НОВАТА РЕГУЛАТИВНА РАМКА ЗА ФИНАНСИРАНЕТО ЧРЕЗ РИСКОВ КАПИТАЛ В ЕС

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THE NEW EU REGULATORY FRAMEWOR FOR VENTURE CAPITAL FINANCING

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ABSTRACT

The purpose of the paper is to analyze the specifics of venture capital financing as part of the EU level framework in the process of further integration of the capital markets in EU. It has been established that despite the advanced degree of capital market integration in EU, various barriers (tax, administrative, legal etc.) still create obstacles in front of the venture capital funds in EU. This presupposes analysis of the public sector initiatives for the elimination of the existing barriers and the degree of their effectiveness. The market driven initiatives aim at creation of single trans European market for SME venture capital financing in order to improve SMEs access to capital. Thus the study concludes that the new EU regulatory framework for venture capital financing in EU is part of the whole EU institutional package for economic recovery via traditional and new forms of SMEs financing being an alternative to the bank financing.

Key words: *venture capital, regulatory framework, capital market integration,alternative financing*

Venture capital financing is part of the general framework at EU level in the process for the deepening of integration of EU capital markets. Regardless of the heightened integration processes various barriers still endure in front of the venture capital funds' expansion in cross-border context. This presupposes research into the public sector activities and the effectiveness of the mechanisms used for the elimination of identified restrictions.

1. Current state of EU venture capital industry

Innovative SMEs (small and medium sized enterprises) can develop in case of available access to proper forms of financing – most often private shareholders' capital and venture capital financing. Creditors often regard the financing of innovative SMEs as not attractive type of business due to the high transaction costs and the low profit returns. Besides, government policies in the field not always encourage EU venture capital industry to make investments in SMEs.

EU venture capital industry is transforming itself into globally – oriented trans-European sector with heightened trend for investment focus expansion. Among the main barriers facing the industry in its way to transnational expansion are the legal barriers and the limited size of EU venture capital funds. The market for EU venture capital is underdeveloped and represents one fourth of its US counterpart. The main weaknesses in the industry are connected with difficulties in raising capital by institutional investors, the quality of investment opportunities and the fragmentation of EU venture capital industry. According to a research by the European Venture Capital Association in 2011[1] only 7% of SMEs are financed through private shareholders' capital whereas the share of public financing in the venture capital funds amounts to about 30 %. Apart

[1] EVCA (2011): Research and Surveys

from that, the publicly quoted SMEs on regulated stock markets are not considered attractive enough due to the low level of liquidity of their shares. The activities of the venture capital funds are concentrated in several EU member states, namely: Great Britain, Germany, Sweden, Denmark, the Netherlands, Finland, France and Spain. A positive correlation is proved to exist between the level of venture capital investments and the competitiveness of countries (measured as per the Global Competitiveness Index of the World Economic Forum).

The level of cross-border activities relating to raising of venture capital funds remains low in EU and for the period 2007-2010 the funds accumulated by venture capital structures in cross-border context represented 12% from the total amount of raised capital as compared to private shareholding investment funds which raised about 20% of their capital abroad. Following the global financial crisis the level of venture capital investments in EU fell to EUR 3 billion. According to a research undertaken by Earnst & Young[2] EU venture capital funds are below the optimal level in the industry and reach around EUR 60 million while the US optimal levels come up to EUR 130 million per fund.

Among the main differences between EU and US venture industry is that in EU venture capital funds extend smaller amounts of financing to companies than that in USA. The average value of investments in technologically innovative SMEs is EUR 0,9 million in EU against EUR 6,1million in the USA. The US venture capital funds are commonly characterized by extending larger-size volumes of capital to targeted SMEs, investing in the start-up phases of existence of these companies and provide more active involvement in their follow-up development.

At EU level differences are found regarding the stage of development of venture capital markets – some countries have more active and well-functioning markets, while in others the venture capital industry is still in its initial stage of development. In the bigger EU member-states with developed venture capital markets the concept of national venture capital funds has been replaced by the idea of sector-based funds so that these funds invest in trans-border context and raise capital at global capital markets.

Within EU – 27 differences emerge not only regarding the stage of development of venture capital markets, but also regarding the regimes regulating the markets. From public point of view the venture capital industry is a factor contributing to the EU competitiveness and is a source of alternative external financing. The main factors stimulating venture capital investments in early stages of development of innovative SMes are as follows:

- Size of deals financed through venture capital funds – for EU these deals are small in volume and insufficient for innovative SMEs;
- Capitalization of venture capital funds – the majority of the existing funds in EU have considerably low capitalization levels. The costs and the difficulties in operating in cross-border legal systems are barriers in front of the growth and the potential for further specialization of the venture capital funds. The capitalization of funds is significant in respect of the potential for establishing international presence and undertaking greater risks within a given investment portfolio;
- Size of venture capital markets – the restricted size of venture capital markets in the EU member–states (specifically in the new EU member-states) presupposes the need venture capital funds to operate in cross-border context to reach a critical mass.

According to evaluations done by an Expert Group in EU[3] (Expert Group on Removing Obstacles to Cross-Border Investments by Venture Capital Funds), difficulties exist in front of venture capital funds to invest in cross-border context. Venture capital funds are subject to separate

[2] Earnst & Young (2010) Back to Basics, Global Venture Capital Insights and Trends Report

[3] EC Communication on Removing Obstacles to Cross-Border Investments by Venture Capital Funds, COM (2007) 853 final

registration or establishment procedure in each EU member–state. The tax legislation, the administrative and legal norms and requirements create main barriers before the funds seeking ways for cross-border investments. The major barriers outlined that hinder the effective functioning of venture capital funds are as follows:

- On supply side the venture capital funds are subject to different registration or establishment regimes that increase the costs and time in structuring of the funds.
- On demand side many innovative companies with growth potential face difficulties in raising venture shareholders' capital.

Generally the costs relating to establishment of venture capital funds represent around 1% from total costs. Venture capital funds may be established under various legal forms. The most common legal form used in the majority of EU countries is Limited Liability Company. Presently any fund structure seeking to raise capital and invest in other EU states needs to establish a parallel subsidiary or structure which as a consequence leads to additional costs and complications. Consequently, only the large venture capital funds are in position to establish intermediary parallel structures thus avoiding double taxation issues regarding the investments' returns.

Venture capital industry encourages market-oriented approach regarding the development of favorable conditions for venture capital financing from tax and legal point of view. At the background of the revised Lisbon Strategy for economic growth and employment and the undertakings for the recovery and further development and integration of financial markets as per "Europe 2020" Strategy, the venture capital industry encourages EU member – states to adopt practical measures and common approach with a view to limiting market fragmentations. The preferred scenario for the venture capital sector in EU is the creation of a single integrated trans-border capital market within EU. The first step in this process would be the creation of a strategic union among existing stock exchanges. An alternative would be further specialization of EU stock exchanges in the venture capital industry. In a long-term perspective it is possible an achievement of syndication of related operations among investment banks in cross-bored context.

The EU stock exchanges point out that the costs for clearing and settlement remain rather high for small and medium-sized companies due to the high level of market fragmentation. As an optimal scenario they support the establishment of cross-border EU market for SMEs with growth potential. It is necessary to reach an adequate level of regulation of SMEs including on issues relating to regulatory disclosure of access requirements.

Following the rise in public well being from the successful commercialization of innovations the public sector is interested in taking position on the problems connected with identified market failures thus the majority of EU members – states have implemented programmes for improving SMEs' access to venture capital funds.

The activities of the public sector should be fine-tuned to the level of development of respective venture capital markets. In more developed markets the private investors need additional stimuli for taking risks and investing in start-up SMEs. In such situatios the recommended course of action is applying various schemes for sharing of risks and benefits through public-private partnerships. It is important to evaluate the significance of public sector programmes as a driving force by considering the thorough effects derived from public financing programmes in the process of development of effective policies in the field of venture capital.

2. The new regulatory framework for venture capital financing in EU

The Risk Capital Action Plan ("RCAP") implemented at EU level (1998 – 2003) is an engine for the completion of a single EU venture capital market. The venture capital industry in EU is developing on the basis of privately negotiated agreements among venture capital funds. The existing regime for mutual recognition of rules for establishment of venture capital funds in EU failed short of reaching the goal for greater harmonization. The RCAP identified six categories of barriers preventing the completion of the single venture capital market which related to the fragmentation of stock exchange markets, differences in institutional and regulatory regimes, tax treatment and cultural differences.

To overcome the identified weaknesses in RCAP, in February 2011 The European Council published jointly with the European Commission The Single Market Act, which formulates twelve measures to encourage economic growth and recovery of market confidence in EU. Regarding the SMEs the Act requires implementation of steps for venture capital funds to invest in EU member – states without unnecessary barriers or additional requirements. These funds face significant difficulties in raising capital abroad due to the presence of differing regulatory regimes and tax barriers. In view to encourage financing in SMEs the European Commission adopted SME Financing Action Plan in 2011. The global financial and economic crisis and the ensuing economic recession made debt financing even more expensive for SMEs. The adopted SME Financing Action Plan contains the following public financing measures for SMES regarding 2013 and beyond:

- Utilization of financial instruments within the framework of Competitiveness and Innovations Programme with a total budget of EUR 1.1 billion;
- Use of financial funds under JEREMIE Initiative in close cooperation between the European Commission and the European Investment Fund. In 2011 the European Investment Bank increased the venture capital programme budget to EUR 5 billion and added joint investment initiatives with "business – angels";
- For the period 2014-2020 the European Commission proposes debt instrument for SMEs financing under COSME and Horizon 2020 programmes;
- Regarding the above-stated programme period the European Commission also proposes share-financing instrument regarding enterprises, innovations and research to improve SMEs access to venture capitals and other forms of risk financing from early stage of development till SMEs' growth and eventual quoting of SMEs on regulated stock exchanges.

The goals of public venture capital financing programmes relate to rectifying identified market failures. Consequently, the public programmes should focus on specific market imperfections with clearly defined aims and restrict the utilization of public funds to the possibly accepted minimum.

On the other side, the Small Business Act adopted at EU level in 2011, lays out the entire framework for EU policy regarding SMEs and encouragement of entrepreneurship spirit. The Law will contribute to the attainment of the goals of "Europe 2020" Strategy; the implementation of the new regulatory reform and besides fiscal consolidation it urges the reforms in venture capital industry. The main measures articulated in the Law are directed toward reduction of regulatory and administrative difficulties for SMEs financing in cross-border context.

In view to deepen the harmonization process, in 2011 the European Commission proposed adoption of Regulation on EU venture capital funds aiming at the establishment of effective and integrated venture capital market. The major problems that venture capital funds face relate to differences in the regulatory framework and the fragmentation of venture capital markets in all 27 EU member – states. Venture capital funds encounter such barriers as preliminary authorization, registration, licensing and various disclosure requirements. Many EU members –states require appointment of local licensed agent for the placement of issued shares, which leads to additional costs for venture capital funds.

Within the meaning of the proposed Regulation EU venture capital funds, which will be subject to the new regulatory regime, shall be obliged to invest at least 70% of their total capital in qualifying SMEs in the form of equity shares. The future Regulation will encompass in its scope professional investors (as per the definitions given in the Markets in Financial Instruments Directive) and other investors as "business angels' making initial investment of not less than EUR 100 000. The approved venture capital funds are envisaged to obtain single marketing passport, which establishes harmonized regime for registration in all EU member – states. The proposed regulatory framework will be conducive for reaching synergy effects among the measures envisaged in the SMEs Financing Action Plan, the Single Market Act and the forthcoming Regulation on EU venture capital funds. This framework is expected to eliminate the barriers relating to parallel registration, overlapping requirements for authorization and will lay down harmonized mechanism for the effective operation of venture capital funds in all EU 27 member – states. The European Commission shall be entitled with the functions to monitor together with The European Securities Markets Authority and the national supervisory bodies the implementation of the harmonized venture capital regime.

Last but not least, Bulgaria as part of the common market in EU is dependent upon the ongoing processes for economic recovery and growth through traditional and new forms of SMEs' financing. The complex financial and economic conditions in the crisis and post-crisis period in Bulgaria also lead to a tightened access for SMEs to bank financing which further limits their potential for recovery and development. The forthcoming accession of Bulgaria to ERM – 2 and to the Economic and Monetary Union presupposes evaluation of the venture capital financing as alternative form of financing driving the future development and deepening of the integration of the Bulgarian capital market to EU.

Concluding, entrepreneurship and innovations are the two key factors for the attainment of economic recovery, accumulation of capital and rise in the standard of living. Fundamental market failures exist in the supply of capital to SMEs in their early stages of development in the USA and EU. Thus the public sector interventions are expected to contribute to the effectiveness and long-term sustainability of venture capital industry. The public financing programmes should take into consideration that public interventions may cause crowding out effects over private sector investments. The best results are to be achieved when the public sector invests in well-managed, accountable, transparent and effectively regulated venture capital funds throughout the EU.

3. Conclusions

From public point perspective venture capital industry contributes to EU competitiveness and provides a source for alternative external financing. The consequences of the global financial and economic crisis lead to proposals for reforms in the institutional mechanisms encouraging harmonized regulation of EU venture capital funds and development of unified venture capital market.

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