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COMMUNICATION FROM THE COMMISSION
TO THE COUNCIL AND THE EUROPEAN PARLIAMENT

Risk Capital: Implementation of the Action Plan
Proposals for moving forward

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INTRODUCTION

In April 1998, the European Commission proposed a communication to the Council and the European Parliament on **Risk Capital : a key to job creation in the European Union.** This document included an Action Plan proposing key measures to be taken at Community and Member States level to remove the main barriers hindering the development of risk capital in the Union. The main political message was that risk capital is essential for job creation, raising productivity and supporting growth in Europe, and crucial for the financing of fast growing companies, especially the high tech, knowledge based industries. Empirical evidence since 1998 continues to support this thesis. Both the 1999 Broad Economic Policy Guidelines (BEPG) and the Cardiff report stressed that efficient risk capital markets play an important role in this process and that the measures necessary to remove the barriers hindering the proliferation of risk capital in Europe are part of the structural reforms needed to improve the overall functioning of the Community's product and capital markets. The present communication shows how some of the recommendations put forward in the BEPG on this issue are being implemented. Efficient risk capital markets are also a precondition for the development of entrepreneurship in Europe, one of the four pillars of the Employment Guidelines adopted by the European Council in February 1999.

The Cardiff European Council (June 1998) welcomed the Commission's report, underlining the importance of access to capital as a key factor in encouraging entrepreneurs and smaller business to achieve their full potential. It called on the Council and Member States to consider its recommendations, including the proposed Action Plan. At the Vienna European Council (December 1998), the European Council invited Member States to report on how they were implementing the risk capital action plan.

The Commission services have now analysed how the Action Plan is being implemented at Community level and through the measures reported by the Member States[1]. Market developments and policy changes to promote risk capital show that whilst some progress is being made, Europe still suffers some major weaknesses, particularly when viewed against its major competitors. It is therefore important to speed up the removal of the barriers to improve the Union's growth and employment prospects in the medium term.

[1] See working document SEC(1999) 1725 for detailed analysis.

1. PROGRESS HAS BEEN MADE

1.1 Risk-capital is developing in Europe, but not fast enough and its allocation remains sub-optimal.

With the arrival of the euro, coupled with a more favourable economic climate and supply side liberalisation, risk capital markets are beginning to develop in Europe, albeit at different rates. A growing number of business angels support the creation of new businesses; increasing amounts of venture capital are beginning to be invested in fast growing companies; and new stock markets are offering high growth companies the possibility to go public. However, the amount and allocation of risk capital still remain sub-optimal, as a result of the persistence of enduring constraints and barriers throughout the financing chain, from seed capital to IPO.

Whilst European venture capital[2] has grown rapidly over the past five years, it remains significantly smaller than in the US and insufficiently oriented towards young and innovative companies. In 1998, for the second year in a row, € 20 billion was raised for private equity investments in Europe (compared with € 3 to 8 billion p.a. between 1988 and 1996) and about € 14.5 billion was invested. But less than half of this € 14.5 billion, only € 7 billion, was invested in venture capital in Europe, compared to € 12 billion in the US. And only € 1.6 billion was invested in early stage compared to € 4.5 billion in the US in 1998. Investment in high-tech has almost doubled in Europe between 1997 and 1998 (from € 2.3 billion in 1997 to € 4 billion in 1998). But, in the US, over 80% of the venture capital investments are in Information Technology (IT) and biotechnology and healthcare, while in Europe it is less than 28% of private equity investment.

European stock markets dedicated to high growth companies, created some 3 years ago, have grown strongly in 1998 and in the first half of 1999 have shown some very positive developments. There are now over 650 companies quoted on the main European markets for high growth companies: Euro.NM, EASDAQ and AIM. But these markets remain dwarfs compared to the American Nasdaq: they quote no less than 8 times fewer companies; their total market capitalisation is a staggering 33 times lower than Nasdaq's and they remain extremely fragmented despite the expansion and tightening of the Euro.NM network.

The very recent and rapid growth of electronic share trading through electronic communication networks (ECNs) will help companies in the future to list and trade their shares globally and round the clock and will contribute to a decrease in the cost of raising capital. It is estimated that already 5% of European equity trading is now carried out through new electronic share trading organizations. In theory, exit opportunities for the venture capitalist should improve as liquidity deepens. But the growth of those alternative trading systems also raises regulators' concerns on safety and investor protection.

[2] Venture capital is a subset of private equity. In this paper, this term will be used in its restricted sense: for equity investments made for the launch, early development or expansion of a business, excluding MBO/MBIs, while private equity includes venture capital and MBO/MBIs.

1.2 Various actions have been taken to remove the barriers to the development of risk capital in the European Union.

Since April 1998, the Commission has taken various actions to promote risk capital in Europe: for example, it has launched a pilot action in favour of business angels, organised a round table on the impact of the fragmentation of the European markets on the provision of risk finance to draw some lessons on what should be done to create an appropriate framework for the development of a true European market, and analysed the economic and financial impact of employee stock ownership and stock option schemes. It has also established a "trend chart on innovation" to gather information on national and EU policy measures to promote innovation and launched several projects to facilitate and develop long term durable interaction between sources of finance and sources of technology. And it has integrated the financial regulatory issues raised in the Risk Capital Action Plan into the Financial Services Action Plan[3] (the latter sets out the regulatory actions needed for an integrated European capital market and proposes reforms to be taken at EU level within an indicative time frame).

The first assessment of the implementation of the Action Plan by Member States shows some very positive progress in areas such as the support for the earliest stages of financing, the simplification of administrative formalities for setting up a company or the promotion of networking between universities, financial backers and other actors. Most Member States have also developed programs of promotion of entrepreneurship and innovation within educational and training systems as well as through conferences, the diffusion of information and the work of governmental agencies or venture capital bodies.

1.3 Financial support can be a catalyst in the provision of risk capital.

The Community is also implementing a number of financial programs to stimulate the mobilisation of capital for innovative companies in fields where private investment is lacking: seed capital (CREA, the new Seed Capital action launched by the Commission in November 1998); innovation (the Innovation and Technology Equity Capital (I-TEC) pilot project, and other measures promoting the co-operation between financial sources, researchers and industry under the research and development framework programme); early stage SMEs (the Luxembourg Growth and Employment Initiative consisting of three schemes: a risk-capital facility ("ETF start-up"), a scheme of financial contributions for the establishment of transnational joint-ventures ("Joint European Venture"), and a guarantee facility ("the SME Guarantee Facility")). The EU Structural Funds, and in particular the European Regional Development Fund (ERDF), co-finance through the mechanism of multiannual Operational Programmes Member States' actions aimed at facilitating SME access to venture capital in the least developed regions of the Union. In addition, the European Investment Fund (EIF) acts as a catalyst in the financing of venture capital funds focussed on early-stage and technology investments while the European Investment Bank (EIB) is a leading source of finance through its new risk-sharing operations

[3] Financial Services: Implementing the framework for financial markets : Action Plan. COM(1999)232

reinforced by the call from the Cologne European Council for a further € 1 billion to be set aside for the period 2000-2003.

All Member States have initiated financial programs channelled through various funds to support the development of innovative SMEs. Investing for example in the software industry or very early-stage, high-tech businesses; funding seed-corn early-stage collaboration between university scientists, venture-capital and industry to commercialise scientific discoveries; providing equity finance to small technology based firms on a co-financing basis with private equity capital provider.

2. MEASURES TO BE TAKEN IN THE YEAR 2000 TO SPEED UP THE DEVELOPMENT OF RISK CAPITAL IN EUROPE.

The analysis of the barriers to the development of risk capital made in the April 1998 Risk Capital communication showed six main areas of concern: market fragmentation, institutional and regulatory barriers, taxation, a paucity of high tech SMEs, lack of qualified human resources and pernicious cultural barriers. It also showed that the barriers affecting the different stages of risk capital financing (early-stage, development, flotation) must be tackled together, enterprise financing being an on-going process. In an integrated financing chain, the overall efficiency of risk capital provision will only be as strong as the weakest part of the chain

Therefore, the Action Plan came up with a wide list of measures to be taken at Member States or at Community level. All of them are important and will help the development of risk capital in the Union. Some major structural reforms however have been slow to start. To speed up the process, it would be useful to set some targets or actions at Community and Member State level and identify a few core actions to be taken in the year 2000. Precise actions that could set a framework and contribute a great deal to further reducing the barriers to the development of risk capital in Europe. Actions that have already been taken in some countries or have been lengthily discussed and prepared so that they can be implemented in the next 12 months.

2.1 Measures already launched should be further enhanced

Both at Community, as well as at national level, the measures already launched in favour of business angels, to simplify administrative procedures, or to facilitate and develop long term durable interaction between sources of finance and sources of technology should be further enhanced. For example, actions taken to promote an entrepreneurial approach towards exploitation of university research or to develop adapted financial models and ownership structures for university incubators are examples of good practices to be developed in all countries.

Well designed public direct financial support, which does not distort competition, but complements and acts as a catalyst for private capital, should be further developed. This support should be limited to the regions and markets (such as early stage) where the provision of private venture capital is not sufficient.

2.2 Core regulatory actions to be taken at Community level in the next 12 months:

1. Adoption of prudential rules to allow institutional investors to invest in venture capital

The Commission published in May 1999 a Communication drawing policy conclusions from the consultation process launched by the June 1997 Green Paper on "Supplementary Pensions in the Single Market". The Communication looks at appropriate investment and prudential rules for pension funds in the context of the euro. As a follow-up of this Communication, the Commission will propose by mid-2000 a directive on the prudential supervision of pension funds. It will take into account the diversity of pension funds operating in the EU and will cover authorisation, reporting, as well as rules on liabilities and investments which would relax existing rules in some Member States concerning investments in unlisted SMEs.

2. Upgrade the prospectus directives to facilitate companies raising cross-border capital (e.g. IPO's)

To overcome obstacles to the effective mutual recognition of prospectuses, work will concentrate in the short-run on clarifying and harmonising, at the practical level, the requirements and procedures involved in cross-border activity. Building on this work, the directives on prospectuses may be upgraded. The Commission intends to move forward on these issues by mid-2000.

These two measures are part of the Financial Services Action Plan.

3. Reform of the European Patent System

In June 1997 the Commission published a green paper on *"Promoting innovation through patents"* followed in February 1999 by a communication[4]. This communication defines a number of important actions which the Commission intends to undertake by the end of 1999 or early 2000:

- A proposal for a regulation concerning the creation of a Community patent system providing adequate services to the users communities.
- A proposal for a directive concerning the patentability of computer programmes
- An interpretative communication concerning patent agents, particularly in relation to the right of establishment and the free provision of services.

On the other hand, the Commission considers that a pilot action should be launched by national patent offices in order to explore how patent information can be more comprehensible, accessible and practical to SMEs. Finally, the Commission considers that the special needs of SMEs in particular in relation to cost and for simpler and less expensive legal proceedings should be taken into account.

[4] COM(99) 42

2.3 Core actions to be taken at Member State level:

Learning from others' experience will accelerate the implementation of the Risk Capital Action Plan. Some interesting experiences in key areas can be put forward. They could become examples of good practice and encourage reforms to be taken in all Member States in the year 2000. For example:

1. Taxation of new firms and investment in venture capital.

To encourage individuals to develop existing businesses or set up a company, interesting tax relief schemes have been developed in some Member States. In Ireland, through the Business Expansion Scheme (BES), an individual who invests in new ordinary shares of a company can obtain tax relief, while the BES Seed Capital Scheme provides a refund of income tax already paid to individuals who are interested in starting up a qualifying business. In the UK, the Enterprise Investment Scheme (EIS) encourages individuals to invest directly in early stage companies with growth potential, while Venture Capital Trusts (VCTs) provide tax incentives for individuals to invest indirectly via pooled investment funds. The comparative taxation of debt and equity instruments could also be further examined.

2. Reform of the legislation on insolvency and bankruptcy:

This issue is clearly considered as crucial by many Member States, but few have been able to implement a comprehensive reform giving entrepreneurs a real "second chance". At the beginning of July 1999, the UK government announced its intention to work on a relaxation of bankruptcy laws to remove the stigma of failure from those whose business fails through no fault of their own. One consideration is whether to allow such bankrupt entrepreneurs to keep some minimum assets (in the range of € 15 000) and to be discharged after a short period (six months rather than the present three years). In Germany, under the new insolvency law it is now possible to obtain discharge of the remaining debt, after seven years. Provided ways are found to avoid protecting "culpable" bankrupts while giving a second chance to those entrepreneurs who were genuinely unfortunate, a relaxation of bankruptcy laws removing the stigma of failure would be a crucial reform to promote entrepreneurship.

3. Promotion of innovative employee ownership schemes, including stock options

Broad range stock option schemes are key to the development of young high-growth companies. Several Member States have been considering developing a more favourable and less complicated taxation of stock options (e.g. through taxation at sale of the underlying shares, taxation as capital gains, etc...). Beyond the level of taxation, what is at stake is the complexity of some regulations and the uncertainty this creates. So far, two experiences can be mentioned: the schemes under consideration in the UK[5], and the new Belgium law (taxation at issue of the options, but at a low rate).

CONCLUSIONS

To go forward, the Commission considers that it is now necessary to review progress regularly, via a benchmarking process which could cover, inter alia, the identification of best practice, especially in those areas requiring major structural reforms (e.g. investment rules for institutional investors; accounting rules; legislation on bankruptcy; taxation (of companies (especially new start ups), investments, stock options, etc)). Such a process would be based where possible on existing instruments. This could eventually lead to political agreement on a set of deliverable benchmarks or objectives over the next 5 years. This benchmarking process will encourage the Community and the Member States to work together, within their respective areas of competence, to create more efficient risk capital markets throughout the Union. It will also be part of the on-going process of assessment of the functioning of Community product and capital markets and of the preparation of the Broad Economic Policy Guidelines.

The Commission therefore requests the Council:

- **to invite the Commission and the Member States to speed up the implementation of the Risk Capital Action Plan in the year 2000.**
- **to acknowledge that the Commission will review regularly progress made by the Member States and the Community towards the development of Risk Capital via a benchmarking process including identifying best practice and focusing on those areas needing major structural reform.**
- **to undertake to promote the development of risk capital by stressing the need to include specific recommendations on this issue in the future "Cardiff report" as well as in the Broad Economic Policy Guidelines and the Employment Guidelines whenever relevant.**

[5] To complement the existing schemes, the UK is preparing two schemes to support employee ownership and equity remuneration: the Employees Share Ownership Scheme (granted to all employees) and the Enterprise Management Incentives (tax relief on equity remuneration given by smaller companies to a few key individuals). The two schemes are complementary and will be developed alongside each other.

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