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**RESEARCH ARTICLE**

# THE REGULATORY ENVIRONMENT OF THE KRAJOWY FUNDUSZ KAPITAŁOWY S.A. AS A PUBLIC FINANCIAL INSTITUTION SUPPORTING THE DEVELOPMENT OF INNOVATION. PRESENT STATE AND AUTHOR'S PROPOSALS OF CHANGES

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**ABSTRACT**

Krajowy Fundusz Kapitałowy S.A. is an entity created and operated under the Act of 4 March 2005 on the Krajowy Fundusz Kapitałowy. The area of operation of KFK S.A. governed by Article 5 of the Krajowy Fundusz Kapitałowy assumes that currently the sole object of KFK S.A. activity is to provide financial support to capital funds investing in companies having their head offices in Poland, particularly in innovative or research and development activities.

Regardless of whether Krajowy Fundusz Kapitałowy S.A. will act as a fund of funds investing in SMEs that will invest directly in SMEs through *venture capital* funds, the sole and exclusive purpose of its actions will be to achieve the objectives of the Community and national policies to support the development and entrepreneurship in the country. The extent to which Krajowy Fundusz Kapitałowy S.A. will carry out these objectives and is in line with Community and national rules for *venture capital* investments, funding from the Krajowy Fundusz Kapitałowy S.A. will not constitute unlawful state aid, and even more so will not interfere with competition in the market.



## INTRODUCTION

### *The Activities Of The Krajowy Fundusz Kapitałowy*

Krajowy Fundusz Kapitałowy S.A. ("National Capital Fund", "KFK S.A.") with its registered office in Warsaw is an entity created and operated under the Act of 4 March 2005 on the Krajowy Fundusz Kapitałowy, which regulates the establishment, tasks, principles of financing and functioning of the Company, as well as conditions for granting financial support to entrepreneurs through capital funds. Provisions of the Act of 15 September 2000 the Commercial Companies Code are applied, unless the provisions of the Act on the Krajowy Fundusz Kapitałowy provide otherwise.

The area of operation of KFK S.A. governed by Article 5 of the Krajowy Fundusz Kapitałowy assumes that currently the sole object of KFK S.A. activity is to provide financial support to capital funds investing in companies having their head offices in Poland, particularly in innovative or research and development activities. The sole shareholder of the KFK S.A. is the Bank Gospodarstwa Krajowego (the Polish state-owned development bank). The mission of the KFK S.A. is to increase the availability of capital for Small and Medium Enterprises (SMEs) through financial support to *venture capital* funds.

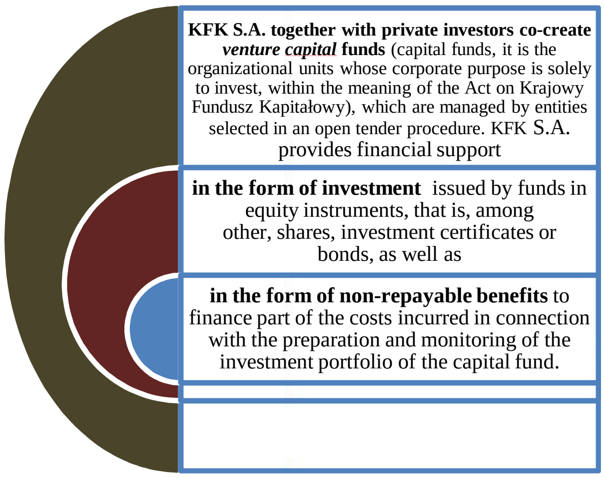


**Figure 1** The financial support offered by the rajowyFunduszKapitałowy

Source: the Bank Gospodarstwa Krajowego and the KFK S.A.

KFK S.A. is carrying out aid programme N26/2007,"Supporting capital funds investing in micro, small and medium-sized enterprises", which aims to encourage private investors to provide *venture capital* for innovative and growth-oriented small and medium-sized enterprises

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established in Poland, which are the target beneficiaries of the aid programme scheme. The legal basis for the scheme, in addition to the act on the Krajowy Fundusz Kapitałowy, is the Ordinance of the Minister of Economy of 15 June 2007 relating to financial support granted by the National Capital Fund.

As at 31 December 2014 KFK S.A. is carrying out three projects supporting the development of *venture capital* funds investing in Polish companies [KFK S.A.; www.kfk.org.pl, 2015]:

1. project financed from earmarked subsidies by the Ministry of Economy granted under the agreement concluded on 27 June 2007, with a value of 54,278,708 PLN;
2. project "Supporting venture capital funds through the Krajowy Fundusz Kapitałowy" under Measure 3.2 of the priority axis "Capital for innovation" Operational Programme of Innovative Economy 2007-2013, with value of 316,576,448.83 PLN;
3. the project "Improving the business environment and access to finance for small and medium-sized enterprises by supporting venture capital funds", under the Swiss-Polish Cooperation Programme, with a value equivalent in PLN of 53,000,000 CHF.

**Table 1** The activities of the KrajowyFunduszKapitałowy

| | 2008-12 | 2013 | Δ% | 2014 | Δ% |
|---|---|---|---|---|---|
| number of investments in SMEs (seed & start-up) | 36 | 69 | 92% | 116 | 68% |
| funds contracted to SMEs [mln PLN] | 88 | 146 | 66% | 242 | 66% |
| funds paid to SMEs [mln PLN] | 56 | 90 | 61% | 172 | 92% |
| KFK S.A. funds deposited to the funds [mln PLN] | 46 | 75 | 65% | 130 | 74% |

Source: the KFK S.A.

### The Author's Proposals Of Changes

According to international standards, KFK S.A. is the first Polish foundation of *venture capital* funds. This formula was chosen in 2005 as the most effective for the "emerging"*venture capital* market in Poland. In this set-up the KFK S.A. does not undertake or directly manage investments in companies, arranging this task to the professional management of the *venture capital* market in return for remuneration (in the form of management fees) seek out investment objectives and then develop and monitor investments to generate the greatest possible value for investors on them (including a public investor, as KFK S.A. is). The role of the KFK S.A. in this model is reduced to a passive shareholder, the so-called "donor capital", which, through paid-in capital investment, reduces the risk of private investors, but is not involved in the investment process, which is the exclusive prerogative of the capital fund managers. Experience has shown that the "fund of funds" model works only with certain categories of projects, i.e. purely business projects that give relatively high probability of generating revenue. Private investors, investing their own resources, are not willing to make too risky (innovation) investment and prefer investments with lower risks; fund managers who are dependent on private capital, must reckon with the investment preferences of private investors. For example, there is an equity gap in the Polish *venture capital* market in terms of specific expertise, such as education, energy technology (*smart grid*) and biotechnology whose projects often focus on the commercialization of scientific research, as well as strategic, from the point of view of the country's economy. On the one hand, such projects are capital intensive (require an investment in excess of 15 million EUR), on the other hand they are of particular interest to *venture capital* funds (including funds, co-written with KFK S.A.) due to the very high degree of investment risk. At the same time, such projects are not being financed from other institutions such as the Polish Agency for Enterprise Development, the National Research and Development Centre, which offer lower financing thresholds or always require the participation of private investors - therefore the equity gap arises, which neither the National Centre for Research and Development nor the Polish Agency for Enterprise Development, or KFK S.A. are able to fulfill. An example of an entity operating in the same area is the International Institute of Molecular and Biotechnology in Warsaw, which has involved in many interesting projects that require commercialization of high importance for medicine and health, but not reputed to be interested in *venture capital* funds (too much risk), while not being able to receive funding from the National Centre for Research and Development and the Polish Agency for Enterprise Development due to too high funding requirements (not fitting in their personal investment criteria). Moreover, in 10 year period (since the creation of the KFK S.A.), the *venture capital* market has changed substantially, both in Poland and in the world. Funds of the *venture capital* profile from public capital operating in Europe have begun to move away from acting solely on the basis of the model of "fund of funds". Most of them make only direct investments and place themselves more on the "investment vehicle" of the state, than on "public support" and "grants for entrepreneurs". Some of these institutions offer two types of products, i.e. both stand-alone making direct investments in companies, as well as operating using the "fund of funds". The experience of such institutions can serve to foster the state policy in the field of entrepreneurship, as well as the development of the economic potential of the country. The intention to make amendments to the Act on the Krajowy Fundusz Kapitałowy is the use of the best experiences on the activities of the state in promoting innovation and economic development [The Letter of 5 August 2015].

As it stands, the Act of 4 March 2005 on the Krajowy Fundusz Kapitałowy and the Ordinance of Minister of Economy of 15 June 2007 relating to financial support granted by Krajowy Fundusz Kapitałowy, the potential and over 10 years of experience of KFK S.A. in capital investments on the *venture capital* market cannot be fully utilized, and the role of the KFK S.A. is basically reduced to administer public funds. The need to develop *venture capital* investments requires amendments to the Act on the Krajowy Fundusz Kapitałowy, regulating the mode of operation of KFK S.A. created to strengthen the Polish innovative small and medium-sized enterprises, which is the prerogative to ensure an appropriate institutional environment for *venture capital* investments in Poland.

**Table 2** Examples of the European national capital funds

| Country | Finland | Estonia | Sweden | Austria | Germay |
|---|---|---|---|---|---|
| **Name of fund** | **Industry Investment Ltd (FII)** | **Fund KredEx** | **Industrifonden** | **Wirtschaftsservice Austria (AWS)** | **Bayern Kapital GmbH** |
| **Legal form/property** | Investment company having legal status, wholly owned by the state. | The Foundation has legal status established in 2001 by the Ministry of Economic Affairs and Communications. KredEx activity is covered by the state guarantee. KredEx activity is not directed towards profit (not profit oriented.). | The foundation has legal status established in 1979 by the Swedish Government and is 100% state owned operating solely on the basis of commercial principles and keeps profits from its own activity, i.e. with the exception of the contributed capital, it does not receive additional subsidies from the state for its activities and any trading profits are further invested. | A trading company (GmbH) with a legal status wholly owned by the state (shareholders are the Minister of Economy, Family and Health, and the Minister for Transport, Innovation and Technology) | A trading company (GmbH) with a legal status, entirely dependent on LfAFoerderbank Bayern (State Bank supporting the Bavarian economy), established in 1995. |
| **Products** | a) Direct investment in SMEs,<br>b) Direct investment in*venture capital*,<br>c) Own dependent funds (100% dependent on subsidiary companies) who invest further in *venture capital* funds. | a) Debt and guarantee support for businesses,<br>b) Indirect investments in *venture capital* funds. | Only direct investments in enterprises. | a) Creates Business Angels Network and a platform for contact with business angels and entrepreneurs,<br>b) Action in the form of guarantees - guarantees repayment of 80% of the loan obtained from the bank, provided that private investors invest,<br>c) It invests in *venture capital* funds<br>d) Funds dependent on the AWS - dedicated funds for direct investment in SMEs. | Investments in enterprises through dedicated fund subsidiaries. Bayern Kapital manages funds dedicated to investments in companies at the subsequent stages of development, which invest in enterprises either alone or with private partners or other public bodies. |
| **Financial instruments** | Equity and quasi-equity. | a) Start-up loans,<br>b) Loan guarantees/bank loans to enterprises,<br>c) Technological Loan for own contribution required for financing from the bank (only for entrepreneurs from the technological sector)<br>d)Loans for companies developing their business (in the phase of growth and development),<br>e) Loans for entrepreneurs who want to start international expansion,<br>f) Equity investments in *venture capital* funds | Investments by equity and quasi-equity financial instruments (*risk-sharing loans, e.g., options and convertibles*). | a)Equity instruments and in quasi-equity,<br>b) Guarantees,<br>c) Loans. | Only capital investment- equity and quasi-equity (*subordinated loan*). |
| **Basic investment assumptions** | In the framework of direct investment, FII invests only in Finnish companies, together with private investors under the same conditions, the FII shareholding does not exceed 50%,. The value of the investment in the company is 0.5 million to 10 million EUR. | KredEx selects managers with the best reputation on the market and adds 50% of the capital to private capital, KredEx is passive investor, *venture capital* funds are invested only in companies from the Baltic countries with high growth potential, from 2 to 15 EUR million . | The fund only invests directly in small and medium-sized Swedish companies with high growth and innovative potential . The fund is known as the active investor, i.e. that brings not only funding, but also know-how and operational support to companies. The fund's investments are in the range of 15% -50% of the shares in businesses. | With investments in *venture capital* funds - part of the AWS in the fund is from 30% to 50%, investments on market conditions<br>For direct investment (through subsidiary funds) - investments on market conditions, for a period of 5-10 years, at least 25% share of founders | Seedfonds Bayern -- technological companies not older than 12 months, with the participation of HTGF, from 250 to 500 thousand EUR.<br>Clusterfonds Start-Up - companies of 12 to 24 months (bridge between the seed and start-up), max. 500 thous. EUR.<br>Clusterfonds Innovation - co-investment fund, i.e. to invest at the so-called co-investment. strategic investor (providing technical input and business), funding for research and development, up to 2 million. |

Source: the KFK S.A.

KFK S.A. is a complementary element of the system to increase access to capital for the Polish innovative companies with high growth potential, in particular carrying out research and developing or marketing a product for the first time on the market.

The KFK S.A. mission therefore contributes fully to the objectives and the "*Europe 2020*" Strategy. In order to align the activities of KFK S.A. to international standards and make full use of its potential and experience to support the "*Europe 2020*" Strategy, KFK S.A. should be equipped with new instruments and mechanisms of action in order to create professional institution, not only granting support to innovative entrepreneurs as a fund of funds, but also directly and indirectly investing its own or raised funds (including EU funds) in order to effectively support the economic policy of the State in the field of innovation as well as R & D and achieve a specific return on investment. Further development of KFK S.A. would provide a major impetus for Poland for the development of an innovative economy financed by capital investments of *venture capital*.

As a rule, every public funding fulfilling the criteria of Article 107, item 1 of the Treaty constitutes state aid and requires notification to the European Commission. Aid to facilitate the development of certain economic activities or of certain economic areas compatible with the internal market can be considered if it does not affect trading conditions to an extent contrary to the common interest, in accordance with Article 107, item 3 of the Treaty. This means that if a Member State develops a funding source of risk in such a way that it will not change trade and will comply with the Community interest, such measures will not even constitute State aid within the meaning of Article 107 of the Treaty.

According to the European Commission, state activity to support the development of the risk finance market, and improve access to risk finance for SMEs are of great importance for the whole EU economy, therefore the rules are compatible with Community interest.

From the point of view of EU regulations, i.e.:

1. The treaty establishing the European Union;
2. EU guidelines on state aid to promote investment in risk financing of 22/01/2014, EC Regulation declaring certain categories of aid compatible with the common market in application of Article 107 and 108 of the Treaty of 17 June 2014 ("Guidelines for venture capital");
3. Commission Regulation (EU) no. 651/2014 of 17 June 2014 declaring certain categories of aid compatible with the common market in application of Article 107 and 108 of the Treaty ("Block exemptions");

each means of risk financing drawn up by a Member State, which meets the conditions of Article 107 of the Treaty and further guidelines on *venture capital* or block exemption will by definition constitute state interference which is allowed on the Community market, i.e. does not interfere with competition in this market. In practice, any Member State which develops means of risk capital financing for SMEs shows such measure to the Commission for approval and on the stage of the certification of the European Commission, the measure undergoes testing from the point of view of its compatibility with the common market and the principles of support for *venture capital*. If the notified measure fulfills the conditions laid down in the EU regulations mentioned above, the Commission considers it compatible with Article 107 of the Treaty.

In conclusion, regardless of whether KFK S.A. will act as fund of funds investing in SMEs that will invest directly in SMEs through *venture capital* funds, the sole and exclusive purpose of its actions will be to achieve the objectives of the Community and national policies to support the development and entrepreneurship in the country. The extent to which KFK S.A. will carry out these objectives and is in line with Community and national rules for *venture capital* investments, funding from the KFK S.A. will not constitute unlawful state aid, and even more so will not interfere with competition in the market.

The following is a proposal for the provisions of the amendment of the Act on the Krajowy Fundusz Kapitałowy:

*Article X. In the Act of 4 March 2005 on the Krajowy Fundusz Kapitałowy(Journal of Laws of 2015, item 562, as amended) Article 5 replaced by:*
*"Article 5*

1. *The core objectives of the Krajowy Fundusz Kapitałowy is to support the economic policy of the Council of Ministers in stimulating the economic development of the state based on the innovation and the competitiveness of the economy.*
2. *The objectives referred to in item 1, the Krajowy Fundusz Kapitałowy is carried out in particular by:*

1. *providing financial support constituting public assistance for entrepreneurs within the meaning of separate provisions, including financial support of capital funds investing in companies referred to in Chapter 3;*
2. *making investments in equity funds or entrepreneurs;*
3. *creating or co-creating capital funds whose principal activity is to invest in entrepreneurs;*
4. *investing in portfolio management and risk management within the meaning of Article 46 of the Act of 27 May 2004 on investment funds (Journal of Laws of 2014, item 157, as amended);*
5. *carrying out other tasks for the Krajowy Fundusz Kapitałowy in separate regulations.*

*The Krajowy Fundusz Kapitałowy may also act as the entity implementing a financial instrument or fund of funds, referred to in the regulation of the European Parliament and of the Council (EU) no 1303/2013 of 17 December 2013 laying down common provisions on the European Regional Development Fund, the European Social Fund, Cohesion Fund, the European Agricultural Fund for Rural Development and the European Maritime and Fisheries Fund and establishing certain general provisions on the European Regional Development Fund, the European Social Fund, the Cohesion Fund and the European Maritime and Fisheries Fund and repealing Council Regulation (EC) no. 1083/2006 (Journal of Laws EU L 347, 20.12.2013, p. 320).*

*The rules and conditions fulfill the role referred to in item 3, determined by separate regulations and agreements with relevant government bodies or local authorities.*".

Moreover, currently, in accordance with Article 86a, item 1 of the Act on the Higher Education Law, only a Higher Education Institute ("HEI") can create a one-man limited company known as a Special Purpose Vehicle ("SPV"), as well as being the sole shareholder or shareholder of the target company. Therefore, the question of extending the scope of the provision seems justified in order to participate in special purpose vehicles created by HEIs, the Bank GospodarstwaKrajowego, the Krajowy Fundusz Kapitałowy and investment funds of the Bank GospodarstwaKrajowego.

**The following is a proposal for amending this Act**

*Article X. The Act of 27 July 2005 on Higher Education Law (Journal of Laws of 2012, item 572, as amended) introduces the following changes:*

***In Article 86a, item 1-4 are replaced by***

1. *In order to commercialize indirectly, the higher education institution can create a capital company, hereinafter referred to as "special purpose vehicle (SPV)" subject to Article 86b,item 1. In order to cover the share capital of the SPV, the HEI can bring in whole or in part a contribution in kind (contribution) in the form of ownership of the results of scientific research or development work, which is an invention, utility model, industrial design or topography of integrated circuit, bred or discovered and derived plant variety, and the tracks or information relating to these results, in particular know-how, hereinafter referred to as "intellectual property rights". The SPV creates a rector with the consent of respective HEI senate, and in the case of non-public HEI - the authority specified in the statute.*
2. *Based on a paid or unpaid agreement, the HEI may entrust the SPV the management of intellectual property in the field of direct commercialization.*
3. *A shareholder or shareholder of the target company may be an HEI, the Bank GospodarstwaKrajowego, or the Krajowy Fundusz Kapitałowy SpółkaAkcyjna.*
4. *Through the involvement of the Bank Gospodarstwa Krajowego in shares in SPVs also means the involvement of subsidiaries directly or indirectly from the Bank Gospodarstwa Krajowego and investment funds established by the company of investment funds that are the direct or indirect subsidiary of the Bank Gospodarstwa Krajowego.";*

***in Article 86a,item 1-4 are replaced by:***

*"Article 86b. 1. The SPV can be formed by several public HEIs or several non-public HEIs. A public HEI can proceed to the SPV formed by another public HEI, and non-public HEI can proceed to the SPV formed by another non-public HEI. The provisions of Article86a, item3 shall apply accordingly.".*

At the same time the Author wishes to note that in connection with the act adopted by the Parliament on 5 August 2015 amending the Act on certain forms of supporting innovative activities and the Act on the Krajowy Fundusz Kapitałowy,

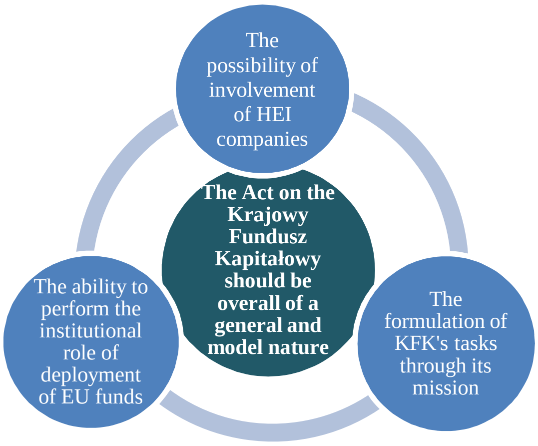


**Figure 2** The proposal of the Act on the KrajowyFunduszKapitałowy

Source: The Bank GospodarstwaKrajowego and the KFK S.A.

Article 5 of the Krajowy Fundusz Kapitałowy has been amended. This change is the sole object of the KFK S.A., i.e. to replace the need to grant financial support to capital funds, investing in companies domiciled in the Republic of Poland with the duty to conduct business through these entrepreneurs in the Republic of Poland (without the need of having a head office). The intention of the designers was to avoid non-compliance with Article 5,item 1 of the Commission Regulation (EU) no. 651/2014 of 17 June 2014 declaring certain categories of aid compatible with the common market in the application of Article 107 and 108 of the Treaty, according to which, among others, limits the grant of aid for the entity subject to the obligation to have the beneficiary established in a Member State or managing its operations predominantly in a Member State, which would constitute breach of Community Law[The Letter of 14 August 2015].

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