

5. FINDINGS AND RECOMMENDATIONS

General findings

Finding n°1: Lack of on-the-spot visits by the holding fund at the level of the final recipients

In 2012 DG REGIO carried out an audit on the Financial Engineering Instruments (henceforth FEI) in Hungary covering also management verifications. Since this latter audit the Holding Fund, MV Zrt. (henceforth holding fund) has significantly improved the frequency and scope of its management verifications. Nevertheless, the on-the-spot checks are still carried out only at the level of the financial intermediaries and not at the level of the final recipients. Such verifications do not allow a full assessment of the eligibility of underlying expenditure. As an example, we refer to finding n°6 of the report in relation to the place of the implementation of investment.

Action n°1 (Responsible body: Holding fund; Deadline: 60 days; Priority: High):

The MA / holding fund should amend its procedures or arrangements with financial intermediaries in order to ensure that on-spot visits are carried out at the level of the final recipients. This would provide an adequate scope of verifications to guarantee that only eligible expenditure is declared to the Commission.

Finding n°2: Management information system does not include sufficient information collected during management verifications

The results of management verifications in relation to the individual final recipients are not stored in the management information system in a way that would allow retrieving the information in relation to individual projects. For instance, in order to know whether a particular loan was subject to management verifications, all the reports from management verifications need to be reviewed as this particular information is not included in the system together with other financial data.

Action n°2 (Responsible body: Holding fund; Deadline: 60 days; Priority: Medium):

The system upgrade to include such information is being implemented according to the representatives of the holding fund. The Commission should be notified when this upgrade becomes operational.

Finding n°3: Inadequate monitoring of the repayments of loan principals by financial intermediaries

The financial intermediaries reimburse the repayments of the principal of the loans received from the final recipients to the holding fund on a monthly basis. Apart from the total amount no other information is provided with these monthly transfers. As a result, the holding fund is not in a position to assess the completeness and adequacy of the monthly repayments. In particular, the holding fund is not in the position to assess whether a particular loan principal due for repayment was actually repaid although the

breakdown of the loan amounts along with other information (duration) is available for the holding fund.

The holding fund argues that the financial intermediaries should ensure the correctness of their reporting. In addition, these intermediaries are motivated not to understate repayments because there is an interest applied on the amounts not repaid (of 0.4% p.a.) and that the processes at financial intermediaries are subject to on-spot management verifications.

The Commission considers that the holding fund cannot ensure completeness, timeliness and accuracy of amounts repaid without also performing a quantitative analysis by comparing the amounts repaid with the information on individual loans.

Action n°3 (Responsible body: Holding fund; Deadline: 60 days; Priority: Medium):

To ensure completeness, timeliness and accuracy of amounts repaid, the holding fund should, based on the data in its system calculate the amounts due from financial intermediaries each month, compare the result with the amount reimbursed and investigate if significant deviations are detected. Alternatively, the financial intermediaries should provide the information on repayments of principal for each individual loan.

Finding n°6: Investments potentially implemented in ineligible regions

The managing authority for the Economic Development programme launched 4 calls for expression of interest to select venture capital fund managers. These calls set out that venture capital investors, receiving also JEREMIE support, should invest in companies with a registered seat in an eligible region, i.e. in any Hungarian region with the exception of Central Hungary. In the call no requirements were set in relation to the place

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of the actual implementation of the projects. The same requirement was included in the funding agreements between the holding funds and financial intermediaries (venture capital fund managers).

Central Hungary is classified as a competitiveness region as it more developed than all the other Hungarian regions. It is to be noted that the Economic Development programme, based on section 2.4.3 of the programme document, can only support developments that are implemented in the 6 convergence regions ie. in the entire territory of Hungary with the exception of Central Hungary.

Central Hungary was considered as an ineligible region and all investments implemented there were to be supported by the Central Hungary operational programme including also a JEREMIE priority.

During the audit it was noted that a significant proportion of the projects audited were actually implemented mainly in the region of Central Hungary (Netfone-Invest Befektetési Kft., iCatapult Technológiai és Üzletfejlesztési Zrt., Dating Central Europe Zártkörűen Működő Részvénytársaság and SmartAdNetwork Mobil Marketing Korlátolt Felelősségű Társaság). For each of the above cases the official seat of the companies was located outside of Central Hungary, but the principal part was implemented in this region.

This problem appears to be systemic based on the cases identified during the audit and due to the fact that it does not result from deficiencies at the level of venture capitalists but rather from incorrect requirements set by the managing authority in the respective calls and funding agreements.

Due to the systemic nature of the deficiency a flat rate financial correction of 10% is proposed based on the classification of systemic irregularities included in the applicable Commission guidelines¹ in relation to all the expenditure declared under measure 4.3 Venture capital of the operational programme.

Action n°6 (Responsible body: Managing authority; Deadline: 60 days; Priority: High):

The managing authority is requested to quantify the amount of the underlying expenditure affected by this error and carry out the proposed financial correction. As the irregularity is considered systemic, the amount of the correction can be reused within the programme for a different operation, which can also be a linked to financial engineering instrument with the exception of the affected venture capital fund.

Finding n°7: Deficiencies linked to the selection of financial intermediaries for the venture capital

As explained under the previous finding the managing authority for the Economic Development programme launched 4 calls for expression of interest to select venture capital fund managers. These calls were published on the website of the National Development Agency and that of the holding fund in July 2009 (Call n°1: GOP-2009-4.3/2), June 2012 (Call n°2: GOP-2012-4.3/B), April 2013 (Call n°3: 2013-4.3/B) and in June 2013 (Call n°4: 2013-4.3/B/2).

The following issues were noted in relation to these calls:

1) Public Procurement requirement

The above mentioned 4 calls resulted in contracts concluded between the Managing Authority (National Development Agency) represented by the holding fund (MV ZRt.) and the venture capital fund manager companies. Based on the contract objective the fund manager is involved in the implementation of the Fund. In particular it needed to assure the availability of the private capital (30% of the fund) and actually manage the fund's investments.

Both the National Development Agency) and the holding fund (MV ZRt.) appear to be contracting authorities in the sense of Article 2(9)c of the Directive 2004/18/EC. The tasks entrusted to the fund managers are considered as financial services listed under Annex IIA of the same Directive.

It should be noted that in the preliminary legal assessment of the Commission services venture capital fund management cannot be considered to be a financial service in connection with the issue, sale, purchase or transfer of securities or other financial instruments and therefore it cannot be exempt from the public procurement rules based on Article 16(d) of the said Directive. This is due to the fact that the above mentioned exception covers the supply of money of the contracting authorities not the funding of any third parties. This is further confirmed by the systematic interpretation of the Directive as the services included under category 6 of Annex IIA of the Directive, namely corporate finance and venture capital services, at the same time do not fall in the scope of the exception set out under Article 16(d) of the Directive.

Section 2.1.3 of the applicable guidance note² sets out that financial intermediaries and financial institutions are among the bodies which may subsequently be selected to implement financial engineering instruments. The Member State or the managing authority must assess whether the contribution from the operational programme should be implemented through a grant to a financial institution - if that is in accordance with a national law compatible with the Treaty - or through the award of a public contract in accordance with applicable public procurement law.

Further in the same guidance, under section 2.1.5, it is set out that throughout the entire selection and decisional process the Member State and the managing authority must ensure that transparent procedures for selecting financial engineering instruments (including inter alia funds, financial intermediaries, financial institutions and fund

² Revised Guidance Note on Financial Engineering Instruments under Article 44 of Council Regulation (EC) No 1083/2006 - COCOF_10-0014-05-EN

managers) and for taking decisions on contributions from operational programmes are followed. In this process the Member State and the managing authority must ensure that all applicable laws are complied with, including State aid rules as well as national and EU legislation on grants and public procurement.

It is to be noted that the value of the financial service contracts at hand is above the applicable EC thresholds.

On this basis, the Commission's legal position is that the national authorities should have applied a public procurement procedure, in line with the provisions of the Directive 2014/18/EC, for the award of the contracts for the provision of financial services in this particular case for venture capital fund management.

Due to the lack of the publication of a contract notice in the Official Journal of the EU the Commission proposes a financial correction in accordance with point 1 of the Guidelines for determining financial correction (Commission Decision of 19 December 2013 - C(2013) 9527).

Taking into account the publication of the calls for the expression of interest on the national websites the applicable financial correction proposed is 25% on the value of the financial services contracts awarded. Based on Article 9(8) (a)(ii) the value of the services is to be determined on the basis of the fees, commissions, interest and other forms of remuneration received by the financial intermediaries.

The Commission notes that the financial intermediaries were selected via a competitive process. The general requirement to apply public procurement rules for this selection and the related consequences are currently assessed by the Commission services and the final position will be communicated to the authorities at a later stage. The Commission will also assess whether the same requirement is to be applied for the loan and guarantee type financial instruments.

2) Requirement for reference investments realised in the territory of Hungary

Calls n°1-3 required that the prospective venture capital fund managers dispose of minimum 2 senior corporate financial experts, who already realised risk capital, venture capital, private equity, development capital type investments in companies having their seat in Hungary.

In the assessment of the Commission services this requirement is discriminatory as experts realising similar investment in other member states should have also been accepted. With reference to the previous observation on the public procurement requirement, this selection criterion is considered as contrary to Article 2 of the Directive 2004/18.

3) Shortened time limits for the submission of tender offers

In the case of calls n°2 and n°3 the time limit available between the publication of the call and the submission deadline was 10 and 15 days respectively. Even taking into account the argumentation that these two calls only served to provide financing to those venture capital funds, which were considered eligible for calls n°1 and n°2 but were not selected as there was not enough budget available these time limits do not seem to be adequate for the preparation of an adequate offer. In addition, these shortened time limits

discriminate against potential new fund management companies, which did not participate in the previous selection rounds.

4) References used as an award criterion

The managing authority set up an evaluation system to assess the applications of the different fund managers. It was noted that scores were allocated for previous reference investments implemented by the senior investment experts proposed (number of appropriate investments carried out).

The Commission services consider that references related to previous risk capital investment are not linked to the subject matter of the service to be rendered but to the service provider in this case to the fund managers. According to the rules of public procurement, applied in analogy with the current selection process, such criteria can be only applied in the selection phase and are illegal in the award phase

Action n°7 (Responsible body: Managing authority; Deadline: 60 days; Priority: High):

1) The national authorities are requested to take into account the above observations when they organise the selection for venture capital fund managers in the future. In particular the authorities are requested:

- To ensure a competitive and transparent selection of financial intermediaries
- Not to include selection criterion restricting reference investments to the territory of Hungary
- Provide adequate time for the submission of tenders
- Apply appropriate selection and award criteria and in particular not apply selection criteria in the award phase

As regards the deadlines available for the submission of applications it was noted that the system applied in Hungary discriminates against fund management companies which are not owned / or closely linked to specific investor groups. These companies need to raise funds from external investors to supply the private investment part of the fund. The time needed for fundraising is generally much longer than deadline for the submission of tender applications.

Therefore, in the future the managing authority / holding fund is requested to regularly publish a planning for the different selection stages for fund managers, which would include the planned date of publication, the amount to be allocated and the number of fund managers to be selected.

2) Due to the weaknesses identified and explained in the finding above a flat rate financial correction of 10% is proposed based on the classification of systemic irregularities included in the applicable Commission guidelines³ in relation to all the

³ COMMISSION DECISION of 19.10.2011 (C(2011) 7321) on the approval of guidelines on the principles, criteria and indicative scales to be applied in respect of financial corrections made by the Commission under Articles 99 and 100 of Council Regulation (EC) N° 1083/2006

expenditure declared under measure 4.3 Venture capital of the operational programme. This correction includes the 25% correction proposed under part 1 of finding n°7 and is not to be cumulated with the correction proposed under finding n°6 in accordance with the above cited guidelines.

Venture capital – MORANDO Zrt.

Finding n°8: Amounts not actually invested declared as investment

The venture capital fund management company, MORANDO Zrt., applies a practice that a special purpose vehicle (henceforth SPV) is created for the investments in similar sectors. The special purpose entity then invests into the actual target company. In case of the investment into the special purpose entity Aurum Horatii Vagyonkezelő Kft., the investment into the actual target company (final recipient) did not take place in the end. Nevertheless, the amount invested into the special purpose entity was reported as invested in MORANDO's reporting to the holding fund.

The amounts paid to the special purpose entities without an investment into the final recipient cannot be considered as eligible expenditure.

Action n°8 (Responsible body: Holding fund; Deadline: 60 days; Priority: Medium):

The amounts invested into SPVs without subsequent actual investment in final recipients should not be considered as amounts invested and declared as eligible expenditure. The holding fund should ensure that no amounts invested into SPVs without subsequent actual investments are declared as eligible expenditure. The review of all the investments undertaken by MORANDO Zrt. should be carried out in this regard.

Finding n°9: Ineligible expenditure –management buy-outs

Morando Zrt, among others, implemented two venture capital investments into the SPVs Netfone-Invest Befektetési Kft. and Netfone-Mobil Befektetési Kft. in the values of HUF 875M and HUF 475M (both private and JEREMIE contribution).

The SPV Netfone-Invest initially acquired a 70% share in its target investment in Netfone Telecom Kft.

In May 2014, this SPV paid an additional HUF 130 million (approximately EUR 433 thousand) to three of shareholders of Netfone Telecom Kft. as a compensation for unlawful termination of the syndicate agreement. The prior termination of the syndicate agreement resulted in that the share of these three shareholders was reduced to 0 and the share of Netfone-Invest in Netfone Telecom was increased. The shareholders removed from the company agreed to terminate the legal action they have launched for the breach of the syndicate agreement in return for this compensation.

The amount of HUF 130 million cannot be considered eligible as it does not comply with the definition of venture capital specified in point 2.2(i) of the Community guidelines on state aid to promote risk capital investments in small and medium-sized enterprises (2006/C 194/02) which is as follows: "*venture capital*" means investment in unquoted companies by investment funds (venture capital funds) that, acting as principals, manage

individual, institutional or in-house money and includes early-stage and expansion financing, but not replacement finance and buy-outs" (emphasis added).

Action n°9 (Responsible body: Holding fund; Deadline: 60 days; Priority: High):

The amounts invested as replacement finance and buy-outs should not be considered as eligible expenditure. The holding fund should ensure that the amount of HUF 130 million paid as buy-out is not declared as eligible expenditure.

Finding n°10: Inadequate separation of investments

As explained under finding n°9, Morando Zrt. implemented two venture capital investments into the SPVs Netfone-Invest Befektetési Kft. and Netfone-Mobil Befektetési Kft.

The investment into Netfone-Invest Kft. covered the purchase of a share in Netfone Telecom Kft. and the implementation of Customer Relationship Management (CRM) system and a client base to sell internet, VOIP and potentially mobile telecommunication services. The CRM software was sold by Mid Europe Invest Limited, a company based in Hongkong, in the value of EUR 577.989.

The investment into Netfone-Mobil Kft. covered the purchase of a share in Mobilhalo Kft., which operated an MLM system for selling telecommunication services. Mobilhalo Kft. was owned by HuCom Telecom Kft. which was in turn owned by 'Mid Europe Invest Limited' based in Hongkong.

These two investments were considered separate by the fund management company and thereby each had a maximum investment amount of EUR 1.5 million in a given 12 months' period. According to the rules of the applicable call and state aid decision⁴ this maximum investment amount refers to an investment into one single company or into companies belonging to the same company group (owned directly or indirectly by the same economic entities).

There is also a similar purpose for the two investments (Netfone-Invest and Netfone-Mobil), namely to provide telecommunication services to customers including the selling of the services and the operation.

Action n°10 (Responsible body: Holding fund; Deadline: 60 days; Priority: High):

The national authorities are requested to clearly demonstrate that the two investments were not implemented into companies belonging to the same company group / owned directly or indirectly by the same economic operators.

Additional argumentation is to be provided, as to why these two investments are to be considered separate taking into account they do not seem to be operational separately and all major investment items were purchased either directly or indirectly from HuCom Telekom Kft.

⁴ Commission Decision C(2008)8350 – recital 24

Finding n°11: Amounts invested spent on purchases from related parties

In relation to the investments explained under finding n°9 and n°10 the auditors verified a sample of purchases from third parties, which were covered by the fund's investment. In relation to these purchases the following issues have been identified:

A) On October 31, 2013, Hucom Telecom Kft sent an invoice to Netfone Telecom Kft for an amount of HUF 136,108,440 HUF.

On May 31, 2013, Netfone Tavkozlesi Szolgáltato Kft sent an invoice to Netfone Telecom Kft for an amount of 12,471,400 HUF.

The description of the actual service purchased is the same for both invoices (CPS ügyféldíj szerződés szerint 2. Részlet). A similar transaction, with the same counterparts was carried out on 13 December 2012 in the amounts of HUF 154,028,140 and HUF 14,188,440 respectively.

Netfone Telecom Kft was the investment target of the venture capital fund realised via Netfone Invest Kft., a special purpose vehicle established for this purpose.

A review of the above four invoices identified the following:

- Both HuCom Telecom Kft and Netfone Tavkozlesi Szolgáltato Kft are located at the same address in Budapest
- The telephone numbers for both companies are almost the same : 40/696-030 and 40/696-020
- Both invoices have the same layout and details with the only exception being the heading of the sender company
- Bank accounts for both companies are at the same banking institution and have almost the same digit numbering with only the last digit out of the 24 digit account number being different

This indicates that these companies are very closely related.

B) On December 1, 2012, Mid Europe Invest Limited sent an invoice to Netfone Telecom Kft for an amount of EUR 577,989. The billing details raise red flags as the company is based in Hong Kong at an address housing multiple companies. In addition, Mid Europe Invest Limited did not provide any meaningful hits in internet searches which would allow concluding that this company actually deals with software development or even software resale for such high value software.

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Action n°11 (Responsible body: Holding fund; Deadline: 60 days; Priority: Medium):

The holding fund should investigate and clarify the relationship between Hucom Telecom Kft and Netfone Tavkozlesi Szolgáltato Kft to verify why these two companies are sending separate invoices to Netfone Telecom Kft and what the invoices actually relate to.

Also, the holding fund should obtain and provide the Commission with further company structure details about the company 'Mid Europe Invest Limited' and provide explanation as to why they were chosen as a supplier for the software. In addition, it should be demonstrated that the software was actually delivered and that its price was in line with the market price of similar applications.

Based on the requested information the Commission will consider to close the finding or propose corrections for the invoices mentioned.

Venture capital – Gran Private Equity Zrt.

Finding n°13: Investment prone to cause reputational harm to the Commission

The Gran Private Equity ZRt. was selected as a venture capital fund manager subsequent to the call for the expression of interest published in June 2013. One of the investments realised by this fund manager targeted a company called Dating Central Europe ZRt. The latter company operates dating internet sites in Hungary and plans to extend its activities to Slovakia and to Romania. In the portfolio of the company there are also internet sites

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which specifically relate to temporary sexual relations/services (szexrandi.hu, szexpartner-kereso.hu, videki-sexpartner.hu etc.). All the legal rights related to these sites were purchased in the framework of the JEREMIE investment.

Action n°13 (Responsible body: Holding fund; Deadline: 60 days; Priority: Medium):

The holding fund should ensure that all the investments are not only compliant with the applicable regulatory requirements, but also that ethical and reputational considerations are made for all the investments. The investment in Dating Central Europe ZRt. appears not to be compliant with these ethical and reputational considerations as part of its portfolio is linked to temporary sexual relations/services.

The holding fund is requested to require Gran Private Equity ZRt. to remove the above mentioned websites from the portfolio of Dating Central Europe ZRt.

General finding on venture capital investments

Finding n°14: Further improvement are necessary for the monitoring of the venture capital investment

Based on the findings n°8 – n°13 the Commission considers that there is still room for improvement concerning the monitoring of the implementation of venture capital fund investments. The holding fund / national authorities are requested to reinforce the verification process and ensure a closer monitoring of the individual investment decisions and the use of the investment amounts by the target companies.