**Findings**

Venture capital should be mainly left to the market, while seed capital investment should be addressed by the public sector.

Public intervention should not aim at reducing private risks in an already developed market also not in so called specific “gaps” where the market can’t (or doesn’t want to) operate.

Seed capital

- concentrates on the very early stages of young innovative companies, which are characterized by high levels of investment risk;
- is aimed at supporting companies in moving from the idea or prototype stage to the first commercial revenues;
- offers limited amount of equity capital (typically in the range of 200-300,000 Euro and usually not beyond 500,000 Euro).

**Recommendation**

It is suggested to establish Seed Capital Funds is created with public resources. Operational guidelines for Seed Capital Funds are as follows.
The management is delegated to an investment vehicle that respects the following conditions:
- Invest only in equity or quasi-equity instruments that are directly issued by young innovative companies in the seed capital phase;
- Take only minority stakes in the target company;
- Do not ask for a position in the board of directors of the target company;
- Prior to investing, require all shareholders of the target company to sign an agreement according to which they are bound to repurchase the Seed Capital Fund stake after a given period (e.g., 3 years from the investment, with a possible postponement for given reasons up to 5 years)
- The agreement must be signed by all shareholders in solidarity (in order to avoid adverse selection and moral hazard);
- Do not invest with the goal of making profits;
- Do not invest more than 500,000 Euro for each target company.

This report does not necessarily reflect the views of the European Commission. These comments are based on a number of previous presentations including expert group reports for the EC.

1. Preliminary remarks

There is an increasing recognition that the European financial landscape, including private and public actors, is not able to produce and sustain a sufficient level of economic innovation.

More specifically, the current risk capital market in Europe doesn’t seem to offer large scale support to the growth and capitalization of young undertakings, causing a market failure known as “equity gap”. This financing gap mostly affects the first stages of development of innovative companies, which are generally considered to have a great impact on both economic development and job creation. In order to address this issue, Member States elaborated a number of policy recommendations, in which they proposed to create public-private partnerships in the venture capital sector. While agreeing on the basic assumptions arising from the analysis on the European equity gap, we believe that the policies proposed so far have been flawed by an incorrect vision of the public intervention in this specific market.

2. Reconsidering the public role in the European venture capital market

If compared to its global competitors, venture capital performance in Europe appears weak in terms of amount invested, number of target companies and general economic impact. This issue becomes even more pressing if we take into account not only traditional competitors such as USA or Japan, but also large emerging markets in Asia, Latin America and Africa.
A number of causes are commonly identified in literature to explain the weak results of the European venture capital market:

- the secondary market (for unlisted companies) is small, illiquid and still fragmented across Member States, making exit options for venture capitalists riskier and more expensive. While the fragmentation deriving from the different national regulatory regimes has been, at least partially, addressed through the recent AIFM Directive and the venture capital regulation, much of the impact of such measures still depends on how the Member States will actually implement them into their national law;

- a significant fiscal fragmentation among national markets is one of the main hurdles preventing European venture capital funds from reaching the necessary dimensions and profitability in order to result attractive to large private institutional investors;

- many European legislations have adopted a bankruptcy law which places a considerable risk on board members of the companies in the case of bankruptcy (which is not an unlikely event for innovative start-ups);

- entrepreneurial culture plays a fundamental role in the current European “equity gap”. More in detail, the deal flow of innovative ideas presented to venture capital managers is large but immature, mainly due to the difficulties met by young entrepreneurs, and especially academic entrepreneurs, in developing ambitious and realistic growth plans;

- the final markets for many applications and products introduced by young innovative companies are still fragmented at European level. The absence of a fully integrated Common market in some strategic areas is a major hurdle to the growth of innovative companies, with a direct impact on their ability to receive risk capital financing.

These considerations are undoubtedly relevant and have already been the object of empirical research. Nevertheless, this paper wants to add further elements to the analysis.

1. Generally speaking, the venture capital market tends to operate mainly with a computable investment risk. It usually tries to minimize uncertainty by concentrating its activity in enterprises with a clearly identifiable business and product structure.

2. In order to serve its main purpose, the venture capital market needs a large, adequately funded and efficient seed capital sector. Seed capital role is crucial as it operates in the enterprise stage with the highest risk, where failure is not an uncommon outcome.

Following a substantial approach, this paper defines seed capital as the segment of the equity market that:
- concentrates on the very early stage of young innovative companies, characterized by high levels of investment risk;
- is aimed at supporting companies in moving from the idea or prototype stage to the first commercial revenues;
- offers limited amount of equity capital (typically in the range of 200-300,000 Euro and never beyond 500,000 Euro).

It is because of a large and efficient seed capital market that US venture capital investors are able to select investment opportunities among a number of high growth prospects. Such prospects are the evolutionary outcome of a multi-layered selective environment, in which the costs of selection are proportional to the risk-adjusted magnitude of the expected return. Investment opportunities are identified on top of a system of stepwise management (and quantification) of risk. A large and efficient seed capital sector also allows and promotes the diversification of target companies’ growth paths, even beyond the venture capital model.

3. Seed capital investments are often performed by business angels, which are normally considered to be part of the venture capital market, as private actors. While this is partially true, it also has to be considered that, due to generous fiscal policies on capital gains, business angels tend to be, de facto, private agents of a public principal. While we agree that further fiscal incentives should be introduced in favour of this sector, we believe that business angels alone cannot provide the large scale seed capital investment currently needed in Europe.

4. Public-private cooperation in the form of jointly funded, jointly operated venture capital funds (e.g. at national or regional level supported with European resources) are bound to fail due to the incompatibility of business models and the high transaction costs. More specifically, there is large evidence that venture capital funds concentrate on big deals in large and growing markets, often in the expansion of companies rather than in their early stages. Additionally, it is often assumed that European venture capital players are more risk-averse than those in the US. We do not believe this is the case (or, at least, we do not find any compelling evidence about it). We rather believe that US venture capitalists benefit from a different investment risk distribution, in which non computable risk is absorbed by the seed capital sector.

Faced with the weak performance of the VC market in Europe, many national and regional governments have implemented financial engineering policies consisting in public-private partnerships for the creation of VC funds, or fund-of-funds schemes. These measures combined private and public resources horizontally, that is at the same stage of the financial cycle. More in detail, in these instruments the operational activities are managed by private operators, while the risk capital is provided jointly by private investors and public sources.
It is our opinion that this model does not work, for the following reasons.

When considering an investment in risk capital, private investors tend to prefer the risk/returns ratio of the VC business over the seed capital model. While the first one is usually carried out by mature entrepreneurial teams and it is structurally oriented towards large deals in fast growing markets, the high risk and the low expected returns (due to the small amount invested) related to seed capital often make this market appear as a poor asset allocation choice for private investment.

We believe that, when trying to develop a strategic area such as venture capital, the role of the public sector is to identify and tackle those specific “gaps” where the market can’t (or doesn’t want to) operate. Public intervention should not be aimed at reducing private risks in an already developed market.

To this end, it is interesting to note that, in Europe, the public sector already accounts for the majority of all venture capital fundraising, following a rapidly increasing trend in the past few years. In other words, national and European Government agencies are now the biggest venture capital investors in Europe. Confronting this data with the overall disappointing performance of the industry, we came to the conclusion that the problem doesn’t lie in the quantity of public capital destined to the industry, but rather in the way such capital is invested. It is clear that, by joining private managers in public-private partnerships, the public mainly acts as profit booster. While such approach may prove useful when trying to further develop an already mature market, in the case of seed capital the public is facing a sector that private investors simply don’t consider profitable enough. By partnering with private capital in the VC market, the public actor tends to replicate the market failure rather than correct it, intervening in a later stage of the equity gap without addressing its very source.

We believe that, if this trend is not corrected, the public share in the risk capital market is bound to become even more relevant in spite of decreasing, and eventually disappointing, results.

On the base of such assumptions, this paper suggests that venture capital should be mainly left to the market, while seed capital investment should be addressed by the public sector.

The proposed policy scheme would require the public to specialize in the high risk seed capital segment, while the market would continue to follow a profit-oriented approach, operating with the computable risk of the more mature venture capital segment. The division of labour would then take place at different stages of the financial cycle, rather than at the same level.

3. The European seed capital scheme

The measure proposed in this paper would be financed through the European Union budget and would consist in the creation of a seed capital fund of funds mechanism
directed to a new public investment vehicle at the national level: the Seed Capital Fund (SCF). In order to receive European funding, the SCF would have to respect a number of investment policy requirements, determined directly by the European law, possibly through a regulation in order to ensure a sufficient grade of harmonization among Member States.

In order to be registered as Seed Capital Fund and receive EU funding, the investment vehicle would be required to respect a number of conditions, among which:

- invest only in equity or quasi equity instruments that are directly issued by young innovative companies in the seed capital phase;
- take only minority stakes in the target company;
- do not ask for a position in the board of directors of the target company;
- prior to investing, require all shareholders of the target company to sign an agreement according to which they are bound to repurchase the SCF stake after a given period (e.g. 3 years from the investment, with a possible postponement for given reasons). The agreement must be signed by all shareholders in solidarity;
- do not invest with the goal of making profits;
- do not invest more than 500,000 Euro for each target company;

Additional requirements are introduced regarding target companies:

- must qualify as Small and Medium Enterprises under the European definition;
- its business plan must cover a period of no more than 3 (or 5) years and its content must be significantly innovative;
- the majority of the company must be owned by individuals;
- must not be listed on a regulated market.

Depending on the circumstances, the price of repurchase can be either fixed in advance, which is the most favourable option to the entrepreneur, or ex post, according to clear accounting rules defined in advance (option most favourable to the vehicle).

Considering that young innovative companies are often brain-intensive and, consequently, their intangible assets are difficult to evaluate legally as part of the equity capital or collateral, the SCF could accept a dilution of its share, following a procedure of evaluation of goodwill.

The due diligence process would be carried out by a team of professional evaluators and firms of proven experience in the related sectors, compensated on a fee basis. The public body setting up the SCF will contract the due diligence team through an umbrella agreement following a public evidence procedure. The selection of young companies will be carried out on the basis of a simplified due diligence which will, however, take
into consideration all elements of the business plan and also the potential for future funding steps. The service will be provided at a fraction of the market cost.

The SCF will monitor the accounts of target companies by appointing one member within the accounting certification board.

If the by-law of the investment vehicle respects all these requirements, it will qualify as SCF and will receive the European funding.

4. **The legal form of the Seed Capital Fund**

While creating a new European vehicle for the purpose of seed capital investing would offer an advantage in terms of harmonization, this approach would be hardly viable when we consider the fragmentation of European legal and fiscal national contexts.

Each Member State has put in place different vehicles dedicated to risk capital and, more specifically, seed investment. Such vehicles are often the result of a long and complex juridical process, which has resulted in relevant normative differences in the way national laws have structured this market. Regarding, for instance, the managing structure of investment funds, while in some cases vehicles are managed internally, some Member States have adopted a structure where funds do not have any legal personality and are managed by a separate legal entity (management company).

All this considered, and taking into account the transnational nature of the financial market, we believe that the identification of a SCF should be based on a substantial approach, based on a number of investment criteria, leaving the choice of the legal form at the national level. Such approach would be much more practical and cost-efficient and it would pose less problems in terms of implementation. It is also important to consider that, given the small average dimensions of both seed capital vehicles and target companies, a large part of this measure will be likely managed by European regional and local governments. To this end, the combination of clear investment requirements with a sufficient degree of flexibility in terms of juridical structuring should facilitate the adoption of the measure. Additionally, the respect of common criteria will help harmonizing the different vehicles and will avoid possible misuse of public funding.

As for the supervision framework of the SCF, all vehicles could be required to respect a set of minimum operational requirements (control functions, minimum capital requirements, etc.) the respect of which will be enforced by national supervision Authorities.

It is also worth noting that a similar approach has been followed in the recent harmonization process of the European alternative funds by the AIFM Directive and the regulation for European venture capital funds proposed by the European Commission on December 2011.

5. **The regulatory framework**
At EU level, private equity investing hasn’t been object of EU harmonization until very recently, with the adoption of the AIFMD, Alternative Investment Fund Managers Directive (2011/61/EU).

On a regulatory level, the first important issue is whether or not a SCF will be defined as an alternative investment fund (AIF), thus falling into the scope of the Directive with all the resulting supervisory and operating requirements.

In a recent Discussion Paper on key concepts of the Directive, ESMA further elaborated on this definition, identifying a series of conditions whose respect will define the vehicle as an AIF.

Pursuant to Article 4(1)(a) of the AIFMD, alternative investment funds are defined as “collective investment undertakings, including investment compartments thereof, which raise capital from a number of investors, with a view to investing it in accordance with a defined investment policy for the benefit of those investors”.

If we apply this definition to the specific case under analysis, since the SCF doesn’t raise funds with the intention to deliver an investment return or profit to its investors, it would not, at least in theory, qualify as an Alternative Investment Fund, thus falling outside the scope of both the AIFMD and the venture capital regulation (which applies to the same category of funds).

The SCF will, however, still qualify as a collective investment undertaking with a defined investment policy, and it will be subject to national supervision authorities and juridical frameworks.

On a commercial perspective, not being defined as AIF and, consequently, not falling under the scope of EU harmonization regimes would prevent the SCF’s manager from adopting the European Passport. Nevertheless, in the case of a SCF this is hardly relevant, since the seed capital company would be participated only by public investors, both at national and EU level, and it would not need to raise private funds across Europe.

If, however, private investors were to be allowed to participate in a SCF, the vehicle would be aimed to deliver a profit and it would qualify as an alternative investment fund. In this case, the SCF would still benefit from the simplified regime established by the venture capital regulation recently proposed by the Commission (COM 2011, 860). Such regime applies to venture capital vehicles investing in SMEs with a venture capital asset under management below 500 Euro Millions. It is worth noting, however, that the current venture capital regulation is still a draft and the final text should not enter into force before 2013.

The regime, whose adoption is optional, could be a valid regulatory framework for the SCF as it shouldn’t pose any strict operating requirements. With regard to the internal control structure of the vehicle, the current draft only requires the managing company
to have “sufficient own funds and use adequate and appropriate human and technical resources as are necessary for the proper management of qualifying venture capital funds”. While further requirements might be added in future versions of the text, it is very likely that the final regulation will foresee a much lighter regime than the AIFMD. Such regime would allow the SCF to adopt a very flexible managing structure with low fixed operating costs.

In general, the regulatory framework of the SCF appears to be quite complex due to the different normative layers introduced by the recent EU harmonization measures, whose interaction has yet to be clearly defined both at European and national level. If, as described above, the SCF doesn’t qualify as AIF, it will be exempted from a number of operational requirements introduced at the EU level, but it will still fall under the scope of national supervision Authorities. While the fundraising Passport would have a very limited impact on the measure outcome, the lack of harmonization of the regulatory requisites of the SCF could eventually have a much greater effect. The main risk in a similar scenario consists in a fragmented implementation of the SCF due to the different national supervision regimes. This would substantially hamper the attempt to create a Common market in the seed capital sector, and it would also make very difficult any benchmarking and evaluation activity of the measure.

If, on the other hand, the SCF falls under the scope of the AIFMD, it may still benefit from the de minimis exemption due to their small asset under management.

There is, however, the possibility that, pursuant to the Level 1 text of the Directive, Member States decide to lower or even remove such threshold, requiring all funds, regardless of their asset under management, to comply with the full Directive. This second scenario could also lead to normative fragmentation which would, in turn, hinder the success of the measure. It is worth noting that the SCF could still opt in to the VC regulation and be subject to a much lighter supervision regime.

In conclusion, when considering the optimal regulatory framework of the SCF, it is important to take into consideration the specific characteristics and operating conditions of seed capital vehicles. Since these funds usually manage (and invest) a limited amount of capital, they pose a nearly non-existent systemic risk. Because of the their small dimensions, such vehicles greatly benefit from a light and flexible management structure. It is, then, crucial to foresee a set of requirements that are proportionate to the activity of the SCF, do not impose an excessive regulatory burden to the vehicle and are, at the same time, adequately harmonized at the EU level in order to prevent normative distortion during the implementation process.

6. The State aid discipline

While we believe that the overall scheme is compliant with the EU discipline in its basic principles (2006/C 194/02), the lack of a profit-oriented approach in the management of
the SCF is probably the most delicate issue to be addressed when verifying the compliance of the measure with the State aid legislation.

When analysing the potential negative impact of the measure in terms of competition in the seed capital market, it is necessary to consider a number of elements specifically related to the demand and the supply side of this sector.

On the demand side, the repurchase of the SGF stake after a given amount of time by the entrepreneur can give rise to a State aid to the benefit of the target company shareholders. More specifically, if the price is too low, the public investor, through the SGF, would renounce to the capital gain which could have been collected from selling its stake in the company. On this specific matter, it may be argued that the local dimension of the SGF and the limited amount invested are unlikely to affect trade between Member States and to distort competition in the Single market.

This scheme could also increase the amount of “investment ready” projects available to European venture capital funds, consequently improving their profitability, their dimension and, eventually, their attractiveness in the eyes of large institutional investors.

On the supply side, a non-profit oriented public intervention could, in theory, pose a serious challenge in terms of competition, possibly causing a “crowding out” process to the detriment of private investments. In this case, it will be necessary to demonstrate that the SGF will only invest in a market which private capital rarely considers because of the high risk and limited expected returns. It may also be demonstrated that a public intervention in the seed capital market as an early customer can ease the equity gap in Europe, not causing but, in fact, correcting an existing market failure by taking those risks private investors wouldn’t take anyway under the current market conditions.

It is also worth noting that the same Commission, in its guidelines on risk capital, explicitly acknowledges a more pronounced market failure affecting the seed capital sector (Section 5.1, letter e). More in detail, the guidelines admit a more favourable stance towards measures with limited or even no private participation.

Furthermore, the SGF will be assisted by a due diligence committee composed by experts and professionals chosen through an open tender. Such provision will constitute a further positive element in the eyes of the Commission when evaluating the aid.

Given the small scale of the average seed investment, the scheme could also be managed within the de minimis framework. While this option would substantially ease the notification and implementation processes, it could not represent the optimal choice as it would make funded companies not eligible for further public funding schemes.

As for the expenses of the SGF which can be eligible for funding, the current State aid guidelines of the European Commission recognize that in the seed capital market the
costs incurred for the scouting of investment opportunities are not to be considered operational expenses, but investment expenses (Section 5.1, letter g). This represents an important exception to the general rules on risk capital, according to which operational expenses of management companies funded with EU funds are not considered eligible.

In general, the implementation of the SCF should not pose any particular issues in terms of compliance with the State aid discipline. The most controversial element of the measure would be the non-commercial management of the measure. To this end, the relatively small dimension of the seed capital market should ensure a limited impact in terms of disruption to EU competition. On the other hand, the relatively low intensity of private capital in this sector should allow the public to intervene efficiently with minimal “crowding out” effects.

7. Conclusions

The scheme proposed in this paper tries to address the current equity gap in the European Union by reconsidering the role of the public actor in the risk capital market.

The entrepreneur-friendly financing mechanism of the SCF is specifically tailored for the seed capital market and does not interfere with the internal decision making of the target undertaking. At the same time, the fixed-term repurchase of the SCF stake by the company and the evaluation of the projects carried out by proven experts minimize both moral hazard and adverse selection risks. Moreover, the solidarity condition in the repurchase of the stake by the entrepreneurs is agreed before the investment takes place, thus avoiding possible conflicts between shareholders on this matter.

The allocation of capital gains, which are entirely distributed to the entrepreneurs, would have a considerable impact on the company development and capitalization and would facilitate further funding steps with private venture capitalists.

Furthermore, the creation of a harmonized investment structure as the Seed Capital Fund could help coordinating the implementation of the measure in the different EU Member States. The scheme will not require the creation of a new ad hoc structure but only the compliance of existing national vehicles with a number of clear investment conditions fixed by a regulation at the EU level. As a consequence of this, SCFs will be relatively easy to manage by local authorities, which are the most likely recipients of the measure.

Due to the recent harmonization process of alternative investment at EU level, the measure will also benefit from a structured regulatory framework. The nearly inexistent systemic risk posed by seed investment should allow the SCF to benefit from a simplified regime with low fixed costs and a flexible management structure.

As for the compliance of the measure with the current State aid discipline, the Seed Capital Scheme will address an increasingly recognized market failure in a EU strategic
area. The measure is therefore likely to have a considerable impact on economic development and low disruptive effects to competition due to its local extent and the limited average amounts of capital invested by the vehicles.