

# **Review of Communication on State aid to risk capital (SARC) – response of the United Kingdom**

## **1. Presence of aid at three levels – SARC point IV.5**

*Do you have any evidence that points to a different conclusion?*

The UK believes that the question of whether there is aid at three levels of a risk capital scheme – that of the investors in the fund, the fund itself or the vehicle administering the fund and the enterprises invested in – depends on the design of the scheme. Where a fund is operated on clear commercial terms with a private sector fund manager who is incentivised solely towards making a financial return (e.g. they are paid a management fee and a carried interest share based on financial return and not on other criteria) there will be no aid to the SME. The UK believes that this is consistent with other aspects of the State aid regime in that although the existence of the Government support enables the supply of finance it does so at a market rate or as close to a market rate as can be determined.

The UK notes that the arguments rehearsed above do not preclude the possibility of risk capital funds/instruments being developed which operate on a different basis; where there is a different incentive structure; or where fund managers are given objectives other than, or as well as, making a financial return.

## **2. Equity gap – safe harbour investment tranches – SARC points VI.4-VI.5 and VIII.3**

*2a) Do you have an estimate of the current size of the equity gap in your Member State? Do you believe that the current level of the safe-harbour investment tranches indicated in the Communication would need to be modified? Please provide a justification of your response and supporting evidence.*

The UK considers that the equity gap for small and medium sized enterprises in the UK significantly exceeds the current safe harbour investment tranche sizes indicated in the SARC. Evidence supporting this position has been provided to the European Commission in relation to a number of State aid notifications. In the case of the Northern Ireland scheme, Venture 2003 (N134/2003) the Commission were willing to accept investment tranche sizes above the safe harbour levels on the basis of the particular political and economic situation in the Province. The UK notification for the new Enterprise Capital Fund vehicle based on the US Small Business Investment Company model also sought tranche sizes significantly above these levels. However, in both cases an Article 88(2) investigation was deemed necessary. The UK is concerned that placing such a large emphasis on the investment tranche size is inappropriate and causes distortionary behaviour in the setting up of risk capital funds. Evidence produced and presented to support the various UK State aid notifications has shown that the size and nature of the equity gap varies between sectors and according to the stages of SME development. Whilst we recognise that tranche size has been used as a proxy for many of these other measures we are concerned that the application of the ‘safe harbours’ has become much too rigid.

There is a large body of evidence in the UK supporting the existence of serious risk capital market failures above the SARC investment tranche levels. The Eleventh report on small firm finance by the Bank of England<sup>1</sup> stated:

“Despite progress made over the last decade, a number of particular challenges remain for the future of financing smaller firms. These include the ability of suitable early stage businesses to attract small amounts of risk capital...”

The size of the existing equity gap is difficult to accurately quantify and there are a number of different estimates, with some practitioners suggesting that it may extend up to £5 million (approx €7.5 million). However, the UK Government consultation exercise “Bridging the finance gap”<sup>2</sup> suggested that a conservative estimate of the finance gap was that it extended to around £2 million:

“...available evidence suggests that the equity gap is most often a constraint for businesses seeking up to £2 million of growth capital, and especially those seeking less than £1 million. The “Bridging the finance gap” consultation process highlighted that, while the risks and information asymmetries associated with investment in early-stage businesses are often particularly high, established businesses (including those in “traditional” sectors) can also be affected by a shortage of risk capital, for example when seeking investment to modernise or diversify their activities.”

However, there is not a rigid equity gap: it can change over time and will also depend on sector and supply/demand factors. The UK would therefore like to see more emphasis placed on the nature of investment criteria and less on the size of investment tranches. Safe harbours are useful in helping notifications to be dealt with quickly but should not be seen as absolute limits beyond which an 88(2) open scrutiny is necessary, particularly when applications are well supported by relevant evidence. Equally, even where a scheme is within the safe harbour limits it does not necessarily mean that it is necessary to pay the proposed levels of aid in order to fill the equity gap. However, if the Commission consider that investment tranche size maxima should be retained in the revised SARC, the UK considers that these should be significantly increased above the current levels. On the basis of reports such as “Bridging the Finance Gap” and responses from our consultations this should beat a level around £2 million/€3 million.

*2b) Do you have evidence that the size of the equity gap differs in the assisted areas covered by Articles 87(3)(a) and (c) of the Treaty?*

The UK believes that finance markets are national in outlook (and possibly wider). Whilst practical evidence has shown that it is more difficult to raise funds in the Assisted Areas, covered by Articles 8(3)(a) and (c) of the Treaty, the reasons for this are more likely to be the lack of entrepreneurial activity in these areas, peripherality (where appropriate) and the poor performance of earlier funds than anything that would be directly addressed by larger investment sizes. Where regional disparities may be present these are likely to be present across areas suffering from the above factors and not linked to its level of Assisted Area

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<sup>1</sup> Finance for Small Firms – An Eleventh Report, April 2004, Bank of England (N.B. The report references “Bridging the Finance Gap” with respect to “small” investments. In this context “small investments” are those below the size currently supported by the market, i.e. below £1-2 million.)

<sup>2</sup> Bridging the Finance Gap: next steps in improving access to growth capital for small businesses – December 2003, HM Treasury/DTI Small Business Service

coverage. Larger investment tranche sizes might make it easier to raise funds but this does not directly address the problem. In many cases the provision of additional business support would better target the specific difficulties in these areas. It may also be appropriate to allow for differentiation in the level of subordination within Assisted Areas rather than to allow higher levels of aid.

The UK recommends that the Commission should consider, on a case-by-case basis, whether any local difficulties justify increased maximum investment tranche size levels above those set out in the revised guidelines. In making a decision on this point, account should also be taken of whether a scheme has been designed in other ways to take account of the higher risks of investing in deprived areas, such as through the level of subordination involved. The revised SARC should allow the Commission scope to make approvals on that basis without the need to resort to an Article 88(2) investigation in all cases.

*2c) In view of the link between the size of the safe harbour investment tranches and the rule requiring a minimum interval of six months for successive investment tranches, do you consider that this rule reflects current investment practices in the Venture Capital field?*

The UK finds the description of the minimum allowable length of time between investment tranches in Footnote 27 of the SARC an acceptable compromise between the need to keep investments within the agreed limits and the need for any fund to follow on its successes and have scope to continue to support an SME that experiences slower than anticipated results:

“(27) Separate injections of capital within six months of each other would be considered to be part of the same tranche, as would different injections, even over a longer period, to which a commitment is made as part of a single transaction.”

We consider that a further footnote could usefully be added to deal with the need to allow anti-dilution investment. This is where new money is being invested by a third party investor and the Government supported fund invests alongside on the same terms as the new investor in order to maintain its level of investment in the SME. Such follow on investment is important to allow the fund to benefit fully from its successful investments, which in turn will allow for lower levels of subordination and the potential to develop a private sector interest in further similar funds.

### **3. Compatibility assessment: quasi-equity vs. debt instruments – SARC point VII.2 and VIII.3**

The UK considers that the Commission should take a flexible approach to the definition of quasi-equity in the revised SARC. The use of quasi-equity instruments in investments can provide the flexibility needed to maximise the effectiveness in respect of the structural needs of the business. Further guidance on the treatment of quasi-equity would be useful in the revised guidelines.

*What are the main characteristics and differences in your legal and financial (i.e. fiscal and accounting) rules between quasi-equity and debt instruments?*

The accounting treatment of debt and equity in vestments are set out in the UK Accounting Standards Board's accounting standard document, FRS 26 – Financial instruments, <http://www.asb.co.uk/asb/technical/pub0654.html>.

#### **4. Level of private involvement required – point VIII.3 SARC**

*50%/30% private sector involvement in funds: what is your experience in the application of this criterion in practice?*

The UK government believes that the involvement of a significant amount of private capital in investment funds is only one manner in which it is possible to ensure that investment decisions are taken on a commercial basis. There may be other ways in which the commerciality of investment decisions can be more effectively assured. As mentioned above we feel that more account needs to be taken of the balance of risks and returns faced by each party. We feel that a fund where the private investors have their money at risk only once all the public money is lost could be less commercial in its operation than a fund with less private money but where the private investors take a higher risk.

In order to provide an incentive effect to attract institutional investors, who are wary of investing in venture capital, it may be necessary to offer various forms of subordination. The UK believes that this level will differ according to the structure of a programme, the quality of fund managers and the nature of the investment criteria. This might mean that for some parts of the equity gap the level of subordination necessary to encourage 50% participation would not be cost effective. For example, if a public authority, in order to attract private funding to the required level, were required to accept all the risk of the fund and (fully or partially) guarantee a return to the private investor this would be unlikely to offer good value or a commercial driver for the fund manager.

As noted in the SARC it is necessary to ensure that within any Government intervention there is a sufficient degree of additionality and “incentive effect”.

*“Decisions to invest should be profit-driven. A link between investment performance and the remuneration of those responsible for investment decisions will be a positive element. This would be assumed to be met:*

(i) by measures under which all the capital invested in the target enterprises is provided by market economy investors, who also make the investment decision, with the aid being solely an incentive for them to do so; and

(ii) by other measures with significant involvement of market economy investors' capital, being invested on a commercial basis (that is, only for profit) directly or indirectly (33) in the equity of the “target enterprises”.

In the case of funds, and while each measure will be regarded on its merits and other aspects will have a bearing on the Commission's assessment, provision of at least 50 % of the fund's capital would be taken to constitute “significant involvement”, or 30 % in the case of measures operating in assisted areas...”

It seems to us that this would more accurately reflect the position we face in dealing with gap funding if the final paragraph used the 30% figure for all areas but added a requirement that the providers of the private funds had a genuine commercial interest in the financial success of the funds. A footnote might describe how this could be achieved. For example, either realistic risk of not getting all of their capital back if the fund underperformed or a need for a positive fund performance before any other income accrued could be used.

The Commission regularly states its concerns over “crowding out” in assessing risk capital notifications. The UK considers that, in reality, with the depth of the market failures in the risk capital sector this should not be an over-riding problem, in particular where the supporting literature with a notification demonstrates that the proposed aid will be operating within a market failure..

## **5. Cumulation – point VIII.3 SARC**

*The SARC states that “the Commission may request commitments from Member State to assess and set limits to other forms of State aid to enterprises funded by the risk capital measure, including under authorised schemes”. Please provide your experience of the application of this rule.*

As noted in Section 1 the UK does not accept that there is necessarily aid at the level of the recipient enterprise. Where funds are constituted in the way described in our response to section 1 we strongly feel that (as in the case of the Regional Venture Capital Funds N334/2000) since the investments would not constitute aid to the SME invested in there should be no question of restrictions on other notified aid.

It is clear, however, that where a single enterprise receives risk capital from two approved schemes within an investment tranche period these should not, taken together, exceed the tranche sizes set out in the SARC or the limits approved for the schemes, (whichever is higher), and we would expect that to continue to be the case.

Where funds do not fully meet the commerciality requirements (and therefore may contain aid to the SMEs invested in) we consider that the formula used for recent UK approvals (such as Venture 2003 N134/2003) remains appropriate. In that notification the UK undertook that where additional equity/mezzanine investments are made in a recipient during an investment tranche period all such investments will be cumulated and this cumulated total will not exceed the maximum investment tranche sizes in the SARC/approval letters. In the case of aids approved under another instrument (e.g. the SME block exemption, the R&D framework etc) where the aid is granted during the investment period the maximum aid intensity of the investment will be reduced to 70% of the prevailing maximum aid intensity of the investment. Although the cumulation provisions impose administrative burdens, the UK has found that this formulation is effective in avoiding unacceptable cumulation of aids and takes steps to ensure that the formulation is correctly administered by aid granting authorities.

The UK considers that the above formulation represents a reasonable interpretation of the cumulation requirement set out in point VIII.3 of the SARC. However, the current text of the SARC is vague in its drafting and needs to recognise the distinction between the most and the least commercially targeted funds.

## 6 Miscellaneous

*Do you have any other comments on the application of the SARC or proposals for its modification on issues other than the ones covered in the previous questions?*

The UK considers that, while the SARC has been a valuable tool for the assessment of risk capital schemes, it was developed at a time when knowledge of such schemes was not great and so does not reflect developments in the risk capital market or sophistication of some investment types. The guidelines are built around a particular paradigm – that risk capital investments are configured in a particular manner, the venture capital fund model as exemplified by the UK's Regional Venture Capital Funds. In this model a number of public and private investors come together, attracted by a level of subordination of public funds, to create a large central fund from which a series of investments are made. Increasingly, and in particular with the reluctance of investors to participate in such funds, different investment models are being developed within the sector. The ECF/SBIC is one example of this but there are others as well.

### **Co-investment or point of investment funds**

This model differs from the traditional fund in that, rather than managing a central fund comprising both public and private monies which are then disbursed to a range of different investments, the fund manager administers a pot of 100% public money with the private funding matching as the investment is made. Thus, each investment will have public/private match which mirrors the proportions set out in the SARC but over the entire portfolio of the "fund" there will be a range of individual private match funding partners. The UK considers that the revised SARC should reflect such emerging fund management practices and facilitate the Commission's consideration of further new portfolio and investment structures.

The guidelines must be able to differentiate between different types of co-investment funds. For example, at one end of the spectrum these funds invest only on the same or better terms than the private investor. Where this happens we believe the Market Economy Investor Principle applies and no aid is conferred as a result. Funds that operate on this basis and select fund managers through open tender should not be considered as state aid. Other funds may offer subordination to the private investor, either in terms of risk protection, return enhancement or payment of fees. Such funds should be considered on their merits.

We also consider that another positive factor should be where the private investor instigates the deal. However, this should not be a requirement of all co-investment funds as market conditions may display a need for a more proactive approach.

### **Fees, Fund manager and Investor selection**

The UK is also concerned that the SARC paradigm is geared towards large venture capital funds where economies of scale minimise transaction and management costs as a proportion of the investment portfolio. In a large regional venture capital fund the management costs may be in the region of 3% but in a smaller, locally based vehicle – such as a Community Development Finance Institution (CDFI) fund – the small scale of the vehicle may mean that management costs are higher. More reliance needs to be placed on proper tendering exercises determining the level of such fees, and if fees are determined in this way then it should be

possible to permit them. It should be possible for those funds that provide additional services to the SME to be able to bid to run funds on that basis.

There have been some difficulties experienced by some authorities in raising private capital where the fund manager has been selected independently of the fund raising process. The process for selecting fund managers and investors needs to be linked so that (as in the case of the RVCF and the ECF notification) fund managers are required to show that they can attract sufficient investment at a given level of subordination. That private investors are willing to invest in a fund managed by that fund manager is an important test of quality. A fund manager appointed before funds are raised and asked to advise on the level of subordination will have an incentive to go for maximum subordination to raise as much funding as possible. A larger fund means, *inter alia*, a larger fee.

Reference has been made above to the UK's ECF notification. A key element of this notification is that, as a quid pro quo for additional levels of leverage, the risk of the private capital is increased (rather than subordinated). This is a relatively new concept in risk capital State aid schemes. The revised SARC should explicitly allow the Commission to take account of such arrangements in assessing schemes. In addition it would be helpful for the guidelines to provide some idea of the relative weightings of different positive and negative factors. Currently there is no indication of such weighting, leading to a very strict interpretation of the guidelines by the Commission. Currently there is a tendency for the Commission to look at the factors set out in the guidelines as absolute criteria rather than, as the guidelines suggest, weighing them against each other in assessing the overall acceptability of the aid. In particular, a higher weighting should be given to the level of private sector risk rather than the level of public funding.

The current SARC allows for grants to be given to venture capital funds to cover part of their administrative and management costs (section VII.1(b)). It is difficult to see how such arrangements are likely to encourage commercial behaviour on the part of fund managers. They should be omitted from the new guidelines.

The UK has found that officials designing schemes on a *pari passu* basis or schemes which contain a mix of loan and equity (but working on a no-aid basis) are frequently concerned about the lack of guidance on these types of fund. There is a reference in the existing guidelines to no-aid, *pari-passu* funds in the SARC (section IV.3(ii)). However, the Commission may wish to consider whether it would be helpful to deal with such funds in the revised SARC. If it considers that the partially non-risk elements of loan based funds take them outside the scope of the SARC it should look at whether it would be useful to produce a *vade mecum* on SME finance, covering current practice on pure equity venture capital aid schemes, mezzanine schemes, *pari passu* non-aid schemes and loan finance.

The Commission should also consider whether there is further scope for the use of the *de minimis* regulation with respect to risk capital or whether some SME finance investments could be the subject of a block exemption regulation.

### **Evidence from consultation**

In making decisions on risk capital schemes, the Commission should also take greater account of the evidence from any public consultations which have been carried out. If a consultation has gathered evidence from those bodies likely to be affected by a scheme within the relevant market there may be little more information that can be gained from an investigation under

Article 88(2) since it will be the same constituencies who are being canvassed in both cases. The potentially limited benefits of further investigation therefore need to be considered against the costs of delay.

End

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