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Master thesis

International Business Law

"Creating a solid framework to stimulate the venture capital industry in the Netherlands"

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Introduction

The dot-com burst in 2000 and the developments in the financial market after 2008 have had a great negative impact on the venture capital market. Venture capital is known for the investment in early stages of Small and Medium sized enterprises ('SMEs'). The crisis hit hard and a lot of firms went bankrupt. As a result many people lost their jobs. The confidence in the financial market got lost and it became even harder for young, innovative entrepreneurs to attract capital in the early stage.

SMEs are known for innovation and job creation, thus it is very important that these companies get the possibility to grow. In Europe, SMEs are responsible for 85% of the new jobs between 2002 and 2010.[1] As a consequence of the crisis, investors got more risk-averse concerning early-stage investments and entrepreneurs are more reluctant to take the risk to start up a company in these financial difficult times. The entrepreneurs that want to take the risk these days have to accept stricter terms than before. The Dutch private equity and venture capital association 'NVP' published recently a report analyzing the Dutch private equity and venture capital industry in 2012. The venture capital investments decreased with €33 million if one compares it to the investments in 2011. Dutch venture capital firms invested € 153 million in 185 young companies. In 2011, these firms invested € 186 million in 191 young companies. This decrease is not alarming, but the decrease in seed investments is a bigger cause of concern. Sixteen companies received seed financing for an amount of € 9.2 million in 2011, while in 2012 only six companies received seed financing for a total of € 2.2 million. This is concerning, certainly when you know that the Dutch government policy was focusing on increasing seed financing. A more positive trend is the increase of money that is raised for venture capital investments. According to the report, venture capital funds raised € 107 million in 2010, € 136 million in 2011 and last year € 171 million was raised to invest in venture capital. However, these increasing amounts are still far under the amounts that the funds raised before 2009. Now that the importance of innovative SMEs is showed and the need of venture capital investment is linked to these SMEs, it will be interesting to take a closer look at the regulatory framework of venture capital in the Netherlands. This leads me to my research question for this thesis:

[1] http://ec.europa.eu/enterprise/policies/sme/facts-figures-analysis/performance-review/files/supporting-documents/2012/do-smes-create-more-and-better-jobs_en.pdf

'How is the venture capital industry in the Netherlands developed and what can the Dutch government do to stimulate the venture capital industry in an effective way?'

This thesis is divided into an introduction, four chapters and a conclusion. In the first chapter, I will explain venture capital and its trends over the years. Chapter 2 analyses the role of the government in flourishing venture capital markets located in the United States, Israel and China. The role of the Dutch Government in the venture capital market will be discussed in the third chapter and some suggestions will follow in chapter 4. These four chapters are followed by a conclusion.

1. Venture Capital

1.1 Existence of venture capital

The need for venture capital arises because of information asymmetry in the market. Akerlof talked about the difference between good cars and the so-called lemons ('bad cars'). When one cannot make the difference between good and 'lemon', the bad will probably drive out the good. The owners of good cars will not place them on the market, because they will get a lower price. The owners of the bad cars on the other hand will put theirs on the market, because they will receive a better price in proportion with the real quality and in the end the market will be inefficient.[2]

Information asymmetry is also a huge problem related to start-up companies. These companies have a lack of operational history and therefore the entrepreneur has more knowledge than the investor. It is not an easy task to screen these companies and select the good firms. Venture capitalists take this job serious and try to screen the companies as good as possible. Because the information is limited, VC funds use different mechanisms to limit their risks. Staged financing is a good example of a mechanism that venture capitalists use to reduce the agency costs. During the time the VC funds get to know the company and the entrepreneur gets an incentive to act well so that he certainly will get more capital in later stages. In meanwhile, the active role of the venture capitalists reduces the moral hazard problem. A VC fund will also demand board seats, in that way they will get significant control over the company's decisions. The appearance of VC funds is mostly focused in specific industries such as biomedical areas and ICT. It seems very plausible that this appearance is related to the industries where informational asymmetries are most rigorous.[3] In these industries, start-up businesses often only have an idea and nothing more concrete than that. Besides, the entrepreneurs expect the first years negative earnings because of the capital intensive industries where they are located in. So, there is a lack of tangible assets and a lot of uncertainty. Therefore it is most of the time impossible for these entrepreneurs to get a bank loan or use other ways of debt financing.

[2] Akerlof 1970.

[3] Amit, Brander and Zott 1998.

1.2 The traditional VC cycle

The traditional venture capital cycle starts with the creation of a venture capital fund. These funds raise money from institutional investors such as insurance companies as well as from private investors. The task of the venture capital funds is to select innovative and promising firms, and most of the time they focus on high tech start-ups. A venture capital fund does not only invest in a company, they take an active position in the selected firms and a long-term business partnership based on trust arises.[4] The VC funds provide the companies with advice, monitoring, and management assistance. This specific task differentiates venture capital from other forms of private equity. The active role of the venture capital fund can be very beneficial to the entrepreneurs because most of the time they lack the expertise to manage the company efficiently. Usually, the venture capital funds diversify their portfolio to spread the risks. Consequently, they are not working with one specific firm but with several companies in the same industry. This results in venture capital fund managers with a wide range of experience from which the start-up companies can take advantage. Especially in the early stage of the company, this expertise is very valuable.[5]

As time goes by, the need for the experience of the venture capital fund manager reduces because of the educational process the entrepreneurs are involved in. After a certain period, the entrepreneurs hopefully have created a successful business with the support of the venture capital fund and then it is time for the venture capital fund to exit the company. After all, cashing out is what they want in the end. There are several ways to exit these companies, but an IPO is the most preferred exit of a venture capitalist.[6] The invested money including the carried interest goes back to the investors and a fee plus a share of the profit is paid to the venture capitalists.[7] If an exit is successful, the chances are high that these investors will start the venture capital cycle again thus creating a vicious cycle.

[4] Thompson 2008, p.2.
[5] Gompers and Lerner 2001, p. 42-43.
[6] Gilson and Black 1999, p.13.
[7] Gompers and Lerner 2001, p. 100-101.

1.3 Other sources of funding

Venture capital is off course not the only and certainly not the first way to raise money for an entrepreneur. These other sources of funding have their own advantages and disadvantages. I will discuss the most common sources of funding below.

1.3.1 Bootstrapping

When an entrepreneur decides to start a company, he will need money. At the start of this adventure, it will be very difficult to raise capital. That is why a lot of entrepreneurs have to start with bootstrapping. This means that one has to be self-sufficient. The use of your own savings will force you to start small but bootstrapping has also its advantages. One will use the money very carefully and will weigh all the risks and possibilities. One knows what is at stake and therefore the entrepreneur will be very engaged to deliver good work. It will not be easy and the entrepreneur will probably not see any profits in the beginning, but it is the best way to learn and know your products and customers very well. This can be seen as a huge benefit in the later stage. Besides, institutional investors prefer to see you putting your own skin in the company. It is a sign for them that you have faith in your idea. And as said earlier, it is a good incentive for the entrepreneur to work with care. Another advantage of using own savings is that one will not lose control in the company so the entrepreneur can retain his creative freedom. It is of course a very cheap source now one does not have to take interest rates into accounts.[8] Personal bank loans are also an option in the early beginning of a company. It is of course more expensive than when one uses his own savings, but the entrepreneur does not lose control. Another risk attached to a personal loan is that it is mostly secured with a mortgage. This can give a lot of stress in a family and failure of the company will have a huge impact on the personal life of the entrepreneur.[9]

1.3.2 Friends, Family and Fools

Most often, the venture capitalist is not the first external source of funding. After the entrepreneur has used his own capital, he will probably try to raise capital via the so called ‘three F’s’: friends, family and

[8] http://www.forbes.com/sites/theyec/2013/02/06/8-ways-bootstrapping-makes-you-a-better-entrepreneur/

[9] Nesheim 2000, p. 217.

fools. These people loan money to an entrepreneur based on a relationship instead of looking to the financial rewards that they can earn. Presenting a real business plan with a SWOT matrix is not typical in this case and that makes it of course easier for the entrepreneur. Another advantage of the 3 F's is that they normally do not ask for active control in the company, but one should definitely be careful with this way of funding. Because of the personal relationship, emotions can cause a lot of problems and one would probably not prefer to risk the relationship with their family because of some money. Besides, if the business doesn't go as planned, it can also ruin long-lasting relationships with friends. If one chooses to use this way of funding, one should make the investors aware of all the risks involved with the funding.[10]

1.3.3 Business Angel

A business angel is a wealthy individual or family that wants to invest in high-risk companies at an early stage. These investors are mostly retired entrepreneurs or executives that do not only want to invest capital in a company, but prefer to transfer knowledge that they have received during their career. The angel investor bears very high risks now that he is often the first investor to approach after the entrepreneur has used its own money and that of the '3 F's'. Therefore, a business angel selects mostly companies that are active in the same industry as he succeeded and that have high-growth prospects. The disadvantage of a business angel is that the entrepreneur has to give up some control. As said, it is an investor that does not only provide capital, but takes an active position in the firm. [11] The business angel has similarities with the venture capitalist but it is very important to make the difference. The most important differences are the use of own money and therefore the amount investing will be smaller in the case of a business angel. Further, a business angel will invest in the early stage of a company where a venture capitalist will enter a company when the concept is proven and initial revenues are obtained.

[10] Sherman 2005, p. 69-70.
[11] ' A guide to angel investors' http://www.entrepreneur.com/article/52742

1.3.4 Corporate venture capitalist

Corporate venture capitalists (CVCs) already exist for a long time, but their influence gets more visible now that the traditional venture capitalists are reluctant with their investments in the early stages of SME's.[12] After the burst of the dotcom-bubble and the start of the financial crisis in 2008, entrepreneurs were forced to search for other options of venture capital than the traditional venture capital funds. Corporate venture capital can offer several benefits to SME's. As said earlier, an exit via an IPO is the most preferred way out of a venture capitalist. But at this moment, the IPO-market is down and this makes it of course harder for VC funds to exit. A CVC can choose to work together with the company which gives possibilities to spin off or spin out so that an IPO is not needed. An innovative SME can also be attractive for corporate investors to have a view on new technology. In this way, one can create synergy between the mature investing company and the young SME. Mature companies need to stay innovative in this harsh times and that is where the SME's can add value.[13] These innovative SME's have an idea but no experience, capital and network. The investing company can use the SME to stay innovative and the SME can get its capital at the same time. Google for example made 21 deals in the third quarter of 2012. In three cases, the investments were done in the seed round and Google also made twelve first round investments.[14]

Corporate investors were known as passive investors in the past, but in the aftermath of the crisis they got more actively involved in the portfolio companies. This can be partly addressed to the lack of innovation that the investing company is confronted with these days.[15] In the past, the CVCs were more known as short term investors, but research shows that this is changing. Now that these companies have an urge of innovation, their view has changed. They take a more active position in the firms and they get more sophisticated. The durability of venture units in technology for example lengthened with almost six years from 2002 to 2012.[16]

[12] Mc Cahery and Vermeulen 2010, p. 3.
[13] The Boston Consulting Group 2012, p.2-3.
[14] http://blogs.wsj.com/venturecapital/2012/10/19/googles-venture-capital-unit-has-busy-third-quarter
[15] Mc Cahery and Vermeulen 2010, p.4.
[16] The Boston Consulting Group 2012, p. 11-12.

1.4 Evolution of Venture Capital

The 21st century started thirteen years ago, but the financial market already underwent two big financial crises. These crises also affected the venture capital industry.

1.4.1 The dotcom-burst (2001)

The dot-com bubble started in 1995 when the growth of internet users increased enormously. Many entrepreneurs saw their chance to make those internet users their customers and a lot of internet start-ups arose in the mid and late '90s.

In contrary to 'normal' companies, the internet companies did not have many or sometimes not any assets. Intangible assets such as knowledge and IP rights were there abundantly, but it is very difficult to value these assets and rights. The value depends much on how future businesses grow. Unfortunately, this is something what is very difficult to determine.[17] So, one can conclude that there was no certainty in this sector. These new companies took a lot of risk hoping that they would be the first and fastest mover. They all wanted to take advantage of this new and fast growing business to get rich in a very easy and rapid way.[18] There was more than enough capital available at that moment and investors responded quickly. Instead of screening the companies thoroughly, the investors almost threw the money blindly at the startups, because everyone wanted to be the first to discover this new market.[19] Especially the American stock market rose significantly during the period 1995-2000 and one lived like kings. After a great start, several events happened which had a big influence on the market and the bubble burst. Probably the most foreseeable cause of the burst was the overly positive and unrealistic expectations that the investors and entrepreneurs had. Warren Buffet stated once:

"Be fearful when others are greedy and be greedy when others are fearful."[20]

I personally think Warren Buffet was right in this case. Everyone wanted to be the first in line while this sector was booming, but as a consequence the valuations got artificially higher and overvaluation seemed to be the standard. Of course being overconfident was not the only reason that the bubble had

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[17] http://www.pwc.tw/en/challenges/financial-advisory/indissue0268.jhtml (accessed latest on June 10th, 2013)
[18] Jain 2010, p. 237.
[19] Hellman and Puri 2002, p. 21-24.
[20] Chairman's letter 2004 http://www.berkshirehathaway.com/letters/2004ltr.pdf

burst. The fall of Enron, after accounting problems were discovered, had obviously a great impact on the financial market. The government did several investigations and trust in the market diminished. The terrorist attacks of September 11th 2001 were another reason that the market took a major downturn in the beginning of the ‘00s.

1.4.2 The global financial crisis (2007-2008)

According to several economists, the financial crisis of 2007-2008 can be seen as the worst financial crisis since the Great Depression of the 1930s and the end is not in sight.[21] It all started as a subprime mortgage crisis, were even the most risky borrowers could get a loan.[22] But then the house pricing stopped appreciating and the system collapsed.

The loans for the risky borrowers were most often made under adjustable-rate mortgages (ARMs). One expected that the mortgagor could refinance his loan at a lower rate mortgage because of the appreciation of the houses in the past.[23] Unfortunately, the opposite happened and many borrowers defaulted. The subprime crisis was of course not the only cause of the following global financial crisis, but it was certainly an important trigger. As a reaction on the defaulting borrowers, low investment-grade mortgage-backed securities got lower ratings and investors got alert. The problems on the US housing market evolved in a global financial crisis and the consequences are beyond belief.

One always said that banks could not go bankrupt and then the global financial crisis struck. A total collapse of large financial institutions endangered and governments had to pump billions of Euros in these institutions to avoid complete chaos. The seriousness of the situation got incredibly visible after that Merril Lynch sold itself to the Bank of America and the Lehman Brothers filed for a Chapter 11 bankruptcy in September 2008.[24] It was just a start and very quickly more well-reputed financial institutions all over the world went bankrupt, were nationalized or were acquired by other parties. Unemployment rates were never so high. The trust in the capital market was once again lost. Not only financial institutions got hit, several countries got also affected by the financial crisis. Greece and Cyprus are two countries that got in big troubles after the financial crisis revealed the weak financial position they were in.

[21] Hilsenrath, Paletta and Ng 2008.
[22] Schwarz 2009, p. 549-550.
[23] Schwarz 2009, p. 550.
[24] See http://online.wsj.com/article/SB122142278543033525.html?mod=special_coverage and http://www.lehman.com/press/pdf_2008/091508_lbhi_chapter11_announce.pdf

1.4.3 New financial regulations after the crisis

As a reaction on these events, world leaders and institutions such as IMF started discussing how they could prevent a new crisis. New regulations for financial institutions with a focus on leverage, liquidity, minimum capital requirements and risk management were created and adopted on a global level as well as on the state level. Basel III[25] on the international level, Solvency II directive for European insurance companies[26], the AIFMD directive[27] for fund managers of alternative investment funds in Europe and the Dodd-Frank Act[28] in the U.S. are some examples of regulations that were developed in order to avoid a new financial downturn. These regulations impose higher standards for the different institutions and will probably have a major impact on private equity now that banks, pension funds and insurance companies are some of the most important institutional investors. The capital buffers that these companies need are much higher in the new regulations when they want to invest in a high-risk market such as venture capital. Therefore, one can expect that these institutions will be more prudent with investing in venture capital.

1.4.4 The changing VC cycle

Some have said that the venture capital cycle is broken[29]; others say that it has changed. I believe that the cycle has evolved over time. The dot-com burst and the financial crisis evidently had a great influence on this development. People lost large amounts of money and grew cautious and reluctant to engage in high risk investments. This results in fewer investments which are concentrated in higher

[25] Basel III: A global regulatory framework for more resilient banks and banking systems, December 2010 (rev. June 2011); Basel III is formed in the post-crisis era to prevent a new 'Lehman Brothers'-scenario. One wants to strengthen the global capital and liquidity rules to create a stronger and safer banking sector. Therefore, a bank will not be able to invest that easily anymore in private equity since the banks need to have more capital set against these investments.

[26] Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II) [2009] OJ L 335/17. This directive tries to limit the risk of insolvency of EU insurance companies. The capital requirement of this directive forces insurers to hold capital against the risk of a risky financial asset. Thus, investing in venture capital will be very expensive for insurers now venture capital is known as a high-risk investment.

[27] Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers. The EU wants to create a single rulebook for AIFMs so that it will be easier to invest across Europe. Although this sounds very promising, the requirements seem to be very burdensome.

[28] Dodd-Frank Wall Street Reform and Consumer Protection Act. This Act was signed in 2010 by President Barack Obama as a response to the late-2000s recession. It wants to create financial stability in the United States by improving accountability and transparency in the financial system.

[29] Austin 2009.

quality funds.[30] The venture capital funds that are left need substantially more time to raise the required funds. The time to raise the desired amount of money increased with a significant 6.5 months in 4 years. In 2007 it took 12 months to raise the desired funds against 18.5 months in 2011.[31] The venture capital funds got more risk-averse, as a reaction to the changing preferences of the investors. The funds select more low risk businesses and instead of investing in the early stage, they now prefer to invest at a later stage. The VC funds were known for their early stage investments with higher risk, but it seems that they have changed into risk-averse later stage investors similarly to other private equity investors. This clearly indicates that the venture capital cycle has changed. Because of the lack of investments in early stage companies, a gap appeared in the venture capital cycle and now it got even more difficult for entrepreneurs to attract capital and as a consequence innovation but also job creation is hampered. We now slowly see a new group of investors filling up the liquidity gap in this stage. Corporate venture capitalists, governments but also super-angels are now investing more and more in these early stage companies.[32] As said before, the venture capital cycle is evolving and the policymakers, regulators but also venture capital fund managers need to evolve as well to create a booming Venture Capital market.

[30] Mendoza and Vermeulen, 2011 p.2.
[31] Preqin Research Report 2011 Private Equity Fundraising. Accessed on 12 April 2013: http://www.preqin.com/docs/reports/2011_PE_FR_Factsheet.pdf
[32] The Boston Consulting Group 2012, p.9.

2. Active role of the government

Innovation and job creation are, certainly in times of crisis, very important for a country. Venture capitalists play an important role in the financing of innovative SME's. Therefore, governments cannot longer ignore the need to create a stable and strong regulatory framework regarding the venture capital industry. Different programs were already created in the past by governments to fill the 'funding gaps', but unfortunately many attempts failed. The government has to pay close attention to the design and management of these programs to be sure that the supply of venture capital will be stimulated in an effective and efficient manner.[33]

A distinction can be made between three types of government programs. Firstly, there is the direct supply of capital to venture capital firms or small firms. This is the most risky way of providing financial funding to SME's or venture capitalists. As a result, this type of program is not that often used to stimulate the venture capital industry. Examples of the direct supply of capital are low-interest loans and equity investments. Secondly, a government can provide financial incentives for those who are willing to invest in venture capital funds or small firms. Financial incentives in the form of tax incentives, loan guarantees and equity guarantees are commonly used by governments. The third type of government programs is focused on regulations that are controlling types of venture capital investors.[34] Through these regulations, institutions such as pension funds and banks are allowed in some countries to invest in the risky venture capital industries.

A government program can focus on a certain stage of investment. In the case of venture capital, most of the programs will focus on early-stage investments now it is the most difficult for entrepreneurs to find capital at that moment. Further, one has to keep in mind that not all companies will survive. Therefore, it is of course necessary to have sufficient supply of start-ups so that enough companies remain in the later stages of investments.[35] In this chapter, I will analyze the construction of the venture capital market in three different countries respectively the United States, Israel and China. Which elements were important in the creation of their venture capital market and which role did and does the government play in the design of the venture capital market?

[33] OECD 1997, p.4.
[34] Ibid.
[35] Ibid, p.8.

2.1 United States

When one says venture capital, one thinks immediately of the United States. The United States is seen as the birthplace of venture capital. Therefore it is interesting to analyze which factors contributed to the creation of a vibrant U.S. venture capital market.

2.1.1 History

The United States is well-known for its strong venture capital market. Before the stock market took off in the early '20s, wealthy families such as the Rockefellers invested in new ventures. Starting from the 1920s, these families began to move their money to the public markets but after the Wall Street crash in 1929, wealthy individuals got reluctant to risky investments and delegated more to institutions.[36] After World War II, the venture capital really started to grow. This strong growth is often addressed to George Doriot. After Doriot served in World War II, he founded the 'American Research and Development Corporation' ('ARD') which is known as one of the first venture capital firms. The private sector investments of this company were focused on businesses run by soldiers who came back from World War II. The description of George Doriot about the way ARD worked can be seen as a good guideline for venture capitalists:[37]

- Assist in creating companies based on the ideas and techniques of competent men.
- Invest in new companies.
- Invest in existing small or medium-sized companies which appear to have growth potential.
- Add value other than the capital contribution (offer technical and administrative experience)

After that, the venture capital industry started growing and evolved in time, but the principles of Doriot are still relevant.

[36] Arun and Scaruffi 2011, chapter 7.; Lerner 2012, p. 36; Bartlett 2006, p.257.
[37] Gupta 2004, p.52-53.

2.1.2 Silicon Valley

Silicon Valley is often seen as the birthplace of venture capital as it is today and it is still the top region for closing deals. In the first quarter of 2013, Silicon Valley was responsible for no less than 37.87 % of the total investments in the U.S. and 274 deals out of 863 were closed in this region.[38] The existence of Silicon Valley is a combination of multiple factors, starting with World War II. Frederick Terman, a MIT Ph.D. became dean of engineering at Stanford University after World War II. He had been a student at MIT, but he was also director of one of the research labs in Boston during World War II. He saw that the combination of a university and the industry could offer many benefits for both parties and used his position as a dean at Stanford to create a good environment for the establishment of a high technology industrial district. Stanford University developed multiple research programs to minimize the gap between the university research and the commercial industry. The university even used some of its own land to create the Stanford Industrial Park. The goal of this park was to enforce the physical relationship between the university and the industry.[39] From that moment on, Silicon Valley was born and is still at the top of the global venture capital industry.

2.1.3 Government programs

- SBIC

In 1958, the US Small Business Investment Act of 1958 came into force and had as goal

> "*to improve and stimulate the national economy in general and the small-business segment thereof in particular by establishing a program to stimulate and supplement the flow of private equity and long-term loan funds which small-business concerns need for the sound financing of their business operations and for their growth, expansion and modernization, and which are not available in adequate supply*"[40]

[38] Moneytree.
[39] Gilson 1999, p.589.
[40] The US Small Business Investment Act of 1958, p.5:
http://www.sba.gov/sites/default/files/Small%20Business%20Investment%20Act%20of%201958_0.pdf

The Small Business Investment Act of 1958 authorized the Small Business Administration to license and regulate the Small Business Investment Companies (SBICs). The SBA assisted to obtain funds for privately owned and operated venture capital investment firms.[41] The SBIC program focuses on providing long-term debt and equity investments to high-risk SME's. These regulations were focused on helping promising entrepreneurs gaining the necessary capital to commercialize their ideas. The SBICs could borrow from the federal government up to half their capital and they would also receive an amount of favorable tax incentives. As favor in return, the SBICs had to limit their investments to small businesses.[42] Therefore, the incentive created a direct increase in venture capital investments. Although this sounds very promising, many experts expressed their criticism even before the legislation came into force. The red tape of the SBA was and is a major drawback for the SBICs.[43] However, entrepreneurs got attracted to the SBIC program because of the large federal subsidies in combination with a booming stock market, but many of the managers appeared to be inexperienced and corrupt.[44] Although the program was not drafted greatly, one cannot neglect the fact that some of the best technology companies such as Apple, Compaq and Intel received support from the SBIC program before they went public.[45] Besides providing a financial incentive to invest in SME's, the program offered training of venture managers and it also wanted to establish the grounds for the development of private funds.[46] Therefore, it seems very plausible that the program helped managers with 'good' intentions to broaden their skills. If one takes a look at the successful companies that were financed via the SBIC program, one cannot deny that this program played an essential role in creating an experienced and mature U.S. venture capital market.

- 'Prudent man' rule

The US government changed regulations and created tax incentives in the 1970s in the hope that it would revitalize the depressed venture capital market. Besides reducing the capital gains tax rates, the 'prudent man' rule of the Employee Retirement Income Security Act's (ERISA) was clarified. Pension

[41] http://www.sba.gov/about-sba-services/our-history
[42] Lerner 2012, p. 38.
[43] Kupta 2000, p.153.
[44] Lerner 2012, p.38; Seidman 2005, p.248.
[45] Lerner 2012, p.39.
[46] Baygan 2003, p.15

funds were permitted to allocate a small part of assets to high-risk investments.[47] Managers of the funds did not have fiduciary responsibility regarding these investment decisions. This created a new source of capital for VC funds. Until then, pension funds were traditionally forbidden to make risky investments in order to protect its beneficiaries. After this change, pension funds started playing a key role in the high levels of institutional investment in private equity and the further growth of the U.S. venture capital market.[48] According to Baygan (2003), more than 7% of institutional investments go to all forms of private equity in the U.S. while this is less than 1 % in other OECD countries with similar financial market profiles such as the U.K.

- Small Business Innovation Research (SBIR) and Small Business Technology Transfer Program (STTR)

SBIR was enacted in 1982 as part of the Small Business Innovation Development Act. STTR was established in 1992 with the enactment of the Small Business Technology Transfer Act of 1992. These programs want to encourage domestic SMEs to participate in Federal R&D that has the possibility to commercialize.[49] All Federal agencies with an extramural R&D budget that exceeds annually $ 100 million are required to allocate 2.5 % in the SBIR program. More than $ 1 billion is each year given to small firms to research high-risk innovations. The SBIR program is divided in three phases. In the first phase, the company can receive up to $ 150.000 for six months to establish the technical merit, feasibility, commercial potential of the R&D efforts and to determine the quality of the SME that received the award. If the results of the first phase are satisfactory, the SME can receive up to $ 1 million for the next two years to continue the R&D efforts. In phase III, the SBIR does not fund it anymore. Phase III may involve extra non-SBIR funding of the R&D efforts or production contracts for the products, processes or services intended for use by the U.S. government.[50]

The STTR program aims to expand the public/private sector partnerships to include the joint venture opportunities for SMEs and nonprofit research institutions.[51] Similar to the SBIR program, the STTR program is divided in three phases. Unique in this concept is the mandatory collaboration of the

[47] Ibid, p. 13.
[48] Ibid, p. 14.
[49] http://www.sbir.gov/about/about-sbir (accessed latest on June 16th, 2013)
[50] http://www.sbir.gov/about/about-sbir (accessed latest on June 16th, 2013)
[51] http://www.sbir.gov/about/about-sttr (accessed latest on June 16th, 2013)

small businesses in phase I and II with a research institution. The three phases are further similar to the SBIR, only the award that can be received in the first and second phase are respectively $ 100 000 and $ 750 0000.[52]

2.1.4 Delaware law

As said earlier, the reason that it is hard to find capital for the entrepreneurs is because of the lack of operational history. This creates a lot of uncertainty. Now that these innovative small and medium-sized enterprises are normally capital intensive, one will not easily take the risk to invest in these kind of companies. The U.S. created a venture capital contracting model that could deal with the high agency costs, uncertainty and information asymmetry. This model lowered the barriers to invest in early stages of innovative small and medium-sized companies.[53] The most preferred business form for venture capital funds is the Delaware limited partnership. This business form is very flexible, certain duties can be waived, and therefore highly suitable for venture capital funds. The business judgment rule is also typical for the U.S. limited partnership, the scope of this rule is defined in Aronson v. Lewis[54]:

> *"It is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company."*

It can be seen as a safe haven for the general partners because it emphasizes the risk involved when leading a company. Not much protection is offered for the investors but the venture capital market characterizes itself by the role of reputation and trust.[55] The venture capital firm acts as the general partner that takes control over the management. Institutional investors in the U.S. are normally passive limited partners.[56] A limited partnership is created in such a way that a limited partner will not have influence on the day-to-day management of the business. The institutional investors will know in which kind of industry and stage of a company they will invest now that the investment strategy of a fund is

[52] http://www.sbir.gov/about/about-sttr
[53] Gilson 2002, p.4.
[54] Aronson v. Lewis, 473 A.2d 805 (Del.1984)
[55] Rosenberg 2002, p.369-371.
[56] Ibid. p.6.

given via the offering memorandum.[57] However, the limited partners will not know in which specific companies the venture capital fund will invest. The approval of particular portfolio company investments is assigned to the general partner. Not only the influence of the limited partner on the decision-making is restricted, but also its liability. The limited liability is a very important reason for the institutional investors to prefer the limited partnership above corporations and general partnerships.[58] The liability of the institutional investor is limited to its capital contribution when the venture capital fund fails. This structure was recognized by the legislator to encourage investments by limited partners.[59] Especially small individual investors want certainty regarding their investments and therefore their risk is limited.[60] A second motivation for institutional investors to choose for the limited partnership is the favorable tax treatment. A limited partnership income is not taxed at the partnership level.[61] The profits are directly passed through to the partners and in this way double taxation can be avoided.[62] Further, the general partner only has to invest one percent of the capital to receive complete control over the fund.[63] The rest of its contribution to the fund is his experience. The goal of a general partner is normally to continue in the venture capital market.[64] Therefore, the general partner will try to raise new capital once the capital in a specific fund has been invested in portfolio companies.[65] The expectation that the general partner wants to raise additional capital after the first investments, gives a strong incentive to perform well in the preceding funds.

Most venture capital funds have a fixed life of ten years. When these ten years are passed, liquidation of the fund will follow so that institutional investors will receive the remaining profits. Part of the profit is already paid during the years now that the realized profits of earlier exits in investments have to be paid out to limited partners on a yearly basis.[66] Also the compensation of the general partner

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[57] Ibid.
[58] Fu, 2001, p.492.
[59] *Evans v. Galardi* (March 2, 1976) Supreme Court of California, 16 Cal 3d at 306. The Supreme Court states in this case that 'this type of business entity is recognised by the legislator to encourage trade by permitting "a person possessing capital to invest in business and to reap a share of the profits of the business, without becoming liable generally for the debts of the firm, or risking in the venture more than the capital contributed, provided he does not hold himself out as a general partner, or participate actively in the conduct of the business." '
[60] Fu, 2001, p.492.
[61] Ibid.
[62] Ibid, p.492-493.
[63] Gilson 2002, p.6-7.
[64] Ibid. p.7.
[65] Ibid.
[66] Ibid.

is two folded. The general partner receives a standard fee of around 2.5 % of the committed capital.[67] But the most important return for the general partner is the carried interest that it receives for its work. Simply said, the general partner will have the right to receive a fixed percentage of profits.[68] A carried interest of 20 percent is what the vast majority of the VC firms receive.[69] The percentage of the profits will normally be paid together with the distributions of the limited partners, but there will most often be two limitations. First, the limited partners will receive the amount equal to their capital contributions and the second limitation is the linking of certain claw back revisions to the GP's payments.[70] These provisions ensure that the general partner will not receive a bigger share of the fund's distributions than they bargained for.

2.1.5 Crowdfunding

The Jobs Act got a lot of attention over the world. An important reason why it got so much attention was because it allows small businesses to use crowdfunding as a new source to attract capital. Crowdfunding SEC 302 contains the crowdfunding exemption. Small companies can raise a maximum of $ 1,000,000 from small investors via a web-based platform. This exemption is added to the Securities Act of 1933 and the Securities Exchange Act of 1934.

Before the JOBS Act was signed, it was not legal to sell equity in companies via crowdfunding. Now that the Act is approved, expensive registration provisions can be avoided and the online crowdfunding platforms are not classified as a broker which should press the registration costs drastically. This exemption should open new funding options for SME's that are not able to raise capital via other sources such as angel investors and venture capital. Crowdfunding seems very promising, but it has certain disadvantages that one cannot and may not ignore. The non-accredited investors can be almost everyone, hence it is to be expected that also unsophisticated investors will invest in the risky SME's.

[67] Ibid.p.7; Gompers and Lerner 2004, p.91, Metrick 2007, p. 29.
[68] Gilson 2002, p.7; Metrick 2007, p. 31-32.
[69] Metrick 2007, p. 32.
[70] Ibid. p.8.

2.1.6 Exit opportunities

- Securities and Exchange Commission (SEC)

One of the biggest benefits in the United States is the exit opportunities that it offers. As said earlier, the IPO is the preferred exit opportunity for investors. Therefore it is very important that a country has a liquid stock market. The SEC plays an important role in the growth and stability of the U.S. stock market. The mission of the SEC is "to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation."[71] The SEC is the watchdog of the American stock market. Important regulations are the Securities Act of 1933 (1933 Act) and the Securities Exchange Act of 1934 (1934 Act). The 1933 Act is focused on the public offering of securities.[72] The 1933 Act requires accurate disclosure of all financial and other significant information related to securities that are being offered for public sale and prohibits fraud in the sale of securities so that investors can make a fair and well-informed decision before purchasing securities of a company.[73] This information has to be disclosed via the registration statement. The disclosure requirements are very broad, the company not only has to give background information of the business and its properties, but also expected risk factors are an example of information that must be included via the registration statement.[74]

The Congress created the SEC with the 1934 Act.[75] The SEC received a broad authority over the whole securities industry via this Act such as the power to register, regulate, and oversee brokerage firms, transfer agents, and clearing agencies as well as the nation's securities self-regulatory organizations (SROs) such as the various U.S. stock exchanges.[76] Further, the 1934 Act identifies and bans different types of conduct in the markets. It also provides the SEC with the possibility to sanction market participants when one deems it necessary.[77] The 1934 Act also requires periodic reporting by registered companies.[78] So, one can conclude that the 1933 Act focuses mainly on securities that are initially offered by the company and the 1934 Act regulates the transaction of these securities in the

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[71] http://www.sec.gov/about/whatwedo.shtml (accessed latest on May 26th, 2013)
[72] Fu 2001, p.499.
[73] http://www.sec.gov/about/whatwedo.shtml (accessed latest on May 26th, 2013)
[74] http://www.sec.gov/about/whatwedo.shtml (accessed latest on May 26th, 2013
[75] http://www.sec.gov/about/whatwedo.shtml (accessed latest on May 26th, 2013)
[76] http://www.sec.gov/about/whatwedo.shtml (accessed latest on May 26th, 2013)
[77] http://www.sec.gov/about/whatwedo.shtml (accessed latest on May 26th, 2013)
[78] http://www.sec.gov/about/whatwedo.shtml (accessed latest on May 26th, 2013)

secondary market.[79] The disclosure requirements are very rigorous in the U.S. Investor protection is the main focus of the SEC and trust in the U.S. market was high.

After the diverse scandals such as Enron and WorldCom, investor confidence vanished. As a reaction on the loss of investor confidence, the Sarbanes-Oxley Act was signed in 2002. The goal of this Act was

"to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes."[80]

Good enforcement of these requirements could not exist without the high quality accounting standards that one uses in the U.S. The financial statements of a company should be made according to the Generally accepted accounting principles (GAAP). U.S. GAAP offers a standard framework of guidelines related to financial accounting. The standard framework makes it easier for informed investors to read and interpret financial statements correctly.[81] These effective disclosure requirements provide the U.S. with a relative strong and growing stock market and with that also a reliable exit opportunity for the venture capital investors.[82]

- Jobs Act

On December 8th 2011, the H.R. 3606 bill, also known as the 'Reopening American Capital Markets to Emerging Growth Companies Act of 2011' was introduced. The final version, also called the Jumpstart Our Business Startups Act, was signed on April 5th 2012 by President Obama. The goal of this Act is:

"To increase American job creation and economic growth by improving access to the public capital markets for emerging growth companies."

[79] http://www.law.cornell.edu/wex/securities_exchange_act_of_1934 (accessed latest on May 27th, 2013)
[80] H.R. 3763--107th Congress: Sarbanes-Oxley Act of 2002.
[81] Fu 2001, p.500.
[82] Fu 2001, p. 500; http://www.nytimes.com/2013/05/16/business/daily-stock-market-activity.html?_r=0 (accessed latest on May 27th, 2013)

The access to the public capital markets is made less costly so that it will be easier for SMEs to go public. As said before, an IPO is a very important exit for venture capitalists and therefore it is also crucial for innovative, job-creating SMEs.

2.1.7 Conclusion

The U.S. venture capital industry has a long history in which the American culture plays an important role. It seems that Americans are not scared to fail, an important quality when working in an industry filled with risk. But their entrepreneurial spirit is not the only reason why the venture capital industry is so successful. The start of the real venture capital can be found in Silicon Valley where law firms, entrepreneurs and venture capitalists collaborated. The specialization that resulted out this collaboration created a unique concept of venture capital contracting. Further, experienced courts, who understand the risks inherent to entrepreneurship, developed case law such as the business judgment rule that offered a safe haven for directors who had to take difficult, risky but necessary decisions. This valuable experience in combination with flexible business forms offered great opportunities for entrepreneurs as well as investors. Also the government understood the characteristics and importance of innovation and investing. Government programs were developed to spur entrepreneurship and investment. Not all programs were that successful, but the key to success is to understand failure and that is what the government did. Finally, the United States offers good exit opportunities and has an experienced IPO-market.

2.2 Israel

Multiple countries tried to duplicate the successful venture capital industry of the United States. Many attempts failed, but Israel, a small country in the middle of the desert that is in war since its independency in 1948, succeeded. Therefore it will be very interesting to analyze how Israel turned its agricultural economy into a vibrant high-tech economy.

2.2.1 History

When one takes a look at Israel, one can see that it is just a desert surrounded by hostile neighbors. Therefore it seems strange that Israel is now known for its vibrant venture capital market, but just these

factors contributed to the high level of innovation. Before Israel was founded in 1948, important institutions were started such as the Hebrew University and Technion, the Israel Institute for Technology. During World War II, many academic Jews fled to Israel. The combination of these institutions and the talent fleeing to Israel contributed greatly to the vibrant venture capital market that we see nowadays. Because of the drought of the land, innovation focused mainly on the farm industry and Israel became a large farm-export industry. [83] After fought several wars in the beginning of the existence of Israel, the government decided to focus on military innovation and much money was spent on military R&D. The focus was therefore put on communications and electronics. Spin-offs from the military technology were created and the first generation of high tech enterprises in Israel was born.[84]

2.2.2 The army

The Israelis are since their independency in 1948 in war. This forced the country to focus heavily on defense. As said earlier, much money goes to military R&D. Additionally, men are obliged, in contrary to most western countries, to serve the military for three years and women have to serve for one year and nine months. This gives the army the possibility to screen the best students and offer them an education that helps them develop their talents. Besides the mandatory military service, the Israeli army has an exclusive nine year program: Talpiyot. This is an extreme training only for the top talent. The goal of this program is to create a corps of master technologists for the military.[85] Not more than twenty-five young people are selected and almost no one refuses this 'once in a lifetime' opportunity. Most of the Talpiyot graduates end up in the world of high-tech and capital. The Israeli army is inter alia via this program closely connected to the high-tech industry of its country.[86] The function of the army in development goes a lot further in Israel than we normally see in other countries. Similar to the U.S., the army in Israel brings innovation. But, the high-tech leaders that this program creates, is unique.

[83] Avnimelech, Kenney and Teubal 2004.
[84] http://www.jewishvirtuallibrary.org/jsource/Economy/eco4.html (accessed latest on May 7th 2013); Chaifetz 2002, p.385-386.
[85] Hiltzik, 2000.
[86] Ibid.

2.2.3 Government programs

The Office of the Chief Scientist ('OCS') of the Ministry of Industry, Trade and Labor ('MOITAL') was created in 1968.[87] The creation of OCS can be seen as the start of government support in industrial R&D. The OCS received the mandate to subsidize commercial R&D projects carried out by private firms.[88]

On the first of January 1985, the Law for the Encouragement of Industrial Research and Development 1984 (also known as the Research Law) came into force. The objectives of this Law are job creation, improve innovation and development of science-based, export-oriented industries.[89] OCS wants to achieve these goals via grants, loans, exemptions, reductions and relaxations.[90] A plan will only be approved to a company incorporated in Israel that expects to develop in Israel by Israeli residents, a novel product or an existing product in which a significant improvement is introduced.[91] OCS was empowered by the Research Law to supervise all the Government sponsoring and support of R&D in Israel.[92] The Chief Scientist is through article 7 of the Research Law appointed to be the Head of the Administration. The Administration has to realize the objects of the Research Law and should encourage investments in Industrial R&D as stated in Article 5 of the Research Law.

The Israeli government took much initiative to support R&D in Israel via OCS. Therefore, I will briefly discuss the most influential programs below.

- Support for Standard R&D programs

This support is the main program of the OCS. R&D grants can be obtained by companies whose projects are approved by the Research Committee of the OCS. The grants are between 30 % and 66%, depending on the circumstances, of the estimated R&D expenditure. If the product is a commercial success, the developers have to repay the grant through royalties.[93]

[87] Trajtenberg 2002, p.82.
[88] Ibid.
[89] Article 1 of the Research Law.
[90] Article 2 of the Research Law.
[91] Article 17 of the Research Law.
[92] http://www.moital.gov.il/NR/exeres/A1541A69-E947-4FAF-8577-76864F59CD1F.htm (accessed on May 8, 2013)
[93] http://www3.matimop.org.il/1/general/ocs.asp

- The Magnet program

Although the high-tech sector grew significantly from the 1960s, the industrial landscape was fragmented in Israel. Therefore, the government created the Magnet program in 1993. Israel already had great institutions, but the use of its research was minimal. The program aimed at creating consortia of industrial firms and academic institutions so that the waste of money and research was minimized. The consortia could receive up to 66% of the total approved R&D expenditures as grants and no compensation requirements were involved.[94]

- The Incubators program

The incubators program tried to make maximal use of the knowhow of the immigrants from the former Soviet Union. These immigrants were often highly skilled and therefore the government gave them the opportunity to develop their innovative technological ideas and establish new businesses for the purpose of commercializing them.[95] This support is be given in several ways such as knowledge of the important languages Hebrew and English, managerial skills and access to capital.

- International cooperation

Israel cooperates with multiple countries to stimulate innovation, but the most important partnership is established with the U.S. The Binational Industrial Research and Development Foundation (BIRD) was established between Israel and the U.S. The Israeli government wants to expand the opportunities for their companies to collaborate with American firms.[96] BIRD offers grants in the funding of joint R&D up to 50 % of the project costs and no more than $ 1.5 million per project. Royalties have to be paid to BIRD if the project is successful with a maximum of 150 % of the conditional grant. Further, BIRD also helps linking partners in order to give them the possibility to submit joint R&D programs that can be funded by BIRD.[97]

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[94] Trajtenberg 2002, p. 84.
[95] Ibid, p.85-86.
[96] Trajtenberg 2002, p.84-87; http://www.moital.gov.il/NR/exeres/802D8E02-473D-4449-801A-694E47CDDB87.htm (accessed latest on May 13th, 2013)
[97] Ibid.

- Yozma

The Yozma program is often seen as the start of the venture capital industry in Israel. Before Yozma was created, Israel had only two venture capital funds: Athena and Veritas. Athena was a U.S.-Israeli venture capital fund that was established in 1985 and dissolved in 1997.[98] Veritas was launched in 1990 by Yadin Kauffmann and Gideon Tolkowsky. The fund is still investing in SME's.[99] Israel was already successful in Research and Development, but was failing in marketing. The IPO market was almost nonexistent and M&A was unknown in the country of milk and honey. Israel needed more capital for the high-tech industry, VC funds that could guide the entrepreneurs how to lead a firm and internationalization to broaden their possibilities. The government intervened and started the Yozma program in 1993. Yozma created multiple venture capital funds that were funded by the government but also by local and foreign private investors. Yozma would provide capital to the funds up to forty percent of the capital invested by the private investors.[100] Further, the Yozma program offered these private investors the possibility to buy Yozma's shares in the funds in 5 years' time at a fixed price.[101] The cap was set at the cost plus a nominal interest rate and seven percent of the future profits from portfolio company investments in which the fund was then invested.[102] Another important element of the Yozma program is its passive role. Yozma did not make investment decisions, these decisions were made through funds. Besides the financial incentives, the project used the Delaware Limited partnership and 'flow-through' tax status for the venture capital funds so that it would make the foreign investors more comfortable with it.[103] The program offered several great opportunities to the managers and investors of these funds and therefore they were highly incentivized.[104] The lifetime of the Yozma program was also determined at the start. The program would be terminated after maximum 7 years. Because of the great success of Yozma, the direct portfolio of the program was already privatized after approximately four years.[105] This was the start of the booming Israeli venture capital market. In meanwhile, Israel became the country with the second largest number of foreign listings on NASDAQ. China holds the leading position with 99 companies, than Israel follows with 54 listings and Canada completes the top 3 with 39 listings.[106]

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98 http://investing.businessweek.com/research/stocks/private/snapshot.asp?privcapId=93055 (accessed on May 7th 2013)
99 http://www.veritasvc.com/about.asp (accessed on May 7th 2013)
100 Gilson 2003, p.1097.
101 Trajtenberg 2002, p.88.
102 Gilson 2003, p.1097.
103 Lerner 2010, p.260.
104 Idem.
105 Trajtenberg 2002, p. 88-89.
106 As per May 11th 2013, data derived from www.nasdaq.com

2.2.4 The Angel law

The Israeli system was very successful, but evaluation of programs and regulations is very important to see if one reached the desired results. Rules for domestic institutions and individuals were more stringent and therefore Israel was dependent on the investments of foreign investors. Knesset[107] made an amendment in 2011 to the Income Tax Ordinance so that Israeli and foreign individuals now can deduct the investment amount from overall taxable income from all sources if these investments are done in Israeli R&D and innovation start-ups that are defined as 'Target Companies". The investments must be done between 1st of January 2011 and 31st of December 2015. The amount that is tax deductible is capped just under € 1 million and may be divided over the year the investment was made and two subsequent tax years. ('Benefit Period'). The investor must hold the shares in the Target Company for the duration of the Benefit Period.[108]

2.2.5 Exit opportunities

The Tel Aviv Stock Exchange (TASE) is the only stock exchange that one can find in Israel. TASE started as a local trade in securities in the 1930s, long before the State of Israel was established, and became officially TASE in September 1953 when multiple banks and brokerages joined forces.[109] TASE is regulated by the Securities Law of 1968 and the Israel Securities Authority (ISA) is its direct supervisor.[110] However, foreign capital markets play a crucial exit opportunity for the Israeli venture capital industry.
As said earlier, Israel has the second most foreign listings on the NASDAQ stock market. This number is, certainly for a small country like Israel, notable. Different reasons can be found why an Israeli company would decide to list on an overseas stock market such as NASDAQ instead of choosing for a listing on the domestic Tel Aviv stock market. Liquidity, image, visibility and the openness of the U.S. capital markets to early-stage companies are possible reasons to choose for listing in another country.[111] Although the investor protection in the United States is very intensive, it does not seem that the law is a reason for

[107] The Israeli government.
[108] http://www.naiot.com/Site/News.asp (accessed latest on June 17th, 2013),
http://www.meetup.com/JerusalemBNF/events/51679532/ (accessed latest on June 17th, 2013),
http://www.arnon.co.il/files/e3b84790d602b8d3179de6a92b2be89a/Angel%20Law_memo%20for%20clients%20DOCX.pdf (accessed latest on June 17th, 2013)
[109] http://www.tase.co.il/Eng/AboutTASE/Overview/Pages/Overview.aspx (accessed latest on June 11th, 2013)
[110] http://www.tase.co.il/Eng/AboutTASE/Overview/Pages/Overview.aspx (accessed latest on June 11th, 2013)
[111] Yehezkel 2005, p.16-19.

Israeli companies to list on a U.S. stock market. Israel stated explicitly that it took the United States as an example while creating a flourishing venture capital market. Yehezkel examined the differences in securities law and concluded that the Israeli investor protection was similar to the U.S. system. The Israeli Supreme Court even used the U.S. securities laws principles to interpret the Israeli Securities Law. Therefore, a legal reason for listing on the U.S. stock market cannot directly be found.[112]

2.2.6 Conclusion

The State of Israel did not have an easy start as an independent country, but they thankfully made use of several such as the fleeing academics to their country and the innovation that arose from the military program to create a vibrant venture capital industry. Innovation was already there but without capital, innovation cannot commercialize. Therefore, the government undertook several attempts to stimulate this market. Yozma launched the venture capital market in the '90s at the moment that the internet bubble took off. Many venture capital funds were established in the '90s and the Israeli venture capital industry grew enormously. Besides the creation of different programs, Israel took the U.S. as an example for their enterprise laws and foreign investment was and is highly encouraged. Israel is only a small country with limited capital and resources and therefore fosters its international relationships very well. However, also the Israeli market got hit by the recent crises and the government is now working on the encouragement of domestic investments in the innovative SMEs. A good example is the Angel law that was created in 2011.

2.3 China

The last years, China is playing an increasingly important role in the global economy.[113] China has a population of 1.3 billion and it recently became the second largest economy in the world. While there was no real venture capital industry thirty years ago, the private equity and venture capital industries are now getting a significant influence on the Chinese economy.[114] However, the VC industry in China is only getting started. Many possibilities can be seen in this new market, but there are also some

[112] Yehezkel, p.32.
[113] http://www.worldbank.org/en/country/china/overview (accessed latest on May 21th 2013)
[114] Li, 2012, p.3.

challenges one has to face when considering to invest in China. Therefore, it will definitely be interesting to see what the role is of the government in financing SMEs.[115]

2.3.1 History

The Chinese economy was for a long time dominated by a Communistic regime under the leadership of Mao Zedong. Until the late 1970s, the economy and private enterprises were strictly regulated by the Chinese government. After the death of Mao in September 1976, the government opened carefully its markets for the outside world and the number of private enterprises in China grew significantly.[116] The Chinese economy is one of the fastest growing economies in the world since 1979 with the help of private and foreign investment.[117] In the beginning of the '80s, the first international venture capital firms made their entrance in China.[118] Similar to Israel and the U.S., the government had an important role in the development of its venture capital industry. However, the culture in China is very different from the Israeli and U.S. culture. The Chinese population is not used to risk-taking, working for the government was the standard and changing a culture takes time. Further, Guanxi still takes a central role while doing business. Relationships, trust and respect are keywords when doing business in China.

2.3.2 1979-1986

The Chinese government is well-known for its major influence towards the economy. The strict communistic government stated that China had to be self-sufficient during the Cultural Revolution (1966-1976). As a consequence, it was not that easy to open the domestic market when the Cultural Revolution ended. Everything and everyone was focused on the domestic market. Legislation had to change in order to let the Chinese domestic economy evolve in a vibrant international economy. In 1979, the CPC Central Committee and the State Council accepted the report on the implementation of special policies and flexible measures on foreign economic activities. 'Special Economic Zones' were created to test the new policy.[119] Shenzhen is an example of such a 'Special Economic Zone'. Originally, Shenzhen was only a small coastal town near the border with Hong Kong. Because of its interesting

[115] http://www.worldbank.org/en/country/china/overview (accessed latest on May 21th 2013)
[116] Ahlstrom, Bruton and Yeh 2007, p.250.
[117] Ibid.
[118] Ibid.
[119] http://english.people.com.cn/90002/95589/6512374.html (latest accessed on May 22th, 2013).

geographical location, it was an ideal place to test China's new flexible policy regarding foreign economic relations. Nowadays, Shenzhen is a big city with more than 10 million inhabitants and it counts as one of the major financial centers of the People's Republic of China.

The National Research Center of Science and Technology for Development proposed the Chinese government to create a venture capital industry to promote high technology.[120] In that time, the venture capital industry in China focused primarily on infrastructure and property investments.[121] Venture capital funds were encouraged and sometimes even sponsored by local governments to invest in state owned enterprises. [122] But many of the early investments in these sectors performed poorly and as a consequence, interest in the private equity sector diminished.[123] Fortunately for China, the interest in the venture capital market increased fast. In the late '80s the Chinese venture capital market got a boost because of the solid growth that one saw in the Chinese economy.[124] At the same time, the Central Committee of Chinese Communist Party issued the Decision on the Reform of Science and Technology System ("The Decision"). China stated that it attached great importance to science and technology because these are seen as the most active and decisive factors of the productive forces in the new society.[125] One refers also to this as the Deng Xiaoping[126] theory of S&T.[127] Shortly after the implementation of the Decision, the first venture capital firm was established. The State Science and Technology Committee formed jointly with the Ministry Of Finance the China New Technology Venture Investment Corporation. Unfortunately, this didn't work out well. The State let government officials select the investments. These officials were no experienced venture capitalists and as a result, the firm made big losses.[128]

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[120] Ahlstrom, Bruton and Yeh 2007, p.250.
[121] Ibid.
[122] Ibid.
[123] Ibid.
[124] Ibid.
[125] http://english.people.com.cn/90002/95589/6512392.html (latest accessed on May 22th, 2013).
[126] Deng Xiaoping was a member of the Chinese Communist Party. One describes him as a far-sighted, innovative man and tried to develop China in a socialistic modern country after the Cultural Revolution via his vice-chairman function in the Central Committee. http://english.peopledaily.com.cn/data/people/dengxiaoping.shtml (latest accessed on May 22th, 2013)
[127] OECD 2008, p.381.
[128] Zhang 2012, p.51.

2.3.3 Government programs

- National Key Technologies R&D Program

The National Key Technologies R&D Program was established in 1982 as the first national S&T program in China.[129] The goal of this program is to serve national economic construction and social development, promotes technical upgrading and restructuring of industries. The total fund of this program was approximately € 2.4 billion in 2009.[130]

- 863 Program

The 836 Program (also called the National High-Tech R&D Program) was established in 1986. The goal of this program was to accelerate China's high-tech R&D so that it could compete with the technology revolution and competition.[131] This program received a state financing of RMB 11 billion during the period from 1986 to 2001.[132] The total fund of this program was approximately € 1.08 million.[133]

- Torch program

The Torch program was created in 1988 with the goal to develop high-tech industries in China.[134] The four main parts of this program are the Innovation Clusters, the Technology Business Incubators (TBIs), Seed Funding (Innofund) and Venture Guiding Fund. This program can be seen as the jump-start of the Chinese high-tech innovation and startups. It evolved in time with the Chinese booming economy and that made this program very successful. National parks were created, the so-called STIPs[135], and one of them is already called the new Silicon Valley[136]. Besides the specialization that was created, collaboration between research and business was established via these clusters.[137] The second aspect of this program is the Technology Business Incubators (TBIs) that provided the startup companies their services such as a network of contacts. The third part covers the seed funding in the form of the

[129] http://www.most.gov.cn/eng/programmes1/200610/t20061009_36224.htm (accessed latest on June 19th, 2013)
[130] http://www.access4.eu/China/274.php (accessed latest on June 19th, 2013)
[131] http://www.most.gov.cn/eng/programmes1/200610/t20061009_36225.htm (accessed latest on June 19th, 2013)
[132] http://www.most.gov.cn/eng/newsletters/2004/200411/t20041130_17780.htm, More than € 1.3 billion or more than $ 1.7 billion.
[133] http://www.access4.eu/China/274.php (accessed latest on June 19th, 2013)
[134] http://www.ctp.gov.cn/ctp-eng/index.htm (latest accessed on June 19th, 2013)
[135] National Science and Technology Industrial Parks
[136] The Zhongguancun Science Park in Beijing.
[137] http://www.ctp.gov.cn/ctp-eng/areas_two.htm (accessed latest on June 19th, 2013)

Innofund that was established in 1999.[138] Innofund offers grants, loan interest subsidies and equity investments to innovative SMEs. In the first six years, Innofund has provided more than 5.3 billion Yuan[139] to almost 8000 projects. The most recent aspect of the Torch program is the Venture Guiding Fund that was created in 2007. The Venture Guiding Fund invests directly in VC Funds, co-invests with VC's and gives guarantees on some VC bets.

- 973 Program

The 973 Program (also called the National Basic Research Program) was established in 1997 to gather strong expertise with a focus on key basic research projects in the field of agriculture, energy, information technology, resources and environment, population and health, and materials, among others, in order to develop China's Research capacity in key disciplines and interdisciplinary fields, and find comprehensive solutions to major issues in China's development.[140]

2.3.4 Limited partnership

'The Partnership Enterprise law of the P.R.C.' was enacted in 1997. Almost ten years later, this law got amended. In 2006, changes were made that have a major impact on the venture capital industry in China. Until the amendment in 2006, one could only establish a general partnership in China. Since the changes took effect on June 1st 2007, three types of partnerships can be established. Besides the general partnership, one can also choose to set-up a special-general partnership and a limited partnership. When analyzing the United States, we saw that the limited partnership form is preferred to create a venture capital fund because it is a flexible business form that can align the different interests of the venture capital firm and the institutional investors the best. In China, the general partners bear unlimited joint and several liabilities for the debts of the limited partnership and the limited partners are liable to the extent of their capital contributions.[141] A limited partnership can have two to fifty shareholders.[142] At least one of these shareholders has to be a general partner. The general partner shall execute the partnership affairs of the limited partnership, the limited partner in contrast is not allowed

[138] http://www.ctp.gov.cn/ctp-eng/areas_one.htm (accessed latest on June 19th, 2013)

[139] Approximately € 645 million or $ 865 million.

[140] http://www.access4.eu/China/274.php (accessed latest on June 19th, 2013)

[141] Article 2 of the Partnership Enterprise Law of the People's Republic of China.

[142] Article 61 of the Partnership Enterprise Law of the People's Republic of China.

to do this nor representing the limited partnership before outsiders.[143] However, there are some affairs where the limited partner is allowed to involve such as deciding with the other partners about the admission or withdraw of a general partner, putting forward a proposal on the business management of the enterprise and offering a guaranty for the enterprise.[144] Further, the limited partner is allowed to compete with the limited partnership and he can also make transactions with the limited partnership to which he belongs.[145] Last, the partners have to pay income tax for the gains they receive out of the limited partnership, in this way double taxation can be avoided.

2.3.5 Exit opportunities

The Shanghai Stock Exchange and the Shenzhen Stock Exchange were established in, respectively, 1990 and 1991. The goal of a normal stock market is to create an efficient and dependable mechanism for the public via which securities can be bought and sold.[146] The Shanghai and Shenzhen Stock Exchange on the other hand were established in the first place to offer the SOEs a way to extract money now that they were performing badly and the government could not continue to subsidize them.[147]

The government controls the issuing and listing of securities closely via stringent requirements. A company that wants to file an application for listing should have met different requirements that one can find in the Securities Law. These requirements are a high burden on innovative SME's. Therefore the Chinese government decided to create ChiNext. On October 23rd, 2009 the Chinext market was launched. Chinext was established with the goal to create an own Nasdaq-style market in China.[148] This market should offer innovative SME's the possibility to list their shares under less stringent rules than one can find for the Shenzhen and Shanghai Stock Exchange.[149] The creation of the ChiNext should solve most of the problems, but the stock exchanges are still inexperienced compared to the stock exchanges of the U.S. and fraud problems cause a lack of trust. In China, it was for a long time very difficult to list overseas. Approval of the CSRC is required and the criteria were even higher than when one asked approval to list in China.[150] Therefore, most Chinese private-owned companies that wanted to list

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[143] Article 67 and 68 of the Partnership Enterprise Law of the People's Republic of China.
[144] Article 68 of the Partnership Enterprise Law of the People's Republic of China.
[145] Article 70 and 71 of the Partnership Enterprise Law of the People's Republic of China.
[146] Zhang 1999, p. 985.
[147] Ibid.
[148] http://www.szse.cn/main/en/AboutSZSE/SZSENews/SZSENews/39740619.shtml (accessed latest on June 6th, 2013)
[149] http://www.businessweek.com/magazine/content/10_48/b4205059211793.htm (accessed latest on June 6th, 2013)
[150] Haitian, Yi and Gongmeng, p.250-251.

overseas followed the ‘red chip’ route to list overseas. To follow the ‘red chip’ route, an offshore special purpose vehicle is established that owns the Chinese company. The Chinese government tried to stop this capital flight multiple times. The last change is made in 2006 when the Takeover Regulations came into effect. These regulations contained even stricter requirements for overseas listing than before so the Chinese entrepreneurs were back to scratch. A third alternative to list overseas is the use of the VIE-structure. To accomplish this route, the offshore holding company has to establish a new wholly owned subsidiary (WFOE) in China and the VIE is formed by a Chinese citizen. These companies are bound through a series of contractual arrangements.[151] The WFOE is wholly owned by a firm that is incorporated offshore and the offshore company than obtains listing on the US exchange. The WFOE controls the VIE and receives the economic benefits.[152] The revenues can be pulled out the VIE through the agreements.

Recently, the Chinese government decided to ease the rules on overseas listings because of the huge amount of applications to list on the Chinese market.[153] A company can now apply with the CSRC for overseas listing if it meets the requirements of the market where it wants to sell its stock. However, the governmental approvals still need to be obtained.

2.3.6 Conclusion

Although the enormous growth on the Chinese market, one cannot compare it with Israel and the United States. In the Chinese culture trust, reputation and networking are very important elements. This causes a different approach regarding the stimulation of the venture capital industry. The Chinese market was for a long time closed for foreigners and still different limitations are set. However, the Chinese venture capital industry grew significantly. Although the transformation was already notable, there is much potential left. The Chinese population still lack experience to identify and invest in high-risk ventures. The loosening of restriction regarding foreign investors and entrepreneurs can help solving this problem. Also, the huge investment that China has made in the development of the science

[151] Roberts and Hall 2011.
[152] Ibid.
[153] http://www.bloomberg.com/news/2012-12-21/china-eases-rules-on-overseas-listings-as-ipo-requests-swell.html , http://www.ft.com/intl/cms/s/0/0ec4aa3a-4b55-11e2-887b-00144feab49a.html#axzz2VRMevqkM, China stopped approving IPO’s to clear the market after several scandals occurred.

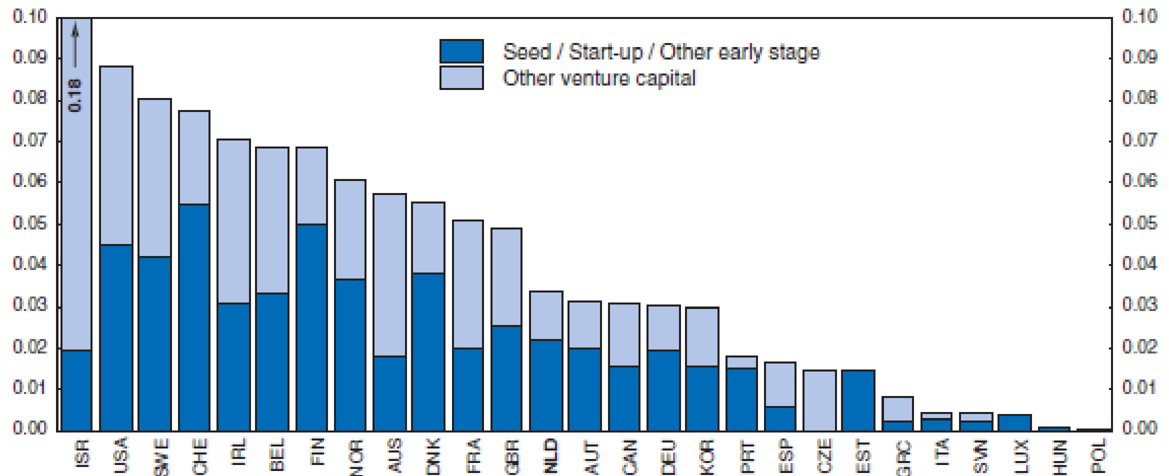
parks and incubators caused a rapid expansion of small technology-based firms which makes China only more attractive for foreign investors.

3. Venture Capital in the Netherlands

Before the internet bubble, venture capital did not play an important role in the Netherlands. In 1990, the total venture capital investment did not reach € 200 million. In 1995, the amount of venture capital was doubled, reaching approximately € 360 million. Only 5 years later, venture capital investments grew to more than € 1.5 billion.[154] When the bubble collapsed, venture capital investments also lowered drastically. Investments slowly recovered in the years after, but never reached the phenomenal numbers that we saw in 2000.

Figure 1.14. **Venture capital market is relatively small**

Venture capital as a percentage of GDP, 2009



Source: OECD (2011), *Entrepreneurship at a Glance.*

StatLink http://dx.doi.org/10.1787/888932614491

3.1 Legal business forms

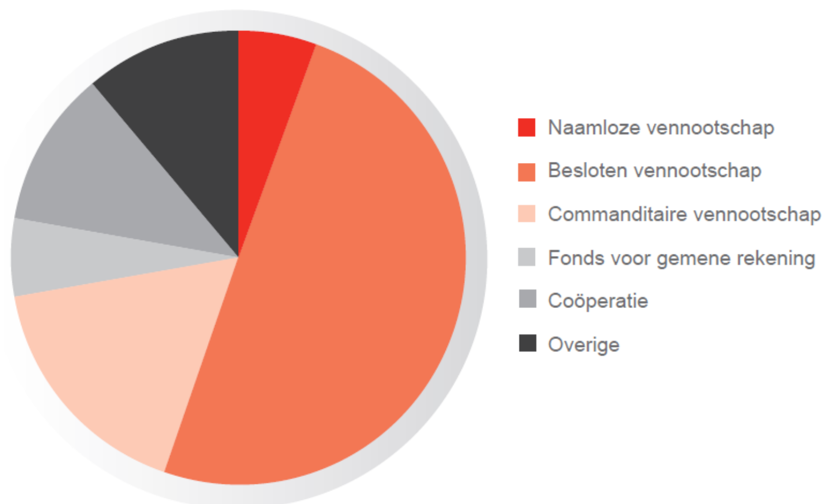
A report from the NVP conducted by PwC indicates that venture capitalists in the Netherlands are fairly satisfied with the existing supply of Dutch legal entities. However, there are also some concerns regarding the characteristics of our legal entities. Dutch legal entities have to comply with many mandatory rules which make it more difficult than necessary to design an ideal fund-structure.[155]

[154] Data derived via Eurostat.

[155] NVP & PwC 2010, p.27.

Interesting to read is that these venture capitalists were very enthusiastic about the proposal of Title 7.13 in book 2 of the Civil Code. This title would revise the Dutch partnership law in such a way that it was more attractive for venture capitalists. This title offered the possibility to create the CV as a legal entity without losing its fiscal transparency. The CV would than resemble more the US limited partnership. The proposal was approved by the parliament in 2005, but critique by the Senate caused a withdrawal of the proposal on December 15th, 2011. The Senate had several reasons why this proposal should not be accepted, but a great opportunity to make the Dutch business climate more attractive was crushed.

The report of the NVP of 2010 further indicates that the 'Besloten Vennootschap' (BV) is the most preferred legal entity followed by the 'Commanditaire Vennootschap; (CV).[156]



Source: NVP report 2010

As said, the CV can be compared with the US and UK limited partnership structures. The U.S. and U.K. form of the limited partnership are worldwide the preferred form for a fund vehicle in VC structures. The CV is often used as a fund structure when there are Dutch and foreign investors involved.[157] The venture capitalists are the general partners (beherende vennoten) and the investors are the limited partners (commanditaire vennoten). The CV has no corporate responsibility, it is a contractual agreement. The general partner has in principle unlimited liability. Therefore a BV is often used as a

[156] Ibid, p.26.
[157] Ibid, p.11.

general partner to limit the liability.[158] The liability of the limited partner is limited to their investment if they act as passive investors. If the limited partner's name is included in the name of the CV or when the partner involves in the management, he can be considered as a general partner and as a result can be hold personally liable. The CV is particularly interesting because of its tax transparency. The company is not subject to tax, instead the partners are subject to tax. The CV is only transparent for tax purposes if entry or replacement of limited partners cannot take place without the consent of all partners. Further, the CV is not subject to many mandatory rules or capital requirements and is therefore very interesting for VC funds. It should be logical that the CV is the preferred legal entity.

The (flex-)BV is the Dutch private company with limited liability. In contrast to the CV, a BV has corporate responsibility. Investors in a BV are only liable for the sum of their contribution. This legal entity is made more flexible on the 1st of October 2012. Besides the removal of the capital requirement of € 18.000, the bank statement and the accountant's report are not mandatory anymore under the new rules. This makes it easier for entrepreneurs to establish a company, but the increased flexibility makes it also more interesting for the VC funds to choose for the BV as fund structure. Also, there is now the option to install shares without voting rights or dividend rights. Although this seems all very promising, the flex-BV has also its downside. The capital requirement is removed, but instead a liquidity test is added. As a result, it is now easier to hold a director liable. The new rules make it also easier to hold a director personal liable for decisions.[159] Innovation and venture capital investments are risky businesses and therefore this increased liability is bad news for the venture capital industry. Further, as per 1st of January 2013, a BV can choose to have a one-tier or the typical Dutch two tier board. A one-tier board is typical in the common law countries such as the UK and the US. All these changes show us that the common law and civil law are growing towards each other. Recognition of rules creates trust and makes it easier for a foreigner to choose for another business form.

[158] NVP & PwC 2010, p.11-12.
[159] http://www.rijksoverheid.nl/onderwerpen/flexibele-bv/bv-recht-eenvoudiger-en-flexibeler (accessed latest on June 20th, 2013)

3.2 Government Programs

➢ Summary of the programs

The Dutch government is very active in creating incentive programs that directly and indirectly affect venture capital. To keep it clear and simple, I created a table with the most influential programs for the venture capital industry that are active at this moment.

Policy instruments of the Dutch government[160]		
Policy instrument	Period	Analysis
Innovatiekrediet (part of SME+ Innovation fund)	2012-2015	Innovative companies with a lack of finance can receive innovation credit for development projects. This credit will be provided directly to the companies. Starters as well as established companies can make use of innovation credit. One has to pay back the credit plus a percentage of interest. The interest rate can be 4, 7 or 10 % depending of your risk profile. SMEs can finance 35 % of their project with innovation credit. A non-SME can finance 25 % of its project with the innovation credit. A company will not receive more than € 5 million. If the project fails, the loan can be waived, if the project succeeds one has to pay the loan + interest back in 10 years. Budget 2013: € 80 million.
Fund-of-funds (part of SME+ Innovation fund)	2013-2015	The goal of the Dutch Venture Initiative (DVI) is to improve the entry to the venture capital market for young and innovative SME's. New venture capital firms can be started with a contribution of the fund-of-funds. The entrepreneur and the investor have to repay the investment from the Fund-of-funds if the development of the innovative product or service is technically successful. Budget: € 150 million.
SEED Capital Regeling (part of SME Innovation fund)	2012-2015	This instrument focuses on closed-end VC funds that are willing to invest in young and innovative SME's. These VC funds can receive a loan up to the amount that it privately invested, up to a maximum of € 4 million. Further, it has a very interesting repayment schedule: The VC fund has to pay only 20 % of the profits until their own investment is paid back. Thereafter, the VC fund has to pay 50 % until the loan is paid back. Remaining profits shall be divided in an 80% -20% ratio between the VC funds and the ministry. 'The Seed Capital regeling' has as goal to close the equity gap.

[160] This table is based on the information that one can find at the website of 'Agentschap NL': www.agentschapnl.nl and www.belastingdienst.nl

		Budget 2013: € 16 million + € 4 million[161]
Topconsortia voor Kennis en Innovatie (TKI)	2013 - present	The Dutch government wants to stimulate entrepreneurs and researchers in the nine top sectors to collaborate. Therefore the government invests 25 eurocent in a TKI for every euro that a company invests. For the first € 20 000 is this TKI-premium even 40 %. Budget 2013: € 83 million
Research & Development Aftrek (RDA)	2012-present	Besides the WBSO, the entrepreneurs can further reduce their R&D costs that are not labor costs by an additional deduction regarding income and corporation tax. The RDA amount is 54 % of the approved costs and expenses, or 54 % of the lump sum based on the S&O hours. Budget 2013: € 375 million. Budget 2014: € 500 million.
Innovatiebox	2010 - present	Profits arising from patents or activities under the WBSO scheme have a lower tax rate. This is lowered to 5 % instead of 25 %. Budget 2013: € 625 million.
Garantie Ondernemingsfinanciering (GO financing)	2009-present	This arrangement is created to help enterprises receive loans. Banks can apply for a 50% bank guarantee on medium and large loans. The minimum amount of a loan has to be between € 1.5 million and € 50 million. The maximum guarantee per company is thus € 25 million. Budget 2012: € 540 million
Programma Groeiversneller	2009 - present	This program is funded by the Ministry of Economic Affairs. Companies with a turnover between € 1.5 million and € 10 million that want to grow and have their head office in the Netherlands can apply. The program helps the companies grow and provides intensive guidance. Complete budget: € 6 million.
Microkredieten (Qredits)	2009-present	Starting entrepreneurs can apply for a 'microkrediet'. This is a combination of coaching before and after the establishment of the company, entrepreneurial tools and a loan up to € 50.000.
Innovatieprestatiecontracten (IPC)	2007-present	IPC is a subsidy for ten to twenty SME's that are working together in the same region, industry or supply chain that are executing an innovation project of maximum two years. The subsidy reimburses 40 % of the implementation with a maximum of € 25.000. At least 20 % of the amount has to be invested in common activities. Budget 2013: € 7 million.
Groeifaciliteit	2006-present	This facility offers a 50 % guarantee on VC investments for growth purposes to participating banks or venture capitalists. A bank can receive a loan guarantee up to € 2.5 million in case of a subordinated loan. A venture capitalist can receive a loan guarantee up to € 12.5 million when it provides a company equity. In the case of insolvency or a lossmaking sale, the loss can be claimed. The guarantee in this case is calculated at 50 % of the loss.

[161] € 4 million is reserved specifically for VC funds that focus on creative starters.

		Budget 2013: € 50 million
Small Business Innovation Research Programma (SBIR)	2005- present	The government identifies specific challenges and offers grants for entrepreneurs. There are three phases in this program. The first phase will be a feasibility study of six months with a budget of € 50 000. The second phase is the development of the project. The company receives maximum € 450 000 per project for a time lapse of two years. The third phase is the commercializing of the project and does not contain a grant, but the government will have the opportunity to be the first buyer of the innovative product.
Business Angels Program	2006-present	This program wants to create awareness under the entrepreneurs of the possibilities that business angels offer. Further, it supports existing and new business angel networks that give guidance to business angels and entrepreneurs.
Wet Bevordering Speur- en Ontwikkelingswerk (WBSO)	1994-present	The WBSO is a fiscal instrument. Innovative entrepreneurs in the Netherlands can use a generic tax system that lowers the labor costs of personnel that have to do S&O activities (similar to R&D). The tax benefits consist of a reduction in wage tax and social security contributions paid for these S&O employees. The S&O deduction will be 38 % of the first € 200.000 in R&D wage costs and 14 % for the remaining R&D wage costs. A start-up company can receive a 50% deduction over the first € 200.000. Budget 2013: € 735 million.
Regionale ontwikkelingsmaatschappijen (ROM)	1974-present	The VC funds are a special part of the ROM's. The VC funds are not funded via grants of the government, instead they work with the 'revolving fund'-concept. The profits of the sale of investments are normally repaid into the fund so that new investments can be done. The VC funds have an independent position in the ROM's, therefore they can make independent decisions regarding the investment in a certain company. The VC funds of the ROM's invested approximately € 72 million in 2012.[162]
Borgstelling MKB kredieten (BMKB, formerly BBMKB)	1915-present	The bank can request a government guarantee up to € 1 million. This guarantee will only be granted for companies with no more than 250 employees with a yearly turnover of € 50 million or a balance sheet total of € 43 million. The lifetime of the guarantee is maximum 6 years. If an entrepreneur has less than 3 year experience, the bank can apply for a loan guarantee of 67.5%. This starters loan cannot be more than € 266.667. In case an innovative company wants a loan, the government will guarantee up to 60 % of the loan with a maximum of € 1.5 million.

[162] NVP Ondernemend Vermogen 2013, p.6.

- Evaluation of the programs

As you can see, most of the active programs are set up recently. This indicates that the Dutch government faces the problems regarding lack of investment in the innovative SMEs. However, the government has to be careful that it stimulates private investment in SMEs and not replaces these investments. For example the new SME+ innovation funds aims at a recovery rate of 80%. The OECD noticed that this number is very high and can cause risk-aversion when selecting the companies that receive grants while these risky and innovative SMEs have the most difficulties with raising capital. Instead, the grants will go to later-stage companies that are probably able to receive private capital. The OECD also highlights the normal time for venture capital funds to receive return on investment. This takes normally 5 to 10 years, unfortunately the Dutch government does not seem to take that into account and the design of the program can thereby hinder the evolving funding process.[163]

The fiscal facility 'Durfkapitaalregeling' is, as you can see in the table, recently cancelled. One of the goals of this facility was to stimulate individuals to invest money in innovative SMEs. However, this individual had to invest the amount directly in the start-up company and not via a venture capital fund.[164] It was thus focusing on angel investors and other investors that are close to the founders of the start-up company. This facility was evaluated in 2005 by Bureau Bartels and it was concluded that the facility did not reach its goal: the stimulation of innovative entrepreneurship. There were several explanations such as the changing name, it was formerly called the 'Tante Agaathregeling , the investment of bigger amounts than the focus of this facility, and that the investors normally invest through shares instead of subordinated loans.[165] Therefore, the government decided to stop the 'Durfkapitaalregeling'.

The WBSO tax facility was last evaluated in 2011. The conclusion of this evaluation was that the WBSO does what it has to do: It promotes private R&D spending. Following from the evaluation, the WBSO has also helped improving the quality of R&D. The users of this facility were more willing to take risks, did more research themselves and were more capable of absorbing external knowledge. The evaluation showed the importance of the facility for small companies and therefore the House of Representatives of the Netherlands decided to increase the ceiling of the first bracket from € 110 000 to

[163] Gerritsen and Hoj, p.20-23.
[164]http://www.belastingdienst.nl/wps/wcm/connect/bldcontentnl/belastingdienst/prive/vermogen/sparen_en_beleggen/beleggen_met_belastingvoordeel_tot_en_met_2012/beleggingen_in_durfkapitaal/ (accessed latest on June 15th, 2013)
[165] Eindrapport 2005, evaluatie van de durfkapitaalregeling, p.9-10.

€ 200 000, while the percentage of the first bracket is decreased from 42% to 38%.[166]

The Growth facility (*Groeifaciliteit*) was evaluated in 2012.[167] The main finding of the evaluation is that the Growth Facility accomplishes a clear function regarding the SMEs, the original target of the program. However, the accreditation for the new companies appeared to be too difficult and the accreditation for the banks was unnecessary. The use of the Growth Facility was also far behind the expectations, this was partly caused by the introduction of the GO financing in 2009.

Next is the GO financing, this governmental guarantee can unfortunately only be used by banks and thus is the effectiveness for the venture capital industry limited. Further, it can only be used for the financing of medium-sized and big companies to limit the governmental risk.

Further, one can see that there are many programs active to stimulate R&D. Some of these programs have overlapping and multiple goals what creates confusion and inefficiency. Unfortunately, there is not much known about the relative effectiveness and efficiency of different innovation schemes which makes it difficult to thoroughly evaluate the programs. It was already noticed in the OECD Economic Survey report of 2006 that the Dutch innovation policies shift often over time. This policy volatility is not desirable because it is expected that permanent R&D incentives should strengthen R&D investment.[168]

- Prudent person rule

Institutional investors are also in the Netherlands very important for the venture capital industry. Pension funds can invest in venture capital industry but have to take the 'prudent person rule' into account. The prudent person rule[169] states that a pension funds has to manage its investments with proper care *('als een goed huisvader')*. However, there is no exact definition of this rule neither in the IORP directive nor in the Dutch Pension Act. This open rule gave therefore relatively much freedom to the pension funds for interpretation. A pension fund can in principle decide how to interpret this rule.[170] However, the Dutch government is preparing a new proposal, the FTK proposal, regarding pension funds

[166] http://www.agentschapnl.nl/actueel/nieuws/wijzigingen-wbsorda-voor-2013 (accessed latest on June 18th, 2013)
[167] Carnegie Consult 2012.
[168] OECD 2006, p.20-23, Gerritsen and Hoj 2013 p.23.
[169] Art. 135 lid 1 PW
[170] District Court Rotterdam August 4th, 2011,PJ 2011/125 m.nt. S.H. Kuiper (PME/DNB), District Court Rotterdam Februari 8th, 2011, PJ 2011/35 (Pf Glasfabrieken/DNB) and District Court Rotterdam March 15th, 2012, PJ 2012/92 (Pf Glasfabrieken/DNB).

and it is expected that more interpretation will be given to this rule.[171] Further, the EU is also working on a reviewed IORP directive[172] and off course the Solvency II Directive. Certainly the Solvency II Directive causes much debate because it is expected that it will limit the possibilities of the pension funds to invest in the venture capital industry. This seems contradictory with the other pillars of the EU such as the creation of a vibrant European capital market to stimulate innovation and investment.

3.3 Exit opportunities

The Amsterdam stock exchange was established in 1607 and is the oldest exchange in the world.[173] In 2000, the Amsterdam stock exchange merged with the Paris and Brussels exchanges and Euronext, the first pan-European exchange, was established.[174] Later on, in 2007, the NYSE Group, Inc. and Euronext N.V. merged. Nowadays, NYSE Euronext covers one-third of equities trading worldwide.[175] If one wants to list on NYSE Euronext, one has to comply with the rules of the AFM and 'De Nederlandsche Bank'. This leads to high listing costs and higher costs to run the business. These requirements and costs make it difficult for SME's to enter the stock exchange. Therefore, NYSE Euronext created the unregulated market Alternext in 2005. Alternext offers the SME's the possibility to list on a stock exchange so that they can raise capital without losing investor trust. One can list in Alternext through an IPO, private placement or a direct listing.[176] Unfortunately, Alternext was not so successful as expected. Therefore NYSE Euronext launched Enternext on the 23th of May 2013.[177] This marketplace is specially designed for SME's with a capitalization of under € 1 billion. The companies that are listed on Alternext and some of the listed companies of Euronext will be moved to the new SME marketplace. Enternext has to be a strong pan-European market for SMEs.

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[171] SZW (2012), 'Uitwerking van het nieuwe Financieel toetsingskader (ftk)', Bijlage 1 bij Hoofdlijnennota herziening financieel toetsingskader pensioenen, AV/PB/2012/8475.

[172] MEMO/13/454, Occupational Pension Funds (IORP): Next steps. May 23th, 2013.

[173] https://europeanequities.nyx.com/nl/markets/nyse-euronext/amsterdam (accessed latest on June 15th, 2013)

[174] http://www.nyx.com/en/who-we-are/history/amsterdam (accessed latest on June 15th, 2013)

[175] http://www.nyx.com/en/who-we-are (accessed latest on June 24th, 2013)

[176] https://europeanequities.nyx.com/nl/listings/nyse-alternext (accessed latest on June 24th, 2013)

[177] https://europeanequities.nyx.com/en/product-news/enternext-nyse-euronexts-new-sme-marketplace-goes-live (accessed latest on June 15th, 2013)

4. Suggestions for the Dutch Government

The Dutch government tries to create a good environment for entrepreneurs and investors. However, some suggestions can be made that can help creating a vibrant venture capital industry in the Netherlands:

- Business Judgment Rule: The structure of the BV was already changed in 2012. The removal of the capital requirement lowers the threshold for innovative entrepreneurs to start a company. However, a new liquidity test is put in place. This test increases the liability of the directors. We saw that the United States makes use of the business judgment rule. I think that this rule could better replace the liquidity test now that risk is inherent to entrepreneurship. Certainly in the venture capital industry the risks are high, but the benefits for a country if one has a flourishing venture capital market outweigh these risks.
- Partnership law: The use of familiar legal entities can be of great influence in the venture capital industry. The United States has a very flexible limited partnership and this is the most used structure for a venture capital fund. China revised its partnership law in 2006 to make it more attractive. Last, Israel made use of certain elements of the Delaware to give trust to foreign investors and it is certainly not sure if Yozma would be so successful if another unknown legal structure was used. Although the failure of Title 7.13 the Dutch government has to revise the possibilities to create a partnership structure that is more suitable for venture capitalists if they want to make the business climate of the Netherlands more interesting. At this moment, the vc funds are mostly structured with a combination of legal entities which makes it more difficult and expensive than necessary.
- KISS: As shown above, a lot of programs are created by the Dutch government to spur innovation and venture capital investments. However, this is not ideal in terms of clarity, simplicity and coherence. Different programs have similar goals which create confusion under entrepreneurs and venture capitalists. Therefore, it will be better to concentrate on a lower number of programs with bigger budgets. The resources of the government are also limited and therefore merging programs can be a solution. As said earlier, especially the seed stage has suffered hard from the recent crises. The SEED capital arrangement is an example of a program that focuses on the early stage but the budget is limited to € 20 million. Merging this program

with for example ‘Groeifaciliteit’ will create a bigger budget and undercapitalization can be prevented in this way.

- Design: Good design of a program is essential for its success. The Yozma program in Israel offered multiple upside incentives to stimulate both managers and venture capitalists to work thoroughly after the investment by the government was made. Further, it was set up as simple as possible. Red tape can discourage investors and entrepreneurs to make use of a program that is maybe very effective in essence.
- Good evaluation: Not all programs are evaluated thoroughly because the bureaus lack information. Agentschap NL does not make intense use of the information they receive and in some cases companies do not have to report. However, it is very important that weak programs are detected as soon as possible so that changes can be made or the program can be ended.
- Other financial sources: The government should consider exploring other sources of capital to fill the gap. Crowdfunding for example got much attention when the United States introduced the Jobs Act. Crowdfunding focuses on the seed stage and this stage suffered the most in the Netherlands from the crises. Investors in crowdfunding may lack the expertise that the angel investors and venture capitalists offer, but they have their own advantages. People that want to invest their money through crowdfunding are normally also the target group of the company. Thus, the possibility that a product is successful can be partially measured with the amount of money that is raised through crowdfunding. Therefore, facilitating and creating awareness about crowdfunding could be an easy and cheap way for the government to close the equity gap.
- Internationalization: Similar to China, where people are used to work for SOEs and focus on the domestic market, the Netherlands are used to the idea: rather safe than sorry. However, risk is inherent to the venture capital industry and in order to establish a strong venture capital industry, the way of thinking has to change also. International contacts can help change this through the exchange of ideas and expertise and cultural characteristics.

Conclusion

The Dutch venture capital industry is very small at this moment. SMEs are having more and more problems raising capital. These SMEs are very important for job creation and innovation and therefore it is essential for the government to step up. I analyzed the important elements for the venture capital industry to flourish in the United States, Israel and China. Although there is no 'one-size-fits-all' approach, if that was the case than my thesis would not be relevant, lessons can be learned from other governments. The United States is the world power were the venture capital industry came alive in the beginning of the 20th century. Israel is the small desert country in war that established a solid venture capital industry after a jumpstart was given by the governmental Yozma program. China is the emerging world power that came from nothing to the second biggest economy worldwide in thirty years. Although these three countries are so different, we can see some trends.

If I take a look at the present conditions in the Netherlands, I see much space for improvement. Much of these improvements are actually based on the KISS-principle. The government tries to incentivize entrepreneurs to innovate and venture capitalists to invest in the early stages filled with risks. Yet, the Dutch government seems cautious when it tries to realize an attractive business environment. Mandatory rules seem to be the standard in the Dutch company law while it is clearly indicated by the three countries that flexible rules are beneficial for this industry. More space is needed in the Dutch laws to align the interests of the parties. Market globalization asks for more global standards. Recognition is certainly in a high-risk business as venture capital very important. Besides the high agency costs that will occur when each country has completely different structures and laws, it is also discouraging for investors and entrepreneurs if they do not understand what the risks and possibilities are. Therefore, Israel based its laws on the American system. Also from importance is the design of government programs, keep it simple is the key to success. Red tape creates a threshold to make use of the program. Moreover, the program needs to be effective, thus enough capital to reach its goal and upside incentives must be provided as the Yozma program showed us. Many programs are created in the last years, but one can better have one effective program with enough capital than four programs that suffer from undercapitalization. And although a program is set up with great care, periodical evaluation remains necessary so that issues can quickly be resolved. A last remark is the importance of internationalization, China and Israel show us that foreign knowledge, expertise and capital can be very valuable.

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