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EVCA's Comments on the current EU SME Definition

The European Private Equity and Venture Capital Association (EVCA) welcomes the opportunity to comment on the implications of [Commission Recommendation 2003/361/EC concerning the definition of "micro, small or medium-sized enterprises"](#)¹ (SME) for venture-backed companies.

EVCA would like to stress the negative implications of the current EU SME definition for venture-backed companies and urgently calls on the European Commission to clarify the current definition.

Art 3.2 of the Recommendation provides that, for the purposes of the SME definition, some categories of investors, like "venture capital companies" and "institutional investors" are not considered "partner enterprises" even if they hold 25% or more of the capital or voting rights of another enterprise, on condition that such investors are not themselves considered "linked enterprises" under the definition of art 3.3.

Under the current EU SME definition, an enterprise only qualifies as an SME if it is not 'linked' with other entities which, when taken together, exceed a certain size. Unfortunately, the new definition of "linked enterprises" works in such a way that all portfolio companies invested in by a single fund can be treated as linked when determining whether any one portfolio company qualifies as an SME. As a result, it is now common that a business invested in by a venture fund ceases to qualify as an SME, as the portfolio of companies taken together will generally exceed the relevant threshold. This means that small businesses that are not, in any real sense, members of a group are treated as though they were simply because they have sourced capital from a private equity fund.

These businesses are therefore denied the advantages offered to other, similar businesses, putting them at a competitive disadvantage. It also has the effect of making venture funding less attractive to SMEs, which increases their reliance on state benefits and exacerbates the equity gap - precisely the opposite of what the policymakers want.

These effects are becoming increasingly apparent as EU Member States use the European-wide definition in progressively wider circumstances. Governments find it helpful to refer to it when targeting a very wide range of benefits, and as a result, venture-backed companies are excluded from those benefits.

Several conditions included in Article 3 are met by private equity and venture capital organisations in the normal course of their business.

- Article 3 leg a) regarding the majority of voting rights leads to a situation where, for example, companies originating from a private equity buyout transaction, are considered as linked to their private equity investors.
- Article 3 legs b) and c) refer both to the ability to remove a majority of the members of the management and the right to exercise a dominant influence. Both are regular mechanisms used by private equity houses, which are designed solely for the protection of the investment made in a specific company by the private equity and venture capital house.

It should be noted that the typical activity carried out by a "venture capital company" or "an institutional investor" holding the majority of the voting rights or exercising a dominant influence on the participated company does not mean that the investor is involved in the management of the enterprise in question.

¹ For more information, please see http://ec.europa.eu/enterprise/enterprise_policy/sme_definition/index_en.htm

- Article 3 leg d) concerns joint control of a company. Private equity portfolio companies, like for example start-ups, are often investment undertaken in syndication with other private equity houses in order to share the risk of such investment. They are under this provision be defined as “linked enterprises” and hence be excluded from consideration as an SME.

EVCA would like to stress the importance to remove obstacles for SMEs controlled by venture capital funds, by extending small company tax reliefs (that are available for other small firms) to venture capital owned or controlled companies. The inability of SMEs controlled by venture capital to qualify for such reliefs is illogical and inhibits growth.

Therefore, for the reasons above, EVCA would recommend the European Commission to clarify that private equity and venture capital funds are not caught by the definition of “partner enterprise”, and calls for an amendment to the definition of “linked enterprises” so that private equity funds have the same get out as companies under common (parallel) ownership.

The definition of “institutional investor” should also include private equity and venture capital investment funds. This is already the case in the Italian implementing legislation, which expressly mentions the SGR - *Societa di Gestione del Risparmio*, the regulated management company of the domestic investment fund structure.