

GUIDELINES ON STATE AID AND RISK CAPITAL

Pursuant to Article 28 (1) of the Competition Law no.21/1996 and Article 22(1) of the State aid Law no.143/1999, the Competition Council adopts the present Guidelines.

Introduction

Certain types of enterprises at certain stages of their existence may be better served by equity or near-equity finance than by loan finance alone, given the costs of servicing debt, the risks of enterprises being too dependent on debt finance and the risk-averse nature of many lending institutions. In the same time, the risk capital market's expansion shows perspectives of economic growth and of creation of new jobs.

Risk capital encourages the redirection of funding towards support for business start-ups, high-tech firms and micro-enterprises, as well as other risk-capital initiatives.

An equity gap, implying that there is a persistent capital market imperfection preventing supply from meeting demand at a price acceptable to both sides, affects negatively small and medium-sized enterprises (SMEs). The gap concerns, on one hand, high-tech innovative and mostly young firms with high growth potential and, on the other hand, a wide range of firms of different ages and sectors with smaller growth potential that cannot find financing for their expansion projects without external risk capital.

Given the perceived advantages of an increase in risk capital provision and also recognizing the challenges for economic operators in undertaking risk capital as an activity, depending on the strategy of development in certain economic fields, public authorities have sought to take measures to promote risk capital markets, such as:

- (a) promoting a culture of entrepreneurship;
- b) relaxation of fiscal constraints on equity, such as less favorable treatment than that given to debt financing;
- (c) measures to foster market integration;
- (d) relaxing regulatory constraints, including limitations on investments by certain types of financial institutions and administrative procedures for setting up companies.

Such measures must be compatible with the provisions of the State aid Law no.143/1999, with subsequent modifications.

1. Definition

Risk capital represents an equity financing to companies in their start-up and development phases (shares subscription at the funding or at the increase of the social capital. The risk capital is involved in activities with an increased risk (the financing of new technologies or products, entering on new markets by direct or portfolio investments degree, s.o.) which,

usually do not lead to capital subscriptions or financing by different traditional ways. Their financing is usually made together with the participation of banks, insuring companies and other specialized financial agents. The term ,venture capital' refers essentially to risk capital provided by investment funds (venture capital funds) established for that purpose. Such funds often provide a mix of equity, mezzanine¹ and subordinated loan finance and the term ,venture capital' refers to the totality of this finance. The investment funds are being settled by OUG no. 26/2002, with the subsequent modifications and completions

2. Aim and scope

2.1. These Guidelines have the main objectives:

- a) set out how the Competition Council will apply the State aid definition in Article 2 of the State Aid Law no.143/1999 to measures designed to provide or promote risk capital (,risk capital measures');
- b) defining the criteria allowing to the Competition Council to authorize this type of measures which really are state aids.

2.2. These Guidelines in no way derogates from the provisions of the Regulation on State aid for rescuing and restructuring firms in difficulty.

The Competition Council will give a special attention to avoid that the present guidelines will be used for modifying the scope of the principles laid down within the existing state aid Regulations and Guidelines.

2.3. These Guidelines only apply to state aid schemes.

3. Reasons for controlling public funding to risk capital measures

3.1. Aside from the requirement to control State aid, when the public authorities decide to authorize public funds for measures designed to promote risk capital, should reduce as far as possible the following distinct categories of risk:

- a) The risk that advantages to the beneficiaries (whether investors or enterprises) create an undue distortion of competition relative to their competitors in the internal market;
- b) The risk of ,dead-weight', or lack of incentive effect. Some enterprises funded through publicly supported measures may have obtained finance on the same terms in any case from the other sources. There is evidence of this happening though this is inevitably anecdotal. In that event public resources are being used unnecessarily.
- c) The risk of ,crowding out'. The presence of publicly supported measures may actually discourage other potential investors from providing capital.

3.2. At the substantiation of the decision of authorization or of forbidding the granting of aids for measures regarding the promotion of risk capital, the Competition Council will take into consideration the accomplishment of these conditions.

¹ "Mezzanine" Fund: financial provision of an undertaking after ensuring the finance for establishment. This type of finance represents an intermediary stage in financing of a new companies, being between the supplying of a credit and the buying of shares.

4. Beneficiaries

Risk capital measures may confer aid on at least three different levels:

a) Aid to investors

Where a measure allows investors to participate in the equity of a company or set of companies on terms more favorable than public investors, or than if they had undertaken such investments in the absence of the measure, then those investors receive an advantage. This remains the case even if the investor is persuaded by the measure to confer an advantage on the company or companies concerned. The fact that owing to the existence of a market failure no investors would otherwise make such investments, is not of itself sufficient to rebut the presumption of advantage. In effect, the investors are being offered more advantageous terms to compensate them for the factors which cause market failure, and the Competition Council considers that such compensation must be considered as an advantage, which will constitute aid if the investors are enterprises and if the other conditions described in art. 2 of the State aid Law, with the subsequent modifications, notably selective, are being met.

b) Aid to an intermediary vehicle or fund

In some cases, a risk capital measure provides for the creation of a fund or other investment vehicle which has an existence separate from investors and the enterprises invested in. 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.

Competition Council would tend to the view that a fund is a vehicle for the transfer of aid to investors and/or enterprises invested in, rather than being an aid beneficiary itself. However, in certain cases, notably measures involving transfers in favor of existing funds with numerous and diverse investors, the fund may have the character of an independent enterprise. In that case aid will usually be present unless the investment is made on terms which would be acceptable to a normal economic operator in a market economy and therefore provides no advantage to the beneficiary.

c) Aid to the companies invested in

The main test, according to which is being established the existence of a state aid, is whether the enterprise has received the investment on terms which would be acceptable to a private investor in a market economy. This test can, as an example, be met when the investment made through the risk capital measures is made “*pari passu*” with such an investor or investors (the State resources are made available on the same terms as those applying to private investors). Where this is not the case, the fact that investment decisions are being taken by commercial managers of risk capital funds, or by representatives of investors, with an interest to ensure a maximum return for the fund is an important indicator, but it is not of itself conclusive. The Competition Council must also take into account the possibility that any advantages accorded to investors in the funds are passed on to the enterprises invested in, when the investments are not made by the fund “*pari passu*” with a private investor in a

market economy. If a risk capital measure has reduced the risks and/or increased the rewards which investors will obtain from making a particular investment, then they may be said no longer to be operating as a normal economic operator.

4¹ - The Competition Council does not use the criteria provisioned at point 5 in order to authorize a measure by which an economic agent would be financed only by the form of loans (including the subordinate loans and loans assimilated to the registered capital) or other instruments which ensure to the investor/ loaner a fixed minimum profit, through the funds or similar means. Such a financing does not constitute “risk capital” in the understanding of the definition given under point 1. The Competition Council regards the existing rules as being adequate in order to assess such measures, these allowing for the calculation of any element of state aid as well as the determining of the connection with the eligible costs.

The Competition Council does not use the criteria provisioned at point 5 in order to authorize a measure for the financing of an individual undertaking.

5. Assessment of compatibility of risk capital measures

5.1. Where measures constitute State aid, the Competition Council is called to assess the existence of a market failure, before the authorization of those risk capital measures which are not enclosed within the application area of the other existing regulations related to the state aid field

These measures which are in turn wholly or partially financed through State aid must not exceed the equivalent in ROL of EUR 1 million. A market failure may manifest itself when the economic efficiency is not met, due to the market mechanisms imperfections (lack of poise between demand and offer, misallocation of resources etc.). The fact that a market failure is recognized does not however alter the aid character of a particular measure, nor the need to assess its compatibility with the existing legislation regarding state aid.

5.2. Where it is recognized that there is a market failure, the Competition Council will examine whether any State aid measure is proportionate to the presumed market failure it is devised to meet, and will seek to ensure that any distortion is minimized. This can best be achieved by measures which are just sufficient to ensure that market investors provide capital and which result in investment decisions being taken on a commercial basis and on terms as close as possible to those which would prevail in the normal economy.

5.3. Once the market failure was identified , the Competition Council will follow up on the following elements in analyzing a measure regarding the risk capital according to the Law no. 143/ 1999 regarding the state aid, with its ulterior modifications and completions:

A. Restrictions regarding the investments or the non-investment of the majority of the funds

- a) in the small undertakings or the microundertakings; and/ or
- b) in medium undertakings, at the moment of constructing or during the beginning period of the activity, or in the assessed areas they will be regarded as a positive element. The access to

the financing of the medium undertakings after the moment of their registration or the beginning period of their activity must be limited to each undertaking in respect to the total financing through the measure. The limitations regarding the conducting of some small size transactions (under 1 million EURO or a level determined for the proven market failure, will be regarded also as a positive element by the Competition Council.

B. The measures must be oriented towards the dysfunctions of the market of risk capital.

If a measure implies the financing as capital or quasi-capital, this will be regarded as positive by the Competition Council. If the measure implies the financing by considerable amounts in other forms or the stimulating effect isn't obvious (by example, when risk capital investments are aided which would have been achieved even in the absence of such measures), the measure will be regarded unfavorably. This could be the case of the measures by which a supplementary financing is supplied for an undertaking which already received state aid as capital injection.

C. The Investment decision must pursue obtaining profit.

A connection between the profitability of the investment and the remuneration of those responsible for the decision to invest will be considered a positive element. The condition is met in the case that:

- a) the measures by which the capital was integrally invested in the target undertakings is supplied by the investor who is operating in the market economy and took the decision to invest, the aid constituting only a stimulant in order to determine them to invest;
- b) the measures which imply a significant capital participation of the investors which are operating in the market economy on commercial bases (only for obtaining a profit). The participation to the registered capital of the target undertakings can be direct or indirect.

In the case of funds, there is considered significant capital participation the contribution of 30% to the registered capital of the fund, every measure being analyzed individually, along with other aspects taken into consideration by the Competition Council in carrying out the evaluation. The following will be considered positive elements:

- a) an understanding between the manager of the fund and the investors according to which the remuneration of the manager is given by the performance of the fund, the stated objectives of the fund and the time suggested for carrying out the investments;
- b) the representation of the investors in the decision making;
- c) the application of the best tactics and the regulation of the supervision of the manner in which the fund is administrated;

When none of these elements shows the fact that decision to invest will be carried out only for the purpose of obtaining profit, the measure will be appreciated in an unfavorable way. This is the case of measures which, having a small scope, are oriented towards a limited number of projects, unprofitable from an economical standpoint or of the measures by which

the financing is determined for a certain economic agent known from before the decision making.

D. The level of distorting the competition between the investors and the investment funds must be limited.

The Competition Council will favorably appreciate a bidding procedure for the determining of the preferential terms for the investors or the possibility of determining such terms for other investors. This possibility can take the form of a public tender for investors upon the launching of an investment fund or can take the form of a scheme (by example a guarantee scheme) which remains open to the participation of other investors, for an extended period. The means by which this element can be achieved positively depends absolutely on the measure taken. Nevertheless, the absence of some elements of verification against the overcompensation of the investors, entirely taking the risk of losses by the public sector and/or the integral obtaining of the benefits of the investment by other investors will be considered negative.

E. The sector orientation.

Considering that many private sector funds are aiming their attention at specific innovative technologies or even towards sectors (such as health, information technology, culture), the Competition Council can accept a sector orientation when this aims at commercial reasons or public policies. Nevertheless, considering the less favorable approach existing at the level of the European Union regarding the sector state aid and especially the state aid for the sectors having an overcapacity, the measures must exclude deliberately the giving of aid in the sector of maritime constructions, steel and coal.

F. The investments based on business plans.

The existence for each investment of a business plan which to contain the details of the products, the estimate of the sales and profit and the determining ex ante of the viability of the project is a standard commercial practice in the achievement of an adequate management of the funds and will be regarded favorably. The measures which do not make provision for an exit mechanism for the direct or indirect participation of the state in the registered capital of certain undertakings will be regarded unfavorably by the Competition Council.

G. Avoiding the cumulating of the state aid measures granted to only one undertaking.

If a measure makes provision for state aid for investments in an undertaking, then the Competition Council will require the engagement of the supplier to evaluate and limit the giving of other forms of state aid towards that undertaking, including the authorized schemes. For such measures and if the supplier of state aid does not make the engagement that the undertaking will not receive any other aid except de minimis aid, this will propose to the Competition Council to examine and approve a reasonable evaluation of the state aid elements which will allow for the application of the cumulating rules. When the risk capital is used for the financing of the initial investments, the research and development costs or

other costs eligible for state aid regarding other objectives, the supplier will include the state aid element in the risk capital measure applying the relevant aid thresholds.

5.4. The Competition Council's assessment will take account of the regional specificity of any measure and will be subject to an overall test of proportionality.

6. Form of the aid measure

Risk capital measures which constitute state aid are the following:

- a) Constituting 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) Allowing to venture capital funds to cover part of their administrative and management costs.
- c) Other financial instruments in favor of risk capital investors or of venture capital funds to provide extra capital for investment.
- d) Guarantees granted to the 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.
- e) Fiscal incentives granted to the investors in order to undertake risk capital investment.

7. Conditions that must be met when enforcing the present Guidelines

The present Guidelines are enforced according to the provisions of the Regulations regarding the form, the content and other details of the state aid notification and of the Regulations regarding the de minimis limit of a state aid which does not compiles to the Order of the Competition Council's President no.27/2000 regarding the form, the content and other details of the state aid notification and of the Regulations regarding the de minimis limit of a state aid.

8. State aids which comply with the present Guidelines

The present Guidelines will apply to the state aids granted for the measures regarding risk capital, notified after the coming into force of those guidelines, even when the state aids are notified a-priori, but the decision of the Competition Council is subsequent to this date or when the Competition Council hasn't decided yet.

9. The coming into force of the present Guidelines

These Guidelines transpose in the Romanian legislation the Communication of the European Commission on state aid and risk capital, published in the Official Journal of the European Communities no. C 235/21.08.2001.