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Summary report of workshops on cross-border venture capital with national experts, industry representatives and researchers

Organised by
the European Commission in 2008

February 2009

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The purpose of this report is to provide a summary of workshop discussions that were organised in July and December 2008 by the European Commission, Directorate-General for Enterprise and Industry, Financing Innovation and SMEs, in order to continue working together with the Member States and the industry to facilitate cross-border venture capital operations EU-wide. In parallel to these consultations, the Commission exchanged views also with researchers and economists, reviewed recent research papers and provided the national and industry experts independent findings that could bring further suggestions on the way towards a more integrated venture capital market in Europe.

The work on removing obstacles to cross-border venture capital is an ongoing process. While this report reflects only identified problems of a fragmented venture capital market and contains no more than the main arguments that were presented in three workshop meetings with national and industry experts, it contains a complete set of researchers' recommendations for this process. A more detailed report encompassing an overview of measures taken by the Member States as well as further policy deliberations of several Commission services will be prepared later in 2009.

The role of the Commission staff was to facilitate discussions and contribute to put together this report. Consequently, the summary report should not be constructed as reflecting the position of the Commission and its services. Neither the Commission nor any person acting on behalf of the Commission is responsible for the use, which might be made of the information contained herein.

More information:

For further information about the ongoing work, you can contact:

Ulla Hudina
Financing innovation and SMEs
Directorate General for Enterprise and Industry
European Commission
Email: entr-finance-sme@ec.europa.eu
http://ec.europa.eu/enterprise/entrepreneurship/financing/investing_across_border.htm

1. Introduction – importance of venture capital for financing of innovative SMEs

Innovative small and medium-sized enterprises (SMEs) can only grow if they have proper access to funds, particularly venture capital (VC) financing. This is not always the case in the EU, where entrepreneurs and small firms often find it difficult to get the funding they need to start and grow their business. And even if successful in obtaining external finance, the money they get is often too little. Financing innovative SMEs is namely considered by many finance providers as a risky activity due to high transaction costs and low returns, especially at the early-stage.

The current financial crisis, a more difficult access to bank finance and rapidly deteriorating European economy have further highlighted the need of an adequate equity source in SMEs.

In short, while finding finance is one of the greatest challenges facing SMEs, venture capital market in Europe still has a long way to go to exploit the opportunities it could offer to innovative SMEs in search for external sources of finance. Although venture capital is mostly suitable for innovative and growth-oriented businesses, many more firms could find investors if the European venture capital markets were developed and more active.

2. The issue - fragmentation of the European venture capital market

The fragmentation of the European Union's venture capital markets along national lines seriously limits the overall supply of early-stage capital for innovative SMEs. There are currently 27 different operating environments, the stage of development and maturity of VC markets varies and there are different conditions along with divergent national approaches, which adversely affect both cross-border fundraising and investing in innovative SMEs.

Operating across multiple borders has become increasingly complex, costly and smaller VC funds thus tend to avoid operating outside their home jurisdictions. In smaller Member States and in jurisdictions where the VC market is new, funds face problems reaching the critical mass to spread their portfolio risk and cover their costs. Facilitating cross-border operations could help VC funds to overcome these hurdles, specialise, diversify their portfolio, increase the overall supply of early-stage capital and deploy their investments towards high-growth companies all over Europe.

Some Member States have more developed venture capital markets with functioning fund structures, while some other Member States still need to enable framework conditions for operations of venture capital funds. A single venture capital fund structure that would not preclude national structures or even a harmonisation could be optimal solutions but these solutions are not possible in the short-term.

There are naturally arguments against cross-border investments. Some established and functioning VC markets and some VC funds might have no need to consider cross-border deals, as they have sufficient deal flow locally and perform well. Such funds provide local solutions for firms seeking equity and if there are no bottlenecks in the investment cycle that would limit later investments and exits, these funds might not need to entertain any thoughts to make investments outside their jurisdictions.

Given the complexity of issues at stake, involving legal and taxation regulation, the Commission has joined forces with the Member States to help create cross-border venture capital funds, stimulate cross-border operations and to work together towards a more integrated European venture capital market.

3. Ongoing policy work

The Commission has paid considerable attention to the development of venture capital operations and to overcome the identified problems that contribute to the fragmentation of European venture capital market. In particular, the Commission organised in 2006-2007 an expert group[1] with national and industry experts that identified problems contributing to the fragmentation. Based on this expert group report and further policy deliberations, the Commission issued in December 2007 a Communication on *"Removing obstacles to cross-border investments by venture capital funds"*[2] and advocated a broad partnership with and between Member States to work towards mutual recognition of the national frameworks for VC funds either through reviewing the existing legislation or through adopting new laws.

The Competitiveness Council of December 2006 and November 2007 invited the Commission to report on obstacles to cross-border investments by venture capital funds and speed up action to facilitate the creation of a truly European venture capital market, respectively. The short-term approach of the mutual recognition as proposed by the Commission Communication was endorsed by the Competitiveness Council of May 2008[3]: the Council, *among others*, "recognised that working increasingly towards a common understanding of the key features of VC funds and their investors was crucial and that the mutual recognition of national frameworks was a promising initial step towards the gradual creation of an EU-wide framework, resulting in lower operating costs, higher legal certainty, less administrative complexities and shorter procedures. The Council considered furthermore that Member States shared certain common basic requirements for operating in VC funds, building upon mutually acceptable levels of supervision and trust, and invited Member States to make progress towards a mutual recognition of national frameworks and work together with the Commission". The Competitiveness Council of December 2008[4], *inter alia*, "recalled the need for Member States and the Commission to reduce the present fragmentation of the venture-capital market by facilitating cross-border investments."

Moreover, the European Parliament[5] has requested, *inter alia*, "the Commission to implement policy proposals set out in the Commission Communication". And also the European Economic and Social Committee[6] has issued its opinion supporting the Commission Communication and policy to develop a pan European venture capital industry.

Further to the mentioned Council Conclusions, the Commission has consulted independent researchers and continues to assists the Member States to take steps towards the mutual recognition of national frameworks for venture capital funds.

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[1] http://ec.europa.eu/enterprise/entrepreneurship/financing/docs/cross_border_investment_report_30march07.pdf

[2] Commission Communication, Removing Obstacles to cross-border investments, COM(2007)853, 21 Dec 2007: http://ec.europa.eu/enterprise/entrepreneurship/financing/docs/COMM_PDF_COM_2007_0853_F_EN_ACTE.pdf

[3] Council Conclusions, A fresh impetus for competitiveness and innovation, 29 May 2008: http://www.consilium.europa.eu/ueDocs/cms_Data/docs/pressData/en/intm/100715.pdf

[4] Council Conclusions, "Think Small First – A Small Business Act for Europe", 1 December 2008: http://www.consilium.europa.eu/ueDocs/cms_Data/docs/pressData/en/intm/104403.pdf

[5] EP Resolution, Annex – Recommendation 1 on VC sector and SMEs (23 September 2008): http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//TEXT+TA+P6-TA-2008-0425+0+DOC+XML+V0//EN

[6] http://eescopinions.eesc.europa.eu/eescopiniondocument.aspx?language=en&docnr=1659&year=2008

4. Other Commission ongoing work, also of relevance for cross-border VC market

The Commission has been analysing national frameworks for non-harmonised funds, including venture capital funds, barriers to cross-border private placement and possibilities for establishing a European private placement regime. Further to a substantial consultation[7] work, the Commission published in July 2008 a preliminary impact assessment report on private placement[8] suggesting that there is a prima facie case for action at EU level, however pending further preparatory work. For this work, a tender into the functioning of private placement markets has been launched. In line with this and in the context of the financial crisis, the Commission has also launched a public consultation about private equity to discuss emerging policy issues and stakeholders' concerns[9].

In parallel, possible double direct taxation for cross-border venture capital investments is being analysed by another Commission expert group that shall report by mid 2009.

The Commission has also proposed to further improve SMEs' access to finance and framework conditions for financing innovation by reducing fragmentation and building a more active EU venture capital market also in the context of the Small Business Act and Community Lisbon Programme.

Lastly, the free movement of capital is a fundamental Treaty freedom and the main vehicle for financial integration. It should be ensured that venture capital markets and funds, as part of the single market, can use opportunities of the freedom of capital that is monitored and enforced by the European Commission.

5. Assisting the Member States in the mutual recognition process

In accordance with the Council Conclusions, the Commission has continued the work together with the Member States and the industry towards a more integrated European venture capital market and organised two workshops in July - December 2008. During these workshops, the Commission launched a debate on measures that Member States have taken or plan to take to accommodate the mutual recognition principle in their respective VC legislation. Hence national experts have been sending inputs to the following questions:

(1) What have been recent new/draft pieces of legislation, regulatory changes, and plans for modifications of national framework for VC funds in your country? (2) Further to the Council Conclusions of 29 May 2008, what will be next possible steps that your country could take in the short-term towards a mutual recognition of national framework for VC funds? (3) Has your country/ministry prepared a roadmap to encompass the Council's invitation to take steps towards the mutual recognition of national VC frameworks? (4) Are you consulting/working together with the representatives of the VC industry in your country? (5) Have the regulatory authorities of your country been cooperating with the respective authorities in other EU countries?

Based on the inputs from the Member States, ongoing work and further policy deliberations, the Commission plans to issue a report by mid 2009 on progress made.

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[7] Call for evidence: http://ec.europa.eu/internal_market/investment/consultations/index_en.htm#call

[8] Preliminary impact assessment report on Private Placement, 17 July 2008: http://ec.europa.eu/internal_market/investment/legal_texts/index_en.htm#nonlegis

[9] Conference on PE: http://ec.europa.eu/internal_market/investment/alternative_investments_en.htm#conference

6. Conclusions and recommendations from researchers and economists' perspectives

In assisting the Member States in the process of mutual recognition, the Commission saw a need to explore additional supporting arguments to those already presented and to review recent research papers and studies. For this reason, the Commission services launched in November 2008 a debate with researchers and economists and their conclusions were summarised by Prof. Markku Maula from the Helsinki University of Technology[10].

Since the work of the Commission and Member States on removing obstacles to cross-border operations is ongoing and further results are still expected, this below-quoted summary of researchers' independent findings with links to underlying research evidence could bring additional suggestions to the Member States in taking measures towards the mutual recognition process:

6.1. Why should European governments care about the functioning of the venture capital market in the first place?

European governments invest a lot in innovation and plan to increase their investments in the future (e.g. Lisbon Partnership for Growth and Jobs). Yet it is well known that Europe has struggled in transforming that investment to sufficiently many successful growth companies to improve economic growth and societal welfare – the problem known as the European paradox [1].

Although venture capital is not the sole key to a more successful and entrepreneurial Europe, venture capital does play an important role in facilitating the growth and development of many of the most successful young innovative growth companies and in contributing positively to innovation and economic and employment growth [2-9]. Venture capital is not only a source of capital for risky ventures not funded by traditional banks, but also tangible and valuable support for ventures through endorsement [10, 11], contacts [12, 13], and advice [12, 14] to facilitate the professionalization [15, 16], growth [8, 17], internationalization [18, 19] and performance [20, 21] of entrepreneurial ventures. Increasing the supply of venture capital alone is not the key to a major increase in successful ventures [1, 22], but many successful ventures would not be even founded unless potential entrepreneurs could anticipate being able to access the necessary resources such as capital, contacts, and advice to make their ventures successful. A good environment for entrepreneurship includes a healthy supply of venture capital by active and experienced investors [21, 23] who are capable of and incentivized to invest in risky ventures using appropriate financing instruments [24] and to support their development through active involvement [21, 25].

A balanced and effective approach for governments to develop a country to become more innovative and entrepreneurial *simultaneously* pays attention to both demand and supply aspects including incentives (i.e. balance of risks and rewards) for potential entrepreneurs to start and grow ventures and for investors to invest in them [1, 25-27]. Innovation potential and human resources are central for thriving entrepreneurial activity, but also the tax and legal environment including

[10] The workshop participants and/or contributors to this summary report are in alphabetical order: Prof. Laura Bottazzi (Bocconi University - IGIER, CEPR), Prof. Marco Da Rin (Tilburg University, CentER), Patrizia Gioiosa (Di Tanno e Associati), Prof. Markku Maula (Helsinki University of Technology), Dr. Thomas Meyer (Deutsche Bank Research), and Prof. Mike Wright (Nottingham University Business School).

competitive capital gains taxation of long term investments in young innovative companies [1], legal protection [28], labour regulation [1], and bankruptcy legislation [26] have to be competitive for a country to realize fully the potential created by investments in innovation and education. The key role for the government is to create the conditions for strong entrepreneurial firms to come into being and grow. Rather than subsidies, this is likely to require more structural kinds of reforms such as setting good law enforcement, investor friendly legal protection, effective IPR, incentives to commercialize university research including enabling university scientists to participate in ownership of innovations [1, 26, 28, 29] etc.

6.2. Why is cross-border venture capital important and what is hindering it?

Cross-border venture capital not only helps complement and fill gaps in the domestic supply of capital for growth-oriented new ventures targeting global markets [30, 31], but also provides tangible support in the internationalization process by bringing advice and contacts needed to enter successfully those markets [18, 31-33]. On the fundraising level, the ability of VC funds to raise capital from foreign institutional investors is important to achieve the scale needed for successful operation [34, 35].

Although the European venture capital market has internationalized rapidly since the late 1990s [31, 36, 37], there are still many obstacles for investors to operate across borders within Europe [38-41]. Barriers to cross-border venture capital lead to:

- Limited opportunities and choice for growth-oriented European ventures concerning potential VC investors. Instead of being able to select from a larger set of competing and specialized internationally operating VCs, entrepreneurs have a narrower selection of more domestically oriented and less specialized investors. This leads to worse negotiation power for entrepreneurs, higher cost of finance, and lower value-added support for international growth due to greater role of domestically operating generalist VCs than would be optimal from the perspective of industry specific support needs of the internationalizing entrepreneurs
- Limited opportunities for VC investors to specialize in investing certain sectors due to lower opportunities to achieve sufficient scale by covering a broader geographic area
- Limited opportunities for VCs to raise capital from abroad making it hard to achieve sufficient scale

Regarding drivers and barriers for cross-border venture capital, investment flows between countries can be largely explained by the balance between the demand and the supply of capital and the frictions influencing how easily the supply can meet the demand [42]. The demand for cross-border venture capital is largely related to the existence of a strong pool of attractive investment opportunities indicated e.g. by high quality human capital [42, 43], patents [44], world class science emanating from universities [45], higher GDP growth rate [43], and supportive exit markets including M&A and IPO opportunities [1, 46, 47]. The supply of venture capital is positively related to a functioning tax and legal framework for raising venture capital funds [48]. The frictions reducing the cross-border flows include e.g. distance [42, 43, 49], foreign language [42], different currencies [50], not belonging to a common market [50], trade relations [44, 49], lack of availability of experienced co-investors [43, 44, 51, 52], lack of information and trust [49, 53], and lack of regulatory environment the investors would know and trust. The factors are largely similar also for cross-border fundraising [34, 54, 55]. However, although some of the frictions are hard to influence by governments, there are also clear obstacles e.g. regarding the tax and legal environments, which would appear to be relatively easier to be addressed by national governments, regulators, and tax authorities in collaboration with their counterparts in other European countries.

Regarding tax and legal environment related barriers for cross-border venture capital, the European VC market still consists of 27 national sets of conditions. A European VC willing to invest in other countries within Europe has to cover significant costs from acquiring and maintaining accurate understanding of country-specific investment regulations and from structuring investments to fit the constraints of the different national investment regimes. In addition to general problems and additional costs stemming from the lack of regulatory harmonization [55], there are some particular cross-border venture capital related problems that appear common between many countries in Europe [38-41].

For instance, when a European VC located in country A considers making an investment in a venture located in another European country B, the VC often faces legal uncertainty on whether the VC would be considered by tax authorities to have a permanent establishment in country B (especially if using a local advisor) leading to taxation of those investments in country B even if the VC funds investments in the home country were tax transparent with the taxation taking place on fund investor level according to their taxation statuses (e.g. tax exempt pension funds).

The same obstacles and legal uncertainties also influence cross-border fundraising. When investing in their home countries, VC funds are usually organized in a tax transparent manner allowing each fund investor to be taxed according to its tax status. When investing in a fund located in country B, the fund (or even the fund investors) may in some cases be considered to have a permanent establishment in that country leading to double taxation with the returns from the investments being first taxed in country B and thereafter in country A according to the tax status of the fund investor. In some countries such double taxation would take place with certainty. In some other countries there is legal uncertainty about the taxation position.

From an investor perspective uncertainty represents a risk which is costly to manage. Although investors can often develop solutions (such as parallel fund structures) to alleviate these real or potential double taxation problems, the resulting structures are often complex and very costly. Especially smaller VC funds cannot afford such costly approaches. These and other problems and uncertainties reduce the cross-border investment flows that would otherwise take place between European countries.

6.3. How could governments reduce the fragmentation of the European venture capital market and facilitate increased cross-border venture capital?

Overall, in improving the competitiveness of entrepreneurship in Europe, the key role for the EU and the Member States is to create the conditions for European entrepreneurs to set up companies with a pan-European and not a domestic focus. As noted above, this is likely to require more attention being paid to various structural changes rather than to subsidies. One way to improve the conditions for stronger entrepreneurial ventures in Europe is to reduce the fragmentation of the European venture capital market place. The reduction of fragmentation essentially means making it easier for venture capital investors to cover larger geographical areas than just individual member states in Europe. In practice this means increased harmonization of the regulation that investors have to deal with when investing in different countries in Europe and reduction of the various kinds of tax and legal environment related barriers to cross-border investments that still exist in many of the EU Member States.

Although many of the factors influencing cross-border venture capital flows are such that they are difficult to change especially in the short term, there are some that are easier to address. The most central and easy approaches are the removal of legal uncertainty and the improvement of the informational basis for investment decisions.

To reduce the fragmentation of the European VC market, it is recommended by the experts that the Commission and the Member States make sure that these easier steps are taken at the same time when pursuing the longer road to an integrated European venture capital market through mutual recognition of national fund structures and eventually a potential harmonized pan-European fund structure. Based on these arguments, experts' recommendations for the Member States of the European Union are as follows:

First, ***remove ambiguity (legal uncertainty)*** concerning cross-border venture capital. Many countries have quite well functioning environments based on explicit legislation and established legal interpretations allowing reasonable investment activity. However, any financially important issues (e.g. taxation) based on an implicit understanding instead of clear guidelines represent a risk for foreign investors, which is costly to manage, and thereby increases the required rate of return. This leads to abandoning of investments opportunities which would be attractive without the legal uncertainty.

Second, ***remove unnecessary obstacles*** for cross-border venture capital. After or in parallel with eliminating any legal uncertainty, it is to be considered also if there are concrete obstacles for foreign institutional investors to invest in funds located in your country, for foreign venture capital funds to invest in companies in your country, or for venture capital funds established in your country to invest in companies located in another country. Starting from the most important potential sources of venture capital investment in companies in your country, and from the most relevant targets of investment of venture capital forms located in your country; consider how any identified barriers could be removed and whether the fund structures could be mutually recognized to facilitate easier and less costly investment activity across borders.

Third, ***improve the availability and quality of information*** that is needed by cross-border venture capital investors to identify investment opportunities and to assess their quality. Consider how the information basis on which foreign investors have to identify investment opportunities and to make their investment decisions in your country could be improved. Poor availability on trustworthy information on investment targets is a key source of local bias in financial markets in general, and an important barrier also to cross-border venture capital investments. The cost of capital for entrepreneurial ventures stems largely from the asymmetric and imperfect information between investors and entrepreneurial ventures. Improvement of information quality and trust are keys to lowering the cost of capital and to improving the functioning of the market. Although private information providers and entrepreneurial ventures themselves are in central positions to influence the information availability and quality, also governments have an important role in information production and in influencing the availability and the quality of information needed to identify and assess the quality of entrepreneurial ventures.

[A complete list of referenced research evidence is in Annex, p. 9-10.]

7. Next steps in the mutual recognition process

Given the complexity of issues at stake, involving legal and taxation matters, promoting mutual recognition of national frameworks has been an initial effort to create an EU-wide framework for venture capital investments. While the Council has agreed with the goal and the process of mutual recognition, in practice Member States have not yet taken any significant measures that would make operating across borders easier for VC funds.

However, the Commission continues to work together with the Member States to facilitate venture capital investments. A final workshop is foreseen in spring 2009 in order to review progress made by the Member States towards the mutual recognition of national frameworks for venture capital funds. The Commission aims to present a full report on the progress achieved in 2005-2009 to create a more integrated European venture capital market, and on that basis will review options for further action.

Annex – References from the researchers' conclusions (see main report, part 6).

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