Balance of competences: Competition and Consumer Policy review

About the BVCA

The BVCA is the industry body and public policy advocate for the private equity and venture capital industry in the UK. The BVCA membership comprises over 230 private equity, mid-market and venture capital firms with an accumulated total of over £200 billion funds under management; as well as nearly 300 professional advisory firms, including legal, accounting, regulatory and tax advisers, corporate financiers, due diligence professionals, environmental advisers, transaction services providers, and placement agents. Additional members include international investors and funds-of-funds, secondary purchasers, university teams and academics and fellow national private equity and venture capital associations globally.

Executive Summary

State aid is an area of EU law that has a significant impact on the UK Venture Capital (VC) market. In particular, investment thresholds and criterion laid out in the General Block Exemption Regulation (GBER), Risk Capital Guidelines and "De Minimis" regulation provide the legal framework for determining how much finance can be allocated and distributed by the various schemes housed within the UK Business Bank, such as Enterprise Capital Funds (ECFs).

Unfortunately, this is not a legal apparatus that is conducive to swift decision making. Policymaking, particularly that which involves the provision of risk finance often runs up against the cumbersome application procedure for receiving approval for notified aid. It was therefore pleasing to see the European Commission launch in May 2012 a programme of "State Aid Modernisation" (SAM) to examine how, with the support of industry, bureaucracy and processing times could be cut in this area. It remains to be seen however whether this process will culminate in a real "step-change" in the manner in which cases are handled at national level, as well as how notifications to the European Commission are managed. If this were to be achieved, it would be fair to say that the relevant balance of competences between the UK and EU is generally appropriate.

However, the BVCA would still like to raise a few specific points, along with a more general observation, that we believe are worthy of attention. First, ensuring a level playing field for business activity across the single market is clearly of paramount importance, but standards must be applied in a consistent manner across each and every Member State to make this a reality. Guidance, such as that contained in the GBER for example should therefore be as precise as feasibly possible, and coherent with the Commission's own approach when handling notified cases.

Second, we remain concerned that the effectiveness of a potentially laudable initiative aimed at cutting red tape in SAM has been unnecessarily hampered by the Commission's desire to introduce new thresholds and limits on public investments into European VC. Although the recent direction of policy travel has been more encouraging, the process behind it has been somewhat haphazard, creating needless uncertainty.

Third, the European Commission's apparent desire to bring the notification of so-called "structural links" within its sphere of influence could add a significant administrative burden to VC funds seeking to acquire minority shareholdings in SMEs. This is a concerning development that could have a chilling effect on investment activity in Europe, and one the UK government should be aware of.

Finally, on a more general note, state aid rules should be more accommodating of the specificities of individual risk finance measures at Member State level. The fact that the very presence of *any* aid (irrespective of size) within domestic schemes necessitates the full application of state aid rules does not make sense. A more reasonable approach would be to measure the actual cost of state aid and differentiate between smaller subsidies (for example against interest rates) and more material incentives, perhaps allowing the former to fall outside the remit of EU competence altogether.

For the purposes of brevity, rather than answering each question in the consultation paper specifically we have limited our response to a broad appraisal of the current state of play as it affects UK VC.

State Aid Modernisation

The issue of bureaucracy with regards to state aid is a significant one for the BVCA, hence our interest in the SAM programme.

We were therefore very encouraged to see the European Commission highlight the following goals for reform:

1. Fostering growth in a strengthened, dynamic and competitive internal market
2. Focussing enforcement on cases with the biggest impact on the internal market
3. Streamlined rules and faster decisions

We will cover each of these points in turn.

- **Fostering growth in a strengthened, dynamic and competitive internal market**

Background

The UK VC market is one of the most mature in the world, but over the last decade investors have been moving away from seed and start-up deals to larger transactions. This is understandable behaviour given the high fixed costs that are inherent in VC investing; for example, a fund manager will want to perform extensive and thorough due diligence prior to any transaction going ahead, and for smaller amounts of capital the numbers often do not add up to warrant an investment taking place.

Unfortunately, this state of affairs is often to the detriment of small businesses whose need for equity finance can be especially pronounced, given they often do not have a sufficient credit score to secure bank loans. As recalled by the Parliament in its own-initiative report on long-term financing[1], commercial banks are the primary source of finance in the EU, providing over 75% of financial intermediation. If recourse to banks is limited, encouraging greater take-up of equity finance becomes all the more important. EU State Aid rules should foster this.

[1] Klinz W (2013) Draft Report on long-term financing of the European economy (2013/2175(INI) - http://www.europarl.europa.eu/sides/getDoc.do?type=COMPARL&reference=PE-519.604&format=PDF&language=EN&secondRef=01

Current state of play

The UK government is fully aware of the damaging effects of the "funding gap" for SMEs[2], particularly at a time of depressed bank lending (a trend confirmed by data from the Bank of England[3] as well as the Organisation for Economic Cooperation and Development[4]).

It is to their credit that considerable amounts of public money have been allocated to catalyse private investors to put capital to work in companies that otherwise would not have received funding.

Unfortunately, the European Commission has on occasion seen it fit to prohibit the UK from allocating the resources to SMEs it believes necessary. For example, as part of the 2011 Budget the Chancellor of the Exchequer announced that companies in receipt of investment via EIS and VCT would in future be able to receive a maximum of £10m per annum (the original limit was £1m per year)[5] from such initiatives.

Introducing this increased threshold would have had a significant impact on the provision of equity finance for SMEs, and contributed to a more diverse funding landscape, hence the Treasury's decision to approve it in the first instance.

A £10m annual threshold did exceed the limits set out in the Risk Capital Guidelines by the European Commission, but there is room for manoeuvre provided market failure can be demonstrated. The BVCA was in agreement that the introduction of a £10m annual threshold was warranted but the Commission disagreed and mandated that the maximum amount of finance a qualifying undertaking could receive through either EIS or VCT could not exceed £5m on per year[6].

When one considers that the original limit was set at £1m an increase of £4m was not an insignificant change for UK SMEs, and illustrated that the Commission was willing to adopt at least a degree of flexibility in this area, and to recognise that in fact the market failure was more significant than what was acknowledged previously[7].

However, as part of the SAM programme, the Commission re-opened the debate over investment thresholds under both a revised GBER and Risk Finance Guidelines (renamed due to the inclusion of debt as a qualifying financial instrument) with the latest proposals suggesting that the annual limit

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[2] Department for Business Innovation and Skills (2012) BIS Economics Paper No. 16 – SME Access to External Finance - https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/32263/12-539-sme-access-external-finance.pdf

[3]Bank of England (2012) Trends in Lending - http://www.bankofengland.co.uk/publications/Documents/other/monetary/trendsJuly12.pdf

[4] OECD (2013) Financing SMEs and Entrepreneurs 2013 – An OECD Scoreboard - http://www.oecd.org/cfe/smes/Scoreboard_2013_extract_chapter2.pdf

[5] HM Treasury (2011) Budget 2011 – pp. 52-53

[6] HMRC (2012) VCM12030 – EIS: income tax relief: general requirements: maximum amount raised annually through risk capital schemes requirement - http://www.hmrc.gov.uk/manuals/vcmmanual/vcm12030.htm. See European Commission, SA.33849 (2012/N) – United Kingdom.

[7] The latest draft General Block Exemption Regulation (published on 18 December 2013) refers to a EUR 15 million threshold, confirming the trend seen in the Commission decision on EIS and VCTs.

will be done away with in its entirety and replaced with an overall limit per eligible SME[8]. This is a slightly confusing state of affairs as it is difficult to see how the risk finance market has changed so significantly in the last 18 months to warrant such a move.

If the guidelines are amended as outlined above then the UK would have to alter its own investment limits (brought about by Budget 2011) in 2014[9] to comply with the new rules. On an objective basis, this appears quite a haphazard approach to policy making and one could that have significant and detrimental effects for UK SMEs. Although an increased overall investment threshold would cater for greater levels of start-up funding, a hard-and-fast limit as mooted could prevent qualifying undertakings receiving follow-on rounds of finance to push them into their next stage of business development, in particular in capital intensive sectors such as pharmaceuticals.

The BVCA would simply request that the Government, in close collaboration with officials at the Business Bank, re-examine this debate and decide whether a potential shift in the balance of competences between the EU and UK in this area is merited. In reality we would suggest expanding the limits contained in the draft GBER as much as feasibly possible, to ensure the UK government has maximum licence (within the spirit and letter of competition law) to pursue policy refined to the specificities of its home market . For a more detailed overview of the concerns of the private equity and venture capital community in this regard please refer to the response of the European Private Equity and Venture Capital Association (EVCA) to the first consultation on the GBER[10]. The BVCA stands ready to provide any additional information as and when required.

- **Focussing Merger control enforcement on cases with the biggest impact on the internal market**

The BVCA believes that cases which have the potential to generate the most pronounced anti-competitive effects should remain front and centre for the Commission when enforcing state aid rules.

Unfortunately, this rationale is not sufficiently in evidence upon first reading of the September 2013 consultation document: "Towards more effective EU merger control" (hereafter the "consultation"). Here, the Commission suggests extending the current Merger regulation so it is in a position to review non-controlling minority interests ("structural links") in businesses.

Two options are put forward:

> *Option 1*: "the notification system": this would extend the Commission's current system of ex-ante control of concentrations to "structural links" (non-controlling minority shareholdings). As a result, any acquisition of a qualifying structural link would have to be notified to the Commission in advance and could not be implemented before the Commission has approved it; and

[8] See the recast draft General Block Exemption Regulation (2013) and Risk Finance Guidelines (2013) – here and here respectively

[9] It appears likely that there will be a 6-month transition period, starting mid-2014, by the end of which the new Risk Finance Guidelines and new GBER would fully apply.

[10] EVCA (2013) Response to the Consultation on a draft General Block Exemption Regulation (the GBER) on state aid measures - http://www.evca.eu/WorkArea/downloadasset.aspx?id=7766

Option 2: the Commission would have discretion to select cases of structural links to investigate. Two possible variants of this option are proposed:

- "Self-assessment system": the parties to the transaction would be required to self-assess the creation of the structural link with applicable EU competition law, but the Commission could decide whether and when to open an ex poste investigation.
- "Transparency system": the parties to a "prima facie problematic structural link" would have to file a short information notice to the Commission. This notice would be published in order to make third parties and EU Member States aware of the transaction.

The BVCA is not aware of any evidence that suggests structural links produce serious anti-competitive effects, which begs the question why such an extension of the Merger Regulation is being proposed in the first place. Furthermore, both systems proposed by the consultation have the potential to generate significant cost and administration for VC firms acquiring minority stake holdings in qualifying undertakings. Inevitably, making the process of providing finance more expensive is likely to depress investment activity in Europe and stands counter to the Commission's express objective of focussing only on cases which have the biggest effect on the internal market. For more information please refer to the EVCA response to the consultation[11].

The UK should seek to highlight this inconsistency as it is damaging what is broadly an appropriate set of competences between national and supranational levels.

- **Streamlined rules and faster decisions**

It is imperative that this ambition is acted upon in the fullest possible manner.

The UK government notified the Commission of its decision to raise the annual investment thresholds under EIS and VCTs to £5m from £2m (following earlier engagement with the Commission that made clear that a £10m cap would not be palatable) , together with supporting evidence on July 21 2011. This was then announced in Budget 2012[12] before being given final approval by the European Commission on June 7 2012[13]. All told, the issue took best part of 15 months to be resolved.

Although this was an ultimately positive move, the interim period coincided with historic lows in lending from banks to new market entrants. [14]For example, according to the October 2011 edition of the Bank of England's "Trends in Lending" report:

"The stock of lending to UK businesses overall contracted in the three months to August, as did the stock of lending to small and medium-sized enterprises".[15]

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[11] EVCA (2013) "Response to the Consultation 'Towards more effective EU merger control' (HT. 3053)" - http://www.evca.eu/WorkArea/downloadasset.aspx?id=7840

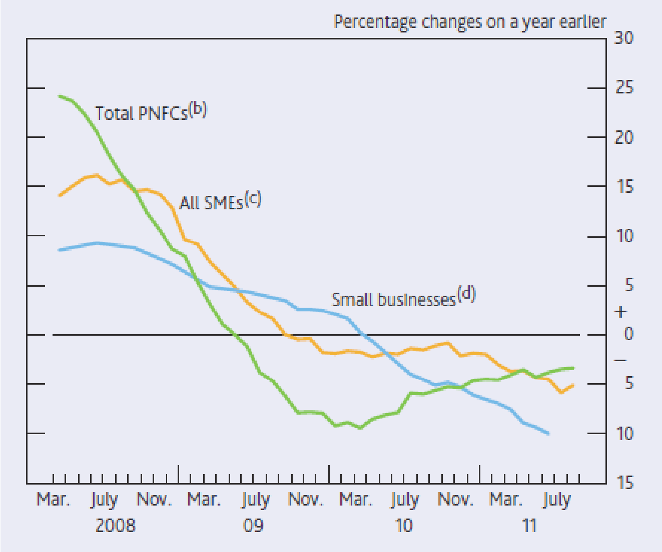
[12] HM Treasury (2012) Budget 2012, p. 59 - http://webarchive.nationalarchives.gov.uk/20130129110402/http://cdn.hm-treasury.gov.uk/budget2012_complete.pdf

[13] Goodall A (2012) New EIS and VCT limits receive state aid approval, Tax Journal - http://www.taxjournal.com/tj/articles/new-eis-and-vct-limits-receive-state-aid-approval-47821

[14]

This is further illustrated by the chart contained in Figure 1.

Figure 1 (right) Lending to Small and Medium Sized Enterprises[16]



Granted the circumstances were unprecedented but it is not difficult to foresee a scenario emerging in future where further delays to clearance needlessly hamper broader economic growth in the country.

The BVCA appreciates that when authorising the provision of state aid to risk finance measures, the presence of market failure must be demonstrated. Unfortunately, the task of illustrating this is very difficult.

For example, the list of criterion contained within the latest iteration of the Risk Finance Guidelines provides a case in point, as they are somewhat "academic" in scope; an appropriate aid measure must satisfy each of the following criteria:

- Contribution to a well-defined objective of common interest
- Need for state intervention
- Appropriateness of the aid measure
- Incentive effect
- Proportionality of aid (aid limited to the minimum)
- Avoidance of undue negative effects on competition and trade between Member States
- Transparency of aid

Although the guidelines contain supplementary information and caveats, the general nature of each of these points renders it difficult in practice to design aid measures that very clearly fulfil every criterion. As such, it is necessary for the Commission to conduct its own analysis which can often (as we have seen) take many months thus delaying the delivery of aid.

This is an area in which the balance of competences between the EU and the UK could be improved. By specifying more clearly exactly what is required of an aid measure that potentially exceeds the thresholds specified under the GBER but could still achieve clearance subject to the presence of market failure, a significant amount of time and effort could be saved on the part of the European Commission and the national authorities involved.

Indeed this is a trend that is already crystallising in the Commission's own work.

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[15] Bank of England (2011) Trends in Lending October 2011 - http://www.bankofengland.co.uk/publications/Documents/other/monetary/TrendsOctober11.pdf
[16] Ibid, p. 7

For example, the explanatory memorandum of the November 2013 “Draft Guidelines on state aid for rescuing and restructuring non financial undertakings in difficulty” highlights the following:

> “The current definition of "undertaking in difficulty" contains both so-called "hard" (objective) criteria and "soft" criteria which require a broader and more subjective assessment of the undertaking's situation. To improve clarity and legal certainty, the draft guidelines aim to shift the emphasis from soft to hard criteria, making it easier for granting authorities and potential aid beneficiaries to determine whether a given undertaking is in difficulty.”[17]

Although there are differences in terms of scope, a similar shift in the context of risk finance may help reduce processing times.

As sole arbiter of State aid concerns, the Commission should still have the right to oversee and enforce treaty provisions, but as the principal architects of policy in this area, Member States will typically have carried out a cost / benefit analysis of a prospective scheme. Unfortunately, anecdotal evidence suggests faith in national competition authorities is not particularly high. This is of course a problem and would need arresting before any slight reallocation of competences in this area could be countenanced.

[17] European Commission (2013) Explanatory Note - Draft guidelines on State aid for rescuing and restructuring non-financial undertakings in difficulty - http://ec.europa.eu/competition/consultations/2013_state_aid_rescue_restructuring/explanatory_note_en.pdf