RESPONSE OF THE EUROPEAN STATE AID LAW ASSOCIATION TO THE COMMISSION CONSULTATION ON THE DRAFT GUIDELINES ON STATE AID TO PROMOTE RISK FINANCE INVESTMENTS

This response is submitted by the European State Aid Law Association ("ESALA") in response to the consultation and draft Commission Guidelines on state aid to promote risk finance investments (the "Draft Guidelines").[1]

ESALA is a forum of leading practitioners in State aid law from law firms across Europe, as well as scholars specializing in State aid law.

For further information on ESALA or in relation to this paper please see www.esala.eu, or contact: [redacted]

Comments on the Draft Guidelines:

1.
ESALA welcomes the opportunity to respond to the consultation on the Draft Guidelines on state aid to promote risk finance.
As the Commission points out in its invitation to respond to the consultation the evaluation of the current Guidelines – ‘the fitness check’ – showed the need to further simplify and clarify the rules.

According to the invitation, the purposes of the revision of the current Guidelines are,:

1. **Reordering** the existing provisions to increase readability and ease of application. Most notably, this includes the consolidation of existing requirements for the ex ante assessment.
2. Further **clarifying** the specific content and level of evidence needed to demonstrate a specific market failure or another relevant obstacle in access to finance. Most importantly, the requirement to quantify the funding gap will only remain in place for schemes with the largest amounts of aid for individual beneficiaries.
3. **Focusing** the Guidelines on compatibility of State aid to avoid overlaps with the Notice on the Notion of Aid.

[1] The following ESALA members contributed to this response: [redacted] This response does not necessarily reflect the views of all individual members of the working group, nor the views of all ESALA members, their law firms or their clients.

4. **Streamlining** existing formulations and aligning definitions to increase consistency with the General Block Exemption Regulation.

2.
We welcome the ambitions of the Commission laid down in these four points. In the context of an instrument that is directed at support to small business, we consider simplicity and clarity of the guidance to be of particular importance. We think that the Commission has succeeded in attaining its goals under points 1, 3 and 4. With regard to point 3, however, we note that the paragraph on the market economy operator test (MEOT) in the current Guidelines is much more detailed than the Notice on the Notion of State aid and more tailored to the specifics of risk finance. We would suggest, therefore, to insert the paragraphs on the MEOT again.

In relation to the goal of clarification (goal under point 2), in our view the draft Guidelines do clarify certain points as compared to the current Guidelines, but there are still areas where this could be developed further.

3.
We also recognize that risk financing aid is a complex area in which it is difficult to strike a balance between providing what may be critical incentives for risk financing to small businesses that are key drivers of innovation and who would have no or worse access to sources of financing without the aid measure, on the one hand, and avoiding perverse incentives (incentivising non-viable sectors or companies, encouraging financiers to take less risk), on the other.
We welcome the fact that the Commission discusses in greater detail than in the current guidelines the balancing factors that play a role in the declaration of compatibility.

4.
In the draft guidelines, the Commission has incorporated the consequences of the Court of Justice's judgment in the *Hinkley* case (judgment of 22 September 2020 in Case C-594/18 P) by removing the requirement that the measure must pursue an objective of common interest. We agree that this updating is required although our expectation is that in practice this will ultimately make little difference in the overall assessment of proposed measures, particularly as the draft guidelines envisage that the balancing of positive and negative effects of the measure shall be conducted in such a way as to ascertain that the measure does not adversely affect trading conditions to an extent contrary to the common interest.

5.
In general, we believe that the approach to aid in the form of risk financing could be more generous/flexible. We note that, according to the European Commission's website, only seven measures have been approved under the Guidelines on State aid to promote risk

finance investments in the period 2014-2020. If the low interest in such measures has to do with the complexity of the scheme, in our view this should lead to a reconsideration of the assessment framework.

6.
A key concern that we have with the proposed guidelines is that they envisage that a market failure will need to be identified in terms of risk financing for (especially) SME's, whereas the requirements for compatibility measures are such that market conformity is, in fact, expected. We would like to point out some examples, without being exhaustive.

- Point 68 of the draft guidelines states that financial intermediaries should be subject to audit to ensure that they have a commercially sound investment strategy that is geared to the defined policy objective and respects the defined selection conditions and financing restrictions. Point 68 continues with "In particular, Member States should select financial intermediaries where it is apparent that the investment strategy proposed by them is commercially sound and includes an appropriate risk diversification policy aimed at achieving economic viability and an efficient scale in terms of the size and geographical distribution of investments." However, the market failure exists precisely because investors do not consider it to be a sound business strategy to invest in, for example, start-ups and innovative SMEs. If the intention is that the financial intermediary invests in a commercially responsible manner, taking the support measure into account (for example, by including a government guarantee as security in the risk assessment), then this might be stated more clearly.

- Point 169 notes that a measure providing for the creation of a public fund with an investment strategy that does not sufficiently demonstrate the potential viability of the eligible enterprises is unlikely to pass the balancing test, because in that case the risk financing investment may amount to a subsidy. Generally speaking, *demonstrating* the potential viability of businesses that could benefit from the measure in the context of the decision to appoint a financial intermediary will in some cases be impossible. However, it may be possible to draw up an investment regulation specifying which undertakings are eligible for financing from the fund. The comment that if potential viability is not demonstrated, the investment will not pass the balancing test because it will be a subsidy is not appropriate in the sense that the balancing test only has to be done in the case of *aid*. In that respect, it *is* already a subsidy and not a market-based investment.

- Point 171 on regional funds indicates that these may not be appropriate for support through risk finance measures as they may be seen by investors as being an instrument serving regional policy objectives rather than as a viable business opportunity offering an acceptable return on investment. We note that a regional policy objective does not exclude the *simultaneous* solution of a market failure in the availability of risk capital for the target group of enterprises. A local authority seeking to remedy a market failure by means of an aid measure may want to limit its intervention to the area where it has jurisdiction. Furthermore, we note that under the 2014 GBER a large part of the notified measures have a regional character.

7.
We believe that the guidelines could be better designed to address the situation of public funds set up by public authorities to invest in start-ups, SMEs and innovative enterprises. Where such a fund (which, according to the definitions of the guidelines, is likely to be a financial intermediary) is set up by the public authority, a selection process for the financial intermediary by means of a procedure in accordance with Directive 2014/24/EU, as referred to in paragraph 84 of the draft guidelines as such may not be appropriate. It would be appropriate to provide here that where Directive 2014/24/EU applies or otherwise where management is outsourced *to a third party*, the award should be made using a procedure in accordance with the Directive or an equivalent competitive procedure. That would allow - or at least: make explicit when the Commission considers that it is already possible - the public authority itself to manage the fund. A parallel can be found here in provisions such as Article 55 or 56 of the GBER.
For those cases where management is awarded to a third party through a selection procedure, we suggest that the selection criteria mentioned above should be re-examined to take into account the possibility that the public sector investor may be the first investor in the fund. In that scenario, it would not be possible to compare the terms negotiated by the fund managers with those agreed with potential private investors at the point of selection of the fund manager.
An alternative approach to this issue might be to exclude a fund established and managed by the government from the concept of 'financial intermediary'.

8.
Paragraph 66 states that a risk financing measure can only be justified if it addresses the specific market failure or other relevant barrier identified in the ex ante assessment. The paragraph continues with a description of the circumstances in which this market failure might exist. It is not clear whether the intention here is that the existence of a market failure can be assumed in the circumstances set out, or whether specific market failures must nevertheless be demonstrated. If the latter is meant – and we assume this is the case – we suggest that the guidelines provide further guidance *on how* the market failure could be demonstrated and what the Commission would consider to be the minimum standard. This could also include the data on the basis of which the Commission is prepared to assume market failure. Should there be quantitative studies showing that the enterprises to be taken into account do not have access to risk financing? And how will the reference (group) be determined in that case? Here we see a tension between, on the one hand, the fact that the guidelines only deal with aid schemes (i.e. not ad hoc aid) and, on the other hand, the comment that the specific market failure has to be demonstrated.

For instance, in case SA.46308 (Germany - INVEST), the market failure for business angel investments seems to be demonstrated by comparing the share of business angels in investments in Germany with other countries (see paragraph 50 of the decision). However, if it is found that access to risk capital is a more general problem in the EU with regard to certain groups of SMEs and some types of mid-caps as the draft guidelines seem to do (see paragraph 53 and 66), such a comparison between countries may not demonstrate a market failure.

9.
It seems that the requirements for risk-financing measures involving financial instruments with a participation of private investors below the percentages provided for in the General Block Exemption Regulation have been tightened compared to the current guidelines. The current guidelines require a reasonable estimate of the targeted proportion of private investment, that is, the estimated potential to raise additional private funds through a portfolio or on the basis of individual transactions. The draft guidelines state (at points 62 and 95) that in this case the ex ante assessment must in addition contain a detailed assessment of the level and structure of the supply of private finance for the type of eligible company in the geographical area concerned and must demonstrate that the identified market failure or other relevant restraint cannot be tackled by measures for private participation as laid down in the General Block Exemption Regulation). We would welcome clarification as to whether the Commission intends to introduce a substantive change on this point and, if so, further explanation of the justification for this tightening.

10.
Paragraph 168 raises the issue of distortive effects at the level of financial intermediaries. While it is understandable that the problem of market power achieved with State aid should be avoided, it is not clear how the remark relates to the requirement that a financial intermediary should be selected by means of - in short - a tendering procedure. There is no basis in such a procedure for someone other than the most efficient intermediary to be selected, even if there is a risk that the winner could gain market power as a result. It would therefore be helpful for the Commission, in the guidelines, to consider more specifically how this problem might be avoided.

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