structures and management companies based on national legislations, they would involve mutually acceptable levels of supervision and trust. In fact, Member States could on this basis build further.

In addition, a more ambitious approach would be that countries agree on **a common understanding on a passport for the management company.** Once a management company would be established in its home jurisdiction, it would get a passport that would allow activities also in other jurisdictions without being established or registered again. Such a passport would allow investors in venture capital to invest easily in other countries.

Furthermore, certain basic requirements are common to all Member States for operating in VC funds. In order to achieve some common understanding, countries should agree a common list of requirements. If regulators agreed upon such requirements, then this would affect that a VC company would have a passport for all EU countries.

13.3.3. Tax transparency

The group discussed tax issues only to a limited extent, since they were not part of its remit. Nevertheless, many of the other obstacles to cross-border investments by VC funds are closely related to taxation.

Mutual recognition implies that if a fund is regarded as being fiscally transparent in the country in which it has been constituted it should also be regarded as transparent for tax purposes **by the investee country**.

The aim of a fully transparent fund structure would be to **avoid economic double taxation**[29]. Simultaneously, investors' ability to enjoy the benefits of any double tax treaty between their [2]country of residence and the investee country should also be ensured.

A transparent tax structure should enable investors of the fund to be treated for all tax purposes in the country of the investee company as if they had received the income and capital gains directly from the investee company. It should not lead to investors being deemed

[29] Economic double taxation (*definition: inclusion of the same income in the tax base when the income is in the hands of different taxpayers*) ≠ Juridical double taxation (*OECD: imposition of income taxes in two (or more) states on the same taxpayer in respect of the same income*)

to have a **permanent establishment in the country of the investee company**. This would be achieved through appropriate provisions in double tax treaties between the investor's country of residence and the investee country.

Given the importance of the tax issues, the Commission services will organise **a further expert group** to cover policy area of direct taxation and cross-border VC investments in order to examine cases of double taxation and discrimination of foreign VC vehicles, funds and investors.

It is clear that tax issues are of considerable significance when reviewing arrangements on venture capital funds. Taxation should take place **at the level of the final investor** (and not at the level of fund, *i.e.* partnership). Double taxation should be avoided. The issues of tax transparency and tax neutrality were briefly discussed within this expert group.

14. EXPERT GROUP RECOMMENDATIONS

This group identified the drawbacks resulting from the lack of a real European venture capital market. The market is fragmented and hinders cross-border investments of venture capital funds. With 27 sets of operating conditions in place within the EU, fund raising and investing outside a fund's local jurisdiction has become increasingly complex and makes the development of a viable VC industry difficult, especially in smaller Member States.

In order to ease cross-border operations, the group took note of industry-driven proposals for a more flexible and adaptive regulatory framework that would contribute to lower fund structuring costs and would increase flow of venture capital within Europe: venture capital funds could find the most deserving start-up companies with highest growth potential and access to finance of innovative SMEs would improve.

The most reasonable way to progress in the short term, apart from exchanging good market and government practices, would be the following two approaches, for which participating national experts were in general supportive:

First, through a mutual recognition of venture capital funds from other jurisdictions: a fund should be established and registered only in its home jurisdiction and should be recognised in other Member States and not be liable for separate registration or establishment in each jurisdiction. National authorities could recognise that venture capital funds domiciled in another country and operating in their market are already subject to regulatory and taxation regimes in their country of residence.

Second, through a mutual recognition of management company of the fund: if the management company, which is subject to regulatory and taxation regime in its home country, could operate directly from the home country also in the investee country without being established there, costs and time required would be reduced.

Steps could be taken towards mutual recognition of the existing national frameworks that allow VC investments. This should gradually lead towards a regulatory framework that all Member States could adopt if they wish.

If national authorities were to agree on mutual recognition of fund structures and management companies based on current national legislation, this would imply mutually acceptable levels

of supervision and trust in regulatory arrangements. Member States could also take these requirements of the venture capital industry into consideration when reviewing existing, or adopting new legislation.

For **investors**, improved coordination between the Member States, increased common understanding and mutual recognition of fund structures would make it easier and cheaper to invest across borders. A consistent approach at European level would be that investors in venture capital would be treated the same way as direct investors in each underlying investee company. It is important that **institutional investors**, such as pension funds, would be permitted to invest in venture capital in all countries, so that their funds would be deployed.

In addition, **private investors** should not be discriminated; to this end, the adoption of a common private placement regime for VC funds would be helpful.

Venture capital firms would benefit from more efficient operations both on the fund raising and on the investment side, enabling them to benefit from economies of scale and scope and to specialise. Deeper and more efficient European venture capital markets would promote economic growth and competitiveness.

15. FOLLOW-UP OF THE EXPERT GROUP REPORT

The main findings of this expert group will be taken into consideration as the Commission develops its policy on venture capital. As part of the broad-based innovation strategy, the Council has requested the Commission to report in 2007 on obstacles to cross-border investments of venture capital funds[30].

The Member States have been invited[31] to monitor closely the developments in risk capital financing and innovation and report these in the context of their Lisbon National Reform Programmes (NRPs).

The Financial Services Committee of the Council has been given a mandate to update its assessment on European risk capital markets and submit a report to Financial Ministers.

To explore identified problems[32] and to enhance the European framework for investment funds the Commission will, based on the White Paper on Investment funds[33], report to the Council and Parliament in 2007 on steps that need to be taken to give full effect to a common private placement regime.

Building on the conclusions of this expert group, the Commission has set up an expert group on the removal of tax obstacles for cross-border venture capital investments, which will review the questions of direct taxation and double taxation of venture capital funds and investors, including cases of discrimination of foreign venture capital vehicles and investors.

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[30] 2796th Competitiveness Council meeting, Brussels, 4 December 2006 (page 6): http://www.eu2006.fi/news_and_documents/conclusions/vko49/en_GB/1165252699841/

[31] 2753rd Economic and Financial Affairs Council meeting, Luxembourg, 10 October 2006 (page 12): http://www.consilium.europa.eu/ueDocs/cms_Data/docs/pressdata/en/ecofin/91272.pdf

[32] Report, July 2006: http://ec.europa.eu/internal_market/investment/docs/other_docs/reports/equity_en.pdf

[33] White Paper on Enhancing the Single Market Framework for Investment Funds, November 2006: http://ec.europa.eu/internal_market/securities/docs/ucits/whitepaper/whitepaper_en.pdf