EFTA SURVEILLANCE AUTHORITY

10B.STATE AID TO PROMOTE RISK CAPITAL INVESTMENTS IN SMALL AND MEDIUM-SIZED ENTERPRISES

10B.1 Introduction

10B.1.1 Risk capital as an EEA objective

(1) Risk capital relates to the equity financing of companies with perceived high-growth potential during their early growth stages. The demand for risk capital typically comes from companies with growth potential that do not have sufficient access to capital markets, while the offer of risk capital comes from investors ready to take high risk in exchange of potentially above average returns from the equity invested.

(2) On 19 July 2006, the Commission of the European Communities (hereinafter the "Commission") issued Community guidelines on State aid to promote risk capital investments in small and medium-seized enterprises[1].

(3) The basis and background for the Commission's new guidelines on risk capital is the recognition of the insufficient level of risk capital available for start-up, innovative young businesses. The "State Aid Action Plan - Less and better targeted State aid: A roadmap for State aid reform 2005-2009 ("the State Aid Action Plan")[2] was published by the Commission in June 2005. The State Aid Action Plan has highlighted the importance of improving the business climate and facilitating the rapid start-up of new enterprises. In this context, the State Aid Action Plan announced the review of the Communication on State aid and risk capital[3] to tackle the market failures affecting the provision of risk capital to start-ups and young, innovative small and medium-sized enterprises ("SMEs"), in particular by increasing the flexibility of the rules contained in the Communication on State aid and risk capital.

(4) While it is the primary role of the market to provide sufficient risk capital within the EEA, there is an "equity gap" in the risk capital market, a persistent capital market imperfection preventing supply from meeting demand at a price acceptable to both sides, which negatively affects European SMEs. The gap concerns mainly high-tech innovative and mostly young firms with high growth potential. However, a wider range of firms of different ages and in different sectors with smaller growth potential that cannot find financing for their expansion projects without external risk capital may also be affected.

(5) The existence of the equity gap may justify the granting of state aid in certain limited circumstances. If properly targeted, State aid in support of risk capital provision can be an effective means to alleviate the identified market failures in this field and to leverage private capital.

1 OJ C 194, 18.8.2006, p. 2.
2 COM(2005) 107 final – SEC(2005) 795.
3 OJ C 235, 21.8.2001, p. 3.

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(6) These guidelines replace Chapter 10A[4], State Aid and Risk Capital, of the Authority's State Aid Guidelines by setting out the conditions under which state aid supporting risk capital investments may be considered compatible with the EEA Agreement. The guidelines explain the conditions under which state aid is present in accordance with Article 61(1) of the EEA Agreement and the criteria that the Authority will apply in the compatibility assessment of the risk capital measures in accordance with Article 61(3) of the EEA Agreement.

10B.1.2 Experience in the field of state aid to risk capital

(7) These guidelines are based on the Community guidelines on State aid to promote risk capital investments in small and medium-seized enterprises, which have been prepared in the light of the experience gained in the application of the Communication on State aid and risk capital, which corresponds to the Authority's guidelines on state aid and risk capital[5]. Comments, received by the Commission, from public consultations of EEA States and stakeholders on the revision of the Communication on State aid and risk capital, on the State Aid Action Plan and on the Communication on State aid to innovation[6] have also been taken into account. The experience of the Commission and the comments received in the consultations have shown that the Communication on State aid and risk capital has generally worked well in practice, but also revealed a need to increase the flexibility in the application of the rules and to adjust the rules to reflect the changed situation of the risk capital market. In addition, experience has shown that for some types of risk capital investments in some areas it was not always possible to fulfil the conditions set out in the Communication on State aid and risk capital, and, as a result, risk capital could not be adequately supported with state aid in these cases. Furthermore, experience has also shown a low overall profitability of the aided risk capital funds. The Authority agrees with the abovementioned views.

(8) To remedy these problems, these guidelines adopt a more flexible approach in certain circumstances so as to allow EFTA States to better target their risk capital measures to the relevant market failure. These guidelines also set out a refined economic approach for the assessment of the compatibility of risk capital measures with the EEA Agreement. Under the Authority's guidelines on state aid and risk capital the assessment of the compatibility of schemes was already based on a relatively sophisticated economic analysis focussing on the size of the market failure and the targeting of the measure. Hence, the Authority's guidelines on state aid and risk capital already reflected the key focus of a refined economic approach. However, some fine-tuning was still needed in respect of some of the criteria to ensure that the measure better target the relevant market failure. In particular, the new guidelines contain elements to ensure that profit-driven and professional investment decisions are strengthened in order to further encourage private investors to co-invest with the State. Finally, an effort has been made to provide clarity where the experience with the Commission Communication on State aid and risk capital and the Authority's guidelines on state aid and risk capital has shown that this was needed.

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[4] With regard to Chapter 10A and its application to unlawful aid, see point 82 of this Chapter.

[5] Chapter 10A of the Authority's State Aid Guidelines.

[6] COM(2005) 436 final.

10B.1.3 The balancing test for state aid supporting risk capital investments

10B.1.3.1 The State Aid Action Plan and the balancing test

(9) In the State Aid Action Plan, the Commission underlined the importance of strengthening the economic approach to state aid analysis. This translates into a balancing the potential positive effects of the measure in reaching an objective of common interest against its potential negative effects in terms of distortion of competition and trade. The balancing test, as outlined in the State Aid Action Plan, is composed of three steps, the first two relating to the positive effects and the last one to the negative effects and the resulting balance:

(1) Is the aid measure aimed at a well-defined objective of common interest, such as growth, employment, cohesion and environment?

(2) Is the aid well designed to deliver the objective of common interest, that is to say, does the proposed aid address the market failure or other objective?

(i) Is state aid an appropriate policy instrument?

(ii) Is there an incentive effect, i.e. does the aid change the behaviour of firms and/or investors?

(iii) Is the aid measure proportional, i.e. could the same change in behaviour be obtained with less aid?

(3) Are the distortions of competition and effect on trade limited, so that the overall balance is positive?

The balancing test is equally relevant for the design of state aid rules and for the assessment of cases falling within their scope.

10B.1.3.2 Market failures

(10) On the basis of the experience gained in applying the provisions on state aid and risk capital, the Authority considers that there is no general risk capital market failure within the EEA. The Authority does, however, accept that there are market gaps for some types of investments at certain stages of enterprises' development. These gaps result from an imperfect matching of supply and demand of risk capital and can generally be described as an equity gap.

(11) The provision of equity finance, in particular to smaller businesses, presents numerous challenges both to the investor and to the enterprise invested in. On the supply side, the investor needs to make a careful analysis not merely of any collateral being offered (as is the case of a lender) but of the entire business strategy in order to estimate the possibilities of making a profit on the investment and the risks associated with it. The investor also needs to be able to monitor that the business strategy is well implemented by the enterprise's managers. The investor finally needs to plan and execute an exit strategy, in order to generate a risk-adjusted return on investment from selling its equity stake in the company in which the investment is made.

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(12) On the demand side, the enterprise must understand the benefits and risks associated with external equity investment to pursue the venture and to prepare sound business plans to secure the necessary resources and mentoring. Owing to a lack of internal capital or the collateral needed to obtain debt funding and/or a solid credit history, the enterprise may face very tight funding constraints. In addition, the enterprise must share control with an outside investor, who usually has an influence over company decisions in addition to a portion of the equity.

(13) As a result, the matching of supply and demand of risk capital may be inefficient so that the level of risk capital provided in the market is too restricted, and enterprises do not obtain funding despite having a valuable business model and growth prospects. The Authority considers that the main source of market failure relevant to risk capital markets, which particularly affects access to capital by SMEs and companies at the early stages of their development and which may justify public intervention, relates to imperfect or asymmetric information.

Imperfect or asymmetric information may result notably in:

(a) Transaction and agency costs: potential investors face more difficulties in gathering reliable information on the business prospects of an SME or a new company and subsequently in monitoring and supporting the enterprise’s development. This is in particular the case for highly innovative projects or risky projects. Furthermore, small deals are less attractive to investment funds due to relatively high costs for investment appraisal and other transaction costs.

(b) Risk aversion: investors may become more reluctant to provide risk capital to SMEs, the more the provision of risk capital is subject to imperfect of asymmetric information. In other words, imperfect or asymmetric information tends to exacerbate risk aversion.

10B.1.3.3 Appropriateness of the instrument

(14) The Authority considers that state aid to risk capital measures may constitute an appropriate instrument within the limits and conditions set out in these guidelines. However, it must be borne in mind that risk capital provision is essentially a commercial activity involving commercial decisions. In this context, more general structural measures not constituting state aid may also contribute to an increase in the provision of risk capital, such as promoting a culture of entrepreneurship, introducing a more neutral taxation of the different forms of SME financing (for example new equity, retained earnings and debt), fostering market integration, and easing regulatory constraints, including limitations on investments by certain types of financial institutions (for example, pension funds) and administrative procedures for setting up companies.

10B.1.3.4 Incentive effect and necessity

(15) State aid for risk capital must result in a net increase in the availability of risk capital to SMEs, in particular by leveraging investments by private investors. The risk of “dead weight”, or lack of incentive effect, means that some enterprises funded through publicly supported measures would have obtained finance on the same terms even in the absence of state aid (crowding out). There is evidence of

this happening, although such evidence is inevitably anecdotal. In those circumstances public resources are ineffective.

(16) The Authority considers that aid in the form of risk capital satisfying the conditions laid down in these guidelines ensures the presence of an incentive effect. The need to provide incentives depends on the size of the market failure related to the different types of measures and beneficiaries. Therefore different criteria are expressed in terms of size of investment tranches per target enterprise, degree of involvement of private investors, and consideration of notably the size of the company and the business stage financed.

10B.1.3.5 Proportionality of aid

(17) The need to provide incentives depends on the size of the market failure related to the different types of measures, beneficiaries and development stage of the SMEs. A risk capital measure is well designed if the aid is necessary in all its elements to create the incentives to provide equity to SMEs in their seed, start-up and early stages. State aid will be inefficient if it goes beyond what is needed to induce more risk capital provision. In particular, to ensure that aid is limited to the minimum, it is crucial that there is significant private participation and that the investments are profit-driven and are managed on a commercial basis.

10B.1.3.6 Negative effects and overall balance

(18) The EEA Agreement requires the Authority to control state aid granted by the EFTA States. This is why the Authority has to be vigilant in order to ensure that measures are well targeted and to avoid severe distortions of competition. When deciding whether the grant of public funds for measures designed to promote risk capital is compatible with the EEA Agreement, the Authority will seek to limit as far as possible the following categories of risk:

(a) the risk of “crowding out”. The presence of publicly supported measures may discourage other potential investors from providing capital. This could, over the longer term, further discourage private investment in young SMEs and thus end up widening the equity gap, while at the same time creating the need for additional public funding;

(b) the risk that advantages to the investors and/or investment funds create an undue distortion of competition in the venture capital market relative to their competitors that do not receive the same advantages;

(c) the risk that an oversupply of public risk capital for target enterprises not invested according to a commercial logic could help inefficient firms stay afloat and could cause an artificial inflation of their valuations, making it all the less attractive for private investors to supply risk capital to these firms.

10B.1.4 Approach for state aid control in the area of risk capital

(19) Provision of risk capital funding to enterprises cannot be linked to the traditional concept of “eligible costs” used for state aid control, which relies on certain specified costs for which aid is allowed and the setting of maximum aid intensities. The diversity of possible models for risk capital measures devised by EFTA States

also means that the Authority is not in a position to define rigid criteria by which to determine whether such measures are compatible with the functioning of the EEA Agreement. The assessment of risk capital therefore implies a departure from the traditional way in which state aid control is carried out.

(20) However, the Authority's guidelines on state aid and risk capital have proved to work well in practice in the area of risk capital, the Authority has decided to continue and thereby ensure continuity with the approach of the Communication and the guidelines.

10B.2 Scope and Definitions

10B.2.1 Scope

(21) These guidelines only apply to risk capital schemes targeting SMEs. They are not intended to constitute the legal basis for declaring an ad hoc measure providing capital to an individual enterprise compatible with the functioning of the EEA Agreement.

(22) Nothing in these guidelines should be taken to call into question the compatibility of state aid measures which meet the criteria laid down in any other guidelines, frameworks or regulations adopted by the Authority .

(23) The Authority will pay particular attention to the need to prevent the use of these guidelines to circumvent the principles laid down in existing frameworks, guidelines and Regulations.

(24) Risk capital measures must specifically exclude the provision of aid to enterprises:

(a) in difficulty, within the meaning of the Authority's guidelines on aid for rescuing and restructuring firms in difficulty[7];

(b) in the shipbuilding[8], coal[9] and steel industry[10].

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

10B.2.2 Definitions

(26) For the purposes of these guidelines, the following definitions shall apply:

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[7] Chapter 16 of the Authority's State Aid Guidelines.

[8] For the purpose of these Guidelines, the definitions laid down in the guidelines on state aid to shipbuilding, chapter 24B of the Authority's State Aid Guidelines, apply.

[9] For the purpose of these Guidelines, 'coal' means high-grade, medium-grade and low–grade category A and B coal within the meaning of the international codification system for coal laid down by the United Nations Economic Commission for Europe.

[10] For the purpose of these Guidelines, the definition laid down in Annex I in the Guidelines on national regional aid for 2007-2013, chapter 25B of the Authority's State Aid Guidelines, applies.

(a) **“equity”** means ownership interest in a company, represented by the shares issued to investors;

(b) **“private equity”** means private (as opposed to public) equity investment in companies not listed on a stock-market, including venture capital, replacement capital and buy-outs;

(c) **“quasi-equity investment instruments**” means instruments whose return for the holder (investor/lender) is predominantly based on the profits or losses of the underlying target company, are unsecured in the event of default. This definition is based on a substance over form approach;

(d) **“debt investment instruments”** means loans and other funding instruments which provide the lender/investor with a predominant component of fixed minimum remuneration and are at least partly secured. This definition is based on a substance over form approach;

(e) **“seed capital”** means financing provided to study, assess and develop an initial concept, preceding the start-up phase;

(f) **“start-up capital”** means financing provided to companies, which have not sold their product or service commercially and are not yet generating a profit, for product development and initial marketing;

(g) **“early-stage capital”** means seed and start-up capital;

(h) **“expansion capital”** means financing provided for the growth and expansion of a company, which may or may not break even or trade profitably, for the purposes of increasing production capacity, market or product development or the provision of additional working capital;

(i) **“venture capital”** means investment in unquoted companies by investment funds (venture capital funds) that, acting as principals, manage individual, institutional or in-house money and includes early-stage and expansion financing, but not replacement finance and buy-outs;

(j) **“replacement capital”** means the purchase of existing shares in a company from another private equity investment organisation or from another shareholder or shareholders. Replacement capital is also called secondary purchase;

(k) **“risk capital”** means equity and quasi-equity financing to companies during their early-growth stages (seed, start-up and expansion phases), including informal investment by business angels, venture capital and alternative stock markets specialised in SMEs including high-growth companies (hereafter referred to as investment vehicles);

(l) **“risk capital measures”** means schemes to provide or promote aid in the form of risk capital;

(m) **“Initial Public Offering” (“IPO”)** means the process of launching the sale or distribution of a company’s shares to the public for the first time;

(n) “**follow-on investment**” means an additional investment in a company subsequent to an initial investment;

(o) **“buyout”** means the purchase of at least a controlling percentage of a company’s equity from the current shareholders to take over its assets and operations through negotiation or a tender offer;

(p) **“exit strategy”** means a strategy for the liquidation of holdings by a venture capital or private equity fund according to a plan to achieve maximum return, including trade sale, write-offs, repayment of preference shares/loans, sale to another venture capitalist, sale to a financial institution and sale by public offering (including Initial Public Offerings);

(q) **“small and medium-sized enterprises”** (“SMEs”) means small enterprises and medium-sized enterprises” within the meaning of Commission Regulation (EC) No 70/2001 of 12 January 2001 on the application of Articles 87 and 88 of the EC Treaty to State aid to small and medium-sized enterprises[11] or any Regulation replacing that Regulation;

(r) **“target enterprise or company”** means an enterprise or company in which an investor or investment fund is considering investing;

(s) **“business angels”** means wealthy private individuals who invest directly in young new and growing unquoted business (seed finance) and provide them with advice, usually in return for an equity stake in the business, but may also provide other long-term finance;

(t) **“assisted areas”** means regions falling within the scope of the derogations contained in Article 61(3)(a) or (c) of the EEA Agreement;

10B.3 Applicability of Article 61(1) in the field of risk capital

10B.3.1 General applicable texts

(27) There are already a number of texts published by the Authority which provide interpretation on whether individual measures fall within the definition of state aid and which may be relevant to risk capital measures. These include the Authority’s guidelines on public authorities' holdings[12],the Authority’s guidelines on the application of state aid rules to measures relating to direct business taxation[13] and the Authority’s guidelines on state guarantees[14]. The Authority will continue to apply these texts, when assessing whether risk capital measures constitute state aid.

[11] OJ L 10, 13.1.2001, p. 33; Regulation as last amended by Regulation (EC) No 1040/2006 (OJ L 187, 8.7.2006, p. 8). Incorporated in Annex XV point 1f of the EEA Agreement by Joint Committee Decision No 80/2002.

[12] Chapter 19 of the Authority’s State Aid Guidelines.

[13] Chapter 17.B of the Authority’s State Aid Guidelines.

[14] Chapter 17 of the Authority’s State Aid Guidelines.

10B.3.2 Presence of aid at three levels

(28) Risk capital measures often involve complex constructions devised to promote risk capital because the public authorities create incentives for one set of economic operators (investors) in order to provide finance to another set (target SMEs). Depending on the design of the measure, and even if the intention of the public authorities may be only to provide benefits to the latter group, enterprises at either or both levels may benefit from state aid. Moreover, in most cases the measure provides for the creation of a fund or other investment vehicle which has an existence separate from that of the investors and the enterprises in which the investment is made. In such cases it is also necessary to consider whether the fund or vehicle can be considered to be an enterprise benefiting from state aid.

(29) In this context, funding with resources, which are not state resources within the meaning of Article 61(1) of the EEA Agreement, is considered to be provided by private investors. This is, in particular, the case for funding by the European Investment Bank and the European Investment Fund.

(30) The Authority will take into account the following specific factors in determining whether state aid is present at each of the different levels[15].

(31) **Aid to investors.** Where a measure allows private investors to effect equity or quasi-equity investments into a company or set of companies on terms more favourable than public investors, or than if they had undertaken such investments in the absence of the measure, then those private investors will be considered to receive an advantage. Such advantage may take different forms, as specified in section 10B.4.2 of these guidelines. This remains the case even if the private investor is persuaded by the measure to confer an advantage on the company or companies concerned. In contrast, the Authority will consider the investment to be effected *pari passu* between public and private investors, and thus not to constitute state aid, where its terms would be acceptable to a normal economic operator in a market economy in the absence of any State intervention. This is assumed to be the case only if public and private investors share exactly the same upside and downside risks and rewards and hold the same level of subordination, and normally where at least 50 percent of the funding of the measure is provided by private investors, which are independent from the companies in which they invest.

(32) **Aid to an investment fund, investment vehicle and/or its manager.** In general, the Authority considers that an investment fund or an investment vehicle is an intermediary vehicle for the transfer of aid to investors and/or enterprises in which investment is made, rather than being a beneficiary of aid itself. However, measures such as fiscal measures or other measures involving direct transfers in favour of an investment vehicle or an existing fund with numerous and diverse investors with the character of an independent enterprise may constitute aid unless the investment is made on terms which would be acceptable to a normal economic operator in a market economy and therefore provide no advantage to the beneficiary. Likewise, aid to the fund's managers or the management company will be considered to be present if their remuneration does not fully reflect the current

[15] It should, however, be noted that guarantees granted by the State in favour of investments in risk capital are more likely to include an element of aid to the investor than is the case with traditional loan guarantees, which are normally considered to constitute aid to the borrower rather than to the lender.

market remuneration in comparable situations. On the other hand, there is a presumption of no aid if the managers or management company are chosen through an open and transparent public tender procedure or if they do not receive any other advantages granted by the State.

(33) **Aid to the enterprises in which investment is made.** In particular, where aid is present at the level of the investors, the investment vehicle or the investment fund, the Authority will normally consider that it is at least partly passed on to the target enterprises and thus that it is also present at their level. This is the case even where investment decisions are being taken by the managers of the fund with a purely commercial logic.

(34) In cases where the investment is made on terms which would be acceptable to a private investor in a market economy in the absence of any State intervention the enterprises in which the investment is made will not be considered as aid recipients. For this purpose, the Authority will consider whether such investment decisions are exclusively profit-driven and are linked to a reasonable business plan and projections, as well as to a clear and realistic exit strategy. Also important will be the choice and investment mandate of the fund's managers or the management company as well as the percentage and degree of involvement of private investors.

10B.3.3 De minimis amounts

(35) Where all financing in the form of risk capital provided to beneficiaries is *de minimis* within the meaning of Commission Regulation (EC) No 69/2001 of 12 January 2001 on the application of Articles 87 and 88 of the EC Treaty to de minimis aid[16], then it is deemed not to fall under Article 61(1) of the EEA Agreement. In risk capital measures the application of the *de minimis* rule is made more complicated by difficulties in the calculation of the aid and also by the fact that measures may provide aid not only to the target enterprises but also to other investors. Where these difficulties can be overcome, however, the *de minimis* rule remains applicable. Therefore, if a scheme provides public capital only up to the relevant *de minimis* threshold to each enterprise over a three-year period, then it is certain that any aid to these enterprises and/or the investors is within the prescribed limits.

10B.4 Assessment of the compatibility of risk capital aid under Article 61(3) (c) of the EEA Agreement

10B.4.1 General principles

(36) Article 61(3)(c) of the EEA Agreement provides that aid to facilitate the development of certain economic activities may be considered to be compatible with the functioning of the EEA Agreement where such aid does not adversely affect trading conditions to an extent contrary to the common interest. On the basis of the balancing test set out in section 10B.1.3, the Authority will declare a risk capital measure compatible only if it concludes that the aid measure leads to an increased provision of risk capital without adversely affecting trading conditions to

[16] OJ L 10, 13.1.2001, p. 30. Incorporated in Annex XV point 1e to the EEA Agreement by Joint Committee Decision No 88/2002.

an extent contrary to the common interest. This section sets out a set of conditions under which the Authority will consider that aid in the form of risk capital is compatible with Article 61(3)(c) og the EEA Agreement.

(37) Where the Authority is in possession of a complete notification which shows that all the conditions laid down in this section are met, it will try to make a rapid assessment of the aid within the time limits laid down in Protocol 3 to the Surveillance and Court Agreement on the functions and powers of the EFTA Surveillance Authority in the field of state aid. For certain types of measures which do not fulfil all the conditions set out in this section, the Authority will undertake a more detailed assessment of the risk capital measure as set out in detail in section 10B.5.

(38) Where there is also aid at the level of target enterprises and the provision of risk capital is linked to costs which are eligible for aid under another regulation or framework or other guidelines, that text may be applied to consider whether the aid is compatible with the functioning of the EEA Agreement.

10B.4.2 Form of aid

(39) The choice of form of an aid measure lies in general with the EFTA State and this applies equally to risk capital measures. However, the Authority's assessment of such measures will include whether they encourage market investors to provide risk capital to the target enterprises and are likely to result in investment decisions being taken on a commercial (that is, a profit-driven) basis, as further explained in section 10B.4.3.

(40) The Authority believes that the types of measure capable of producing this result include the following:

(a) constitution of investment funds ("venture capital funds") in which the State is a partner, investor or participant, even if on less advantageous terms than other investors;

(b) guarantees to risk capital investors or to venture capital funds against a proportion of investment losses, or guarantees given in respect of loans to investors/funds for investment in risk capital, provided the public cover for the potential underlying losses does not exceed 50% of the nominal amount of the investment guaranteed;

(c) other financial instruments in favour of risk capital investors or venture capital funds to provide extra capital for investment;

(d) fiscal incentives to investment funds and/or their managers, or to investors to undertake risk capital investment.

10B.4.3 Conditions for compatibility

(41) To ensure that the incentive effect and the necessity of aid as set out in section 10B.1.3.4 are present in a risk capital measure a number of indicators are relevant. The rationale is that state aid must target a specific market failure for the existence of which there is sufficient evidence. For this purpose, these guidelines lay down

specific safe-harbour thresholds relating to tranches of investment in target SMEs in their early stages of business activity. Furthermore, so that aid is limited to the minimum necessary, it is crucial that aided investments into target SMEs are profit-driven and are managed on a commercial basis. The Authority will consider that the incentive effect, the necessity and proportionality of aid are present in a risk capital measure and that the overall balance is positive where all the following conditions are met.

Measures specifically involving investment vehicles will be assessed under section 10B.5 of these guidelines and not under the conditions in this section.

10B.4.3.1 Maximum level of investment tranches

(42) The risk capital measure must provide for tranches of finance, whether wholly or partly financed through state aid, not exceeding EUR 1.5 million per target SME over each period of twelve months.

10B.4.3.2 Restriction to seed, start-up and expansion financing

(43) The risk capital measure must be restricted to provide financing up to the expansion stage for small enterprises, or for medium-sized enterprises located in assisted areas. It must be restricted to provide financing up to the start-up stage for medium-sized enterprises located in non-assisted areas.

10B.4.3.3 Prevalence of equity and quasi-equity investment instruments

(44) The risk capital measure must provide at least 70% of its total budget in the form of equity and quasi-equity investment instruments into target SMEs. In assessing the nature of such instruments, the Authority will have regard to the economic substance of the instrument rather than to its name and the qualification attributed to it by the investors. In particular, the Authority will take into account the degree of risk in the target company’s venture borne by the investor, the potential losses borne by the investor, the predominance of profit-dependent remuneration versus fixed remuneration, and the level of subordination of the investor in the event of the company’s bankruptcy. The Authority may also take into account the treatment applicable to the investment instrument under the prevalent domestic legal, regulatory, financial, and accounting rules, if these are consistent and relevant for the qualification.

10B.4.3.4 Participation by private investors

(45) At least 50% of the funding of the investments made under the risk capital measure must be provided by private investors, or for at least 30% in the case of measures targeting SMEs located in assisted areas.

10B.4.3.5 Profit-driven character of investment decisions

(46) The risk capital measure must ensure that decisions to invest into target companies are profit-driven. This is the case where the motivation to effect the investment is based on the prospects of a significant profit potential and constant assistance to

target companies for this purpose. This criterion is considered to be met if all the following conditions are fulfilled:

(a) the measures have significant involvement of private investors as described in section 10B.4.3.4, providing investments on a commercial basis (that is, only for profit) directly or indirectly in the equity of the target enterprises; and

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

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

10B.4.3.6 Commercial management

(47) The management of a risk capital measure or fund must be effected on a commercial basis. The management team must behave as managers in the private sector, seeking to optimise the return for their investors. This criterion is considered to be present where all the following conditions are fulfilled:

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

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

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

10B.4.3.7 Sectoral focus

(48) To the extent that many private sector funds focus on specific innovative technologies or even sectors (such as health, information technology, biotechnology) the Authority may accept a sectoral focus for risk capital measures, provided the measure falls within the scope of these guidelines as set out in section 10B.2.1.

10B.5 Compatibility of risk capital aid measures subject to a detailed assessment

(49) This section applies to risk capital measures which do not satisfy all the conditions laid down in section 10B.4. A more detailed compatibility assessment based on the balancing test outlined in section 10B.1.3 is necessary for these measures due to the need to ensure the targeting of the relevant market failure and due to the higher risks of potential crowding-out of private investors and of distortion of competition.

(50) The analysis of compatibility of the measures with the functioning of the EEA Agreement will be based on a number of positive and negative elements. No single

element is determinant, nor can any set of elements be regarded as sufficient on its own to ensure compatibility. In some cases their applicability, and the weight attached to them, may depend on the form of the measure.

(51) The EFTA States will have to provide all the elements and the evidence they consider useful for the assessment of a measure. The level of evidence required and the Authority assessment will depend on the features of each case and will be proportionate to the level of market failure tackled and to the risk of crowding out private investment.

10B.5.1 Aid measures subject to a detailed assessment

(52) The following types of risk capital measures not complying with one or more of the conditions set out in section 10B.4 will be subject to a more detailed assessment given the less obvious evidence of a market failure and the higher potential for crowding out of private investment and/or distortion of competition.

(a) Measures providing for investment tranches beyond the safe-harbour threshold of EUR 1.5 million per target SME over each period of twelve months

The Authority is aware of the constant fluctuation of the risk capital market and of the equity gap over time, as well as of the different degree by which enterprises are affected by the market failure depending on their size, on their stage of business development, and on their economic sector. Therefore, the Authority is prepared to consider declaring risk capital measures providing for investment tranches exceeding the threshold of EUR 1.5 million per enterprise per year compatible with the functioning the EEA Agreement, provided the necessary evidence of the market failure is submitted.

(b) Measures providing finance for the expansion stage for medium-sized enterprises in non-assisted areas

The Authority recognises that certain medium-sized enterprises in non-assisted areas may have insufficient access to risk capital even in their expansion stage despite the availability of finance to enterprises having a significant turnover and/or total balance. Therefore, the Authority is prepared to consider declaring measures partly covering the expansion stage of medium-sized enterprises compatible with the functioning of the EEA Agreement in certain cases, provided the necessary evidence is submitted.

(c) Measures providing for follow-on investments into target companies that already received aided capital injections to fund subsequent financing rounds even beyond the general safe-harbour thresholds and the companies' early-growth financing

The Authority recognises the importance of follow-on investments into target companies that already received aided capital injections in their early stages to finance financing rounds even beyond the maximum safe-harbour investment tranches and the companies' early-growth financing up to the exit of the initial investment. This may be necessary to avoid dilution of the public participation in these financing rounds while ensuring continuity of financing for the target enterprises so that both public and private investors can fully benefit from the risky investments. In these circumstances and taking into account the specificities of the targeted sector and enterprises, the Authority is prepared to consider declaring follow-on investment compatible with the functioning of the EEA Agreement provided the amount of this investment is consistent with the initial investment and with the size of the fund.

(d) Measures providing for a participation by private investors below 50% in non-assisted areas or below 30% in assisted areas

Within the EEA the level of development of the private risk capital market varies to a significant extent in the various EEA States. In some cases, it might be difficult to find private investors, and therefore the Authority is prepared to consider declaring measures with a private participation below the thresholds set out in section 10B.4.3.4 compatible with the functioning of the EEA Agreement, if EFTA States submit the necessary evidence. This problem may be even greater for risk capital measures targeting SMEs in assisted areas. In these cases there may be an additional shortage of capital available for them given their remote location from venture capital centres, the lower population density, and the increased risk-aversion of private investors. These SMEs may also be affected by demand-side issues such as the difficulty in drawing up a viable, investment-ready business proposition, a more limited equity culture, and particular reluctance to lose management control as a result of venture capital intervention.

(e) Measures providing seed capital to small enterprises which may foresee (i) less or no private participation by private investors, and/or (ii) predominance of debt investment instruments as opposed to equity and quasi-equity

The market failures affecting enterprises in their seed stage are more pronounced due to the high degree of risk involved by the potential investment and the need to closely mentor the entrepreneur in this crucial phase. This is also reflected by the reluctance and near absence of private investors to provide seed capital, which implies no or very limited risk of crowding-out. Furthermore, there is reduced potential for distortion of competition due to the significant distance from the market of these small-size enterprises. These reasons may justify a more favourable stance of the Authority towards measures targeting the seed stage, also in light of their potentially crucial importance to generate growth and jobs within the EEA.

(f) Measures specifically involving an investment vehicle

An investment vehicle may facilitate the matching between investors and target SMEs for which it may therefore improve the access to risk capital. In case of market failures related to the enterprises targeted by the vehicle, the vehicle may not function efficiently without financial incentives. For instance, investors may not find the type of investments targeted by the vehicle attractive compared to investments of higher tranches of investments or investments in more established enterprises or more established market places, despite a clear potential for profitability of the target enterprises. Therefore, the Authority is prepared to consider declaring measures specifically involving an investment vehicle compatible with the functioning of the EEA Agreement, provided the necessary evidence for a clearly defined market failure is submitted.

(g) **Costs linked to the first screening of companies in view of the conclusion of the investments, up to the due diligence phase ("scouting costs")**

Risk capital funds or their managers may incur 'scouting costs' in identifying SMEs, prior to the due diligence phase. Grants covering part of these scouting costs must encourage the funds or their managers to carry out more 'scouting' activities than would otherwise be the case. This may also be beneficial for the SMEs concerned, even if the search does not lead to an investment, since it enables those SMEs to acquire more experience with risk capital financing. These reasons may justify a more favourable stance of the Authority towards grants covering part of the scouting costs of risk capital funds or their managers, subject to the following conditions: The eligible costs must be limited to the scouting costs related to SMEs mainly in their seed or start-up stage, where such costs do not lead to investment, and the costs must exclude legal and administrative costs of the funds. In addition, the grant must not exceed 50% of the eligible costs.

10B.5.2 Positive effects of the aid

10B.5.2.1 Existence and evidence of market failure

(53) For risk capital measures envisaging investment tranches into target enterprises beyond the conditions laid down in section 10B.4, in particular those providing for tranches above EUR 1.5 million per target SME over each period of twelve months, follow-on investments or financing of the expansion stage for medium-sized enterprises in non-assisted areas as well as for measures specifically involving an investment vehicle, the Authority will require additional evidence of the market failure being tackled at each level where aid may be present before declaring the proposed risk capital measure compatible with the functioning of the EEA Agreement. Such evidence must be based on a study showing the level of the 'equity gap' with regard to the enterprises and sectors targeted by the risk capital measure. The relevant information concerns the supply of risk capital and the fundraising capital, as well as the significance of the venture capital industry in the local economy. It should ideally be provided for periods of three to five years preceding the implementation of the measure and also for the future, on the basis of reasonable projections, if available. The evidence submitted could also include the following elements:

(a) development of the fundraising over the past five years, also in comparison with the correspondent national and/or European averages;

(b) the current overhang of money;

(c) the share of government aided investment programs in the total venture capital investment over the preceding three to five years;

(d) the percentage of new start-ups receiving venture capital;

(e) the distribution of investments by categories of amount of investment;

(f) a comparison of the number of business plans presented with the number of investments made by segment (amount of investment, sector, round of financing, etc.).

For measures targeting SMEs located in assisted areas, the relevant information must be supplemented by any other relevant evidence proving the regional specificities which justify the features of the measure envisaged. The following elements may be relevant:

(a) estimation of the additional size of the equity gap caused by the peripherality and other regional specificities, in particular in terms of total amount of risk capital invested, number of funds or investment vehicles present in the territory or at a short distance, availability of skilled managers, number of deals and average and minimum size of deals if available;

(b) specific local economic data, social and/or historic reasons for an underprovision of risk capital, in comparison with the relevant average data and/or situation at national and/or EEA level as appropriate;

(c) any other relevant indicator showing an increased degree of market failure.

(54) EFTA States may resubmit the same evidence several times provided that the underlying market conditions have not changed. The Authority reserves the right to question the validity of the submitted evidence.

10B.5.2.2 Appropriateness of the instrument

(55) An important element in the balancing test is whether and to what extent state aid in the field of risk capital can be considered as an appropriate instrument to encourage private risk capital investment. This assessment is closely related to the assessment of the incentive effect and the necessity of aid, as set out in section 10B.5.2.3.

(56) In its detailed assessment, the Authority will take particular account of any impact assessment of the proposed measure which the EFTA State has made. Where the EFTA State has considered other policy options and the advantages of using a selective instrument such as state aid have been established and submitted to the Authority, the measures concerned are considered to constitute an appropriate instrument. The Authority will also assess evidence of other measures taken or to be taken to address the 'equity gap' notably *ex post* evaluations and both supply and demand side issues affecting the targeted SMEs, to see how they would interact with the proposed risk capital measure.

10B.5.2.3 Incentive effect and necessity of aid

(57) The incentive effect of the risk capital aid measures plays a crucial role in the compatibility assessment. The Authority believes that the incentive effect is present for measures meeting all the conditions in section 10B.4. However, as for the measures covered in this section the presence of the incentive effect becomes less obvious. Therefore, the Authority will also take into account the following

additional criteria showing the profit-driven character of investment decisions and the commercial management of the measure, where relevant.

10B.5.2.3.1 Commercial management

(58) In addition to the conditions laid down in section 10B.4.3.6 the Authority will consider it positively that the risk capital measure or fund is managed by professionals from the private sector or by independent professionals chosen according to a transparent, non-discriminatory procedure, preferably an open tender, with proven experience and a track record in capital market investments ideally in the same sector(s) targeted by the fund, as well as an understanding of the relevant legal and accounting background for the investment.

10B.5.2.3.2 Presence of an investment committee

(59) A further positive element would be the existence of an investment committee, independent of the fund management company and composed of independent experts coming from the private sector with significant experience in the targeted sector, and preferably also of representatives of investors, or independent experts chosen according to a transparent, non-discriminatory procedure, preferably an open tender. These experts would provide the managers or management company with analyses of the existing and the expected future market situation and would scrutinise and propose to them potential target enterprises with good investment prospects.

10B.5.2.3.3 Size of the measure/fund

(60) The Authority will consider it positively where a risk capital measure has a budget for investments into target SMEs of a sufficient size to take advantage of economies of scale in administering a fund and the possibility of diversifying risk via a pool of a sufficient number of investments. The size of the fund should be such as to ensure the possibility of absorbing the transaction costs and/or financing the later more profitable financing stages of target companies. Larger funds will be considered positively also taking into account the sector targeted, and provided the risks of crowding-out private investment and distorting competition are minimised.

10B.5.2.3.4 Presence of business angels

(61) For measures targeting seed capital, in view of the more pronounced level of market failure that can be perceived in this phase, the Authority will consider positively the direct or indirect involvement of business angels in investments in the seed stage. In such circumstances, it is therefore prepared to consider declaring measures compatible with the functioning of the EEA Agreement even if they foresee a predominance of debt instruments, including a higher degree of subordination of the State funds and a right of first profit for business angels or higher remuneration for their provision of capital and active involvement in the management of the measure/fund and/or of the target enterprises.

10B.5.2.4 Proportionality

(62) Compatibility requires that the aid amount is limited to the minimum necessary. The way to achieve this aspect of proportionality will necessarily depend on the form of the measure in question. However in the absence of any mechanism to check that investors are not overcompensated, or a measure where the risk of losses is borne entirely by the public sector and/or where the benefits flow entirely to the other investors, the measure will not be considered proportionate.

(63) The Authority will consider that the following elements positively influence the assessment of proportionality as they represent a best-practice approach:

(a) **Open tender for managers.** A transparent, non-discriminatory open tender for the choice of the managers or management company ensuring the best combination of quality and value for money will be considered positively, as it will limit the cost (and possibly aid) level at the minimum necessary and will also minimise distortion of competition.

(b) **Call for tender or public invitation to investors**. A call for tender for the establishment of any "preferential terms" given to investors, or the availability of any such terms to other investors. This availability might take the form of a public invitation to investors at the launch of an investment fund or investment vehicle, or might take the form of a scheme (such as a guarantee scheme) which remained open to new entrants over an extended period.

10B.5.3 Negative effects of the aid

(64) The Authority will balance the potential negative effects in terms of distortion of competition and risk of crowding-out private investment against the positive effects when assessing the compatibility of risk capital measures. These potentially negative effects will have to be analysed at each of the three levels where aid may be present. Aid to investors, to investment vehicles and to investment funds may negatively affect competition in the market for the provision of risk capital. Aid to target enterprises may negatively affect the product markets on which these enterprises compete.

10B.5.3.1 Crowding-out

(65) At the level of the market for the provision of risk capital, state aid may result in crowding out private investment. This might reduce the incentives of private investors to provide funding for target SMEs and encourage them to wait until the State provides aid for such investments. This risk becomes more relevant, the higher the amount of an investment tranche invested into an enterprise, the larger the size of an enterprise, and the later the business stage, as private risk capital becomes progressively available in these circumstances.

(66) Therefore, the Authority will require specific evidence regarding the risk of crowding-out for measures providing for larger investment tranches in target SMEs, for follow-on investments or for financing of the expansion stage in medium-sized enterprises in non-assisted areas or for measures with low

participation by private investors or measures involving specifically an investment vehicle.

(67) In addition, EFTA States will have to provide evidence to show that there is no risk of crowding-out, specifically concerning the targeted segment, sector and/or industry structure.

(68) The following elements may be relevant:

(a) the number of venture capital firms/funds/investment vehicles present at national level or in the area in case of a regional fund and the segments in which they are active;

(b) the targeted enterprises in terms of size of companies, growth stage, and business sector;

(c) the average deal size and possibly the minimum deal size the funds or investors would scrutinise;

(d) the total amount of venture capital available for the target enterprises, sector and stage targeted by the relevant measure.

10B.5.3.2 Other distortions of competition

(69) As most target SMEs are recently established, at the level of the market where they are present, it is unlikely that these SMEs will have significant market power and thus that there will be a significant distortion of competition in this respect. However, it can not be excluded that risk capital measures might have the effect of keeping inefficient firms or sectors afloat, which would otherwise disappear. Furthermore, an over-supply of risk capital funding to inefficient enterprises may artificially increase their valuation and thus distort the risk capital market at the level of fund providers, which would have to pay higher prices to buy these enterprises. Sector specific aid may also maintain production in non-competitive sectors, whereas region-specific aid may build up an inefficient allocation of production factors between regions.

(70) In its analysis of these risks, the Authority will examine, in particular, the following factors:

(a) overall profitability of the firms invested in over time and prospects of future profitability;

(b) rate of enterprise failure targeted by the measure;

(c) maximum size of investment tranche envisaged by the measure as compared to the turnover and costs of the target SMEs;

(d) over-capacity of the sector benefiting from the aid.

10B.5.4 Balancing and decision

(71) In the light of the above positive and negative elements, the Authority will balance the effects of the risk capital measure and determine whether the resulting

distortions adversely affect trading conditions to an extent contrary to the common interest. The analysis in each particular case will be based on an overall assessment of the foreseeable positive and negative impact of the state aid. For that purpose the Authority will not use the criteria set out in these guidelines mechanically but will make an overall assessment of their relative importance.

(72) The Authority may raise no objections to the notified aid measure without entering into the formal investigation procedure or, following the formal investigation procedure laid down in Article 6 in Part II of Protocol 3 to the Surveillance and Court Agreement, it may close the procedure with a decision pursuant to Article 7 in Part II of Protocol 3. If it adopts a conditional decision pursuant to Article 7(4) in Part II of Protocol 3 closing a formal investigation procedure, it may in particular attach the following conditions to limit the potential distortion of competition and ensure proportionality:

(a) if higher thresholds of investment tranches per target enterprise are foreseen, it may lower the maximum amount proposed per investment tranche or set an overall maximum amount of finance per target enterprise;

(b) if investments in the expansion stage in medium-sized enterprises in non-assisted areas are foreseen, it may limit investments predominantly to the seed and start-up stage and/or limit the investments to one or two rounds and/or limit the tranches to a maximum threshold per target enterprise;

(c) if follow-on investment is foreseen, it may set specific limits to the maximum amount to be invested into each target enterprise, to the investment stage eligible for intervention, and/or to the period during which aid may be granted, having also regard to the sector concerned and to the size of the fund;

(d) if a lower participation of private investors is foreseen, it may require a progressive increase of the participation of private investors over the life of the fund, having particular regard to the business stage, the sector, the respective levels of profit-sharing and subordination, and possibly the localisation in assisted areas of the target enterprises;

(e) for measures providing seed capital only, it may require EFTA States to ensure that the State receives an adequate return on its investment commensurate with the risks incurred for these investments, in particular where the State finances the investment in the form of quasi-equity or debt instruments, the return on which should, for instance, be linked to potential rights of exploitation (for example, royalties) generated by intellectual property rights created as a result of the investment;

(f) require a different balancing between respective profit- and loss-sharing arrangements and level of subordination between the State and private investors;

(g) require more stringent commitments as regards cumulation of risk capital aid with aid granted under other state aid regulations or frameworks, by way of derogation from section 10B.6.

10B.6 Cumulation

(73) Where capital provided to a target enterprise under a risk capital measure covered by these guidelines is used to finance initial investment or other costs eligible for aid under other block exemption regulations, guidelines, frameworks, or other state aid documents, the relevant aid ceilings or maximum eligible amounts will be reduced by 50% in general and by 20% for target enterprises located in assisted areas during the first three years of the first risk capital investment and up to the total amount received. This reduction does not apply to aid intensities provided for in the Authority's Guidelines on aid for research and development[17] or any successor framework or block exemption regulation in this field.

10B.7 Final provisions

10B.7.1 Monitoring and reporting

(74) Protocol 3 to the Surveillance and Court Agreement and EFTA Surveillance Authority Decision No 195/04/COL of 14 July 2004 on the implementing provisions referred to under Article 27 in Part II of Protocol 3 to the Surveillance and Court Agreement, require EFTA States to submit annual reports to the Authority.

(75) In respect of risk capital measures the reports must contain a summary table with a breakdown of the investments effected by the fund or under the risk capital measure including a list of all the enterprise beneficiaries of risk capital measures. The report must also give a brief description of the activity of investments funds with details of potential deals scrutinised and of the transactions actually undertaken as well as the performance of investment vehicles with aggregate information about the amount of capital raised through the vehicle. The Authority may request additional information regarding the aid granted, to check whether the conditions of the Authority's decision approving the aid measure have been respected.

The annual reports will be published on the internet site of the Authority.

(76) In addition, the Authority considers that further measures are necessary to improve the transparency of state aid within the EEA. In particular, it appears necessary to ensure that the EFTA States, economic operators, interested parties and the Authority itself have easy access to the full text of all applicable risk capital aid schemes.

(77) This can easily be achieved through the establishment of linked internet sites. For this reason, when examining risk capital aid schemes, the Authority will systematically require the EFTA State concerned to publish the full text of all final aid schemes on the internet and to communicate the internet address of the publication to the Authority.

The scheme must not be applied before the information is published on the internet.

[17] Chapter 14 of the Authority's State Aid Guidelines.

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(78) EFTA States must maintain detailed records regarding the granting of aid for all risk capital measures. Such records must contain all information necessary to establish that the conditions laid down in the guidelines have been observed, notably as regards the size of the tranche, the size of the company (small or medium-sized), the development stage of the company (seed, start-up or expansion), its sector of activity (preferably at 4 digit level of the NACE classification) as well as information on the management of the funds and on the other criteria mentioned in these guidelines. This information must be maintained for 10 years from the date on which the aid is granted.

The Authority will ask EFTA States to provide this information in order to carry out an impact assessment of these guidelines three years after their entry into force.

10B.7.2 Entry into force and validity

(79) The Authority will apply these guidelines from the date of their *adoption*. These guidelines will replace Chapter 10A of the Authority's State Aid Guidelines.

(80) These guidelines will cease to be valid on 31 December 2013. After consulting EFTA States, the Authority may amend them before that date on the basis of important competition policy or risk capital policy considerations or in order to take account of other EEA policies or international commitments. Where this would be helpful the Authority may also provide further clarifications of its approach to particular issues. The Authority intends to carry out a review of these guidelines three years after their entry into force.

(81) The Authority will apply these guidelines to all notified risk capital measures in respect of which it must take a decision after the guidelines have been adopted even where the measures were notified prior to the publication of the guidelines.

(82) In line with the Commission notice on the determination of the applicable rules for the assessment of unlawful State aid ("*consecutio legis*")[18], the Authority will apply the following in respect of non-notified aid:

(a) these guidelines, if the aid was granted after their adoption

(b) Chapter 10A of the Authority's State Aid Guidelines in all other cases.

10B.7.3 Appropriate Measures

(83) The Authority hereby proposes to EFTA States, on the basis of Article 1(1) in Part I of Protocol 3 to the Surveillance and Court Agreement, the following appropriate measures concerning their respective existing risk capital measures.

(84) The EFTA States should amend, where necessary, their existing risk capital measures in order to bring them into line with these guidelines within twelve months after the adoption of the guidelines.

(85) The EFTA States are invited to give their explicit unconditional agreement to these proposed appropriate measures within two months from the date of adoption of

[18] OJ C 119, 22.5.2002, p. 22.

these guidelines. In the absence of any reply, the Authority will assume that the EFTA State in question does not agree with the proposed measures.