EUROPEAN COMMISSION

Brussels, 29.04.2009
C(2009) 3045 final

Subject: **State aid NN 42/a/2007 and NN 42/b/2007 (ex N 300/2007) – United Kingdom**

Enterprise Investment Scheme (EIS), Corporate Venturing Scheme (CVS) and Venture Capital Trusts Scheme (VCT)

Sir,

1. PROCEDURE

(1) By letter dated 30 May 2007, registered at the Commission on the same day, the UK authorities, notified to the Commission the above-mentioned measure. The Commission asked for supplementary information on 27 June 2007, on 13 September 2007, on 18 February 2008, on 19 May 2008 and on 29 May 2008, and received answers on 3 August 2007, on 12 October 2007, on 7 March 2008, on 12 March 2008, on 23 May 2008, on 30 May 2008, on 3 June 2008 and on 11 July 2008, 13 August 2008, 22 January 2009 and 8 April 2009.

2. DESCRIPTION OF THE MEASURE

2.1. Objective of the measure

(2) The measure is designed to encourage private individuals and companies to invest in smaller, unquoted, high growth-potential companies in the UK in order to grow their businesses into sustainable, profitable enterprises.

2.2. Mechanism

(3) The notified measure is comprised of three different schemes:

(a) Enterprise Investment Scheme (EIS);

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United Kingdom

(b) Venture Capital Trusts (VCTs);

(c) Corporate Venturing Scheme (CVS);

(4) The combination of tax reliefs offered by the measures is supposed to increase investment returns for investors whilst mitigating investment risk, thus encouraging private investments in small and micro enterprises in the UK.

(5) Qualifying companies receiving investments across the EIC, CVC and VCT schemes are subject to an annual investment tranche limit of GBP 2 million.

(6) Aid is accorded automatically once the qualifying objective criteria are fulfilled. There is no discretion available to the awarding authority.

2.3. Legal basis, granting authority, budget, duration

(7) The legal basis is:

(a) Income Tax Act (ITA) 2007;

(b) Taxation of Chargeable Gains Act (TCGA) 1992;

(c) Finance Act 2000, as amended by Finance Acts of 1998, 2000, 2001, 2002, 2004, 2006, 2007, 2008 and 2009.

(8) The expected annual amount of tax relief across the schemes is GBP 250 million. HM Revenue & Customs is the aid granting authority.

(9) The notification covers duration until 6 April 2013 in respect of the EIS and VCT scheme, while the CVS scheme will end on 31 March 2010.

2.4. The EIS scheme

(10) The EIS scheme provides for the following tax incentives to <u>private individuals (natural persons)</u> to encourage investments in target enterprises. Qualifying investors must be liable to UK income tax and must not be 'connected' with the company issuing the EIS shares. There are no residency requirements for an investor:

- <u>Income tax relief</u> at 20% of the amount invested in new full-risk ordinary shares in qualifying companies (up to a maximum of the individual's pre-EIS income tax liability). Relief is given for investments of up to GBP 500,000 per year, per investor. Shares must be held for at least three years to retain the relief. The relief is not available to individuals or associates of individuals who possess more than 30% of the company or who work for the company (although this does not apply to an investor who becomes a paid director of the company only after the shares are issued).
- <u>Relief from</u> capital gains tax on gains from shares that have qualified for income tax relief (set out above) and which are disposed of after at least three years.
- <u>Capital gains tax deferral.</u> Where the investor has made a taxable capital gain on the disposal of any other asset, the tax charge arising on this gain can be deferred if the gain is invested in shares under EIS.

(11) In addition, investments can also be made through collective investment schemes managed by specialised fund managers that would invest on behalf of investors in a portfolio of qualifying companies. An EIS fund is a transparent vehicle and not a legal entity in its own right. Beneficial ownership of underlying shares in the target companies remains with the individual investors, thereby satisfying the requirement of investing directly into individual companies. There is no specific residence requirement regarding where EIS funds should be established.

(12) If investments are made through the funds that are approved by HMRC, there is no minimum investment per company requirement, and investors can claim income tax relief from the date of investment in the fund, rather than when the actual underlying investment is made. Such HMRC approval does not bear on the commercial viability of the investments. In the same way as investments made directly into the qualifying company, EIS fund managers will take commercial decisions on behalf of their investors and protect investor interests.

2.5. The VCT scheme

(13) The VCT scheme provides the following tax incentives to private individuals (natural persons) to encourage them to invest collectively into qualifying companies through investment funds (VCTs) which enables them to spread their investment risk through portfolio investments:

- Income tax relief at the rate of 30% of the amount invested in qualifying companies (up to a maximum of the individual's pre-VCT income tax liability). Shares must be held for a minimum of five years.
- Tax-free dividends. Any dividends received in respect of the VCT shares are exempt from income tax.
- Capital gain tax relief. No capital gains tax is payable on gains on VCT shares.

(14) Qualifying investors do not need to be residents in the UK. They must have tax liabilities against which to claim relief. They must not be connected with the qualifying companies.

(15) VCTs are investment trusts that are set up for the purpose of acting as a collective investment to invest in other companies (collective investment schemes may be formed by legal trust or by statute) and managed by independent fund managers. VCTs are publicly quoted companies whose shares are trading on the EU Regulated Market (regulated market named under the Markets in Financial Instruments Directive).

(16) VCTs are supervised by the Financial Service Authority (FSA). A VCT must satisfy the FSA that investment managers have sufficient experience in the management of portfolio investments of the size and type in which the VCTs proposes to invest. VCT managers are appointed by investors through a free and open application process. There is no government intervention to appoint the VCT fund managers. The scheme does not stipulate the management selection or remuneration criteria.

(17) VCTs must be approved by HMRC for the purpose of tax relief under the scheme. The approval of a VCT means that it currently satisfies the scheme's requirements enabling investors in VCTs to qualify for tax reliefs. An individual investor can invest up to £200,000 under the VCT scheme, per tax year. VCTs may only invest up to £1 million per enterprise, per tax year.

(18) At least 70% of the VCTs assets must be qualifying investments. The remaining 30% are liquid assets, such as cash in banks, fixed money market funds, gilts and bonds. A minority of holdings have been invested in shares traded on AIM (the Alternative Investment Market). Such liquid investments are necessary in order for VCTs to operate commercially and to ensure flexibility, i. e. to enable the VCT management to realise investments at the optimal time, to reinvest profits in new companies, to make follow on investments in existing portfolio companies, to pay management and regulatory costs and to realise and distribute profits.

(19) At least 70% of the VCT's qualifying investments must be in equity (i.e. in full-risk ordinary shares) or quasi-equity, as defined in the Community guidelines on state aid to promote risk capital investments in small and medium-sized enterprises[1] (Risk Capital Guidelines). The total investment in any individual company must be at least 10% invested in equity (full-risk ordinary shares). Apart from full-risk ordinary shares, investment in qualifying companies may be securities, which can include secured and unsecured loans. The meaning of securities is restricted to cases where the terms on which the investment is made do not allow the VCT or anyone else to require repayment of the loan, repurchase or redemption of the stock, within five years.

2.6. The CVS scheme

(20) The CVS scheme is similar to the EIS, but provides tax incentives to corporate investors to encourage direct investments into qualifying companies:

- Corporation tax relief at the rate of 20% of the amount invested in target companies (up to a maximum of the company's pre-CVS corporation tax liability).
- Deferral relief. Capital gains tax on realisations of CVS investments can be deferred if the proceeds are reinvested in shares that qualify for CVS corporation tax relief.

(21) To retain the reliefs the investment must be held for at least three years. Tax relief is given only to companies making minority investments in independent companies. Qualifying corporate investors must not be connected with qualifying companies. They must have tax liabilities in the UK to claim relief. There are no residence or place of incorporation requirements.

2.7. Qualifying companies

(22) The target enterprises for investment ("qualifying companies") have to fulfil the following criteria that are used as proxies to identify high-risk, high-potential growth businesses, suffering the most severe market failure:

1 OJ C 194, 18.08.2006, pages 2-22

(a) *Gross asset test.* The gross assets must not exceed GBP 7 million immediately before the investment and GBP 8 million immediately after it ("the gross assets test"). If the issuing company is the parent company of a group, this test is applied to the gross assets of the group as a whole. The exchange rate may change during the period when the schemes are in force. While the amount of gross assets before investment is expressed in GBP, it will not in principle exceed EUR 10 million according to the Euro foreign exchange reference rates expressed by the European Central Bank[2] at the moment the aid is granted. The UK authorities confirmed that they would monitor the exchange rates and if the threshold of EUR 10 million corresponding to the EC small company definition is to be permanently exceeded in the long run, they will take appropriate measures to make the schemes in conformity with the EU definition of a small enterprise.[3]

(b) *Number of employees.* Since 2007 qualifying companies and groups of companies are subject to an employee limit of fewer than 50 full-time equivalents.

(c) *Qualifying trade.* All trades are qualifying trades unless certain activities which are considered less risky and are affected by a less severe market failure. These trades are dealing in land, dealing in commodities, futures or (subject to exceptions for ordinary trades of wholesale and retail distribution) goods, dealing in shares, securities or other financial instruments, banking, insurance, money lending, debt factoring, hire purchase financing or other financial activities, leasing, including the letting of assets on hire subject to a waiver for certain lettings of ships on charter, receiving royalties or licence fees - subject to waivers in certain cases, providing legal or accountancy services, property development, farming and market gardening, activities concerned with forestry and timber production, operating or managing hotels and similar establishments, operating or managing nursing homes and residential care homes, providing services or facilities for any trade carried on by another person (other than the parent of the company), in certain circumstances. In addition, in order to meet the requirements of the Risk Capital Guidelines, the UK authorities added to the list of excluded activities shipbuilding, coal and steel production.

(d) *Unquoted status.* At the time when the shares are issued neither they, nor any of the company's other shares or debentures or other securities may be quoted – that is, listed on an exchange which is at that time a recognised stock exchange. In addition, at the time when the shares are issued there must not be any arrangements for such a listing.

(e) *Permanent establishment.* A company receiving investments under the schemes must have a permanent establishment[4] in the UK. This is because

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2 http://www.ecb.int/stats/exchange/eurofxref/html/index.en.html

3 Commission Recommendation of 6 May 2003 concerning the definition of micro, small and medium-sized enterprises (notified under document number C(2003) 1422) OJ L 124, 20.05.2003, pages 36-41

4 The term "permanent establishment" is based on Article 5 of the OECD Model Tax Convention on Income and on Capital (2003), which means a fixed place of business through which the business of an enterprise is wholly or partly carried on, including a place of management, a branch, an office.

the measures are intended to encourage investors to invest in small companies in the UK in order to address the risk capital equity gap.

(23) The UK authorities have committed to limit the application of the aid to the relevant risk capital investments under the criteria defined in the Community Risk Capital Guidelines, that is equity and quasi-equity financing to companies during their early-growth stages (seed, start-up and expansion phases), including informal investment by business angels, venture capital and alternative stock markets specialised in SMEs including high-growth companies[5].

(24) As regards the stage of development of the target companies, the UK authorities believe that while it is accepted that the inability to access finance and in particular risk capital can stifle the development of seed, innovative start-up and early stage businesses, it can also constrain the supply of capital for established businesses that are seeking to modernise or diversify their activities. At the same time, buy-outs, as defined by the Risk Capital Guidelines, are not permitted under the schemes as investors are not allowed to purchase a controlling percentage of a target company. Similarly, replacement capital as defined by the Risk Capital Guidelines is also excluded under the schemes, as investors must subscribe for new shares, rather than purchase existing shares.

(25) The UK authorities committed to exclude the provision of aid to enterprises in difficulty, as defined by the R&R Guidelines[6]. The investors promoted by the schemes have clear commercial incentives to make investments in viable companies that they believe will be able to develop and succeed. The rules of the schemes also make it clear that a company may not receive investment if the company's trade is not conducted on a commercial basis and with a view to the realisation of profits.

2.8. Cumulation

(26) Where capital provided to a target enterprise under these measures is used to finance initial investment or other costs eligible for aid under the block exemption regulations, guidelines, frameworks, or other State aid documents, the relevant aid ceilings or maximum eligible amounts will be reduced by 50% in general and by 20% for target enterprises located in assisted areas during the first three years of the first risk capital investment and up to the total amount received. This reduction does not apply to aid intensities provided for in the Community framework for State aid for Research and Development[7] or any successor framework or block exemption regulation in this field.

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5 See point 2.2, letter (k) of the Risk Capital Guidelines.

6 Community guidelines on State aid for rescuing and restructuring firms in difficulty, OJ C 244, 01.10.2004, pages 2-17

7 OJ C 323, 30.12.2006, p. 1-25.

3. ASSESSMENT

3.1. Legality

(27) The UK implemented the schemes before the adoption of a Commission decision. Therefore, the UK authorities did not respect their standstill obligation under Article 88(3) of the EC Treaty.

3.2. Existence of State aid

(28) The Commission has examined the measure on the basis of the Risk Capital Guidelines on State aid to promote risk capital investment in small and medium-sized enterprises[8], which set out the application of Article 87(1) in the field of risk capital measures to SMEs. In order for a risk capital measure to fall within the scope of Article 87(1) EC Treaty, four cumulative criteria must be met:

- the aid must be granted by the State or through State resources;
- it must confer a selective advantage on certain undertakings;
- it must be capable of affecting competition and trade between Member States.

(2) In line with point 3.2 of the Risk Capital Guidelines, the assessment of the presence of State aid within the meaning of the Treaty is carried out on three different levels:

- aid to investors;
- aid to an investment fund, investment vehicle and/or its manager;
- aid to the enterprises in which investment is made.

3.2.1. Aid to investors

(29) In accordance with point 3.2 of the Risk Capital Guidelines, where private investors make investments on terms more favourable than public investors, or than if they had undertaken such investments in the absence of the measure, then those private investors will be considered to receive an advantage.

(30) As far as the EIS and VCT scheme is concerned, the Commission considers that these investors receive an advantage as the measures contemplated by the schemes constitute derogation from the normal fiscal rules applicable in the UK and allow investors to reduce their tax liability. It is likely therefore that in the absence of these fiscal advantages which are conditional on making some investment under the schemes, private investors would not have made such investment.

(31) Under the CVS scheme there is, moreover, aid to undertakings (corporate investors) investing directly in target companies through tax incentives. The measures contemplated by the CVS constitute derogation from the normal fiscal rules applicable in the UK. They reduce the fiscal revenues of the State and grant an advantage to corporate investors (i.e. undertakings) investing in qualifying companies, which sees a correlative reduction of their tax liability. The measure

[8] OJ C 194, 18.08.2006, p. 2-21.

grants therefore an advantage to these investors through State resources. It cannot be excluded that these investors are engaged in activities which have the potential to affect intra-Community trade. The measure is also selective since only those investors participating in the scheme (i.e. making investments within the condition provided for by the scheme) will benefit from the tax advantages in question. For example, in order to benefit from the tax incentives in question the investing companies may not carry out financial activities.

3.2.2. Aid to fund

(32) At the level of the fund, the Commission in general tends to the view that a fund is a vehicle for the transfer of aid to investors and/or enterprises in which the investment is made, rather than being an aid beneficiary itself pursuant to point 3.2 of the Risk Capital Guidelines. However, measures such as fiscal measures or other measures involving direct transfer in favour of an investment vehicle or an existing fund with numerous and diverse investors with the character of an independent enterprise may constitute aid unless the investment is made on terms which would be acceptable to a normal economic operator in a market economy and therefore provide no advantage to the beneficiary.

(33) EIS collective investments are referred to as Funds, they are not legal entities. EIS funds are transparent vehicles where portfolio investments are made up of qualifying shares where beneficial ownership of the underlying shares remains with the individual investors. In the light of the above the Commission, considers that the EIS funds are not undertakings, therefore Article 87 (1) EC does not apply to the EIS funds.

(34) On the other hand, VCTs trusts are legal entities separate from investors. They are publicly quoted companies and part of their assets must be reserved to qualifying investments while the remaining must be kept in liquid assets in order for VCTs to operate commercially and to ensure flexibility. However, VCTs trusts are set up for the purpose of acting as a collective investment vehicles to transfer funding to the qualifying companies. In the light of the above the Commission cannot exclude that VCTs Trusts constitute undertakings. However, since the scheme at issue does not provide for any direct transfer of State resources to the investment vehicles, the Commission considers that it does not grant any State aid to them, within the meaning of point 3.2 of the Risk Capital Guidelines.

3.2.3. Aid to fund manager

(35) According to point 3.2. of the Risk Capital Guidelines, aid to the fund's managers or the management company will be considered to be present if their remuneration does not fully reflect the current market remuneration in comparable situations. On the other hand, there is a presumption of no aid if the managers or management company are chosen through an open and transparent public tender procedure or if they do not receive any other advantage granted by the State.

(36) EIS and VCT fund managers are specialised commercial fund managers, chosen by investors on a commercial basis. There is no government intervention in the appointment of fund managers and the schemes do not impose any management remuneration conditions. Their remuneration is subject to commercial negotiations. Therefore, the Commission considers that there is no ground to believe that the

remuneration does not reflect the current market remuneration in comparable situations.

3.2.4. Aid to undertakings in which investments are made

(37) According to point 3.2 of the Risk Capital Guidelines, where aid is present at the level of the investors, the investment fund, the Commission will normally consider that it is at least partially passed on to the target enterprises and thus that it is also present at their level. This is the case even where investment decisions are being taken by the managers of the fund with a purely commercial logic. In cases where the investment is made on terms which would be acceptable to a private investor in a market economy in the absence of any State intervention, the enterprises in which the investment is made will not be considered as aid recipients. *Mutatis mutandis*, the same holds when the Commission has simply established that there is advantage at the level of the investors. Indeed, the grant of an advantage to investors on condition that they make certain investments will increase the availability of equity for the companies in which the investment is made, i.e. it will translate into an advantage for the invested undertakings as well[9].

(38) In the light of the above the Commission concludes that there is indirect aid to target companies arising from the schemes. All tax advantages are granted to individual or corporate investors, but the companies invested in also benefit from them indirectly. The effect of granting tax incentives to investors in qualifying companies is to increase their capital base, i.e. allow qualifying companies to receive investments on more favourable terms and greater amount than they would in the absence of the measure. This advantage is granted through State resources as it originates in the reduced fiscal revenues of the State which modifies the market conditions and pushes investors to direct their resources towards the targeted companies[10]. The measure is also selective as only "qualifying companies" may receive the indirect advantage of the scheme. Since it cannot be excluded that the target enterprises are active in intra-Community trade, an impact on competition and trade cannot be excluded either.

(39) The Commission therefore considers that the three schemes under examination contain State aid elements within the meaning of Article 87(1) EC Treaty to the benefit of undertakings in which investment is made.

4. COMPATIBILITY ASSESSMENT

4.1. Scope

(40) As the measure involves State aid to corporate investors (under the CVC scheme) and to the target companies, the Commission has to examine whether this State aid is compatible with the common market. The RCG are applicable to the case at hand, since the measure concerns the provision of risk capital to small companies. It falls within the scope of the RCG as set out in section 2.1 of the RCG. The latter section requires the exclusion of aid to enterprises in difficulty, and to enterprises in the shipbuilding, coal and steel industry.

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[9] Case C-156/98, Germany v Commission [2000] ECR I-6857

[10] See by analogy case C-156/98, Germany v Commission [2000] ECR I-6857

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

(42) The present measure excludes the provision of aid to enterprises in difficulty and in the shipbuilding, coal and steel industry. The requirements for qualifying investments do not include any provision that the aid would be conditioned upon export activities of the targeted companies or the use of domestic in preference to imported goods.

(43) The Commission will consider that the incentive effect, the necessity and proportionality of aid are present in a risk capital measure and that the overall balance is positive where all the conditions in section 4.3 of the RCG are met. If the risk capital measure is not complying with one or more of the conditions set out in section 4.3, it will be subject to a more detailed assessment given the less obvious evidence of a market failure and the higher potential for crowding out of private investors and/or distortion of competition. The next step of the assessment is therefore to examine whether the measure meets the conditions of section 4.3 of the RCG.

4.2. Compatibility assessment under section 4 of the RCG

4.2.1. Maximum level of investment tranches

(44) According to point 4.3.1 of the RCG, the risk capital measure must provide for tranches of finance, whether wholly or partly financed through State aid, not exceeding EUR 1.5 million per target SME over each period of twelve months.

(45) The measure does not comply with point 4.3.1, since the maximum size of investment tranches is higher than EUR 1.5 million as it is limited to GBP 2 million.

(46) However, in point 5.1(a), the RCG lays down a possibility of accepting measures providing for investment tranches beyond the safe-harbour threshold of EUR 1.5 million per target SME over each period of twelve months. The Commission is aware of the constant fluctuation of the risk capital market and of the equity gap over time, as well as of the different degree by which enterprises are affected by the market failure depending on their size, on their stage of business development, and on their economic sector. Therefore, the Commission is prepared to consider declaring risk capital measures providing for investment tranches exceeding the threshold of EUR 1.5 million per enterprise per year compatible with the common market, provided the necessary evidence of the market failure is submitted.

4.2.2. Restriction to seed, start-up and expansion financing

(47) In line with point 4.3.2 of the RCG, the risk capital measure must be restricted to provide financing up to the expansion stage for small enterprises, or for medium-sized enterprises located in assisted areas. It must be restricted to provide financing up to the start-up stage for medium-sized enterprises located in non-assisted areas. Since the measure at hand provides financing to small enterprises including their

expansion stage, excluding buy-outs and replacement capital, it complies with point 4.3.2 of the RCG.

4.2.3. Prevalence of equity and quasi-equity investment instruments

(48) Point 4.3.3 of the RCG requires that the risk capital measure must provide at least 70% of its total budget in the form of equity and quasi-equity investment instruments into target SMEs. As far as the EIS and CVS schemes are concerned, the UK authorities confirmed that aid may only be claimed in respect of ordinary share capital. Therefore 100% of the investment is made in the form of equity.

(49) As for the VCT scheme, the UK authorities explained that it is necessary for VCTs to have 30% of their funds in liquid assets for their commercial operations, to ensure flexibility for the fund management to realise investments at the optimal time, to reinvest profits in new companies, to make follow on investments in existing portfolio companies, to pay management and regulatory costs and to realise and distribute profits. At least 70% of their funds must be held in qualifying investments in target companies. A minimum of 70% of the qualifying investments must be in equity or quasi-equity investments, as defined in point 4.3.3 of the RCG.

(50) Consequently the measure complies with point 4.3.3. of the RCG.

4.2.4. Participation by private investors

(51) In line with point 4.3.4 of the RCG at least 50% of the funding of the investments made under the risk capital measure must be provided by private investors, or for at least 30% in the case of measures targeting SMEs located in assisted areas.

(52) In the case at hand, taking into account the nature and the scope of the tax advantages, more than 50% of the funding is provided by private investors. Therefore, the measure complies with point 4.3.4 of the RCG.

4.2.5. Profit-driven character of investments decisions

(53) Point 4.3.5 of the RCG requires that the risk capital measure must ensure that decisions to invest into target companies are profit-driven. This criterion is considered to be met if all the following conditions are fulfilled:

(a) the measure has significant involvement of private investors, providing investments on a commercial basis directly or indirectly in the equity of the target enterprises;

(b) a business plan exists for each investment containing details of product, sales and profitability development and establishing the ex ante viability of the project; and

(c) a clear and realistic exit strategy exists for each investment.

(54) All of the capital delivered through the schemes is provided by private investors investing directly or indirectly through collective investment schemes. The State plays no part in the investment choices apart from setting out the rules to ensure that investments are restricted to the target enterprises.

(55) There is an explicit legal requirement that investments shall be made into qualifying companies trading on a commercial basis with a view to profit. Private investors, including fund managers making investment decisions on behalf of private

investors, must be satisfied of the viability and profitability of the investment in order to invest, so adequate business planning and exit is effectively a pre-requisite for funding. This exit mechanism allows investors to realise a profit or make a timely exit from loss making venture.

(56) It must be concluded that the measure is in line with point 4.3.5 of the RCG, since decisions to invest into target companies are profit-driven.

4.2.6. Commercial management

(57) According to point 4.3.6 of the RCG the management of a risk capital measure or fund must be affected on a commercial basis. This criterion is considered to be present where all the following conditions are fulfilled:

(a) there is an agreement between a professional fund manager or a management company and participants in the fund, providing that the manager's remuneration is linked to performance and setting out the objectives of the fund and proposed timing of investments;

(b) private market investors are represented in decision-making, such as through an investors' or advisory committee; and

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

(58) As concerns direct investments made under the EIS and CVS schemes, there are no professional fund managers involved. Private investors will be responsible for their own investment decisions seeking to optimise investment returns.

(59) As for the EIS and VCTs funds, they are operated by professional fund managers, appointed by private investors on a commercial basis. Under a standard commercial practice, there would normally be a management agreement setting out a performance fee and defining management structure. Private investors will likely be represented in decision-making insofar as their interests are represented in the funds. It would be in the interest of investors and fund managers to apply best management practices, with the view of realisation of profits. As concerns the VCT funds, they are supervised by the Financial Service Authority (FSA). It could be concluded that all above criteria are being met and, the measure therefore is line with point 4.3.6 of the RCG.

4.2.7. Sectoral focus

(60) According to point 4.3.7 of the RCG, the Commission may accept a sectoral focus for risk capital measures. Although certain trades are excluded from the scope of the measure, such exclusions are justified by the nature of the risk capital aid scheme in question which is appropriately targeted to sectors where the expected market failure is more severe.

4.3. Detailed assessment

(61) Since the measure does not comply with point 4.3.1 of the RCG, it is subject to a detailed assessment according to point 5.1 of the RCG. This assessment will be based on a number of positive and negative elements. No single element is determinant, nor can any set of elements be regarded as sufficient on its own to

ensure compatibility. In some cases their applicability, and the weight attached to them, may depend on the form of the measure.

(62) According to point 5.2.1. of the RCG "for risk capital measures envisaging investment tranches into target enterprises beyond the conditions laid down in section 4, in particular those providing for tranches above EUR 1.5 million per target SME over each period of twelve months, follow-on investments or financing of the expansion stage for medium-sized enterprises in non-assisted areas as well as for measures specifically involving an investment vehicle, the Commission will require additional evidence of the market failure being tackled at each level where the aid may be present before declaring the proposed risk capital measure compatible with the common market.

(63) In the Enterprise Capital Funds decision[11], the Commission considered as proven the market failure corresponding to an equity gap in the UK with an upper bound of GBP 2 million. That decision was based on information presented by the UK authorities, supportive comments of third parties, data from the British Venture Capital Association and the consultation 'Bridging the finance gap: next steps in improving access to growth capital for small businesses' by the HM Treasury12. In the Investbx decision13, the Commission also acknowledged the existence of market failure up to GBP 2 million in respect of its focus on the West Midlands region of the United Kingdom.

(64) The UK authorities submitted an academic report[14], which provided some powerful evidence about the equity gap with an upper bound of approximately GBP 2 million. Among others the report stated: "…there is a widely held perception amongst business support agencies, venture capitalists and entrepreneurs alike that the minimum and average sizes of acceptable investments to the formal venture capital market has continued to increase over time. Accordingly, companies seeking investments up to the level of circa £2 million may face significant restrictions in their access to finance." Furthermore, "It is our prognosis that this gap is likely to grow in scale as fixed cost issues will irrevocably encourage professional venture capital firms to increase the size of both their funds and their minimum acceptable deal sizes."

(65) The 'Bridging the finance gap: next steps in improving access to growth capital for small businesses' consultation also concluded that the equity gap is severe for investments of up to around GBP 2 million. The consultation paper concluded that the equity gap has been growing over time, driven in part by the success of the UK private equity industry in moving to larger size investments. The evidence on the extent of the equity gap was backed strongly by the responses to the Bridging the finance gap consultation paper.

11 Commission Decision of 3 May 2005 on the aid scheme 'Enterprise Capital Funds', OJ L 91, 29.3.2006, p. 16

12 Bridging the finance gap: next steps in improving access to growth capital for small businesses, HM Treasury, Small Business Service, December 2003

13 Commission Decision of 20 December 2006 on the aid to 'Investbx', OJ L 45, 20.2.2008, p.1

14 Harding, R., Cowling, M. and Murray, G., Assessing the Scale of the "Equity Gap" in the UK Economy: Report to H.M. Treasury and Small Business Service, November 2003

(66) In general, smaller high-risk high growth-potential companies may suffer from the following problems related to getting access to equity financing. On the supply side, they are constrained by information asymmetries, and as a result, by relatively higher costs of identifying suitable investment opportunities compared to larger deals, including search, due diligence and monitoring costs. Significant fixed transaction costs tend to discourage investors from investing in smaller or higher-risk deals. There is an increasing preference for larger, lower risk transactions. Information asymmetry may result in risk aversion, which may be due to negative inaccurate perceptions of risks and returns in this part of the market. British Venture Capital Association research showed that UK institutional investors do not invest in venture capital because they believe that the returns achieved by the asset class are considerably below reality. A further problem is the cost of competing with larger firms to attract adequate investment talent. Among demand side constraints, namely among reasons that deter small businesses from seeking equity capital, the loss of control, restricted management freedom, costs of securing equity finance, lack of knowledge of external sources of equity finance, lack of investment readiness were mentioned as main factors.

(67) The UK authorities presented arguments that the equity gap is a persistent and long-standing problem, which has not decreased in size, but there are indications that it rather increased to GBP 5 million. According to the British Venture Capital Association, in 2003 the overwhelming majority (~90%) of UK based venture capital firms invested only in deals above GBP 5 million. The British Venture Capital Association's Report on Investment Activity 2006 gives the following breakdown of funds invested in UK companies as follows:

Funds (£ million)	2004	2005	2006
0 < £2m	450	432	397
£2m < £5m	411	383	338
£5m+	4,475	5,998	9,491
Total	5,336	6,813	10,227
0 < £2m	8%	6%	4%
£2m < £5m	8%	6%	3%
£5m+	84%	88%	93%
Total	100%	100%	100%

Table: Breakdown of funds invested in UK companies in 2004-2006[15]

(68) According to the Small Business Service's Annual Small Business Survey in 2005 only 2 per cent of SMEs have considered and used equity financing as a source of finance. It was reported that professional Venture Capital firms were not going to solve the equity gap, as the sums of money involved were too small for these funds.

(69) Based on the foregoing, the Commission accepts that there is a market gap for investments up to approximately GBP 2 million and considers it positive that the tranche size is limited to the size of the equity gap.

15 Report on Investment Activity 2006 available from: http://www.bvca.co.uk/doc.php?id=187

(70) In line with point 5.2.2 of the RCG, an important element in the balancing test is whether and to what extent State aid in the field of risk capital can be considered as an appropriate instrument to encourage private risk capital investment. According to the UK authorities, upfront reliefs like these are particularly well suited to venture capital funding. They consider that tax reliefs in general offer certain advantages over grant funding direct to SMEs, as they can limit the distortion to efficient market processes. Tax breaks ensure that the UK authorities do not need to assume any responsibility for selecting viable investments ('picking winners'), but can instead incentivise investors, and then allow them to make decisions in selecting investment opportunities, based on purely commercial criteria.

(71) Moreover, the UK authorities have been constantly evaluating the tax schemes. Such evaluations include both supply and demand side issues affecting small enterprises, to see how they interact with risk capital measures. In March 2008, an independent econometric evaluation was published. The results of the study suggest that the injections of equity finance through EIS investment are used to grow businesses; it had a positive impact on companies' growth. Companies receiving investment through EIS exhibited higher fixed asset formation, sales turnover and employment than companies not receiving EIS investment. All of these have to be viewed positively.

(72) According to point 5.2.3, the Commission, when assessing the incentive effect and necessity of the aid, will take into account the criteria mentioned in points 5.2.3.1 to 5.2.3.4 of the RCG showing the profit-driven character of investment decisions and the commercial management of the measure, where relevant. In this regard it is enough that the measure has a fully profit-driven character and the commercial management complying with points 4.3.5 and 4.3.6 of the RCG. Therefore, the Commission considers that the measure has incentive effect and is necessary to overcome the market failure.

(73) In line with point 5.2.4 compatibility requires that the aid amount is limited to the minimum necessary. The way to achieve this aspect of proportionality will necessarily depend on the form of the measure in question. The Commission considers positively that there is an open tender for managers and public invitation to investors. This represents a best-practice approach. Any losses are borne entirely by private investors. This has to also be considered positively. Therefore, the measure must be considered as proportionate.

(74) As far as negative effects of aid are concerned, the Commission will balance, according with section 5.3., the potential negative effects in terms of distortion of competition and risk of crowding-out private investment against the positive effects when assessing the compatibility of risk capital measures. These potentially negative effects will have to be analysed at each of the three levels where aid is present.

(75) According to point 5.3.1 of the RCG, the risk of private investors being crowded out increases with the higher amount of an investment tranche, the larger size of an enterprise, and the later business stage, a private risk capital becomes progressively available in these circumstances.

(76) In the case at hand the size of investment tranches corresponds to the established equity gap. Therefore, the risk of crowding-out investors who would invest in small companies in any event is very limited. The identification of the scale of the equity gap as well as the setting of criteria for the target companies are aimed to ensure that the measure appropriately targets the identified objective and limits the risk of

deadweight and crowding out. Private funds tend to concentrate the majority of their investments in deals above GBP 5 million. According to the UK authorities, the incentives provided by the tax schemes do not appear to be to the detriment of the wider scale private equity market; they do not crowd out investors or draw money away from non-qualifying companies. The British Venture Capital Association report 2006 "The economic impact of private equity and venture capital in the UK" shows that there has been a largely continuous trend of growth within the private equity industry.

(77) As target companies must be small companies by complying with the employee limit of 50 and the gross asset test of GBP 7 million before investment and GBP 8 million after investment, at the level of the market where they are present, it is unlikely that they will have a significant market power and thus that there will be a significant distortion of competition in this respect. Since the schemes are cross-sectoral, the choice of investment is decided entirely by private investors and the private investors bear fully the risk of their investments, the distortion of competition such as keeping inefficient firms or sectors afloat as an impact of the measure does not seem to be present. Moreover, the measure does not seem to over-supply the target companies with risk-capital. Therefore, the risk of artificial increase of the valuation of inefficient companies in non-competitive sectors is limited. In light of all the above, the negative elements, if any, are by the nature of the schemes minimal.

(78) Having analysed positive and negative elements, the Commission is convinced that the positive elements outweigh the negative ones, especially when there is no evidence of possible crowding-out of private investment and other distortions of competition are minimal if not non-existent. Therefore, the result of a detailed assessment leads the Commission to consider the measure as compatible with the common market.

4.4. Cumulation

(79) Where capital provided to a target enterprise under these schemes is used to finance initial investment or other costs eligible for aid under the block exemption regulations, guidelines, frameworks, or other State aid documents, the relevant aid ceilings or maximum eligible amounts will be reduced by 50% in general and by 20% for target enterprises located in assisted areas during the first three years of the first risk capital investment and up to the total amount received. This reduction does not apply to aid intensities provided for in the Community framework for State aid for Research and Development[16] or any successor framework or block exemption regulation in this field.

(80) As the UK authorities confirmed that they would apply the above rule, the measure complies with point 6 of the RCG.

4.5. Conclusion

(81) As the result of a detailed assessment of the schemes foreseen by section 5 of the RCG, the Commission concludes that the measure fulfils the conditions as set out in the Risk Capital Guidelines on State aid to promote risk capital investment in small and medium-sized enterprises and that the overall balance of the measure is

[16] OJ C 323, 30.12.2006, p. 1-25.

positive. It has therefore found the measure to be compatible with the common market pursuant to Article 87(3)(c) of the EC Treaty.

5. DECISION

(82) The Commission regrets that the United Kingdom put the measure into effect, in breach of Article 88(3) of the Treaty. However, it has decided, on the basis of the foregoing assessment, to consider the measure compatible with the common market pursuant to Article 87(3) (c) EC Treaty. It has decided not to raise objections.

(83) The Commission reminds the UK Government to submit an annual report on the implementation of the scheme.

(84) The Commission further reminds the UK Government that all plans to modify these aid schemes have to be notified to the Commission.

If this letter contains confidential information which should not be disclosed to third parties, please inform the Commission within fifteen working days of the date of receipt. If the Commission does not receive a reasoned request by that deadline, you will be deemed to agree to the disclosure to third parties and to the publication of the full text of the letter in the authentic language on the Internet site:
http://ec.europa.eu/community_law/state_aids/index.htm

Your request should be sent by registered letter or fax to:

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State Aid Greffe
B-1049 Brussels

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Yours faithfully,

For the Commission

Neelie KROES

Member of the Commission