EUROPEAN COMMISSION
Competition DG

22-11-2012

Revision of the State aid rules for SME access to risk finance

ISSUES PAPER

This document does not represent an official position of the European Commission. It is a tool to explore the views of interested parties. The suggestions contained in this document do not prejudge the form or content of any future proposal by the European Commission.

Executive Summary

In the context of the envisaged modernisation of the EU State aid policy ("SAM"), the Commission proposes to review the Risk Capital Guidelines ("RCG") and the relevant provisions of the General Block Exemption Regulation ("GBER") concerning risk capital aid, in line with the Europe 2020 objectives, One of the key priorities set out in the Europe 2020 Strategy is to ensure access to debt and equity finance for SMEs in Europe through actions that leverage private investment. The objective of the present review is therefore to support sustainable growth of innovative SMEs and contribute to the quality of public spending, while discouraging aid that does not bring real added-value and distorts competition.

The current GBER provisions applicable to risk capital aid are rather narrow in scope because, on the one hand, they only cover aid provided through private/public funds investing predominantly in equity/quasi-equity on a non-*pari passu* basis, which leaves most financial instruments (FIs), including debt instruments and guarantees, outside the safe-harbour[1]. On the other hand, they only cover investments into seed, start-up and early-expansion capital, which excludes SMEs in their growth stage. Within this narrow scope, the GBER provides for relatively simple compatibility criteria[2]..

The RCG cover a wider range of risk capital measures, including private-public capital co-investment at SME level, guarantees and, fiscal incentives and are structured into two types of assessments: (i) a "standard" assessment relying on the same compatibility criteria as laid down in the GBER, except for a higher threshold for the annual investment tranches (up to €2.5 million); and (ii) a "detailed" assessment for measures requiring specific evidence of market failure beyond the presumed equity gap and justifications as to the incentive effect and proportionality of the aid.

The public consultation launched by the Commission in July 2012 has revealed that the basic principles underpinning the current regime (focus on proven market failures, leverage of private investment and commercial management) are well-founded. Simple safe-harbour rules and appropriate flexibility under the detailed assessment are also appreciated. Nevertheless, most stakeholders also call for a simplification of the current legal framework and emphasize the need to address a number of shortcomings, including risks of undue restrictiveness and over-deterrence, as well as risks of undue permissiveness and under-deterrence.

The weak performance of the European risk capital market, the Commission's case practice and the results of the public consultation, all point to the need for a far-reaching reform as regards both the <u>scope</u> of the future rules and the design of appropriate <u>compatibility criteria</u> to underpin the safe-harbour pursuant to the GBER and the substantive assessment under the Guidelines.

[1] In particular,the current GBER requires that 70% of the budget of the measure has to be made in equity and quasi-equity investment instruments, leaving only the remaining 30% for debt instruments and liquidity management.

[2] In particular, the current GBER limits the maximum investment in each target SME to annual tranches of €1.5 million per successive periods of 12 months and requires compliance with a 50%- 30% private capital leverage ratios, depending on the assisted/non-assisted status of the regions where the target SMEs have their permanent establishment. Moreover, it requires compliance with 'profit-driven investment' and 'commercial management' principles

In essence, this Issues Paper identifies the following areas for reflection and further discussion:

(i) Changing the compatibility architecture (GBER and Guidelines)

The overall architecture of the rules could be reviewed, so as to strike a better balance between well-designed automatic compatibility rules allowing for more simplicity and legal certainty, on the one hand, and a substantive assessment ensuring that potentially more distortive cases are scrutinized in order to only allow "good" aid, on the other hand. To this end, it could be envisaged to do away with the current distinction between standard and detailed assessment in the future Guidelines and to broaden the scope of the future GBER to include those cases which were so far subject to standard scrutiny.

(ii) Extending the scope of the safe harbour

The main issue proposed for discussion concerns the possibility of substantially enlarging the scope of the GBER so as to have a broader framework for SME access to risk finance. This change could be made along two dimensions. Firstly, the range of eligible SMEs could be broadened with a view to enabling support beyond the SMEs' early development stages up to their later expansion/growth stages, while providing for sufficient safeguards ensuring that investments are made only to innovative SMEs with solid business plans and high-growth potential. In this respect, support for follow-on investments and replacement capital could be block-exempted under certain conditions, so as to bring State aid rules in line with market practices.

Secondly, in order to ensure legal certainty and contribute to simplification, it would seem to be necessary to cater for different SME financing forms (equity, quasi-equity and standard debt) and for different intervention instruments (not only capital injection in a public-private fund, but a range of financial instruments and funding structures, as well as fiscal instruments). Moreover, support related to SME alternative trading platforms and pre- due diligence (scouting) activities could also be covered in the future GBER.

In this context, various stakeholders claim that the current differentiated treatment of investments in assisted and non-assisted areas reflects a cohesion objective but does not correspond to financial market realities. Therefore, the rationale for such an approach should be carefully considered. Besides, the current rules are sometimes seen as too lenient as regards too small scale (regional) venture capital funds, which are not able to diversify their portfolio, achieve adequate returns and attract sufficient private capital. One of the objectives of the reform should be therefore to provide incentives for venture capital funds to operate at an efficient scale.

(iii) Better-designed compatibility conditions

The possible extension of the scope of the regime would necessitate a thorough revision of the current compatibility conditions. For block-exempted measures, the objective is to translate the SAM principles into simple and straightforward *per se* automatic compatibility rules in the GBER, which would ensure that aid is well-designed and the overall balance is positive. For notified measures, the Guidelines should set out clear conditions under each of the relevant common assessment principles, acting as "filters" to ensure that the aid targets a material market failure, is an appropriate instrument, has an incentive effect and is proportionate, while negative effects remain limited.

The current investment thresholds (EUR 1.5/2.5 million over for successive periods of 12 months) have been criticized for being too inflexible and not reflecting the true nature and size of the funding gap affecting innovative and growth-oriented SMEs, which may go as high as EUR 10-15 million. The new regime should therefore reconcile the need to target investments at the relevant market failure, while avoiding inefficiencies in the financial markets and allowing the industry to optimise its performance through a well-diversified portfolio. In this respect, it could be considered introducing an overall investment cap covering both equity and debt finance over a sufficiently long period of time and sufficiently large to accommodate successive financing rounds (e. g. EUR 10 to 15 million).

Moreover, the future *per se* automatic compatibility rules should address one of the drawbacks of the current regime, which is a lack of sufficient safeguards ensuring the incentive effect and proportionality of aid to investors. Under the GBER, consideration should be given to the idea of better tailoring the minimum private capital participation ratios (currently 30%/50% depending on the assisted status) to reflect the risk, which normally varies in function of the development stage of the investee company. The possible extension of the scope of the GBER would probably need to be accompanied by more stringent conditions for the nature of incentives offered to private investors. The incentives must be effective in generating the leverage effect, however without undermining the genuine profit-driven character of investment decisions.

As for the future Guidelines, a stronger emphasis could be put on the requirement for an *ex-ante* assessment, to ensure that the notified measures target situations where private capital would not be invested (in the same amount or timeframe) and to evaluate the appropriateness of the measure by comparison to other policy instruments and other possible State aid instruments. Moreover, it is important to fix some key financial design requirements and procedural safeguards to ensure that aid to private investors or funds has an incentive effect (i.e. maximises private capital provision to the target SMEs without undermining the profit-driven logic of investment decisions) and is proportionate to the objective sought, taking into account the actual funding gap affecting the target SMEs and the minimum preferential treatment to be granted to private investors in order to secure their participation.

Revision of the State aid rules for SME access to risk finance

ISSUES PAPER

1. INTRODUCTION

On 8 May 2012, the Commission adopted a Communication on the EU State aid modernization[3]. The envisaged reform of State aid control is needed to strengthen the quality of the Commission's scrutiny and to shape that instrument into a tool promoting a sound use of public resources for growth-oriented policies and limiting competition distortions that would undermine a level playing field in the internal market. In addition, there is a need to better explain State aid concepts and to consolidate substantive rules.

In this context, the Commission intends to revise the state aid rules for SME access to risk capital as the ability of SMEs to access finance is of great importance to the European economy at large. Innovative, fast growing companies are a vital source for long-term economic growth. Thus, encouraging the development and expansion of new businesses, especially innovative and high-growth businesses, can contribute to growth and have great potential to create jobs in Europe. An effective funding landscape is needed for entrepreneurial companies to be able to access finances at each stage of their development.

2. MARKET FAILURES FOR SMES' ACCESS TO FINANCE

Despite their growth prospects, SMEs may face difficulties, particularly in their early stages, in gaining access to finance. At the heart of these difficulties lies a problem of *asymmetric information*: SMEs, especially when they are young, are often unable to demonstrate their credit-worthiness or the soundness of their business plans to investors. The type of active screening that is undertaken by investors for providing financing to larger companies may not be worth the investment in case of transactions involving those SMEs because the screening costs are too large relative to the value of the investment. Imperfect information in new or emerging product markets may act as a deterrent for venture capital investors and may weaken innovative firms' ability to present robust business plans to investors. Independently of the quality of their project and growth potential, these firms are likely to be finance constrained as long as they lack a proven track record and sufficient collaterals. Therefore, as a result of such information problems, business finance markets may fail to provide the necessary equity or debt finance to newly-created and potentially high-growth firms.

The consequences for a firm not receiving finance may well go beyond that single firm, due in particular to *growth externalities*. Many successful sectors witness productivity growth not because firms present in the market gain in productivity, but rather because the more efficient and technologically advanced firms grow at the expense of the less efficient ones (or ones with obsolete products). To the extent that this process is disturbed by potentially successful firms not being able to obtain finance, the wider consequences for productivity growth are likely to be negative. Allowing a wider base of companies to enter the market may then spur growth.

The supply of risk capital to SMEs in the EU is constrained by certain structural weaknesses affecting all main segments of this market: the informal venture capital

[3] Communication on EU State Aid Modernisation (SAM), COM(2012) 209 final, 8.5.2012.

(business angels), the formal venture capital (VC funds) and the alternative trading platforms.

While business angels remain the main source of risk finance for early stage businesses, there is evidence that the operation of the informal venture capital market is inefficient due to several factors, including the low visibility and scarcity of informal investors who are often confined within a narrow geographic scope, unstructured communication channels between entrepreneurs and business angels resulting in higher transaction costs and restricted choice of investment opportunities, as well as concerns about investment exit routes. Overall, the size of the European informal venture capital market is four times smaller than in the US.

As regards the formal venture capital segment, it is widely acknowledged that the European VC industry faces a fundraising gap for investments in SMEs, as it struggles to raise capital from private institutional investors who consider this asset class as unattractive because it does not deliver competitive financial returns and is too risky and illiquid. More generally, it lacks critical mass and efficient scale in terms of average fund size.

To express the relative fragmentation of the European VC industry, certain key indicators point to significant differences between the situation in the EU and in the US. In the period 2003-2010, a volume of approximately €131 billion was raised into venture capital funds in the US, against €28 billion in the EU. Moreover, the average US venture capital fund size reaches €130 million of assets under management, against €60 million in the EU. Venture capital investments make up only 0.03 % of EU's GDP, whereas the corresponding US figure is 0.14%. As a result of lack of competitive financial returns, their sub-optimal size and insufficient capitalisation, VC funds may fail to achieve two intertwined aims: on the one hand, building an overall balanced investment portfolio spread across diversified assets and, on the other, supporting individual SMEs with follow-on investments through all their development stages.

Moreover, different national regulatory and tax regimes also contribute to keep the European VC markets fragmented along national lines. SME’s financing suffers therefore not only from structural market failures but also from regulatory barriers. Furthermore, prudential regulation on VC investors, such as Solvency II for insurers, has increased investor risk aversion and further constrained fundraising.

Finally, as regards alternative trading platforms, it is commonly recognized that, although such alternative exchanges are already in place in several Member States, only a few of them have achieved critical mass. Common problems include insufficient liquidity and a shortage of listings. In addition to possible regulatory failures, this seems to be linked to information asymmetries deterring potential investments into alternative trading platforms and by the imperfect functioning of business finance markets at the earlier stages of SMEs’ development.

Most comments received during the consultation emphasise that such a failure in business finance markets translates into a "funding gap" which affects SMEs not only at their seed/start up and early expansion stages, but also at later expansion/growth stages. The funding gap is not a specific number, but can be best understood as being a function of many different factors, such as the sector concerned, the business cycle, supply and demand conditions in the financial markets and the characteristics of the company. Hitherto, the Commission has generally considered there to be a funding gap for equity and quasi-equity investments up to EUR 2,5 million. According to certain stakeholders, however, this funding gap would be significantly higher and generally affect investments of a size of €10 to 15 million, which is considered the level at which private equity providers would normally consider investing. In one specific recent case, the Commission has found, following a detailed assessment, evidence of a funding gap affecting early stage SMEs reaching GBP 5 million[4].

The economic and financial crisis has exacerbated these structural problems. Due to their historic over-reliance on debt, and with bank loans accounting for about 80% of their financing sources, SMEs have been hit particularly hard by the general contraction of the volume of debt funding available from banks. In this context, the VC industry, which normally provides a mix of equity and debt finance as a complement or an alternative to the traditional bank debt, has been unable to fill the gap. The cause seems to lay in the endemic under-capitalisation of VC funds. A recent Commission/ECB survey on SME financing[5] seems to suggest that SMEs with less than 5 years sales history are those that normally encounter more difficulties in obtaining bank loans, which may constitute an indication of the categories of SMEs the most affected by a failure in the overall business financing market.

In these circumstances, Member States may seek to facilitate access to finance for innovative and growth-oriented SME by stimulating and leveraging private investment through an appropriate use of financial and fiscal instruments. However, within the EEA, any advantage given by a public body to undertakings which has the potential to distort competition and affect trade between EU Member States is subject to the EU State aid rules. The General Block Exemption Regulation[6] (GBER) and the Risk Capital Guidelines[7] (RCG) set out the conditions that Member States should respect when granting State aid to promote access to risk capital for SMEs in their early development stages, particularly with a view to ensuring that such aid targets a proven equity gap and does not crowd out financial markets, or distort the valuations of target companies.

This Issues Paper identifies areas for reflection and indicates possible orientations on the future rules in this field. It examines whether the scope of the current risk capital regime is sufficient to cover a range of State aid measures offering incentives to leverage private capital for risk capital investments. It also discusses whether the current rules contain sufficient safeguards to ensure that incentives for private investors are effective in stimulating such private investment, so as to fill funding gaps and correct market failures, and efficient in balancing investment risks and rewards, so as to avoid overcompensation and distortions of competition.

3. THE COMMISSION'S CASE PRACTICE: BENEFITS AND SHORTCOMINGS OF THE CURRENT REGIME

3.1. The current risk capital aid regime

The General Block Exemption Regulation[8] (GBER) and the Risk Capital Guidelines[9] (RCG) set out the conditions that Member States should respect when granting State aid to

[4] SA.33849 – United Kingdom – Amendments of the Enterprise Investment Scheme and the Venture Capital Trusts Scheme.
[5] http://ec.europa.eu/enterprise/policies/finance/files/2011_safe_summary_en.pdf
[6] OJ L 214, 9.8.2008, p. 3.
[7] OJ C 194, 18.8.2006, p. 2.
[8] OJ L 214, 9.8.2008, p. 3.

promote access to risk capital for SMEs in their early development stages, with a view to ensuring that such aid targets a proven equity gap and does not crowd out business finance markets.

The **GBER** only covers investments into seed, start-up and early-expansion capital, which excludes SMEs in their growth stage. Moreover, it covers only risk-capital aid provided through private/public funds investing predominantly in equity/quasi-equity on a non-*pari passu* basis, which leaves most financial instruments (FIs) outside the safe-harbour. In particular, 70% of the budget of the measure has to be made in equity and quasi-equity investment instruments, leaving only the remaining 30% for debt instruments and liquidity management. Within this narrow scope, it provides for relatively simple compatibility criteria reflecting the need to ensure an adequate incentive effect, while limiting the aid to what is necessary without adverse crowding out effects. In particular, it limits the maximum investment in each target SME to annual tranches of €1.5 million per successive periods of 12 months and requires compliance with a 50%/ 30% private capital leverage ratios, depending on the assisted/non-assisted status of the regions where the target SMEs have their permanent establishment. Moreover, it requires that aided measures comply with 'profit-driven investment' and 'commercial management' principles.

The **RCG** covers a wider range of risk capital measures, including private-public capital co-investment at SME level, guarantees and, fiscal incentives. The RCG are structured into two types of assessments: (i) a "standard" assessment relying on the same compatibility criteria as laid down in the GBER, except for a higher threshold for the annual investment tranches (up to €2.5 million); and (ii) a "detailed" assessment mainly focused on seven specific measures included in a white list[10]. For these measures, the RCG aim at providing guidance as to how to evaluate the equity gap and the factors that influence the incentive effect and proportionality, as well as some indication as regards the potential negative effects and the balancing test.

In addition, the *de minimis* Regulation[11] allows a maximum of €200 000 over three fiscal years per undertaking, irrespective of the size of the company and the type of capital and Section 5.4 of the R&D&I Framework[12] allows young innovative small enterprises to receive maximum €1 million (or €1.25 or 1.5 million in assisted areas), which may also take the form of risk capital[13].

Since the entry into force of the current RCG in August 2006, the Commission adopted 85 decisions.[14] By way of comparison, since the entry into force of the GBER in August 2008, Member States implemented 42 block-exempted risk capital measures.[15] Therefore, on a yearly average, the Commission has adopted about 14 risk capital decisions and Member States have implemented about 10 GBER risk capital schemes. This means that the ratio of notified aid compared to GBER measures is high, which can be explained by the fact that

---

[9] OJ C 194, 18.8.2006, p. 2.

[10] These are measures providing for: (i) investment tranches beyond EUR 2.5 million per target SME over each period of twelve months, (ii) expansion capital for medium-sized enterprises in non-assisted areas (iii) follow-on investments beyond the safe-harbour thresholds, (iv) a minimum participation by private investors below 50% in non-assisted areas and 30% in assisted areas, (v) seed capital to micro and small enterprises with less or no private participation by private investors, and/or predominance of debt, (vi) directed to alternative trading platforms or (vii) to scouting costs

[11] OJ L 379, 28.12.2006, p. 5.

[12] OJ C 323, 30.12.2006, p. 17.

[13] For an example, see N 469/2009 – Germany – Fund for young innovative enterprises, Hamburg.

[14] Until 31 September 2012.

[15] Until 31 September 2012.

the GBER does not cover certain forms of aid or delivery modes which are frequently used by Member States (44 co-investment measures, 13 guarantee measures, 17 fiscal incentives notified during the reference period).

During the period 2006-2011, Member States' expenditure on risk capital aid has totalled €3.5 billion, which is low compared to other forms of aid. In particular, in 2011, only 1,11% of the total aid to industry and services was spent through measures having risk capital as their primary objective. These figures do not include market conform (*pari passu and market economy investor*) interventions. Overall, risk capital measures represent about 0.005% of EU's GDP, while venture capital investments as whole make up about 0.03 of EU's GDP.

In order to verify the impact of such a regime, the Commission has published in July 2012 a questionnaire inviting comments from all stakeholders concerned. The outcome of this consultation, as well as the experience gained by the Commission through the enforcement of the current rules, seems to suggest both positive and negative features.

3.2. Aspects of the current regime that have worked well

i. Soundness of the basic principles

The basic principles underpinning the current regime are generally accepted as they provide a sound basis for channelling Member State resources to the right SMEs while limiting risks of crowding out. Their main focus is rightly placed on proven market failures, leverage of private investment and commercial management. These principles should therefore continue to guide the Commission policy in this area and should only be adjusted in order to reflect changing market realities. However, this does not remove the need to verify whether the current rules have actually translated such principles into a clear and consistent set of compatibility criteria.

ii. Simple safe-harbour rules

The current regime has provided relatively simple safe-harbour rules for SMEs affected by proven market failures. If the GBER automatic compatibility conditions are met, Member States can implement their measures without delay or administrative costs of notification. Moreover, for such measures, compliance costs for undertakings (investors, fund managers and SMEs) seem to remain within acceptable limits.

iii. Appropriate flexibility

The current regime has proven to provide appropriate flexibility for Member States to design tailor-made risk capital schemes which do not fulfil the safe-harbour conditions. For these schemes, the Commission carries out a detailed assessment and balances the overall positive and negative effects to establish whether they target a relevant market failure and do not distort competition.

3.3. Main shortcomings

Despite such positive features, it emerges from the Commission case practice and the public consultation that, in its practical implementation, the current regime for risk capital may have encountered the following problems.

i. Risks of undue restrictiveness and over-deterrence

In general, the current risk capital regime is considered to be too restrictive both in terms of eligible SMEs and their financing forms, aid instruments and funding structures.

The main issue raised in this respect is that, at present, the GBER and the Guidelines target only SMEs in their early-growth development stages (seed, start-up and expansion phases). However, there is evidence suggesting that SMEs in their later-growth stages also face the same type of market failure when seeking access to a level of finance which is below the level required by private equity investors. In addition, certain commentators have also expressed the view whereby, the application of the general definition of SMEs would unduly exclude those firms whose growth and job-creation potential lead them to exceed the headcount thresholds set out for SMEs in Commission Recommendation 2003/361[16] .

A second main issue stems from the fact that the current rules require that 70% of the total budget of the risk capital measure takes the form of equity or quasi-equity investment, leaving the remaining 30% for possible debt instruments and/or for liquidity management. Case experience shows however that a considerable number of measures uses part of the funds' allocation for the provision of sub-commercial/unsecured loans linked to equity investments[17], market-conform loans[18] or *de minimis* loans. This requirement could have, therefore, unduly restricted the ability of fund managers to strike the appropriate balance between equity and debt in their deals with target SMEs, thereby deterring potential investors seeking for a balanced mix of fixed returns generating an income stream combined with good prospects for future capital gains.

Finally, it has also been observed that lack of clarity as to the criteria applicable to, and the evidence required under the detailed assessment for approving aid to alternative trade platforms has discouraged Member States to design proper measures aiming at correcting possible failures in this market segment. In the reference period, the Commission was notified and approved only one measure for an alternative SME marketplace[19].

ii. Risk of undue permissiveness and under-deterrence

In some respects, the current rules may also be too permissive. A concern relates to the effectiveness of mechanisms for limiting aid to the investors or to the funds so as to keep it proportionate in view of the objective sought. In essence, aid to investors is presumed to be proportionate if the investments at the level of the target SME are limited to the annual investment tranche, which does not capture the quantum of aid for large investors. Consequently, investors may theoretically invest unlimited amounts under the measure, or benefit from any type of fiscal advantage, entitling them to large and/or unquantifiable amounts of State aid.

A second important concern relates to the effectiveness of the current rules in providing for the necessary safeguards against territorial restrictions (e.g. the requirement to only invest funds in a particular region) which may contribute to the fragmentation of VC industry and hamper the development of the internal market in this area. This issue is particularly pertinent as a large number of risk capital measures are regional in dimension (about 50% of the decisions in the reference period). The question here is whether too little or too local VC funds may end up financing inefficient firms or ignite subsidy races across regions with increasingly different funding capabilities.

---

[16] OJ L 124, 20.5.2003, p. 36.

[17] E.g. N 68/2009; N 136/2010; N 722/2009; SA.32147; SA.32835; SA.32525.

[18] E.g. N 355/2008; N 700/2007; N 395/2007; SA.34006. Loans are considered to be market-conform if they respect the reference rates.

[19] Case C 36/2005, Investbx, OJ L 45, 20.2.2008, p. 1. The positive decision was adopted following the opening of a formal investigation.

Finally, fully public funds investing seed capital into small companies without any private investment at any level are currently subject to a 'light' detailed assessment[20]. The question arises whether sufficient safeguards are in place to ensure that the screening of projects is undertaken in a profit-oriented manner, so that only the most viable companies are supported. More in general, the current RCG do not specify the type of evidence which should be required to properly balance the positive and negative effects of such measures under detailed assessment. Moreover, as regards the assessment of the negative effects of risk capital measures, the current rules seem insufficiently clear.

iii. Unnecessary administrative and compliance costs

Under the current regime a number of measures which are likely to be unproblematic need nevertheless to be notified and assessed under the RCG.

Firstly, the scope of the GBER only covers public-private funds and excludes other common funding structures (e.g. co-investment of public funds and private capital at the level of each target SME), as well as certain widely used instruments (fiscal incentives, guarantees and other financial instruments), which therefore require notification and individual scrutiny. In particular, they do not provide an adequate legal framework for the assessment of fiscal measures clarifying when such measures are to be considered selective, such as to entail State aid. Pursuant to recent case practice, even if a fiscal incentive is open in principle to all investors and/or funds, irrespective of their forms, it may be *de facto* selective for instance because it may confer an indirect economic advantage to the target SMEs[21] or because the eligible investments have to comply with the investment restrictions required by the RCG[22]. As a result, Member States have notified a significant number of fiscal incentives, most often in the form of tax reductions or tax exemptions to investors or funds, which have led the Commission to adopt 17 decisions in this area during the reference period.

Secondly, measures which meet all the conditions of the GBER but foresee annual investment tranches between € 1.5 and 2.5 million require notification and are subject to a standard assessment under the Guidelines. This triggers unnecessary administrative and compliance costs for the assessment of cases for which market failures may be presumed and which are unlikely to raise serious competition concerns.

Finally, the same can be said for measures directly targeting scouting costs which must undergo a detailed assessment pursuant to Section 5 of the RCG[23].

iv. Inconsistencies with market practices and lack of clarity of certain compatibility conditions

In the first place, most stakeholders strongly advocate that the regional dimension built in the GBER and RCG does not correspond to market realities and commercial logic. This criticism touches upon several provisions of the current regime, intended to differentiate

[20] See e.g. N 263/2007 – Germany (Saxony) – Saxon Early Stage Fund (Technology Founder Fund Saxony).
[21] C 2/2009 – Germany – MoRaKG.
[22] For a recent decision, see SA.34582 – Italy – Measures to encourage risk capital investments in newly created enterprises. This measure foresaw a tax exemption for investors investing in SMEs through investment funds, independent of their form.
[23] The Commission approved only two measures involving scouting costs: N 629/2007 – France Régime cadre d'interventions publiques en capital-investissement régional, amended by N 415/2010; and N 722/2009 – Italy (Region Lazio) – Risk capital aid scheme, amended by SA.32525.

Sate aid control to favour investments in assisted regions.[24] It is argued that SMEs' growth potential and ability to access finance would not depend in fact on their location in a particular region, as business finance markets are national in scope or even wider.

In the second place, case experience shows that the use of innovative financial instruments has rapidly developed in recent years and the current rules may not be sufficient to duly cover measures involving these instruments. The GBER covers only a public-private venture capital fund model, excluding other types of financial instruments and funding models. While the current Guidelines foresee a range of financial instruments, they do not specify any key criteria for their design and the funding models. Thus, while a number of measures coming within the JEREMIE programme[25] were adopted under the Guidelines, two recent decisions regarding JESSICA measures[26] required an assessment directly under the Treaty[27]. This is a particular source of concern given the wider use of financial instruments which is currently foreseen under the next Multiannual Financial Framework to support diverse policy objectives, including SME access to finance..

Finally, there are a number of concepts in the Guidelines which are open to interpretation or difficult to apply in practice. Thus, it appears that the criterion of commercial management underpinning the safe harbour rules gives rise to divergent interpretations, in particular in the case of public funds managed by public sector bodies. Another question relates to the need for the measure to leverage private capital up to the required minimum ratios and to the weigh that 'love money'(i.e. capital invested by the owner of the target firm or his relatives and friends) should have in establishing the proof of the incentive effect of such a measure[28], as well as the qualification as private capital of market-conform interventions by public entities. More in general, the minimum requirement of 50% or 30% private participation depending on the non-assisted/assisted status of the investment area is claimed to be particularly difficult to achieve irrespective of location for measures supporting SMEs in their seed stage.

4. REVISING THE RISK CAPITAL RULES: A PROPOSED NEW ARCHITECTURE

Structural problems of the European risk capital market, the Commission's case practice and the results of the public consultation all point to the need for a far-reaching reform of the current risk capital aid rules as regards both the scope of the rules and the compatibility criteria to underpin the safe-harbour criteria of the GBER and the substantive assessment under the RCG.

The proposed policy reform can be designed along three main substantive directions and

[24] In particular, at least 50% private participation is required if the measure targets SMEs located in non-assisted areas, while this ratio is reduced to 30% in assisted areas. Moreover, in non-assisted areas, medium-sized companies in their expansion phase are excluded from the scope of the GBER and require detailed assessment under the RCG. Also, the cumulation rules are different according to the assisted and non-assisted status of the target investment area.

[25]JEREMIE financial engineering instruments pursuant to Article 44 of Regulation (EC) No 1083/2006, Articles 3(2)(c), 4(1), 5(1)(d) and 6(2)(a) of Regulation (EC) No 1080/2006, Article 11(1) of Regulation (EC) No 1081/2006 and Articles 43 to 46 of Regulation (EC) No 1828/2006.

[26]JESSICA financial engineering instruments financial engineering instruments pursuant to Article 44 of Regulation (EC) No 1083/2006, Articles 3(2)(c), 4(1), 5(1)(d) and 6(2)(a) of Regulation (EC) No 1080/2006, Article 11(1) of Regulation (EC) No 1081/2006 and Articles 43 to 46 of Regulation (EC) No 1828/2006.

[27] SA.32147 – Spain – Andalucía Jessica Holding Fund; SA.32835 – United Kingdom – Northwest Urban Investment Fund (JESSICA).

[28]For recent cases where 'love money' counted towards the required level of private participation, see cases SA.31730 – France – Fonds National d'amorçage; and SA.34006 – Italy – Fondo regionale di Venture Capital.

can be implemented to represent an important contribution to simplification

First, if properly framed, financial and fiscal incentives for risk capital and risk finance are probably least distortive and more growth-enhancing State aid instruments than grants. They work upstream and preserve the market incentives to select the most promising ventures (rather than picking winners or supporting losers), while facilitating entry and competition. Risk capital aid measures may also help bridging the gap between the successful achievement of R&D results and the translation of such ideas into marketable products. This justifies an e ambitious policy proposal. However, venture capital funds should be free to operate at an EU scale to reap the benefit of the single market rather than partitioning it into protected regional enclaves.

Second, the financial crisis has left large scars especially in some Member States for access to finance for young and innovative firms. There is scope therefore for extending the forms of interventions from risk capital to risk finance, thereby providing more flexibility as to the instruments to be used.

Third, many small firms lack the capacity to make the dimensional jump to become larger enterprises competitive at a global scale. Hence, State aid policy should provide smart incentives to allow small young innovative firms to become EU champions rather than over-subsidizing small firms with limited growth prospects.

In the light of these considerations, it is considered to review the overall architecture of the rules, so as to strike a better balance between well-designed automatic compatibility rules allowing for more simplicity and legal certainty, on the one hand, and a substantive assessment ensuring that potentially more distortive cases are scrutinized in order to only allow “good” aid, on the other hand.

To this end, it is suggested to do away with the current distinction between standard and detailed assessment in the future Guidelines and to broaden the scope of the future GBER to include certain cases which were so far subject to standard scrutiny. However, in order to achieve this objective, the compatibility safe-harbour criteria required under the GBER should be revised and the future Guidelines strengthened in terms of analysis of market failure, incentive effect, proportionality and negative effects.

In the following two sections, this Issue Paper will firstly discuss the proposed approach for better designing the scope of the future regime so as to foster a more efficient access to risk finance for innovative SMEs (Section 5). Secondly, it will provide some initial indications as to the rules which could be set out in the GBER and in the Guidelines in order to ensure that aid measures are effective in addressing the relevant market failure, are proportionate and have an adequate incentive effect, while keeping distortions of competition to the minimum (Section 6).

5. SCOPE OF THE PROPOSED NEW SME AID REGIME FOR ACCESS TO RISK FINANCE

5.1. Objective of common interest

One of the key priorities set out in the Europe 2020 Strategy is to ensure a healthy supply of and access to debt and equity finance for SMEs in Europe through actions well designed to stimulate and leverage private investments.

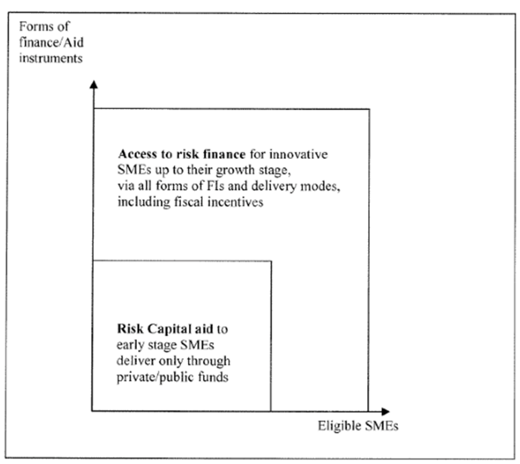
In particular, in order to facilitate SME access to finance, the Commission committed itself to adopt, by 2012, new rules whereby venture capital funds established in any Member

State may freely invest throughout the EU. Member States were also invited to remove tax obstacles so that tax treatment in different jurisdictions would not lead to double taxation and hamper cross-border flows.

Moreover, the Commission has proposed new financial instruments (FIs)[29] to facilitate SMEs' access to finance under the 2014-2020 MFF, while optimising the use of public resources through revolving funding mechanisms. Thus, under the future Common Strategic Framework for cohesion policy, the use of FIs (both equity and debt) will be enhanced, by extending their scope and by rendering their implementation frameworks more flexible and effective. In addition, the integrated implementation of COSME[30] and Horizon 2020[31] will endeavour to improve access to equity and debt finance for SMEs in their start-up and growth phases, with a particular emphasis on actions designed to provide seamless support from innovation to market, including the commercial implementation of R&D results.

In view of such a common interest objective, it is appropriate to reflect about the possibility to substantially change the scope of the current regime along two dimensions. Firstly, the range of eligible SMEs should be broadened so as to enable support beyond early-growth stages up to their later expansion/growth stages, while providing for sufficient safeguards ensuring that investments are made only to innovative SMEs with solid business plans and high-growth potential. Secondly, in order to ensure legal certainty, it would be necessary to cater for the different forms of finance by capturing under the GBER safe harbour all the relevant Financial Instruments (FIs) and funding structures, as well as fiscal instruments. At the same time, the new rules should also respond to the need to facilitate the development of a more efficient Internal Market for venture capital.

In practice, such a change would imply a shift from a State aid regime for risk capital to a broader framework for SME access to risk finance. The diagram below illustrates the extent of the possible change in scope for the safe-harbour under the future GBER:



This possibility is consistent with the spirit of the SAM, and in particular with the objective of fostering growth of young innovative SMEs, while focusing the substantive assessment on a more limited number of cases with the biggest impact on the market.

---

[29] FIs cover non-grant financial instruments, which may take the form of debt instruments (loans, guarantees) or equity instruments (pure equity, quasi-equity investments or other risk-sharing instruments).
[30] http://ec.europa.eu/cip/files/cosme/com_2011_0834_proposition_de_reglement_en.pdf
[31] http://ec.europa.eu/research/horizon2020/pdf/proposals/communication_from_the_commission_-_horizon_2020_-_the_framework_programme_for_research_and_innovation.pdf#view=fit&pagemode=none

5.2. A market failure extending beyond the early growth stage for innovative SMEs

i. Definition of eligible SMEs

It has been observed that the current definitions of SMEs development stages are intrinsically vague and open to interpretation, which could introduce an artificial bias in the design of risk capital measures. Besides, it is frequently argued that an innovative SME in its later expansion/growth stage might still face funding constraints as the financing gap would mainly depend on the required size of the investment (too high for traditional business angels and too small for typical VC financing and private equity investments[32]).

In order to better reflect the nature of the relevant market failure, it is suggested to consider the possibility of extending the scope of the GBER beyond SMEs in their early-growth stages so as to cover SMEs in their later expansion/growth stages by defining the target group as SMEs which have not exceeded a 5-year period following their first sale on a market.[33]

The aim is to provide a straightforward and operational eligibility criterion that would adequately capture companies facing a funding gap (due to their lack of track record/reputation, small scale and/or their inherent business risk) and uncertainty of cash flows for the financing needs of their growth plans (e.g. ramp-up of capacities for the production of new products).

Moreover, additional conditions regarding minimum leverage ratios, requirements for all debt financing to be provided only to equity-backed firms and adherence to profit-driven investment and commercial management principles will be devised so as to ensure that only potentially high-growth, innovative companies are selected (these aspects are discussed below in Section 6)

ii. Follow-on investments

The exclusion of follow-on investments under the current rules has been criticised for two main reasons. Firstly, such a restriction could prevent the financing of further investment rounds thereby deterring potential investors who may fear a dilution of their stake in the company and, secondly, it could undermine the profitability of private and public investments in venture capital funds by limiting their exit strategies. On the other hand, evidence of a structural funding gap for growth-oriented investments seems to suggest low risks of crowding out.

In view of these considerations, it is suggested to extend the scope of the safe harbour under the GBER to follow-on investments in SMEs beyond the 5-year period. As the timing of follow-on investments may vary considerably from firm to firm, it could be probably difficult to correlate the relevant market failure with any meaningful time-limit. Instead, one could link the seriousness of the market failure for follow-on investments with a condition allowing investments at the level of each individual investee up to a maximum

[32] The size of the investment would be too small compared to the fixed screening costs undertaken by VC and private equity funds. Therefore, the expected cost-adjusted returns would be too low.

[33] This rule could eventually be further refined by referring to the first entry in a new product market. Moreover, even for established SMEs equity and debt finance may be extremely difficult to obtain when they decide to move their activities into a completely different market. Banks do not generally provide this type of "transition finance" as they can no longer rely on the existing track record of the company. Therefore these companies may need managerial expertise by VC funds and require alternative finance, normally in the form of quasi-equity or specialised loans to fund such transition.

investment amount, reflecting the size of the funding gap (for more details see Section 6.1(i) below)

iii.. Replacement capital

It is claimed that the funding system for growth-oriented companies should be appraised as an interconnected system of different sources of finance intervening at different stages of the business lifecycle, where earlier providers may sell all or part of their shares to later investors in accordance with their respective exit and entry strategies. However, the current restrictions limit the possibility for aided VC funds to acquire shares from business angels or other VC funds willing to exit their investments. Therefore, it has been argued that State aid rules should not exclude replacement capital when this is necessary for one provider of capital to exit and in order for other investors to finance new growth investments. A more far reaching view has also been expressed whereby the wider restriction placed on aided VC funds to refrain from investing in all types of LBOs could impede private investors to fully reap the benefit of their investment, thus limiting the efficiency and the fundraising potential of such funds.

Evidence from the market would suggest that it cannot be presumed, as a general rule, that aid for replacement capital necessarily entails negative effects. VC funds acquiring shares from previous investors (e.g. business angels) and bringing additional fresh capital into the investee may very well have the positive effect of facilitating the exit of the former (thus enhancing their ex-ante incentives to invest) while sustaining the growth prospects of the latter. Moreover, the additional capital contributed to the investee should avert the risk of excessive aid being passed on to exiting investors.

Therefore, it is considered to allow aid for replacement capital, on the condition that such type of investment is combined with the provision of new growth capital and the size of the latter is significant relative to the overall size of the investment.

5.3. A market failure affecting all forms of SME finance and justifying different aid instruments

i. Different forms of finance

The current rules aim at stimulating risk capital investments predominantly in the form of equity or quasi-equity, as opposed to standard debt, so that the investment entails a significant degree of risk and its potential returns depend on the underlying company's profits. In view of this objective, the GBER fixes a minimum threshold of 70% for equity and quasi-equity instruments, which means that the fund's capital available for debt financing and liquidity management purposes is capped at 30%.

Two main issues have been raised in this respect. Firstly, it has been argued that the asymmetry of information problem is to a large extent the same for debt and equity investors and is generally due to the inability of early growth companies to signal themselves as viable business opportunities. Therefore, the scope of the current rules should be extended so as to cover all forms of risk finance (equity, quasi-equity and debt provided by VC funds or directly by private investors).

Secondly, stakeholders have also pointed out certain differences which distinguish traditional bank lending from specialised business finance. In particular, differently from VC providers, banks privilege investments yielding fixed returns over risk-sharing. Moreover, a financial institution's decision to lend is based primarily on collateral and track record and to a lesser extent on the economic viability of the business. Furthermore, VC fund managers combine the provision of finance with business expertise and management services, which is not the case in the framework of standard bank debt. It would follow that, the objectives and incentives of the two categories of finance providers being different, State aid rules should reflect such diversity.

Considering the above, one possible option could be to extend the scope of the safe harbour and cover under the GBER any forms of risk finance, such as non-*pari passu* equity, quasi-equity, guarantees and loans provided via financial intermediaries. However, in order to ensure that pure debt financing instruments are made available to high-growth and innovative SMEs and do not support established businesses and/or financial institution acting as intermediaries, two conditions should restrict the use of such different forms of finance. Firstly, pure debt instruments should expressly target only equity-backed SMEs, i.e. firms where equity is provided by independent external investors following a screening supporting the likelihood of their growth prospects. Secondly, in order to exclude aid at the level of the financial intermediaries, debt instruments should ensure that any advantage granted to lenders (for instance in the form of sub-commercial guarantees) has to be fully passed on to the target SMEs.

ii. Different funding structures

The current GBER covers only one type of aid instrument whereby State resources in the form of risk capital are provided as "participation into a profit driven private equity investment fund". This means that only the classic private-public fund model is covered, This also means that a large number of measures involving funds of funds and direct co-investments at the company level by a fund entirely endowed with public capital must be assessed pursuant to the RCG.

In most instances, such cases are not problematic, notably because the compatibility conditions under the GBER and the standard assessment criteria under the RCG are substantially the same. As a result, the issue has been raised as to what extent the compliance costs for Member States to undergo the full notification process are justified by the added value arising from the Commission's individual scrutiny. On the one hand, measures involving public funds leveraging co-investments at the level of the target SMEs may require appropriate conditions for ensuring an effective commercial management and profit-driven investment decisions, namely when such funds are run by in house managers.

In the light of this, it is suggested to consider the possibility of extending the scope of the GBER to various measures (i) targeting funds of funds or (ii) supporting direct co-investments at the company level by public funds. Nevertheless, the principles of commercial management and profit-driven investment decisions should be adjusted and strengthened (e.g. by requiring the presence of independent experts in the fund management board. For further details, see Section 6.3 below).

iii. Fiscal incentives

In addition, the scope of the GBER could be extended to cover fiscal instruments which are currently assessed under the RCG following systematic notification of all types of fiscal incentives to investors and funds (e.g. tax incentives to natural persons, reliefs on corporate taxes, tax credits, fiscal breaks on capital gains).

Both the public consultation and case practice confirm that fiscal measures are in direct correlation with the amount of private investment raised from business angels and/or by VC funds and are very efficient in incentivising investments into the appropriate category of innovative and high-growth SMEs, while leaving the actual selection to the market.

At this stage of the revision process, one could consider extending the safe-harbour in respect of fiscal advantages granted to natural persons investing directly or indirectly into target SMEs. This broadening of the safe-harbour could require the introduction of a new condition whereby the aid measure should not exclude any financial intermediary fulfilling predefined and objective criteria justified by the nature of the investment and should not discriminate between financial intermediaries on the basis of their place of establishment. This should avoid undue distortions in the market for business finance and support the creation of a true internal market for venture capital.

Other fiscal incentives, namely those granted to corporate investors and/or to specific categories of funds would in principle continue to be subject to substantive assessment under the future Guidelines in order to better verify the incentive effect and proportionality of the aid..

iv. Aid to alternative trading platforms

Alternative exchanges specialised in SME (mainly high-growth and innovative firms) are not only a means to attract new private investors into viable SMEs at their expansion/growth stage, but also an effective exit route for earlier investors. However, such platforms are faced with the same market failure which generally affects this type of businesses, as the screening and listing costs may be too high compared to the value of the investments. For this reason, as pointed out above, direct or indirect aid to alternative trading platforms may be necessary for maintaining a seamless financing ladder for innovative SMEs.

In practice, there are two main forms of support for such platforms: The first consist in providing fiscal incentives to investors who invest in SMEs traded on such platforms. For this type of indirect aid to the platform, it seems desirable, following the same reasoning as for fiscal incentives to investors via VC funds, to include such fiscal measures under the future GBER. The second is aimed at subsidizing the platform as such. For this type of direct aid, which often involves direct grants to newly established platforms, it is suggested to clarify the relevant compatibility conditions in the future Guidelines, in line with recent case practice[34].

v. Aid for pre-due diligence costs

The current GBER excludes a range of measures (including grants) that specifically target the so-called 'scouting costs' (i.e. the costs linked to the first screening of companies in view of the conclusion of the investment up to the due diligence phase). These measures are subject to detailed assessment under Chapter 5 of the RCG, which establishes a positive presumption when the grant excludes the legal and administrative costs of the fund and does not exceed 50% of the eligible costs.

While the Commission's case practice concerning aid for scouting costs[35] has been

[34] Investbx (C 36/2005, Investbx, OJ L 45, 20.2.2008, p. 1).

[35] N 629/2007 – France – Régime cadre d'interventions publiques en capital-investissement regional, amended by N 415/2010, and N 722/2009 – Italy (Regione Lazio)- Risk capital aid scheme, amended by SA.32525.

relatively limited, there appear to be sound grounds for including these measures under the future GBER, as these measures do not relate to a distinct market failure but try to solve the same information asymmetry problem.

To provide for the necessary flexibility in devising well targeted aid measures related to such a market failure, it seems desirable therefore to include measures supporting the costs for the scouting and initial screening of eligible SMEs under a specific provision of the future GBER. To provide more clarity, it might be necessary to introduce a definition for eligible scouting costs incurred in the phase prior to formal due diligence, as well as appropriate maximum intensities.

5.4. Efficient fund scale and internal market dimension

As indicated above, a number of regional restrictions,[36] intended to differentiate State aid control to favour investments in assisted regions, are questioned as they lack a clear link with the relevant market failure (which generally affects investments below a certain size and investees at certain development stages, irrespective of their location). Many stakeholders claim that such a differentiated treatment is rather aimed at a cohesion objective, not corresponding to market realities. Therefore, the rationale for such a regional approach should be carefully considered.

In addition to the regional restrictions, the current rules are sometimes seen as too lenient as regards risk capital aid measures involving too small scale (regional) funds, which are not able to differentiate their portfolio, achieve adequate returns and attract sufficient private capital. One of the recurrent problems raised in the comments received during the public consultation concerns the sub-optimal scale of many VC funds seeking to attract private capital at fund level, particularly regional funds, and the ensuing fragmentation of the VC industry across all Member States.[37] While proximity matters for business angels, a regional focus for more institutionalized venture capital funds may result in a small pool of investment targets and unsatisfactory performance, and therefore more reliance on continuous State aid.

Given the above, one of the objectives of the reform should be to provide incentives for the setting up of larger VC funds operating at an efficient scale. In this perspective, it could be possible to introduce incentives to avoid aid to VC funds with a too narrow geographical and/or sectoral scope that are unlikely to produce sufficient returns. The exact conditions are to be worked out in light of the upcoming consultations. In this perspective, it could be discussed whether a requirement might be introduced whereby, in order to be block-exempted, aid measures should require from eligible funds to present a business development plan demonstrating their ability to achieve a certain minimum size, including in terms of territorial scope of investments.

6. KEY COMPATIBILITY CONDITIONS UNDER THE FUTURE GBER AND GUIDELINES

The suggested extension of the scope of the regime for risk finance would necessitate a

[36] For standard measures, the regional dimension is reflected in the following three rules: (i) risk capital investments in medium sized enterprises established in non-assisted areas are limited to the start-up stage (ii) a lower level of private participation is required for investments in assisted areas, (30%) as compared to the requirement applicable to non-assisted areas (50%); and (iii) more relaxed cumulation rules apply to investments in assisted regions.

[37] During the reference period, about 50% of all decisions in the risk capital area concerned regional measures An approximate figure of the average size of regional funds is between €20 and 25 million.

thorough revision of , the current compatibility conditions, in line with the common principles devised within SAM, with a view to supporting "good aid" while limiting competition distortions and contributing to competitiveness and growth in the internal market.

For block-exempted measures, the objective is to translate these common principles into simple and straightforward *per se* automatic compatibility rules in the GBER, which would ensure that aid is well-designed and the overall balance is positive.

For notified measures, the future Guidelines should set out clear and concrete conditions under each of the relevant common assessment principles, which will act as "filters" to ensure that the aid targets material market failure, is an appropriate instrument, has an incentive effect and is proportionate, while negative effects remain limited. This would mean that if one of these common principles is not met, the aid would not be compatible. By contrast, if all the common principles are fulfilled a balancing of the positive effects in terms of contribution to the objective of common interest and the potential distortions on competition (negative effects) would be undertaken in a second step.

The sections below outline key ideas for the suggested conditions to be fulfilled for aid to be considered compatible with the Treaty, both for block-exempted measures (GBER) and measures to be assessed by the Commission under the Guidelines[38].

6.1. Objective of common interest and market failure

As discussed in Section 5 above, the objective of improving access to risk finance for young and innovative SMEs is to be seen as an objective of common interest within the meaning of Article 107(3)(c) since an efficient and competitive internal SME finance market contributes to foster economic growth in the EU as a whole.

However, State aid may only be justified if it is targeted at a material market failure affecting the achievement of an identified objective of common interest. In this respect, the Commission considers that there is no general market failure affecting all SMEs without distinction, but market gaps for some types of investment at certain stages of SMEs' development due to imperfect information resulting in high transaction and agency costs. Therefore, the future regime needs to provide clear and operational criteria reflecting the nature and size of the market failure faced by innovative SMEs up to their growth stage.

i. Automatic compatibility rules (GBER)

The current rules under the GBER have been criticised for being too strict and too inflexible to reflect the true nature and size of the relevant market failure. On the one hand, the maximum investment tranche of €1.5 million for successive periods of 12 months is seen as totally insufficient to fill the funding gap that innovative SMEs are facing. Even the threshold of €2.5 million fixed in the RGC for defining the scope of the standard

[38] The following main types of measures would require a substantive assessment under the future Guidelines: (i) measures supporting investments above the maximum investment threshold; (ii) measures providing for a minimum participation by private investors below the GBER ratios; (iii) aid instruments providing non *pari passu* loss sharing where the State is in a first loss position; (iv) funds below a certain size; (v) fiscal incentives other than those granted to natural persons (i.e. exemptions on corporate taxes). It should be emphasised that, at this stage of the consultation process, this list should be regarded as non-exhaustive and subject to further discussion. Nevertheless it may provide a good indication of the types of cases which will require notification.

assessment would underestimate the size of such a gap, and figures as high as € 10 to 15 million have been floated as more realistic parameters. On the other hand, the limitation by periods of 12 months would be the cause of an undesirable rigidity because, in reality, the volume and frequency of individual investment tranches do not follow any standard pattern, and subsequent capital injections may form part of the same initial investment commitment. Such rigidity would therefore amplify the claimed inadequacy of the current thresholds. This problem would be especially severe in particular sectors with high capital requirements for growth and, more in general for capital-intensive industries (e.g. biotech, environmental, medical & pharmaceutical, and certain high technology sectors).

In order to avoid that undue restrictions in the legal framework put a strait-jacket on VC industry and create inefficiencies in SME finance markets, the threshold should reconcile the need to allow industry to optimise the performance of its investments for each individual deal with the need to avoid subsidy races between Member States and distortion of competition between SMEs.

In view of these considerations, a possible option could be to do away with the current system based on annual investment tranches and introduce an overall investment cap covering both equity and debt finance over a sufficiently long period of time as from the initial commitment, and sufficiently large to accommodate successive financing rounds including follow-on investments. Bearing in mind that, currently, risk capital measures are allowed if the investment tranches are limited to € 2.5 million every 12 months with no limitation as to the number of tranches, the value of the cap could for instance reflect the sum of the standard € 2.5 million investment threshold, multiplied by 5 to 7 years (corresponding to an average holding period) and be fixed at an overall level of €10 to 15 million.

ii. Substantive assessment (Guidelines)

For measures targeting investments beyond such an overall cap, a substantive assessment based on specific evidence of the relevant funding gap could apply

The current RCG contain an indicative enumeration of specific indicators of market failure which, while relevant, may be insufficient or ineffective to establish the required link between evidence of a market failure at macro level and the proposed design of the measure.

Should the possible widening of the safe-harbour under the GBER be accepted, it will be inevitably very important to strengthen the requirements for Member States to provide specific evidence of a link between the macro-level findings and the proposed design of the measure. For this, a proper *ex-ante* assessment should be provided in the form of a comparative impact analysis, taking as a basis the specific profile of the target beneficiaries, i.e. eligible SMEs, funds and private investors, so as to confront different counter-factual scenarios.

The future Guidelines should avoid being too prescriptive with regards to the content of the *ex-ante* assessment. Nevertheless, they could lay down key principles to be covered in the *ex-ante* assessment, such as the identification of the market failures that give raise to sub-optimal investment situations (funding gaps) affecting the companies targeted by the measure, constraints affecting the investors and intermediaries that do not provide adequate financing to the target companies, as well as a comparative analysis of policy options to address the constraints.

Moreover, for measures targeting firms of intermediate size (namely those companies which, as a result of the successful implementation of their growth plans, exceed the headcount threshold fixed in the SME definition), the future guidelines could specify the type of evidence which would be required to conclude that aid may be justified by a specific market failure affecting such companies.

6.2. Appropriateness of aid

As a general principle, each State aid measure must be an appropriate instrument to tackle the identified market failures and be an effective tool to pursue the relevant objective of common interest compared to alternative policy measures or other State aid instruments.

i. Automatic compatibility rules (GBER)

Under the current GBER, risk capital aid is presumed to be an appropriate instrument if the safe harbour conditions are met. It could be envisaged to maintain the same approach in the new GBER, meaning that the appropriateness of risk finance aid measures could be presumed in so far as the future safe harbour criteria under the GBER are complied with.

ii. Substantive assessment (Guidelines)

For measures falling outside the safe-harbour, it is considered to evaluate the appropriateness of State aid compared to other policy instruments, as well as compared to other aid instruments. This would deviate from the current RCG, which requires Member States to only provide evidence demonstrating that State aid is an appropriate instrument to address the identified market failure compared to other policy instruments.

As a first step, all notifications should provide evidence demonstrating how the proposed measure fits in the context of other policy interventions which may be equally effective in enhancing a well-functioning ‘funding ladder’ for the eligible SMEs, and justify why the proposed measure is an appropriate tool to address a proven equity gap. In this context, the possibility of using market-conform (*pari passu*) interventions should also be addressed. As a second step, Member States should justify why the form and design of the proposed aid instrument is more appropriate than alternative aid instruments. For instance, should the measure consist in setting up a public fund co-investing at the level of each target SME, Member States should demonstrate that the establishment of a private/public fund would be unfeasible or less efficient under the concrete circumstances addressed by the measure.

Alternative policy options and other State aid instruments should be evaluated as part of the *ex-ante* assessment on the basis of well-established methodologies, such as cost-benefit analysis, benchmarking, comparison of instruments.

6.3. Incentive effect

State aid must have an incentive effect, i. e. it must induce the aid beneficiary to undertake activities contributing to the achievement of a common interest objective, which it would not carry out without the aid or would carry out in a restricted or different manner. State aid should play a catalytic role by leveraging private capital to the target businesses, which would not be provided otherwise or would not be adequate in terms of form of finance, amounts or timing.

i. Automatic compatibility rules (GBER)

Under the current GBER, an incentive effect is presumed if State aid granted through private-public funds leverages a minimum flat ratio of private capital (30% in assisted and 50% in non-assisted areas). In addition, the current GBER contains conditions to ensure profit-driven and commercially managed investments. Such an approach has given rise to three types of problems.

Firstly, the current requirements take into account only the regional dimension, but not the degree of market failure, which normally depends on the development stage of the eligible SMEs, hence their size, age, sales history and evidence of credible growth prospects. Only for measures subject to the detailed assessment, the current rules allow lower participation of private investors in seed stages. Therefore, the issue is whether the current flat ratio of private capital requirements is appropriate, considering that the optimal leverage effect may vary from one eligible investee to another.

Secondly, the current rules are not sufficient to ensure that the various aid instruments, used to leverage private capital into the eligible SMEs, are effective in achieving the desired incentive effect. In theory, Member States could grant any type of downside risk protection and/or profit enhancing incentives in order to leverage the minimum required level of private capital. This could lead in particular to private investors benefitting from an extensive downside risk protection, e.g. by public capital being in an uncapped first loss position, which could in turn undermine the profit-driven logic of the investment decisions.

Thirdly, case practice shows that the concepts of profit-driven investments and commercial management are not sufficiently clear and, more importantly, are largely built on a standard VC fund model.

In order to reflect these three dimensions of the problem, it is considered to revisit the current rules so as to presume the existence of an incentive effect for measures compling with the following conditions.

Firstly, it is considered to <u>better tailor the ratios of minimum private capital so as to reflect the relevant funding gap</u>, which normally varies in function of the development stage, as risk tends to decline as a business develops. Thus, for pre-sales stage such a ratio could be [20-30]% for SMEs within the 5 years post-first sale period such figure should be higher, e.g. [40-50]% and for follow-on investments after the eligible 5-year period, it should be further increased up to for instance [60-70]%. It might also be envisaged to delink minimum private participation from the assisted/non-assisted status of the area of establishment of the target SMEs. It should also be made clear that the minimum private capital requirements apply to private investors that are independent of the target companies (as opposed to 'love money').

Secondly, the possible extension of the scope of the GBER would probably need to be accompanied by <u>more stringent conditions for the nature of incentives offered to private investors</u>. The incentives must be effective in generating the leverage effect, however without undermining a genuine profit-driven character of investment decisions. It is therefore considered to exclude measures providing non *pari passu* loss sharing between public and private investors. Under a softer approach, only measures where the State is in an uncapped first loss position could be excluded. This means that an incentive effect could be presumed only for those measures where the public investor limit its first loss position up to a [20%] cap, so as to avoid that the risk of losses is borne entirely by the public sector. Within these parameters, the exact level of the leverage effect and the nature of incentives should be determined in a competitive process of selecting private investors and/or funds (the same applies for ensuring proportionality of aid).

As regards fiscal measures, one could consider that for measures coming within the scope of the safe-harbour of the future GBER, as outlined above in Section 5.3.(iii), the incentive effect can be presumed without any additional condition.

Finally, it seems desirable to further clarify and strengthen the criteria underpinning the principles of profit-driven investment decisions in order to encourage measures targeted at potentially viable companies and ensure financial sustainability of all forms of funding structures. In this regard, the following improvements could be considered:

- <u>Profit-driven decisions at the SME level</u>: the GBER could provide that investments should be made only to potentially economically viable companies. The viability of the business model and financial plan is to be verified by the entity representing the State on the basis of the findings of commercial, financial and legal due diligence.
- <u>Profit-driven decisions at the fund level:</u> new provisions in the GBER could clarify that investments may only be provided to those funds that are deemed potentially economically viable at the time of the investment on the basis of a business plan to be appraised in the context of due diligence carried out by the entity representing the State at any level of the intervention chain before each investment in the fund.
- <u>Professionalism and independence of fund managers</u>. It could be clarified that eligible investment funds must be run by professional and independent managers (independence with regards to investors and without prejudice to the manager's investment in the fund to strengthen the alignment of interests). The selection of the fund manager should be based on an open and transparent competitive process. The manager would need to have the necessary experience, expertise and capacity and comply with the applicable national law of the jurisdiction where it is legally established and operates.
- <u>Governance requirements</u>. The representatives of market-oriented investors should be represented in the governance bodies of the fund with a weigh proportionate to their investment. An appropriate governance structure should be in place, which allows for decisions to be made transparently and in accordance with the applicable legal requirement or market practice. The role of the representative bodies (including representatives from the public authorities) should not extend to the day-to-day management, including individual decisions concerning investments, divestments or risk diversification. In case of public funds co-investing with private investors at the level of each target SME, the day-to-day fund management, including individual decisions concerning investments, should be vested with independent experts enabled to take decisions in full autonomy.
- <u>Alignment of interest</u>: Fund managers should have a strong incentive to maximize financial performance of their fund. This could be achieved through two alternative mechanisms: either through a management remuneration entailing a performance-based component, or through a requirement for the manager to co-invest at the same terms as the public investor. The current rules cover only the former. The introduction of the latter would increase flexibility for Member States to design the most appropriate incentive.

ii. Substantive assessment (Guidelines)

For the incentive effect, the current RCG set out a number of criteria to demonstrate the profit-driven character of investment decisions and the commercial management of aided funds. According to these criteria, State aid measures targeting investors in a fund are considered to be proportionate if (i) the fund is managed by professional and independent private sector managers, (ii) has an investment committee composed of independent experts and (iii) is of a sufficient size. The logic behind the above criteria is that only well-structured fund with commercial management and of a sufficient size may attract private capital to the fund.

However, while entirely relevant and useful, the above criteria are probably insufficient to distinguish and 'filter' situations where private capital would have been invested (in the same amount or timeframe) into the target segment in the absence of State aid.

In order to give more prominence to the idea that the incentive effect ultimately depends on the specific design of the measure as regards the balance of risks and benefits between public and private investors, the future Guidelines should introduce additional and/or more focused criteria. These should be aimed at ensuring that measures subject to a substantive assessment are well designed up-front to achieve the desirable incentive effect.

The following is a list of possible criteria, submitted for further discussion with Member States and stakeholders:

- Aided funds and their managers should commit to keep formal records showing that the results of due diligence based on the business plan of each final recipient confirm that the proposed investment would not have been made without State aid because of low expected risk-adjusted rates of return. This should form part of the investment mandate that should be included in the funding agreements between granting authorities and funds.
- Aided funds and their managers should also commit, as part of their investment mandate, not to invest in companies that do not provide any evidence of failed attempts to raise finance from private sources.
- For schemes falling below the GBER ratios of private capital participation, preference should be given to profit enhancement incentives instead of downside protection. However, it is possible to explicitly state that measures with total absence of private investors are not allowed. This would be a modification of the current rules which allow no private participation in well-justified cases.
- For all schemes involving the intervention of funds (including funds of funds), evidence should be produced demonstrating that the nature and magnitude of the incentives offered to private investors, as well as the specific repayment arrangements and the exact value for the leverage effect, have been determined thorough an open and non-discriminatory competitive process for selecting fund managers and their investors.
- For all schemes (equity, quasi-equity, guarantees and loans) providing for a first loss piece to the State, or no public capital repayment, or no combination of downside risk protection with upside incentives for private investors, evidence should be produced proving that the balance of risks and benefits between private and public investors has been the result of an open, transparent and non-discriminatory competitive process, where possible through public tenders.
- For fiscal schemes not covered in the scope of the GBER, evidence should be produced demonstrating that the selection of the investees is based on a well-

structured set of investment restrictions, made public through appropriate publicity, setting out the characteristics of target investees and the policy of the fund. Furthermore, fiscal advantages on corporate taxation may be subject to appropriate limits (e.g. a capped percentage of deductible investments).

- For debt instruments exceeding the limits of the GBER, evidence should be produced demonstrating that adequate monitoring and reporting mechanisms are put in place to ensure full pass-on of the aid to the final target SMEs and that no aid is granted to the financial institutions entrusted with the operation of the measure. In addition, the maximum aid intensity (calculated as a percentage of the debt NGE over the relevant funding gap) should be assessed in the light of the actual size of the funding gap that Member States may be able to prove.

6.4. Aid limited to the minimum (proportionality)

As a general principle, State aid must be proportionate in relation to the targeted policy objective in order to be compatible with the internal market. More specifically, at the level of the target SMEs, the size of the aided investment must be limited to the size of the targeted funding gap. Moreover, at the level of private investors, State aid must be designed in a cost-effective (efficient) manner and must be limited to the strict minimum necessary to attract private capital to the businesses affected by such a funding gap. Therefore, the objective of maximising the leverage effect must be balanced against the need to secure a reasonable value for the public money.

i. Automatic compatibility rules (GBER)

Two separate problems arise in relation to the issue of whether the current threshold based on maximum annual tranches for investment are well designed so as to ensure that risk capital aid is proportionate and reflects the funding gap faced by the investees.

In the first place, as has already been observed above, the current approach has been criticised for being too strict and too inflexible. The current thresholds may be too restrictive as they do not necessarily reflect the true size of the actual funding gap which may be as high as €10 to 15 million, particularly in capital-intensive industries. Moreover, the current proportionality system based on annual investment tranches may be too rigid because, in reality, the frequency of individual investment tranches do not follow any standard pattern, and subsequent capital injections may form part of the same initial investment commitment.

In the second place, one of the main shortcomings of the current GBER appears to be the absence of appropriate safeguards designed to limit the aid to investors (and funds). This means that the level of subordination necessary to encourage the required level of private participation might not be cost-effective. Hence, the objective of maximising the leverage effect should be balanced against the degree of incentives offered to private investors. Currently, this principle is recalled only in the RCG (under detailed assessment) [39] but not enshrined in the GBER, which can therefore lead to serious problems of under-deterrence for block exempted measures and entail crowding out effects. Such could be the case, for example, if the State, in order to attract private investors, would decide to accept all investment risks and guarantee to such investors a return above a fair rate.

[39] For measures subject to the detailed assessment, aid may not be considered proportionate "where the risk of losses is borne entirely by the public sector and/or where the benefits flow entirely to the other investors".

In view of these constraints, the two following compatibility conditions could be considered:

Firstly, in order to ensure proportionality of aid at the level of the target SMEs while providing the necessary flexibility for investments, <u>the current restriction based on annual investment tranches could be abolished and replaced by an overall maximum investment amount</u> that would encompass any forms of financing. As explained above in Section 6.1(i), such a new cap could be fixed at € [10-15] million and cover a period of [5-7] years corresponding to a normal holding period. This overall cap would reconcile the different degree of market failures that may exist in different market segments in different Member States.

Secondly, in order to ensure proportionality of aid at the level of the investors (and funds), <u>the exact level of the incentives could be determined through a competitive process for selecting private investors and/or funds</u>, in the context of the strengthened principles of commercial management and profit-driven investment decisions described in the previous section on incentive effect. It should be noted that such a requirement would only be applicable to measures deploying financial instruments, but not to <u>fiscal measures</u>. For the latter instrument, no specific condition would be necessary as long as the scope of the safe harbour remains within the limits outlined above (see Section 5.3(iii)).

It remains to be further discussed whether the above criteria would be sufficient to keep the aid to the minimum in case of soft loans and non-market conform guarantees, or whether the future GBER should include maximum intensities based on the net grant equivalent applicable to such instruments.

ii. Substantive assessment (Guidelines)

Due to the enlarged scope of the regime, it seems important to improve and strengthen the proportionality test through a specific set of new and improved financial parameters in respect of those measures which will fall outside the safe-harbour. In particular, the following are considered:

- <u>Remuneration of public capital</u>: While public capital may not seek to generate market-level financial returns, the principle should be clearly set out that compatible measures should ensure that adequate up-front arrangements between the granting authority and the fund manager are in place which provide for a realistic and significant prospect of material capital gain or premium, so that the fund may operate in a financially self-sustaining manner and State aid can achieve its objective in an efficient manner.
- <u>Balancing of risks and benefits for private and public investors</u>: Arrangements for risk exposure and profit sharing between public and private investors in the fund should be agreed in advance before the investment is made. Such arrangements (i.e. funding agreements and operational agreements) should reflect a fair balance between an acceptable level of remuneration of public capital, on the on the hand, and risks and benefits for the private investor, on the other. To ensure that this criterion is met, Member States should produce evidence demonstrating, for instance in case of downside risk protection in the form of non-*pari passu* capital repayment, or in case of public investment being in a first loss position, that this type of preferential treatment for private investors is strictly necessary to achieve a fair rate of return (FRR) for the private investor.
- <u>Fair rate of return</u>: economically, aid is considered proportionate if it is limited to what is necessary for private investors to reach a risk adjusted hurdle rate expressed as a

certain annualized IRR on their investment (a fair rate of return, FRR). The FRR benchmark would be considered to be established either (i) through the use of an open, transparent and non-discriminatory bidding process for selecting investors and/or funds (with their investors), or (ii) exceptionally, under strictly defined conditions on the basis of an opinion by an independent expert. Provisions should be in place for the qualification and selection of independent experts. The competitive process would establish not only the nature of possible preferential terms given to investors, but it would also define the exact level of private capital, the general terms for capital repayment, profit sharing, including any carried interest arrangements. Only those investors (funds) would be selected that offer the best overall value for public money in meeting the defined objectives of the fund.

- Alignment of interest: There should be a clear link between financial performance and the remuneration of fund managers. This could be achieved by the requirement of carried interest or minimum co-investment by the fund manager (with built-in provisions to avoid any potential conflict of interests). In addition to the positive incentives, penalties in case of non-performance against business plan targets could be envisaged, with the ultimate sanction of replacing the managers if there is persistent under-performance.
- Transparency: In addition to the requirement for open and transparent competitive selection of fund managers (possibly via public tenders) and investors (normally via calls for manifestation of interest), the future rules could establish that the selection of fund managers and investors should be coupled, so that fund managers can show, when the funding agreement with the public authority is concluded, that they can attract sufficient investment at a given level of subordination.

6.5. Negative effects and balancing test

Following the SAM principles, State aid must be designed in a way that limits competition distortions and keeps the internal market competitive and open.

i. Automatic compatibility rules (GBER)

The current rules specify a number of excluded aid measures (for example exclusion of companies in difficulty, export-related activities, etc.). It is unclear, however, to what extent this enumeration is exhaustive or indicative, and whether all the practices enumerated above are 'black listed', i.e. prohibited in all circumstances. With this in mind, it could be considered to set out in the future GBER a list of exclusion criteria where State aid would be prohibited. The the following could be included:

- *Excluded target companies:* large companies, companies in difficulty within the meaning of the R&R guidelines, companies listed on a stock exchange (quoted companies)[40];
- *Excluded capital:* buyouts (MBOs and MBIs), except for replacement capital within the limits set out in the future GBER
- *Excluded measures:* absence of independent private investors; investments into companies without a viable business plan and an ex-ante defined realistic exit strategy;
- *Excluded sectors:* the shipbuilding, coal and steel industries;
- *Excluded activities:* export-related activities[41];

[40] It is important to clarify that businesses quoted on SME alternative stock exchanges would be considered unquoted for the purpose of the Guidelines, which is in line with the Commission's risk capital case practice.

- *Degendorff cases (i.e.* cases where the received illegal aid has not been recovered.

ii. Substantive assessment (Guidelines)

Under the future Guidelines, all aid measures which are not covered by the block exemption and which are not ‘black-listed', should in principle be subject to a substantive assessment of their negative effects (i.e. distortions of dynamic incentives and crowing out, risks of creation or enhancement of market power, notably at the fund level, and possible risks of maintenance of inefficient market structures).

Under the new rules, guidance could be given as to the situations where a measure would most likely raise concerns (and possibly not be allowed), so as to ensure a higher predictability of the rules and help Member States to appraise the negative effects. Such negative effects should be assessed (i) at the level of the market for the provision of risk capital, where the main risk is crowding out, and (ii) at the level of the product markets on which the target enterprises compete.

Firstly, as regards the risks of *distortion of dynamic incentives and crowding out effects*, appropriate guidance could be provided as to the situations where a measure would most likely not meet the balancing test. These could include measures where private investors do not bear any risk, or which provide for no minimum remuneration of public capital, or targeting certain market segments with only a few and mainly public funds.

Secondly, in order to avoid the *risk of maintaining inefficient market structures*, in particular at the level of funds, funds of a small scale and without adequate governance arrangements should be looked with particular care. The focus of the analysis could be on the funds without a business development plan demonstrating their ability to achieve a minimum efficient scale, including in terms of territorial scope of investments.

7. CROSS-CUTTING ISSUES

In its practice, the Commission has identified a number of horizontal cross-cutting issues that present challenges for State aid control and require further reflection. The issues concern cumulation of State aid and reporting obligations.

Firstly, *the current cumulation rules* seem difficult to apply, in particular because they refer to the concept of eligible costs, while risk capital investments are normally not intended to cover the costs of a particular project but constitute instead acquisitions of shares of businesses. Also they introduce a differentiation based on the sequencing of the aid and based on the region, which might not be justified. Moreover, according to certain stakeholders, the current cumulation rules may impede follow-on investments in SMEs that have received State aid at their earlier stages. Therefore, counting the whole value of the investment for cumulation purposes may not be appropriate because the aid element is usually smaller than the actual public equity contribution. Given the above, greater clarity and simplification of the current rules seem to be needed so they can be implemented effectively.

Secondly, case experience shows that *reporting requirements* may not be sufficiently clear and appropriate for State aid monitoring purposes. Under the current rules, Member States

[41] Excluding aid directly linked to the quantities exported, to the establishment and operation of a distribution network or to other current expenditure linked to the export activity, as well as aid contingent upon the use of domestic in preference to imported goods.

must provide annual reports containing specific information. In order to improve accountability and support a better use of public money, the transparency requirements under the GBER and the Guidelines could be strengthened. For this, Member States could publish information on all aids granted. In exchange, the existing reporting requirements could be simplified or even abolished.