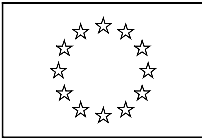

COMMISSION OF THE EUROPEAN COMMUNITIES

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COMMUNICATION OF THE EUROPEAN COMMISSION

Risk Capital : A Key to Job Creation in the European Union

April 1998

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INTRODUCTION

The Luxembourg European Council on Employment (20/21 November 1997) acknowledged, in paragraph 30, *"...**the importance of the role that large pan-European risk-capital markets can play in job creation and asks the Commission to report to the June 1998 European Council on barriers to the development of such markets in the Union**..."*.

This document is a first response to this mandate. It sets out the main arguments why developing a full range of risk capital markets in the European Union is vital for future job creation. In Section 1 it compares, in summary form, the EU's performance vis-à-vis the United States, and underlines in Section 2 the main barriers that are preventing a much wider use of these financing instruments in the EU. In Section 3 some preliminary ideas are forwarded for the contents of an Action Plan to be agreed eventually by the Council and the European Parliament to deal with the main barriers.

The present document will be submitted to the Ecofin Council on 21 April to gauge the opinion of the Member States and to the European Parliament, Economic and Social Committee and the Committee of the Regions. It will then be adjusted, where necessary, and submitted as a formal Commission proposal in response to the European Council's mandate during May.

The political message of this document is a simple one.

Developing risk capital in the European Union, leading towards the development of pan-European risk-capital markets is essential for major job creation in the EU. Although Economic and Monetary Union and the arrival of the Euro will create a more favourable environment and be a major catalyst for change, there remain a number of pernicious barriers – regulatory, economic, fiscal, cultural – that need to be addressed as a matter of urgency.

In essence, what is at stake is the creation of a new entrepreneurial culture in Europe. The real political challenge is to provide the tools, enabling technologies and financial instruments for a new generation of European entrepreneurs to start up and succeed. To provide the conditions for European diversity to flourish. So European skills and knowledge can be translated into winning global companies. To create sustainable jobs and additional growth. In the European Union.

The Commission considers the provision of substantial pan-European risk-capital markets a necessary condition for this to happen.

I.

THE IMPORTANCE OF PAN-EUROPEAN RISK CAPITAL FOR THE EUROPEAN UNION

❑ Political Background

In recent months there has been a strong, emerging political consensus that if the European Union and the Member States are to create the jobs to reduce, sustainably and substantially, its unemployment levels, the Union must become far more entrepreneurial. This conclusion was confirmed in the Luxembourg Employment Summit, in the 1998 Employment Guidelines and in the recent G8 meeting in London.,[1] Entrepreneurship is one of the four pillars of the Employment Guidelines, which specifically underline the need to improve the conditions of risk capital markets. In a nutshell this means creating the right conditions for small and medium sized enterprises to start up, flourish and grow and for those with the best growth prospects to be eventually quoted on European Stock Exchanges. The Commission believes that encouraging this systemic growth process will create many jobs in the EU.

Two conditions are crucial for this to happen. **First**, European entrepreneurs must be able to access the right financing, at the right price, at the right place and at the right time to develop their companies and their ideas. This means European entrepreneurs must be able to access start up capital; intermediate and development capital as the company expands; and finally access institutional and private investors supported by a sizeable, liquid, secondary European stock market where their shares can be traded. The scope of this paper applies to all the stages of this process : from seed to start up to early growth and then sustained growth. Indeed it should, because in this field the European Union is weak on all fronts.

The **second** condition is that risk capital investors need a stream of good investment opportunities as well as fair reward for risk taking. This implies both creating a more entrepreneurial Europe and a new approach to risk sharing by European entrepreneurs and investors based on a mutually beneficial partnership. This paper addresses both supply and demand side issues related to the development of a pan-European capital market.

❑ Employment Creation : EU-US Evidence

There is a large amount of empirical evidence pointing towards the crucial importance of risk-capital markets for job and wealth creation. In the European Union, one survey has shown that during the period 1991-5, employment increased by 15% per year in companies who benefited from investor financed venture capital with 60% of the companies saying that they believed that this investment had proved positive for employment generation. Indeed 80% said their companies would not have existed or would have developed more slowly without such venture capital participation. This trend is confirmed from other

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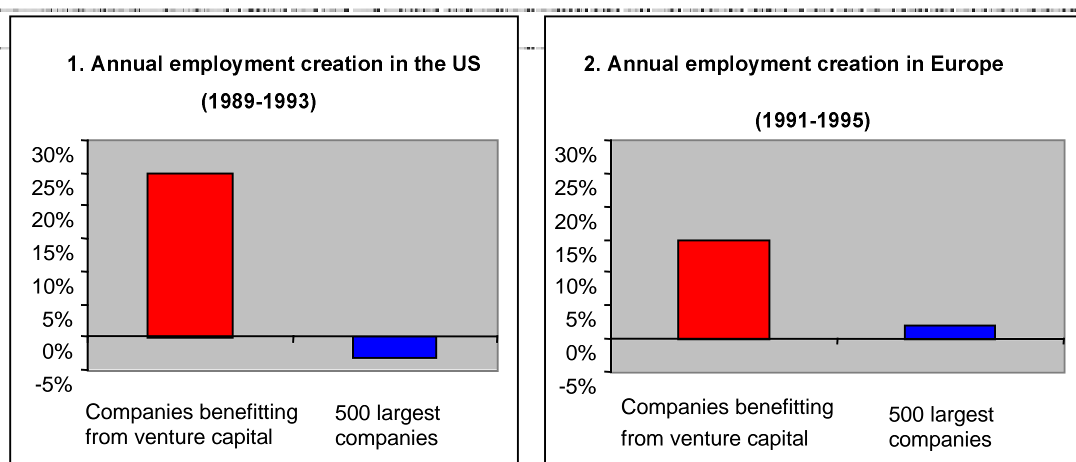
[1] One of the recommendations of the G8 Conference on Growth, Employability and Inclusion suggested to be adopted at the G8 Heads of State and Government at Birmingham in May should be *"...fostering entrepreneurship and creating an economic environment favourable to SMEs, in particularly new businesses, including better access to venture capital…"*.

surveys and evidence from the EU's small risk capital stock markets (Euro-NM, EASDAQ etc).



Source : National Venture Capital Association

Source : EVCA *"The economic impact of venture capital in Europe"*

There is even more persuasive evidence from the United States :

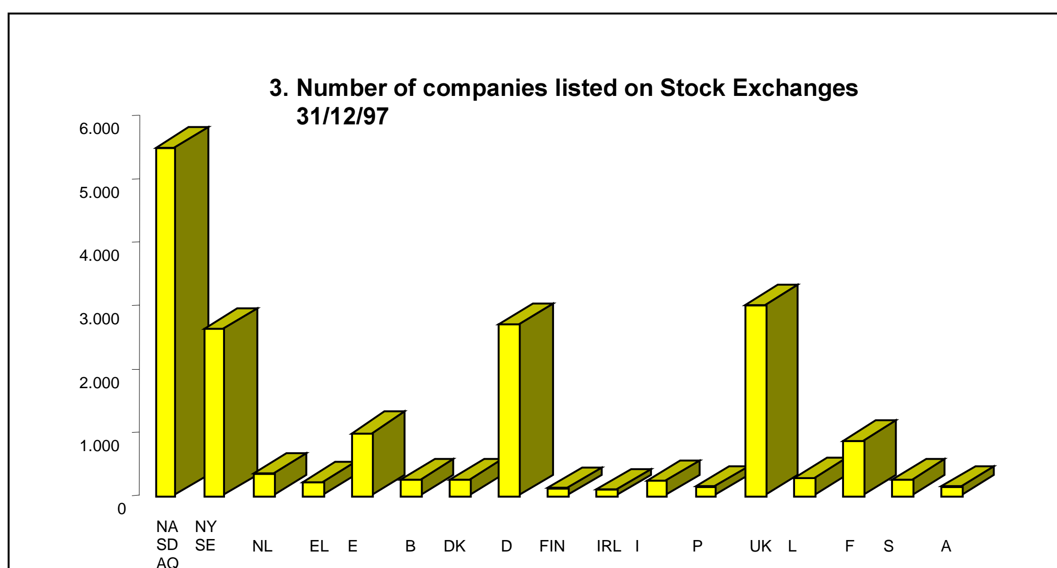
In the US the development of a limited number of high growth firms has had a crucial impact on employment creation. In 20 years from 1975 to 1995, barely two dozen US biotech and Information Technology companies saw their turnover multiply by over 100 times to nearly 250 billion $. Nearly 1.5 million jobs were created in the process. Between 1991 and 1995, 3% of the firm population, called *"gazelles"*, accounted for 80% of job growth – 6 million out of an additional 7.7 million jobs in the US economy (source : Cognetics, Who's Creating Jobs).

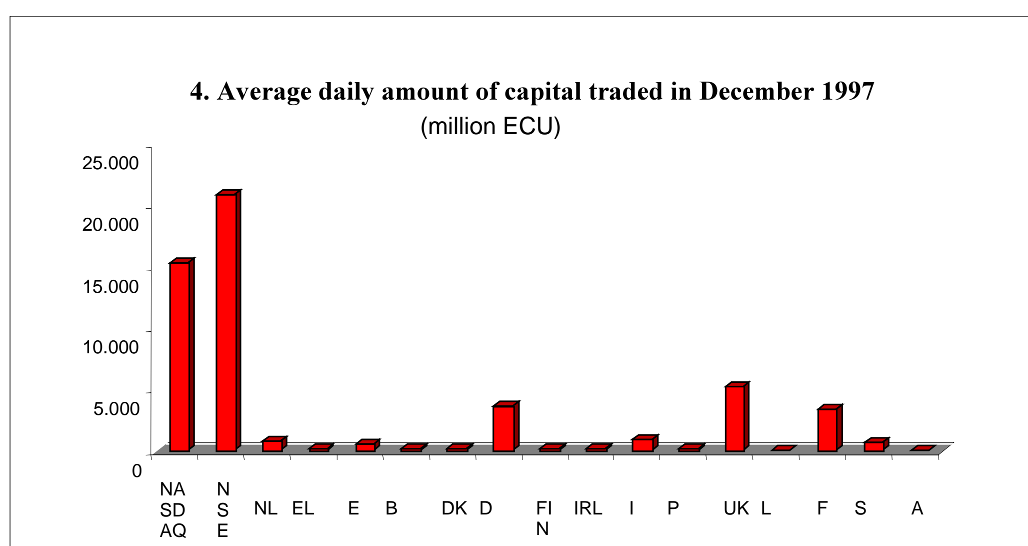
The US NASDAQ market has been developing for over 25 years and has become the market of choice for raising capital to finance fast growing SMEs in the US. Today, no less than 5,500 companies are quoted on it (including a small number of European ones). These companies **employ approximately 9 million people**. The 1995 Cognetics study showed that from January 1990 to June 1994, NASDAQ companies created more than 16% of all new jobs in the US.

There have also been business failures in the US – and risk capital is not the sole reason for all the successes. But there is hardly any doubt that it has greatly assisted the growth and job creation process.

❑ Risk Capital : EU-US Evidence

The NASDAQ market is liquid with a daily turnover comparable to the New York Stock Exchange. Assuming the normal multipliers in the economy, the accumulated number of **direct and indirect** jobs created in the US could be at least half as much again. The EU has nothing comparable in size or scope (see graphics over page). Latest data suggests that in 1997 NASDAQ raised more than 7 times the capital raised on EASDAQ, EURO NM and AIM combined. As for venture capital, total US investments were at least 3 times more. Evidence from 1996 shows that total venture capital investments in SMEs in the IT and life science domains in the US were also at least 6 times larger than the EU. This gap has probably widened since.

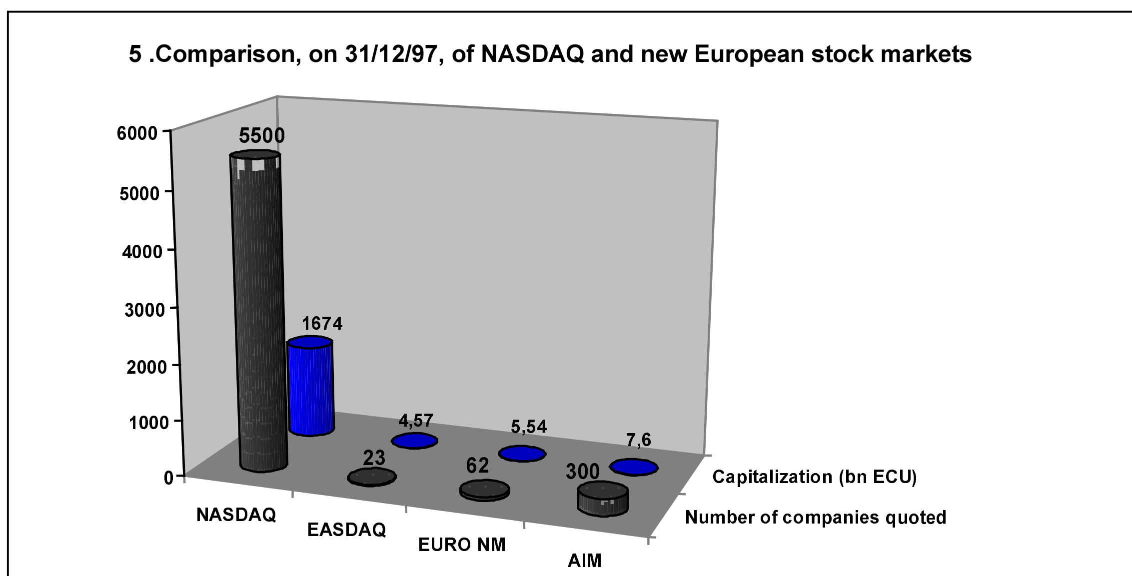




Source : FIBV, own calculations.

- The size of early stage and venture capital investments in the United States are also much higher than in most of the EU Member States : microcredit,[2] private equity, Business Angels, corporate venturing etc. In the US, there are estimated to be 250,000 active individual investors investing in 20 to 40 times more businesses than formal venture capital and 5 times the amount of formal venture capital. Furthermore, early stage investments in technology based companies seems to be intensifying in the US, particularly in internet start ups, communications technology and biotechnology. The Price Waterhouse Venture Capital Survey of venture capital investment throughout the United States indicates record results in 1997 and in the fourth quarter of 1997, a record for the third time in a row [3.7 billion $ of venture capital invested in 749 companies].

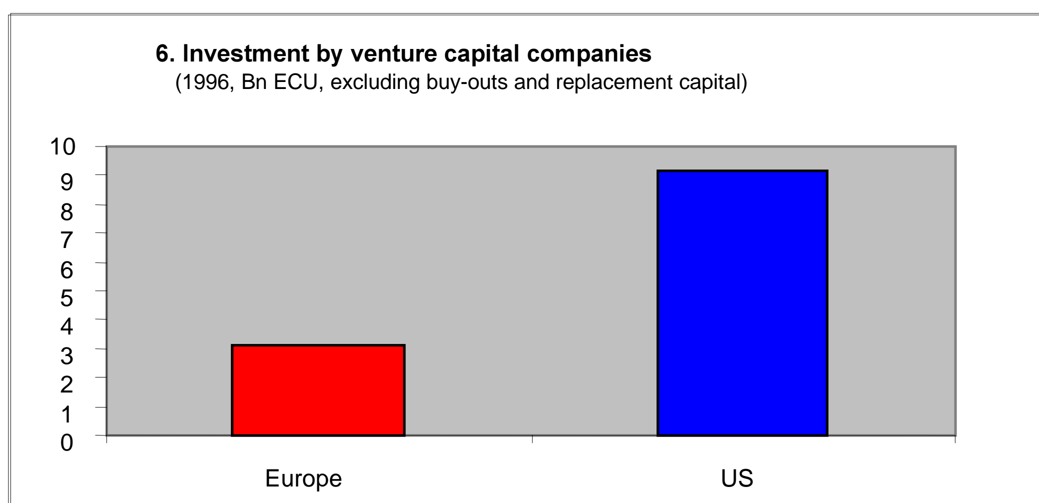
[2] In the US, microcredit programmes are widespread. They help the unemployed or poor to start their business. Several Member States have also developed similar schemes, albeit on a more limited scale.



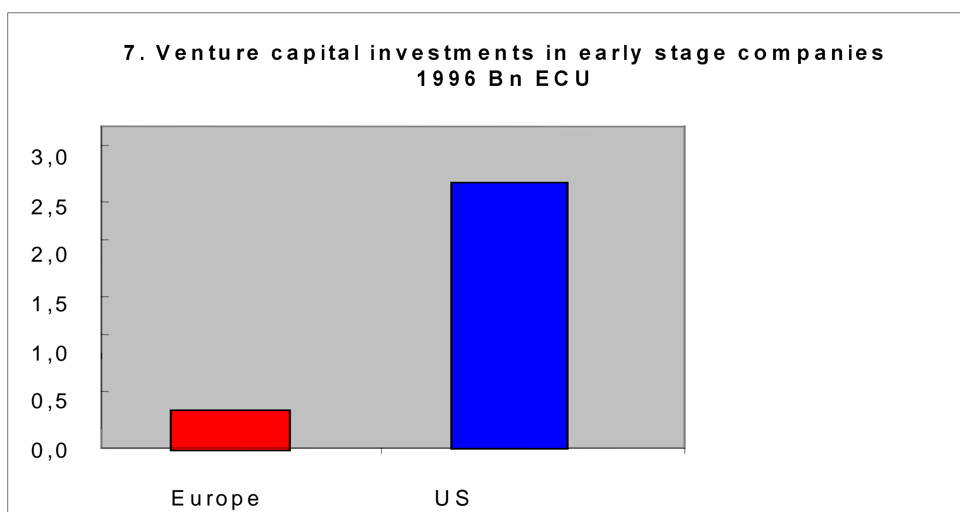
Source : NASDAQ, EASDAQ, EURO-NM, AIM, our calculations.

- In the EU a larger share of a smaller venture capital pot is invested in management buy outs (MBOs) or corporate restructuring, both of which have a smaller impact on job creation. In the European Union the relatively high investment and monitoring costs and the perceived high risk of early stage finance compared to MBOs are other reasons braking the development of venture capital. The problem in Europe seems to be threefold :

(i) Creating the necessary venture capital dynamics throughout the whole business lifecycle chain.
(ii) Orienting venture capital more towards higher risk, high tech investment areas, particularly towards start-ups.
(iii) Generating high tech start ups able to exploit advances in RTD.



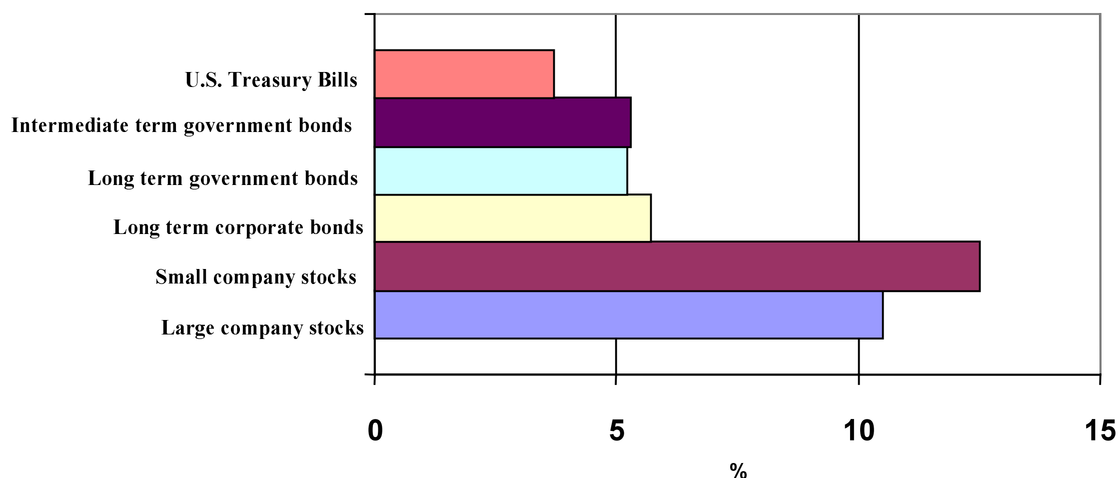
Source : EVCA, Venture One, own calculations.



Source : EVCA, Venture One, own calculations.

A recent survey concluded for the Commission[3] confirmed these findings. Start ups, early stage, R&D based, technology based, high growth SMEs were those who had the most difficult financing problems.

- A further striking difference concerns the extent to which US pension funds contribute to the provision of venture capital in the US. Spurred on by what is termed *"prudent man legislation"* adopted at the end of the 1970s, the United States pension funds have provided a growing source of capital for traded equities and also for venture capital financing. Furthermore, this prudent man legislation, through the diversification process, has allowed a significantly higher real total annual return enhancing pension benefits in those countries which have adopted such legislation.[4] This is because experience shows that in the long run, the return on equity investment out-performs the yields on government bonds or property. Around 50% of the capital of pension funds in those countries with *"prudent man"* legislation are invested in equities compared to 16% of those who restrict asset placements in various ways.



Source: Morgan Stanley Dean Witter

[3] European Business Angels network : Report on the potential for Business Angels investment and networks in Europe – February 1998.

[4] NL, UK, Ireland, USA, Canada, Australia have similar legislation.

Here there is a treble dividend. First : removing unnecessary restrictions on pension fund investments or other institutional investors releases extra capital for risk capital investment in the economy. Second : improving the pension fund benefits for pensioners. Third : lowering the cost of funding of pension contributions, translating into increased competitiveness.

Preliminary results from the EU innovation finance benchmarking study indicate that the rates of return on private equity and venture capital funds in the EU are also substantial.

- There is another major factor that facilitates venture capital generation and investment in high technology start ups in the US. This is the dynamics of clustering seen in several centres in the United States such as Silicon Valley, Seattle, New York, Boston, Austin-Texas. In these locations there is a melting pot of venture capitalists, researchers, technology experts, real estate merchants, lawyers, accountants, business schools and universities – all of whom have a stake in the entrepreneurial process. The result of this clustering and cross-fertilization is a spur to innovation, entrepreneurship, and the development and marketing of new ideas, sourced by a fertile venture capital community. Again, apart from one or two exceptions, the European Union is lagging behind.

Consequences of Structural Weaknesses in the European Union

- European entrepreneurs and small and medium sized companies are very far from realizing their full potential in terms of job creation. This unfulfilled potential can probably be measured in terms of millions rather than thousands of good jobs. The jobs that are being created by these high growth companies using risk capital in the US are generally of high quality – paying considerably above average wages.

- Many good European ideas – themselves the result of expensive public investments in education and research – end up being developed in the United States where capital, know-how and the business environment are more conducive to their development and success. It means the migration and loss of some of Europe's best talent and best ideas. The rapidly increasing number of Europeans working in Silicon Valley is but one indicator. Furthermore, there is strong evidence of major US corporations *"buying"* the latest high tech European ideas on the market – either with annual *"war chests"* or with specially made to measure venture capital instruments to scoop the best European ideas when they emerge**.** There is nothing wrong or illegal with these business practices. But it is important that these investors are induced to exploit these ideas inside the EU. If not, the long term negative effects on employment in Europe will be very significant.

  This is of major strategic importance for the Union. The crux of the matter is that the European Union must develop its own financial and entrepreneurial capacity to develop its own innovative ideas through new high technology companies inside the EU.

- In the EU it can take from 1 – 4 decades to be listed on a stock exchange, but in the US venture capital assisted businesses can go public on NASDAQ in a few years after creation – a tremendous incentive for the entrepreneur. Furthermore, on

average US IPOs of this form tend, on average, to raise ten times more capital than equivalent operations in the EU.

The EU has no liquid stock market like NASDAQ, or of the same size, to attract European entrepreneurs to develop their enterprises. The inevitable consequence is market inefficiency.

- If technology and business leadership in the most promising sectors of the world economy are left to the EU's principal competitors, de facto this will tend to lead to others setting the future global business and trade agenda and a consequential decline in the Union's external trade influence.

- The lack of the necessary risk capital in the EU means young European entrepreneurs and companies, particularly for high technology products, often become over dependent on bank loans and overdrafts for early stage financing. Such financing is usually less flexible, more expensive, less secure and frequently *"fair weather"*. It can be particularly inappropriate for high tech start ups where cash flow will either be negative or limited in the start up phase. High tech start ups play a vital role in the emergence of new products and industries and hence job creating growth. The EU SME sector relies far more on bank loans and overdraft financing than the US.

  These findings were confirmed by the European Business Angels Survey (February 1998). The security required by banks and the lack of credit, start up, early stage and business angels capital were considered as the most acute financial problems among the SMEs surveyed.

- Finally, the size of sectoral State Aids still being granted in the EU remains a worrying element acting largely against the interests of European entrepreneurship, SMEs and cohesion.

Positive Signs of Change

- Although it should not be seen as a miracle cure, the launching of the Euro on 1 January 1999 will greatly facilitate the emergence of more pan-European financial instruments and gravitation, over time, towards more harmonized conditions in financial markets.

- Some European stock exchanges are beginning to co-operate more closely – for example, in the fields of cross access to quotations, harmonised negotiation systems, identical settlement procedures, standardised software and working stations and a family of joint indexes representing the pan-European equity market. These developments could just signal the beginning of a far-reaching process which could help reduce fragmentation in the European stock market.

- The removal of exchange risks between participating countries will significantly enhance the size and liquidity of the European financial market place – for issuers and investors alike. One reason for this is the obsolescence, as of 1 January 1999, of current currency matching requirements between assets and liabilities, which leave a limited capacity to invest abroad to pension and insurance funds. These requirements will no longer be necessary in the Euro zone without prejudice to prudential safeguards, therefore creating more freedom for institutional investors.

- Another positive effect of EMU is the prevention of excessive public deficits guaranteed in the long run by the Growth and Stability Pact. This long lasting reduction in borrowing requirements of public authorities will diminish their *"crowding out"* effect and release further capital for the private sector. This will begin in the bond markets but certainly spread quickly to equities. The sustained low level of interest rates which can be expected as a result will also facilitate portfolio adjustment towards a higher percentage of equities.

- EASDAQ, Euro-NM etc although still relatively small are nevertheless positive signals that the market recognizes that pan-European risk capital instruments are needed.

- In connection with EMU, Finance Ministers are also more aware of the need for progress towards the integration of financial services. This was clearly illustrated by a first and promising exchange of views at the informal Ecofin Council in York on 21 March. Member states agreed with the Commission that the euro offers new opportunities and called for a more coordinated framework, including an appropriate level of consumer protection.

- There are also positive signs of risk capital developing in most Member States, although apart from the United Kingdom and to a lesser extent Germany, the Netherlands and Sweden, it still remains rather limited. Furthermore, a number of Member States have also made some significant tax and regulatory changes recently to encourage further the use of venture capital in their economies.

- Pension funds and insurance funds are now growing steadily in Europe albeit from a lower base than in the US. Provided reasonable prudential rules are agreed for the deployment of these funds, then a deeper pool of capital will be available for risk capital investments in the future (see below).

- Competitive pressures are intensifying as United States entrepreneurs refocus on Europe in the light of the positive forthcoming effects of the Euro and enlargement on the one hand, and the negative effects of the Asian financial crisis on the other. According to the United States operators, venture capitalism in an enlarging EU, with the biggest single market in the world, offers a tremendous *"frontier"* opportunity on the eve of the 21st Century. EU risk capital actors should think accordingly.

- The development of the Internet and electronic commerce will open up new global trading opportunities for SMEs. In the near future new European entrepreneurs will be able to set up a web site and start up and trade in the biggest single market in the world, indeed globally, at far lower cost than in the past.

- The size of the single market offers European entrepreneurs a substantial home base. Recent liberalization of the air transport, telecom, electricity and natural gas markets will offer fresh opportunities for new market entrants.

- The Investment Services and the Prospectus Directives have established some basic ground rules for the construction of a pan-European capital market, although further developments are now necessary (see below).

- In the last few months the European Union has itself launched a number of new venture capital initiatives as a result of the European Council on Employment held in Luxembourg, last November. The EIF is already investing in venture capital funds and 3 new instruments are in the process of adoption by the Council in the context of the Growth and Employment initiative, one of which is specifically a risk capital initiative. The EIB has also developed a European Technology Facility.

- Last but not least, the ongoing recovery and the buoyant financial markets throughout the European Union make it easier today to recognize the importance of risk capital both for companies and investors.

In summary, all these indicators are favourable. But there remain a number of obstinate barriers which must be removed in order to develop a full range of pan-European risk capital instruments. The main barriers are considered in the next section. Removing them can be considered as a vital component for job creation in the Union.

Basic Requirements for Risk Capital Markets

At the present time, countries with well developed risk capital markets are rare, principally confined to the United States and to a lesser extent in the United Kingdom. This is because the requirements of such markets are demanding and that many of them must be met simultaneously before they can develop strongly. The first requirement is for a large pool of suitable firms in which to invest. Even high risk firms will attract investors providing that investors can diversify risk over a sufficiently large number of investments and that they provide an adequate rate of return from successful firms after writing off the losses from unsuccessful investments. No country in the European Union possesses a sufficient number of these firms.

The situation today is that European firms can seek risk capital on the US market for instance by listing on NASDAQ, because in the US there is a sufficient pool of suitable firms available to adequately diversify risk. The alternative, to invest in Europe, requires a sufficient pool of companies being available for investment. **This can only be achieved on a Europe-wide basis.**

To attract investors in risk capital, firms must also meet the high standards of disclosure, transparency and corporate governance which investors expect from such firms, irrespective of whether these standards are met by existing, well-established firms from the same countries. The needs of investors for information, liquidity, transparency and clear governance rules are just as important as the requirements of entrepreneurs for secure venture capital investment

Not only investors, but also the markets which bring together investors and high growth firms must meet the same levels of liquidity, transparency and prudential which characterise US stock markets. **As a result, markets for risk capital on this continent will need to be pan-European practising very high standards or they will not be at all.**

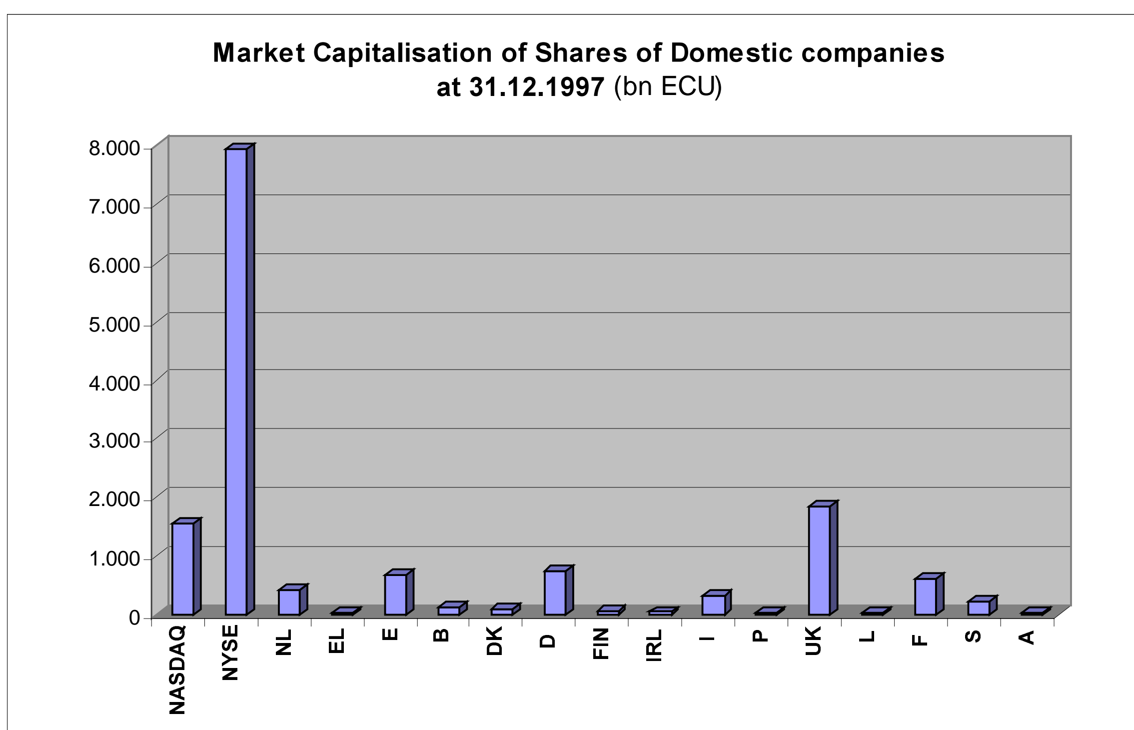
II.

REMAINING BARRIERS

The Commission has identified 6 major categories of barriers :

- **Fragmentation.**
- **Institutional and regulatory.**
- **Taxation.**
- **Paucity of high tech SMEs.**
- **Human resources.**
- **Cultural.**

Fragmentation



The liberalization of European capital markets, which can be expected to accelerate further with the introduction of the Euro, has not succeeded yet in overcoming fragmentation into smaller national markets. On the most restrictive definition, the European Union still has 33 regulated stock markets and 18 regulatory organizations. This configuration reduces both the capitalization and liquidity for each national market and hence *"exit"* opportunities for the venture capitalist. The US has 3 principal stock markets (10 altogether with the US regional markets) and one national *"coast to coast"* regulatory body, the Security and Exchange Commission.

Unlike US SMEs and entrepreneurs, most European SMEs do not have easy access to capital markets in other Member States : information and transparency is lacking; taxation, accounting rules and bankruptcy laws differ; the capacity for cross border risk evaluation is limited. These are additional factors why European companies, especially SMEs, rely more on short term credit and less on equity than their US counterparts. This damages European employment creation and growth in the process.

In terms of the primary equity markets for SMEs and fast growing high tech companies, two simultaneous trends are evident in Europe. **First**, the attempt to create a pan-European second tier capital market – EASDAQ. **Secondly**, growing cooperation between some existing markets (such as Euro NM) and increasingly between different securities and options markets (e.g. between La Société des Bourses Françaises, la Deutsche Börse and La Bourse Suisse).

However, a number of regulatory and institutional barriers are hindering their development (see below). Furthermore, **there are also some worrying signs of yet further fragmentation in the EU** - with a plethora of diverse, new initiatives being discussed. Finally, there is also evidence of strong regional fragmentation in the EU as well, with an overemphasis on *"domestic"* equity placements.

The Commission believes that over time further consolidation of these various initiatives and markets is essential to provide future European entrepreneurs with a deep, liquid pan-European stock market, yielding comparable positive effects to those that NASDAQ has generated in the US.

❑ Institutional and Regulatory Barriers

The European Union's institutional and regulatory framework does not provide the necessary incentives or create the required transparency, stability and predictability for the growth of pan-European risk capital. A heavy price is paid in poor job-creation and sub-optimal economic growth.

The Commission's analysis leads it to the conclusion that the following shortcomings in the regulatory framework contribute most to this sub-optimal outcome:

- **Venture Capital Funds : Absence of Community Legislation**

  A harmonized, transparent structure is lacking at Community level which will enable venture capital funds to raise capital by marketing their units in other Member States. Currently, Member States restrict the commercialisation of partner country funds by making liberal use of the *"general good"* or due diligence principle. This situation prevents venture capital funds from acquiring the critical mass to operate viably.

- **Traditional Institutional Investors (UCITS, Insurance Companies, Pension Funds)**

  Institutional investors are currently prevented from putting part of their massive resources at the disposal of companies needing risk capital. The nature of the underlying restrictions vary depending on whether SME equity in question is listed or not. In the first case, the emergence of some new regulated stock markets (e.g. EASDAQ, EURO.NM, AIM etc) should be able to provide a gateway for SMEs to

raise equity finance, allowing investors to subscribe under the same limitations as those applying to large companies. Supervisors and policy-makers must ensure that listing conditions and other requirements encourage SMEs to make full use of these new facilities.

In the case of unlisted shares, which are considered to be illiquid, institutional investors are subject to stricter restrictions, even prohibition to invest. In practice, Community legislation on UCITS deters investment in non-liquid assets by fund managers - because investors may request at any moment the redemption of their units. Due to these constraints, channelling a significant portion of the large pools of **institutional investment** towards unlisted SME equity requires the development of specialist venture-capital funds which are authorized to invest in illiquid assets. As the SME prospers and becomes large enough to list its shares in the new regulated markets, they will be able to attract interest from other institutional investors.

In the case of pension funds (where legislation has not been harmonized at EU level) and insurance companies, restrictions abound as regards the placement of funds by category of asset. This severely distorts the optimal allocation of resources in the single market. In particular, institutional investors are generally unable to incorporate the optimal quantities of risk capital and equities in their portfolios. These regulatory restrictions are compounded by the conservative attitude of fund managers in many Member States regarding how they match assets and liabilities. Consequently, many fund managers in the EU fail to exploit their full leeway in relation to investment in equity or in non-liquid assets. What is required is sensible, prudential rules that allow pension funds to optimize their portfolio structures with appropriate allocations of pan-European equity, international equity, real estate and fixed income assets.

The disappearance of currency matching restrictions may broaden the horizons of fund managers and encourage them to enlarge the proportion of equity in their portfolios whilst protecting pension fund beneficiaries through *"prudent man"* regulations. It is very important the Member States ensure that investment restrictions that are allowed under the Treaty for prudential reasons are not used for discriminating against foreign assets nor as an excuse to favour privileged access for the financing of national, regional or local government.

- **Investment Services Directive**

The Investment Services Directive (ISD) has only recently entered into force and its full effects have yet to materialise. However, Article 11 currently offers a substantial margin of discretion to host-country supervisors as regards the application of business conduct rules to management companies trading in securities. As integration of equity markets gathers pace under the impulse of EMU, there may be a need to review again the host country supervisors role in imposing local conduct business rules. Without such adaptation, it will remain difficult for financial services and products, which are acceptable in one Member State, to be traded in other EU markets. Regulatory fragmentation has a particularly severe impact on risk capital markets.

Investors may not be willing to deal cross-border unless high quality standards for common rules are in place. Therefore mechanisms for closer co-operation between supervisory authorities will need to be reinforced. A positive step in this direction has been the creation of FESCO (Forum of European Securities Commissions) at the

end of 1997. This body will concentrate on establishing procedures to deal with day-to-day cross-border matters in the field of supervision. Its work will complement that of the High-level Securities Supervisors Committee (to be substituted by the Securities Committee once the relevant directive is adopted) which concentrates on regulatory matters.

- **Prospectuses**

Up to now prospectuses have been little used for cross-border purposes. Issuers have not shown great interest in cross-border issues/listing. With the launch of the single currency and the subsequent integration of securities markets in the Community this situation may change dramatically.

The (limited) experience seems to show that, in practice, large companies and SMEs may still face lengthy and costly procedures in case of multilisting or simultaneous public offers in several Member States. In addition, SMEs wishing to raise capital through an IPO (Initial Public Offer) prior to becoming listed on a stock exchange may not benefit from automatic procedures available to large companies. This unintentional discrimination results from the fact that at the time of adoption of the legislation, it was not expected that SMEs would seek listings on official stock exchanges in large numbers. There is a clear need to bring regulation into line with contemporary market reality.

- **Accounting Rules**

Ideally, all EU companies seeking equity financing should be able to do so on the basis of one set of accounts. This would save costs resulting from publishing different sets of accounts. It would also facilitate the simultaneous listing in different EU, or non-EU markets. However, this situation does not currently prevail.

Until now, the problem of being forced to prepare more than one set of accounts has mainly affected big EU companies wishing to raise capital in international markets. However, the problem has now also arisen for SMEs because stock exchanges specializing in high risk stocks require SMEs to prepare an additional set of accounts based on International Accounting Standards or US GAAP.

The introduction of the Euro will require a new look at the area of accounting rules. Company accounts are not readily comparable because of the important number of accounting options contained in the Accounting Directives, because of divergences in respect of basic accounting principles (e.g. prudence principle), or because of a lack of harmonization on a number of important issues such as deferred taxation, pension liabilities etc. This discourages pan-European private and institutional investment. In the long term, a single set of accountancy rules in Europe taking into account international standards is desirable in order to satisfy the requirements of international investors. This will probably require a modification of the directives that concern company accounting (78/660/CEE, 83/349/CEE, 84/253/CEE).

❑ Taxation – Fiscal Barriers

The taxation of risk capital and equity (public and private) is crucial for determining its propensity of use and deployment. This matters both on the demand side [the high growth SMEs seeking finance] and the supply side [the institutional and

individual investor]. The stability and predictability of the overall tax environment is also important for investors.

As might be expected the picture in the European Union is a complex one – varying considerably from Member State to Member State. But the crucial questions to be kept in mind are the following :

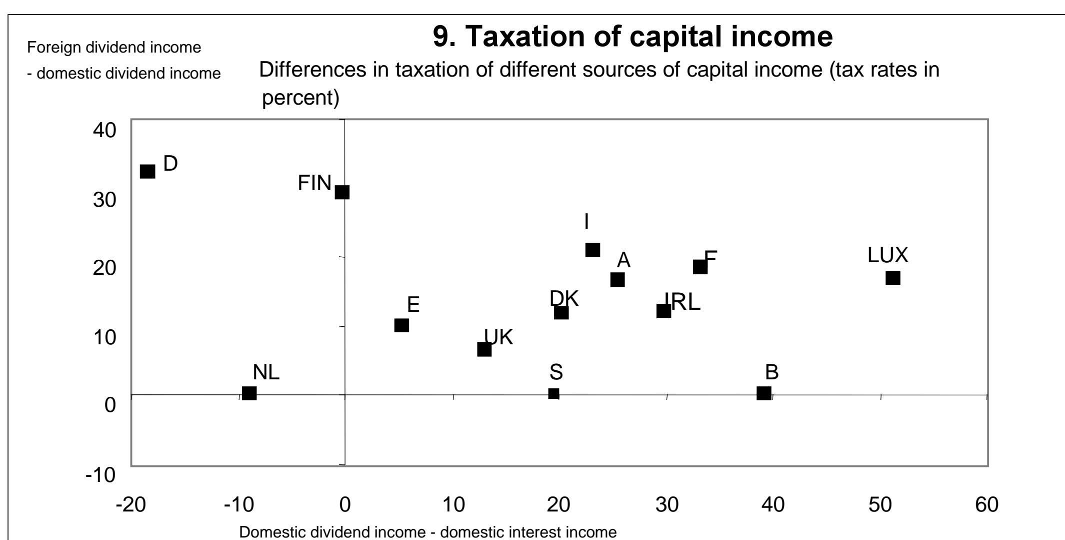
Does the overall tax system help (or hinder) innovation and the development of risk capital investments?
Are other financial instruments taxed more favourably than risk capital?

Whilst it is difficult to give a clear overall judgement, the weight of evidence suggests there are a variety of issues and problems that require immediate attention **by the Member States** in order to ensure the right incentives are present in the economy, whilst recognising that favourable tax investment is carefully targeted on those investors taking genuine risks. Among some of the most important issues are :

(i) The Relative Taxation of Debt (Interest) and Equity [Dividends, Retained Earnings]

A broad brush analysis of Member States practices indicates that marginal tax rates applied to debt (interest income) appear, in general, to be significantly lower than those charged on equity income (dividends and retained earnings) – although this difference can sometimes be alleviated by various tax credits. Taxation rates also differ between individuals and corporations. It is also the case that in the EU foreign dividends tend to be taxed at a higher rate than domestic dividends. The fact that the EU is more heavily dependant on debt financing compared to the US increases the significance of any tax treatment favouring debt, even though the EU and US have similar tax structures in many respects.

All things considered, **if confirmed**, tax structures of this type will not be providing the right economic signals or incentives to encourage risk taking investment which is so important for employment growth. Indeed, the adverse effect of tax structures of this type may be even greater given that, in order to attract investors, there should be an attractive *"premium"* for riskier venture capital investments compared to risk free interest income. Some Member States have begun to introduce some targeted tax incentives to encourage risk investment, for example tax reductions for private individuals investment in business start ups etc.



Source : European economy (December 1997), Advancing financial integration, based on a study carried out by the Confédération Fiscale Européenne in 1996/7.

[Explanation of Graph]

Interest income from debt instruments (bank accounts and bonds) tend to be subject to lower rates of taxation than direct participation in companies (dividend income). This is not in line with the general objective of promoting entrepreneurship and job creation. The creation of a pan-European capital market is also hindered by the differences in taxation between foreign and domestic dividend income. The above graph shows the taxation difference between dividend income and interest income and between foreign dividends and domestic dividends. It gives a general picture based on the basic provisions concerning the marginal rates that apply (maximum rates or withholding tax depending on the case) to domestic and foreign income from interest and dividends earned by resident individual investors. Concerning dividends, the tax rates calculated take into account taxation on companies, on investors and, where appropriate, any tax credits. **It does not take into account specific provisions for limited amounts or specific types of investments that can, in some cases alleviate the tax burden. It does not reflect any taxation changes since December 1996/January 1997.**

(ii) Capital Gains Tax [CGT]

CGT matters in two ways. Firstly because CGT applies in the disposal of assets and hence affects the rate of return on investments. It also influences decisions by individual investors, financial institutions and venture capitalists to invest in early start up companies. Secondly, CGT can affect parts of remuneration packages in the form of assets or future assets. This is crucial in the case of early start up firms, who will be unable to pay large salaries to their employees. But what these firms can do is offer stock options – in other words a promise to the managers and workforce of significant rewards for taking the risk of joining a start up company. This kind of equity pay, together with employee related ownership plans, is playing a critical role in the growth of dynamic knowledge – intensive businesses in the US.

The venture capital community in the European Union is firmly of the view that the current tax treatment of stock options in most Member States is acting as a

significant disincentive to the development of new start up companies, and hence the spread of risk capital. This disincentive is clear in cases where some Member States levy taxation before the sale of the shares by the stock option holder.

Other issues that need very careful examination are the overall tax regimes for start up companies (where positive incentives are necessary); the early tax treatment of retained earnings for high tech start ups; various forms of income tax relief for longer term risk investments – with particular attention to the needs of high tech companies.

(iii) Taxation of Venture Capital Funds

Venture capital funds will be an essential part of the European matrix of risk capital instruments available in the EU in the future. It is extremely important the Member States clarify the tax environment – thereby improving transparency and predictability for the funds and their investors. The tax treatment of those funds should be as favourable as possible, coherent with other elements of tax regimes applicable to venture capital, and be such as to act as an incentive for their overall development in the EU.

❑ Paucity of High Tech SMEs in the EU

- The development of pan-European risk capital markets requires a steady stream of good investment opportunities. In Europe, the net creation of companies lags behind, particularly for high tech sectors where the inherent risks are higher. European research institutes do excellent research and technology work but far too few new, dynamic, companies are created to exploit their results. Regional or national schemes (e.g. science parks, innovation centres) are sometimes successful at spurring the creation of new technology based firms with an above average rate of survival. However most of the time, these companies tend to remain small (an average of 10 employees after 10 years of existence).

- Exacerbating these paucities is a general lack of networking:

  In Europe there exist few geographic concentrations of high tech clusters of SMEs as compared to the US. Neither are the European clusters as deep nor as integrated as in the US. Networking of SMEs also seems less easy in the EU than in the USA. Yet the ability of companies to tap the best available competencies and resources through flexible cooperation patterns are key assets for innovation and competition. The lack of networking between European research and financial circles is particularly damaging. It accounts for a general lack of understanding and awareness of financing options, increases access times to finance and creates information asymmetries which in turn raise costs.

- In addition, the European legal and regulatory environment for companies is not fully conducive to innovation[5] and company creation. Numerous provisions can act as a disincentive for researchers and entrepreneurs to take up the risk of creating a new business.

  This is clearly the case of the intellectual property rules and the administrative requirements for company creation. A striking example is the overall European

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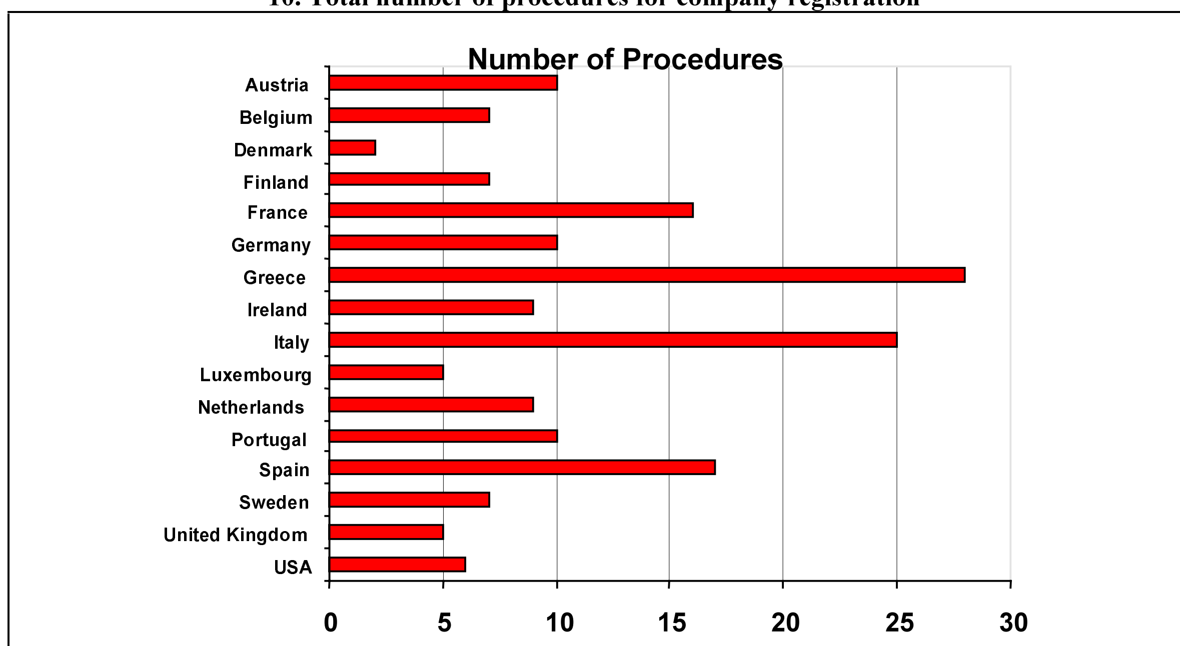
[5] Green Paper on Innovation COM(95)688.

patent system which is profoundly unsatisfactory.[6] Alongside national patents, which continue to exist, there is a European patent, which, once granted by the European Patent Office in Munich, operates to all intents and purposes like a national patent. However, the system is complex and expensive and does not provide a unitary patent for all the Member States, in the form of a Community patent.

Recent results are not good. For example, more than 640,000 inventions are patented each year in the world, compared with 220.000 in the 1960s. This growth can essentially be attributed to Japan and the United States. Over the past seven years, the percentage of application for European patents from Europe has decreased by 11%, whilst during the same period the part of US applicants has increased by 32%. The European industry files less than 43% of the total European patent applications. Furthermore, it is estimated that 2/3 of the 170 000 European SMEs which produce inventions do not apply for patents. Yet an effective system for protecting intellectual property is indispensable for carrying out innovative activities; for the creation of, and investment in, high tech start-ups and for ensuring effective protection throughout the single market. Urgent reform is necessary.

- Starting up an SME to implement an innovation often has to be carried out very rapidly, in order to have the time advantage over competitors. Delays of over three months can be fatal to the introduction of new products or services. However, in many Member States there still are long and complicated requirements to form companies which hamper their creation. In Europe, the most favourable registration schemes can be found in the UK, Ireland, Sweden, Luxembourg, Denmark where registration prerequisites are very few, the cost of registration is limited and the time delays are minimal.

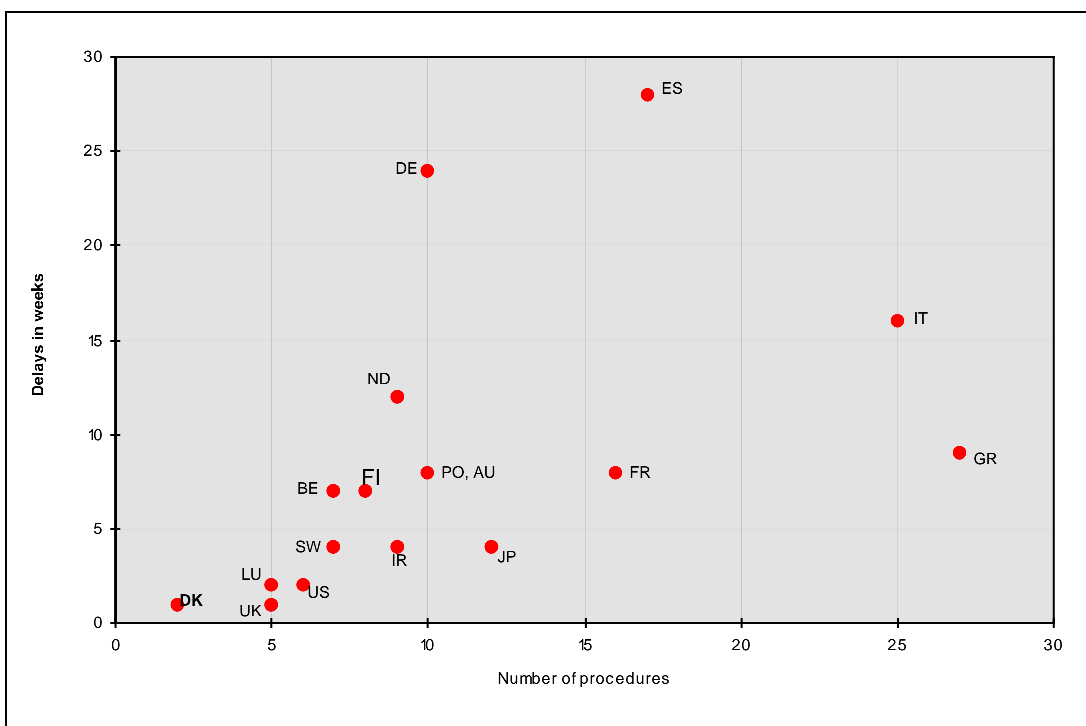
10. Total number of procedures for company registration



Source: "International comparison of the formal requirements and administrative procedures required for the formation of SMEs of any legal status in the EU and other major countries", Project EIMS 96/142, final report (by Logotech), page 45. Data: 1996.

[6] Green Paper on the Community Patent and the Patent System in Europe COM(97)314

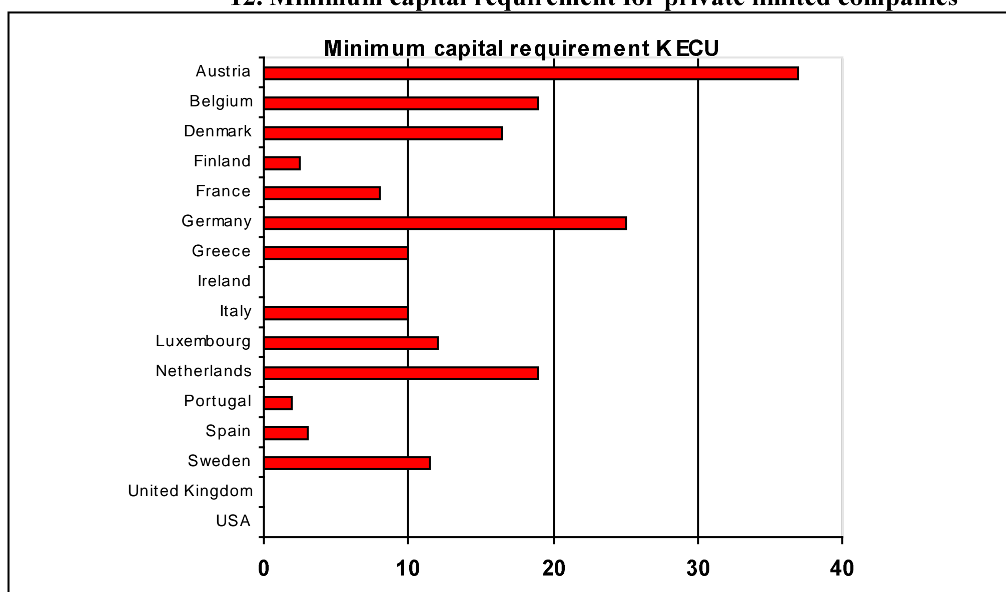
11. Relation between number of procedures and delays for company registration



Source: "International comparison of the formal requirements and administrative procedures required for the formation of SMEs of any legal status in the EU and other major countries", Project EIMS 96/142, final report (by Logotech), page 49. Data: 1996.

The minimum capital requirements in 10 of the 15 EU countries for a private limited company are in excess of 8000 ECU's which is a substantial amount for a company formed by new entrepreneurs that do not have accumulated capital. Especially in the case of university spin-offs, companies started by young entrepreneurs, or persons that do not have large savings it can mean the difference between exploiting an innovation and not attempting to exploit it at all.

12. Minimum capital requirement for private limited companies



Source: "International comparison of the formal requirements and administrative procedures required for the formation of SMEs of any legal status in the EU and other major countries", Project EIMS 96/142, final report (by Logotech), page 44. Data : 1996.

❑ Human Resources

Pan-European risk-capital markets will only develop in the EU at the required speed and in sufficient depth, if there is an adequate supply of qualified entrepreneurs and experts to make it happen. Data from the EVCA[7] suggests Europe possesses no more than 3,000 full time equivalent venture capitalists –fewer than the US. This is significant because the role of the venture capital expert extends beyond simply providing finance, often covering as well management expertise and technological networking.

Training/education opportunities to acquire the necessary skills are thin on the ground – especially for the start up phase of innovative and technology based enterprises. Too few graduates embark on the creation of their own enterprise. Entrepreneurship has low visibility in education systems, despite some recent measures to spur it at national level. There is also a need to open entrepreneurial opportunities to the poorer members of society, through the provision of capital on favourable terms.

In the US, equity pay and employee ownership schemes have played an important role in helping to stimulate the growth of new, dynamic companies. In particular, they have enabled individual employees to build-up capital to start their own entrepreneurial activities, involved employees in the development and well-being of the company (helping to promote stakeholding and an entrepreneurial *spirit*) and eased the problems of company succession. The EU should draw on the lessons of this experience.

A third area of weakness concerns a shortage of multilingual specialists able to support dedicated market makers and traders – as well as a lack of analytical capability and data, particularly concerning innovative high technology projects. The mobility of those who are qualified in the EU is also less than optimal. Indeed, in general, there is an insufficient number of qualified market makers or teams of experts in the European Union to support a liquid, pan-European secondary market.

❑ Cultural Barriers

Creating a more entrepreneurial Europe will also require a change of mind set – from the earliest formative years of education to high school, training college and university. A new *"approach"* to risk taking, wealth creation, entrepreneurship, employment mobility and collaboration between universities and businesses needs to be triggered.

The European Union has too few entrepreneurs. Business start up rates are lower in the EU – no doubt strongly correlated with an inadequate availability of seed capital. But there are other subliminal reasons – partly cultural, societal, historical, legal and economic – braking the formation of a new generation of European entrepreneurs.

In order to match the requirements of European investors with European entrepreneurs, a real effort to improve the transparency of companies and markets is necessary.

Among the most important are :

- Excessive punishment for *"failure"*. European insolvency and bankruptcy laws often prevent a second chance. In the US the *"right to fail"* is considered a part of the learning process of business.
- Narrow-minded views about the benefits of equity participation.
- Fear of loss of *"control"* of a company.
- Lack of importance attached to corporate governance.
- Investor attitudes towards risk taking and stock options.
- Lack of an entrepreneurial culture in schools, universities etc.

III.

ELEMENTS FOR AN ACTION PLAN

The Commission considers that it is now important to agree on an Action Plan and timetable to remove the barriers identified in Part II and so improve the conditions for the development of risk capital in the European Union. These elements require a differentiated political response, some at the level of European Union, but many by the Member States themselves. This approach requires fully understanding the needs of the market and intensifying the dialogue with the EU's Regulatory Authorities. A piecemeal, sporadic effort will not resolve the problems that have been identified. What is required is a coordinated, systematic approach in all the main areas and the political will to move forward. The Commission considers the sum of the parts of this Plan will optimize both the growth of risk capital in the Union. Job creation will follow.

[Priorities are in bold typeface.]

❑ Fragmentation

Measure	Responsibility	Timetable
• **Round Table Conference : The impact of European market fragmentation on the provision of risk finance** ***"Building the consensus for change"***	Commission, MS, Market Experts	Second half 1998
• **Market monitoring and developing information and statistics on all levels of risk capital in the EU**	Commission, ECVA	Report end 1998
• Detailed examination of costs to firms of raising debt and equity finance across Europe	Commission (cf. Ecofin Informal)	Autumn

❑ Institutional & Regulatory

Measure	Responsibility	Timetable
• **Venture capital funds : Community legislation covering specific closed end funds**	Commission, Proposal, Council, EP	1998-9
• **Traditional institutional investors (UCITS, pension funds, insurance companies) : Adopting prudential rules to facilitate investment in risk capital; follow up to the Green Paper on supplementary pensions in the Single Market.**	Member States, Council, EP	1998-9
• **Reinforcing cooperation to encourage cross border equity activity, and regulatory convergence**	Commission FESCO, SME Organizations, EVCA	1998 ➩
• **Modification of existing legislation** - **Prospectus – simple/automatic *"one passport"* procedures for large companies and SMEs** **(A prospectus or offer document approved in one Member State should be able to be used in all MS – facilitating competition between stock exchanges and financiers)**	Commission, Proposal, Council, EP	1998
- **Assess existing** accounting and auditing rules (taking into account the specific concerns of SMEs, in view of facilitating their access to pan-European risk capital)	Commission Proposal	1999
• Transposition and implementation of all financial services directives	Commission on-going (using Single Market scoreboard)	1998

❑ Taxation

Measure	Responsibility	Timetable
• **Capital Gains Tax (CGT)** - **Examine impact of CGT on venture capital** - **Examine tax treatment of stock options to encourage high tech start ups**	Member States	1998
• Early Tax Regimes for Start Up Companies - Benchmarking - Determination of best practice	Member States, Commission,	1998
• **Taxation of Venture Capital Funds** - **Clarification of tax environment**	Member States	1998
• **Examine Taxation of Debt/Equity**	Member States	1998

❑ Paucity of High Tech SMEs

Measure	Responsibility	Timetable
Develop networking and clustering between universities, research centres, partner search, finance, technologists, market and business rating…	Member States, Community programmes	On-going
Simplifying administrative requirements for company creation based on best practice in the Member States	Member States, Commission to identify best practice	1998-9
Reduce capital requirements for company creation	Member States	
Stimulate creation and growth of high tech companies – including setting up a pan-European *"club"* of high tech, high growth companies to facilitate role model building, contact with financiers…	Commission, Member States	1998-9
Follow-up to Green Paper : Reform the European patent system	Commission, Proposals	1998
Develop "made to measure" electronic commerce modules for SMEs	Commission pilots Member States, Private Sector	1998-9

❑ Human Resources

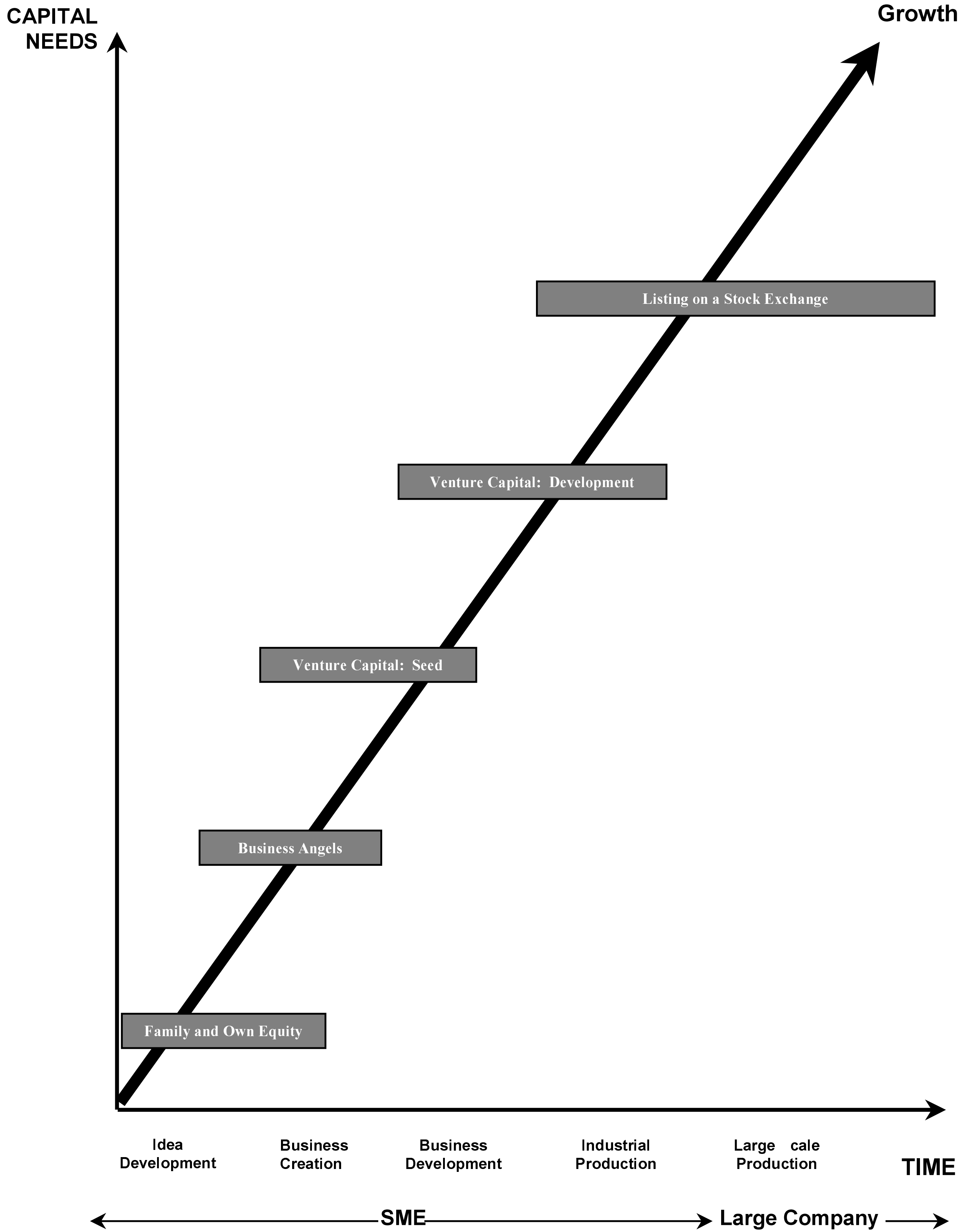
Measure	Responsibility	Timetable
Promote educational and training systems conducive to entrepreneurship and innovation [multidisciplinarity, creativity, portfolio and risk management…]	Member States, Commission	On-going
Determine training needs of European venture capital companies and *"high tech"* market makers	Commission	1998-9
Review measures to stimulate Business Angels networks	Commission, Member States	1998
Examine the benefits of equity pay and employee ownership schemes	Member States, Commission	1998-9

❑ Cultural Barriers

Measure	Responsibility	Timetable
Review insolvency and bankruptcy laws to avoid *"excessive punishment"* for failure	Member States	1998
Explain benefits of venture capital/equity participation and promote the role of entrepreneurship in society	Member States, Commission Local Authorities, Chambers of Commerce, Private Sector, ECVA	1998-9
Corporate Governance – Review European practice	Commission	1998-9

Annex 1

Company Equity Financing Needs Over Time



GLOSSARY

Accounting Directive:	Directives 78/660/EEC and 83/349/EEC.
Business Angels:	Private individuals who invest directly in new and growing unquoted businesses. Business angels usually provide finance in return for an equity stake in the business, but may also provide other long-term finance. This capital can complement the venture capital* industry by providing smaller amounts of finance (generally under ECU 150,000) at an earlier stage than most venture capital firms are able to invest.
Capital market:	A market in which long term capital is raised by industry and commerce, the government and local authorities. Stock exchanges are part of the capital market.
Corporate governance:	The manner in which organisations, particularly limited companies, are managed and the nature of accountability of the managers to the owners. This topic has been of increased importance since the beginning of the 1990's, the providers of external finance to a company wanting to ensure management is not acting contrary to their interests.
Corporate venturing:	Provision of venture capital by a company for another company.
Development capital:	Financing provided for the growth and expansion of a company.
Early stage capital:	Financing to companies before they initiate commercial manufacturing and sales, before they be generating a profit. Includes seed* and start-up* financing.
Electronic commerce:	Direct marketing of trading using a computer or a TV screen.
Equity:	The ordinary share capital of a company.
High level Securities Supervisors Committee :	Informal advisory group created in 1985 by the Commission and the EU Securities Supervisory Regulators with the purpose of dealing with co-operation and cross border matters. It will be replaced by the Securities Committee
Institutional investors:	This term refers mainly to insurance companies, pension funds and investment companies collecting savings and supplying funds to the markets, but also to other types of institutional wealth (e.g. endowment funds, foundations, etc).
IPO:	Initial Public Offering (flotation, going public) : the process of launching a public company for the first time by inviting the public to subscribe in its shares.
Investment Services Directive:	Directive 93/22/EEC. It provides a European "passport" for investment funds (brokers, dealers, etc.) and gives the right to electronic exchanges to place their terminals in other Member States.
Management buy-out:	Financing provided to enable current operating management and investors to acquire an existing product line or business.
Market capitalization:	The price of a stock multiplied by the total number of shares outstanding. The market's total valuation of a public company. By extension, the total valuation of companies listed on a stock market.
Microcredit:	Very small loans, granted by specialized institutions.
Primary market:	Market into which a new issue of securities is launched.

Private equity: As opposed to public equity; investment in equity stake by private investors in companies not listed on a stock market.

Prospectus: A formal written offer to sell securities that sets forth the plan for a proposed business enterprise, or the facts concerning an existing one that an investor needs to make an informed decision.

Prospectus Directive: Documents drawn up according to the rules of Directives 89/298/EEC (public offers) and/or 80/390/EEC (listing particulars).

Prudent-man regulation: Obligation of pension managers to invest as a prudent investor would do on his own behalf, in particular by carrying out sensible portfolio diversification, with no limits to portfolio distribution other than on self investment for pension funds financing defined benefit plans. NL, UK, Ireland USA, Canada, Australia have such a legislation.

Regulated markets: Organized markets where buyers and sellers meet to trade according to agreed rules and procedures. Markets meeting the conditions set under article 1.13 of the ISD.*

Replacement capital: Purchase of existing shares in a company from another venture capital investment organization or from another shareholder or shareholders.

Risk capital markets: Markets providing equity financing to a company during its early growth stages (start-up* and development*). In the framework of this communication, it covers three sorts of financing:

- Informal investment by Business Angels*
- Venture capital.*
- Stock markets specialized in SMEs and high growth companies.

Secondary market: Market where securities are bought and sold subsequent to original issuance. The existence of a flourishing, liquid, secondary market creates the conditions for a healthy primary market.

Securities Committee : To be created. It will have both consultative and comitology roles and will replace the High Level Securities Supervisors Committee. In the securities area it will have the same role as the Banking Committee in banking and the Insurance Committee in insurance.

Security: A financial asset, including shares, government stocks, debentures, bonds, unit trusts and right to money lent or deposited.

Seed capital: Financing provided to research, assess and develop an initial concept.

Start-up capital: Provided to companies for product development and initial marketing.

Stock exchange (Stock Market): A market in which securities are bought and sold. Its basic function is to enable public companies, governments and local authorities to raise capital by selling securities to investors.

Stock option: Option given to employees and/or managers to buy shares at a fixed price.

Venture capital: Investment in unquoted companies by venture capital firms who, acting as principals, manage individual, institutional or in-house money. Four main financing stages are identified in relation to the stages of development of a venture-backed company : early stage,* expansion*, replacement* and buy-out.* In the USA, the word "venture capital" does not include most of the buy-out deals.

Venture capital funds Closed-end funds, created to provide venture capital.

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* Word defined in the glossary or the acronyms.

ACRONYMS

AIM :	Alternative Investment Market [London]
EIB :	European Investment Bank
EIF :	European Investment Fund
EASDAQ :	European Association of Securities Dealer Automated Quotation [Brussels]
ERISA :	Employee Retirement Income Security Act; (US pension law of 1974 which defined fiduciary responsibilities, set minimum-funding standards and vesting rules, and set up benefit insurance scheme)
EURO. NM :	Nouveau Marché (Paris) + Neuer Markt (Frankfort) + Nouveau Marché (Brussels) + Nieuwe Markt (Amsterdam)
EVCA :	European Venture Capital Association
FESCO :	Forum of European Securities Commission
IAS :	International Accounting Standards
ISD :	Investment Services Directive (93/22/EEC)
IT :	Information Technology
NASDAQ :	National Association of Securities Dealers Automated Quotation system
RTD :	Research and Technological Development
SOEC :	Statistical Office of the European Communities
SME :	Small and Medium sized Enterprises
UCITS :	Undertakings for Collective Investment in Transferable Securities; (Investment funds)
US GAAP :	US Generally Accepted Accounting Principles