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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

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1. FINANCING GROWTH AND INNOVATION

In a highly competitive global economy, improved access to financing by innovative small and medium-sized enterprises (SMEs) has become essential for enhancing competitiveness and meeting the objectives of the **Lisbon Partnership for Growth and Jobs**.

Raising capital is one of the preconditions for successfully setting up a business and ensuring its further expansion. Relying on own resources or debt financing is often not sufficient for **SMEs in their early-stages or those with high-growth potential**. Many investors are reluctant to invest in such firms due to high transaction costs, and because they estimate that the expected returns do not compensate for risk. Such companies typically look for **venture capital**[1] that can provide them with amounts to break into markets and grow faster. Although venture capital is a small part of the larger asset class of alternative investments, it is essential for the growth of innovative firms.

The **fragmentation** of the European Union's venture capital markets along national lines seriously limits the overall supply of early-stage capital for innovative SMEs. As a consequence, in Member States, where the market is new, venture capital funds face problems reaching the **critical mass** they need to spread their portfolio risk and cover their costs. Facilitating cross-border operations could help them to overcome this hurdle and increase the overall supply of early-stage capital.

In its Communication "Financing SME Growth – Adding European Value"[2] of June 2006, 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, and the Commission called for steps to overcome the regulatory and tax barriers.

To monitor the development of risk capital financing and innovation, the Economic and Financial Affairs Council of October 2006 invited the Member States to report on their national environments within **National Reform Programmes** and requested the Commission to study further the conditions for early stage venture capital investments.

Moreover, the Competitiveness Council of December 2006 invited, *inter alia*, the **Commission to report** on obstacles to cross-border investments by venture capital funds.

In preparing this Communication, the Commission has consulted both the Member States and market participants. The annexed **expert group report** from March 2007 on "*Removing obstacles to cross-border investments by venture capital funds*" analyses the barriers and outlines solutions for venture capital funds investing across borders in Europe.

[1] A glossary is in the Annex.
[2] COM(2006) 349, 29.6.2006

2. THE ROLE OF VENTURE CAPITAL FOR INNOVATIVE SMEs

2.1. Economic potential of venture capital

Despite the positive impact **innovative SMEs** have on European competitiveness, they face significant problems in accessing finance necessary to start, grow and compete on global markets. Improved access to venture-backed investments would help them exploit technologies and compete globally.

While innovative SMEs are a relatively small proportion of SMEs, they have the potential to yield high benefits in creating new jobs and technologies. Accordingly, there are studies showing that venture capital contributes significantly to **job creation**. A recent study[3] reported that companies in the EU receiving private equity and venture capital created one million new jobs 2000-2004; over 60% of these jobs were created by venture capital backed companies and employment in these companies grew by 30% per annum.

In addition, innovative and growth-oriented firms backed by venture capital spend on average 45% of their total expenses **on R&D**. This amounts to an average €3.4 million per company yearly or €50 500 per employee, which is six times higher than in the EU-25 top 500 R&D spenders[4].

Econometric studies have also described a positive relation with **economic growth**. A recent analysis[4] estimated that an increase in investments at the venture capital stage by 0.1% of GDP contributes up to one percentage point increase in real economic growth.

Moreover, venture capital is being increasingly important for **environmental sustainability** (€1.25 billion was raised in 2006)[5]. Sustainable venture capital funds invest in the range of €1-5 million with focus on early-stage and typical investments in renewable energies and clean technologies.

2.2. Recent trends and challenges

After the downturn due to the dotcom bubble bursting in 2000, European venture capital industry has shown an upward trend since 2004 and reached very high levels in 2006[6]: of the total €112 billion of funds **raised**, €17 billion went to venture capital representing an increase by 60% on 2005 levels. Out of €71 billion of total equity capital **invested**, venture capital investments amounted to €17.2 billion, an increase of 36% over the previous year.

Although the figures from 2006 showed a considerable growth in seed investment, the major share of venture capital investments still continues to go to expansion capital. The main challenge is to create an environment where **seed investments** can be kept at a high level despite the cyclical nature of venture capital.

Another challenge is that the growth potential is limited by the **small amount** of venture investments per deal. The European average deal size for early-stage investment is just €0.4 million against €2.2 million in the US.

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[3] "Employment Contribution of PE and VC in Europe, EVCA Publication, October 2005
[4] "Venture Capital in Europe: Spice for European Economies" T. Meyer, Deutsche Bank Research, Oct. 2006
[5] "Venture Capital for Sustainability 2007", Eurosif, 2007
[6] "Annual Survey of Pan-European Private Equity & Venture Capital Activity", EVCA Yearbook 2007

In addition, although investments in **clean-tech** start-ups are increasing in Europe, these investments in the US more than doubled in the past two years and are now four times higher than in the EU. The challenge for Europe is to generate profitable clean-tech investments to sustain their growth[7].

3. MARKET FRAGMENTATION LIMITING VENTURE CAPITAL DEVELOPMENT

At present, the potential of EU venture capital markets is not fully exploited and markets do not provide sufficient capital to innovative SMEs at early growth stages. The lack of an equity investment culture, informational problems, fragmented market and high costs are among the main reasons for this **market failure**.

The stage of development of venture capital markets **varies**. In larger Member States with more mature markets, **sector funds** are becoming more common; these funds could benefit from improved opportunities to invest across borders and raise money in the single market. In markets that are in the early stages of development, the catalytic role of **country funds** with public investors is beneficial to market growth. Yet in smaller or emerging venture capital markets, funds have difficulties in expanding, growing, specialising and reaching a **critical mass of deals**.

Further, **divergent national policies** create significant market fragmentation, which affects **adversely both fundraising and investing** within the EU. Venture capital funds and their managers are authorised and regulated according to national requirements. Those funds that would otherwise expand their portfolio across borders are hindered due to operational and regulatory obstacles.

In a fragmented venture capital market with currently **27 different operating environments**, fund structuring across multiple borders becomes increasingly complex and smaller funds tend to avoid operating outside their home jurisdictions.

4. BETTER CONDITIONS FOR VENTURE CAPITAL

4.1. Creating framework conditions

As outlined in the Communication on a broad-based innovation strategy[8], the deficiencies in the framework conditions as well as the barriers in the Internal Market, including lack of availability of venture capital market, are hampering capital mobility, depriving businesses of the necessary scale to fully capitalise on investments, and limit EU innovation capacity.

Government policies can create incentives for the venture capital industry and encourage investments in innovative SMEs. **Public co-funding** can in particular help to address the shortcomings in seed capital provision, reduce the equity gap and help to develop the venture capital market, whilst acknowledging the differences in the development of venture capital markets in the Member States.

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[7] A substantial part of the Community programme CIP is earmarked for support of eco-innovative SMEs.
[8] COM(2006) 502, 13.9.2006

Targeted horizontal state aid can also play a role in encouraging private investments. In the new Community framework for state aid for research and development and innovation,[9] **state aid for young innovative enterprises** allows to support SMEs' first years of existence, to overcome their initial cash shortages due to insufficient funding, and to facilitate their growth. And the new Guidelines on **state aid to support risk capital** investments in SMEs[10] include a light assessment procedure with a number of elements, such as a higher investment threshold of €1.5 million per SME over a period of 12 months; below this ceiling the Commission accepts that a market failure is assumed to exist.

Moreover, a key aspect of any venture capital investment is the exit strategy – the point at which the venture capitalist can sell its shares and release funds for new opportunities. Venture capital thus also needs **more liquid exit markets** in the EU, in particular growth stock markets that provide liquidity and can achieve a critical mass of advisory services.

Although venture capital is in many ways a local business, relying on close connections between funds and entrepreneurs, it is also a global one that competes for both funds and investment opportunities. Venture capital thrives around clusters and universities that produce new ideas and entrepreneurs. The European innovation policy pays special attention to **supporting clusters** and their cooperation that can also help the venture capital industry and its long-term sustainability by providing deal flow.

4.2. Community policies to support financing of innovation

The following Community programmes focus on the renewed Lisbon Strategy for Growth and Jobs priorities to support innovation and entrepreneurship:

The **Seventh Framework Programme** (FP7) aims to boost the funding of collaborative research in Europe in the period 2007-2013 with more than €53 billion, of which €1.3 billion is for innovative actions to outsource SMEs' R&D. Additional €0.4 billion of public funding should be made available in 2008-2013 for the Eurostars Joint Programme supporting SMEs performing R&D.

Linking innovation with commercialisation and building on the previous experience, in the **Competitiveness and Innovation Programme** (CIP), €1.1 billion helps to improve SMEs' access to finance in the period 2007-2013. The new High Growth and Innovative SME Facility was introduced to increase equity for innovative SMEs by investing on market terms into venture capital funds focused on SMEs in the early- and expansion phase.

Complementary instruments are available within **JEREMIE** (Joint European Resources for Micro to Medium Enterprises), a joint initiative of the Commission and the European Investment Fund to tackle the risk capital for SMEs in some regions. It will enable the Member States, if they choose it, to use part of their structural funds to develop different forms of risk capital and financial instruments specifically designed to support SMEs.

[9] OJ C 323, 30.12.2006, p. 1-26
[10] OJ C 194, 18.8.2006, p. 2-22

Coherent policy and good practices are important in developing venture capital markets at both the EU and national level. The Commission will promote **exchange of good practices** at all levels, from national down to the regional level and specific industry sectors, in particular by supporting platforms and innovation networks.

5. A STRATEGY FOR IMPROVING THE CROSS-BORDER CONDITIONS

Policies that directly support the financing of innovation will, however, not be sufficient to reach the critical mass and meet the challenges of a global economy. Public-private partnerships and public incentives can contribute to overcome the equity gap, but only **increased investment by private investors** can provide a long-term solution. For this, the Commission and the Member States have to act to improve the framework conditions for venture capital funds, of which cross-border operations are one.

5.1. The role of free movement of capital

The free movement of capital is a fundamental Treaty freedom and the main vehicle for financial integration. An **integrated financial market** brings benefits to the European economy through an efficient allocation of capital that increases long-run economic performance. A well-functioning venture capital market is an important part of the financial market, especially for reaching the goal of more innovative and competitive Europe.

This is why it should be ensured that venture capital markets and funds operating on a cross-border basis are made fully aware of the freedom of capital movement that is monitored and enforced by the European Commission.

5.2. Improving conditions for fundraising

Venture capital market provides **institutional investors**, such as banks, pension funds and insurance companies, with an opportunity for portfolio diversification and the choice of different risk return profiles. In some Member States, pension funds are not permitted to invest in venture capital funds or face quantitative and geographic restrictions. Wherever this is the case, a possible source of capital is absent from the venture capital market. The national implementation of Directive 2003/41/EC[11] should allow occupational pension funds in the EU to make a professional decision on their exposure to venture capital based on the '**prudent person rule**'. Member States are invited to extend the use of the 'prudent person rule' also to other types of pension funds and institutional investors.

Another obstacle hindering cross-border business is the **lack of a European private placement regime**. This results in higher organisational costs of raising money (in particular legal and advisory fees, which are paid for by investors). This has a negative impact on returns and on the attractiveness of raising funds. Private placement is a specific method for selling investment products directly to institutional investors. National private placement regimes seek to reduce many of the restrictions that are imposed in the event of marketing a fund to the wider public, as would be the case with a stock market listing. Current national regimes differ substantially and a common private placement regime could allow managers to

[11] OJ L 235, 23.9.2003

deal directly with knowledgeable investors across the EU and expand their business without giving rise to retail investor protection concerns.

The MiFID[12] introduces provisions to facilitate cross border transactions involving interests in venture capital funds, between seasoned professionals. There may be more that can be done to facilitate cross border private equity transactions between fund managers, intermediaries and sophisticated investors.

The Commission is analysing national frameworks for non-harmonised funds, including venture capital funds, and barriers to cross border private placement and will report on the possibilities for establishing a European private placement regime in the first half of 2008.

5.3. Improving the regulatory framework

A better regulatory framework would contribute to lower operational costs and risk, higher returns, increased flow of venture capital and **more efficient venture capital markets**. This would be advantageous for all Member States since risk capital could find the most deserving entrepreneurs and companies with the highest growth and development potential.

Removing administrative obstacles for cross-border investments would make it easier even for smaller funds – and funds in smaller countries – to operate over a **wider geographical area,** increase their efficiency, reach economies of scale, improve returns, specialise and diversify their portfolios.

For each Member State it is essential to have in place arrangements to facilitate the establishment of, and investment by, a venture capital fund. The Commission recognises the importance of such solutions and regulations along national lines. The authorities should locally assess all possible supply and demand factors contributing to the equity gap and identify the necessary legal measures for improvement.

Member States are invited to **review** their legislation, by taking into account the possibilities of cross-border venture capital investments along with local investments.

In Member States without formal provisions for venture capital structures, **any new regulation** should enable cross-border operations.

5.4. Reducing tax obstacles

In addition to regulatory questions, tax issues are of paramount importance. In order to ensure that cross-border venture capital investment is not hindered, fund structures should have features that can accommodate the individual legal and fiscal needs of investors.

Currently, funds can be established across the EU under **a variety of legal forms**, regimes, and structures, the interaction of which can lead to unrelieved double taxation. Member States can be broadly divided into three categories:

[12] Directive 2004/39/EC; OJ 2004/L 145/01, 30.4.2004

(i) Member States with a developed venture capital market provide specific structures to accommodate national and foreign venture capital investors on a transparent[13] or tax exempt basis, such as limited partnerships.

(ii) Member States with specific venture capital structures, including some structures that are tax exempt (fiscally transparent). However, these structures are too complex and/or restrictive and are therefore not used in practice.

(iii) Member States without any specific rules or regulation and with no suitable structure; investments are only possible by using an off-shore or intermediary investment vehicle or an existing corporate structure (limited liability companies, limited partnership company, qualified investment company, as well as kind of closed-end structures for collective investments, joint-stock company, local corporate structures or parallel investment structures).

A comprehensive consultation[14] with the industry and the Member States has revealed that venture capital structures currently available in Europe are not able to accommodate all types of foreign investors from within and outside the EU.

Therefore, complex fund structures with parallel vehicles have to be set up, in order to minimise the tax disadvantages from investing cross-border. The high transaction costs of setting up the structure[15] and of its on-going management, together with the existing legal uncertainty, further dissuade venture capital funds from cross-border investment.

The Nordic Innovation Centre[16] has proposed some solutions to improve the conditions for the Nordic venture capital market: funds established as limited partnerships should be tax transparent; no VAT should be imposed on the management company of the fund and foreign funds should not be taxed. Such an approach could bring competitive advantages and would strengthen the region within the European venture capital market.

The Commission has already taken various initiatives in the direct tax field with a view to improving the functioning of the Internal Market. As the Commission has previously suggested about the implementation of the Risk Capital Action Plan[17], there is scope for further improving national regulatory frameworks and **eliminating** economic and juridical **double taxation** on cross-border venture capital operations.

The Commission has set up an expert group with governmental and private experts from Member States **to identify cases of double taxation and other direct tax obstacles** to cross-border venture capital investments in the EU and to reflect on and discuss technical solutions to overcome these. This expert group shall report by end of 2008.

5.5. Progressing with mutual recognition

The Commission believes that in order to remove the barriers to venture capital cross-border fundraising and investing and to ensure the benefits of the Internal Market, venture capital

[13] Tax transparency means that income and capital gains is not in principle liable to taxation at the fund level in the country where the fund is established.
[14] See the annexed Expert group report, March 2007
[15] Up to 1% of total fees as a percentage of a Limited Partner’s commitments over the 10-year life of a fund.
[16] “Obstacles to Nordic Venture Capital Funds”, Nordic Innovation Centre, September 2007.
[17] COM(2003) 654, 4.11.2003

structures that are functioning well in some Member States, together with those structures that are appropriate for non-domestic investors, could be **adopted and recognised elsewhere**. Efforts would in practice include some regulatory changes and their implementation would require commitment at both national and industry level.

Optimally, a single venture capital fund structure could be established to provide the same conditions for every fund's investors throughout the EU. This solution would not preclude national structures being used for national and locally established funds. However, such an outcome does not seem possible in the short-term due to the complexities arising from the divergent fiscal treatment of investors located in different jurisdictions.

Given the complexity of the issues at stake, involving legal and taxation regulation in the Member States, the Commission advocates increased efforts to work towards a **common understanding** of the key features of venture capital funds and their investors. On this basis, the **mutual recognition of the existing national frameworks** would be a way forward. In a fragmented venture capital market, this is the most pragmatic approach **in the short-term**.

To achieve a sustainable and efficient venture capital market, the Member States, when reviewing the existing or adopting new legislation are invited to recognise the following features[18] constituting good practice:

- **Mutual recognition of venture capital funds**: a venture capital fund could be established only in its home jurisdiction and recognised in other Member State as equivalent to domestic venture capital funds and not be liable for separate establishment in each jurisdiction. National authorities could recognise that funds domiciled in another Member State and operating in their market are already subject to the regulatory regime in the home country.

- If the **fund manager**, subject to a regulatory regime in its home country, could also operate directly in the investee country without being 'established' there, operational costs and time needed would be reduced.

The Commission acknowledges that the proposed solution implies **mutually acceptable levels of supervision and transparency**. On this basis, national competent authorities could recognise that venture capital funds from other Member States are subject to similar regimes, and ensure **cooperation and comparability of supervision** within existing structures of cooperation.

For venture capital funds and management companies, adherence in spirit and substance to world-class industry standards is highly recommended. As with other contracts, firms receiving investment can use recourse to applicable legislation in cases of dispute.

[18] See the annexed Expert group report, March 2007.

6. CONCLUSIONS

6.1. Next steps and recommendations

To improve fundraising and investing across-borders, **the Commission will**:
- Analyse national approaches and barriers to cross border private placement. A report on the possibilities for establishing a European private placement regime will be issued in the first half of 2008. - Identify, together with experts from the Member States, cases of double taxation and other direct tax obstacles to cross-border venture capital investments; the expert group shall report by the end of 2008. - Based on these reports, the Commission will analyse the possibilities of defining common features in order to move towards an EU-wide framework for venture capital. The Commission will also study possible ways of assisting the Member States in the process of mutual recognition.
In order to reduce market fragmentation and improve conditions to venture capital fundraising and investing, the Commission **invites the Member States** to:
- Where it is not yet the case, *extend the 'prudent person rule'* to other types of *institutional investors*, including pension funds. - Create *a common understanding* of the features of venture capital funds and qualified investors and consider *a mutual recognition of the national frameworks.* - *Overcome regulatory and tax obstacles* by reviewing existing legislation or by adopting new laws. The aim is to give all venture capital funds the opportunity to specialise and diversify, including smaller specialist funds. For this reason, the goal is for funds and management companies to invest across borders under the same conditions as domestically. This implies the absence of a separate registration. - Enable *cooperation and mutually acceptable levels of supervision and transparency*. - Encourage development of c*ompetitive clusters* and promote *liquid exit markets.*

6.2. A partnership approach

Close cooperation between the Member States, the European Commission and the industry is essential to implement these recommendations and to progress towards a European venture capital market.

The Commission will further monitor the development of risk capital markets as reported in the **National Reform Programmes**.

The Commission will continue to work towards a more unified venture capital market that contributes to improved access to finance for innovative SMEs and will report again on these issues in 2009.