International
Capital
Market
Association Ltd

ICMA

25 September 2007

European Commission
Directorate-General for Competition
State Aid Registry
HT 920

Dear Sir/Madam

Draft revised Commission Notice on the application of Articles 87 and 88 of the EC Treaty to State aid in the form of guarantees

The International Capital Market Association (**ICMA**) is pleased to comment on the Draft revised Commission Notice on the application of Articles 87 and 88 of the EC Treaty to State aid in the form of guarantees (the **Draft Notice**).

ICMA is the self-regulatory organisation and trade association representing investment banks and securities firms issuing and trading in the international capital markets worldwide. ICMA's members are located in some 50 countries across the globe, including all the world's main financial centres, and currently number over 400 firms.

Our response is based on extensive consultations with our member firms and their legal counsel.

We attach our comments as **Annex 1** to this letter and would be pleased to discuss them with you at your convenience. We also attach an extract from the letter which we sent you on this subject on 12 January 2007 as **Annex 2**.

Yours faithfully,

Ondrej Petr

Ondrej Petr
Regulatory Policy – Primary Markets
+44 (0)207 510 2709
ondrej.petr@icmagroup.org

ANNEX 1
COMMENTS ON THE DRAFT NOTICE

Background

We recognise the importance of transparent guidance on the application by the Commission of the EC state aid regime to state guarantees and the need to revise the existing notice 2000/C 71/07. We welcome the opportunity to comment on the Draft Notice.

In this response, we focus on state guarantees which support borrower's obligations under bonds or similar instruments. These are debt securities issued by the borrower (in this context also called the **issuer**), with the assistance of the banks arranging the issue, to a multitude of investors and traded in international capital markets. Such bonds constitute an important segment of the markets and it is vital that the application of the state aid regime does not give rise to unforeseen risks to the investors, issuers or the banks arranging the issues and the stability and efficiency of the capital markets.

In January, we submitted to the Commission a letter (the **January Letter**) in which we outlined our general concerns regarding the application of the EC state aid regime to guarantees of obligations under bonds. We identified the mismatch between the allocation of risks and mitigating tools between the public and the private operators involved as the main source of difficulties and suggested a potential way to address it. We do not know whether the Commission staff has had the opportunity to review the January Letter. We continue to believe, however, that the position set out in the January Letter merits your attention although we understand that some of our proposals would require some changes in approach to the application of the EC state aid regime in this area. Under "General comments", we therefore first summarise our key concerns described in more detail in the January Letter.

We have now had the opportunity to review the Draft Notice. Under "Specific comments", we list several topics, additional to those addressed in the January Letter, which we believe will require consideration in the further discussions of the Draft Notice.

General comments

<u>Inefficient allocation of risks between public and private operators</u>

As we explained in the January Letter, invalidity or unenforceability of a state guarantee resulting from its non-compliance with the EC state aid regime can have dramatic impact on the issuer, investors, banks arranging the issue and the capital markets generally.

As a standard procedure, the banks arranging the issue therefore seek to ensure that the state guarantee is in compliance with the EC state aid regime. Where, however, the legal analysis is for any reason not conclusive and the relevant Member State is unwilling to seek formal (or informal) comfort from the Commission, the private operators run out of options to ensure this compliance. In other words, while they are expected to ensure the compliance and motivated to do so by bearing the risk of non-compliance, they are unable to obtain clearance by the Commission when there is uncertainty about the compliance.

On the other hand, the public operators, who usually benefit from the transaction subject to the state guarantee, do have the tool to obtain the clearance from the Commission. Often, however, they are not motivated to use it because, if the state guarantee proves to be illegal, they do not bear any risk and they may even actually benefit from the invalidity of the guarantee.

Solution proposed in January Letter

Any solution to this problem needs to strike a proper balance between the principles of the EC state aid regime (namely the requirement that no illegal state aid be provided and that which is provided be recovered) and the principles of the single EC securities market (namely the importance of systemic stability of the markets and protection of investors) as well as the general principles of legal certainty and legitimate expectations. It also needs to align the tools available to the public and private operators with the risks borne by them.

As we proposed in the January Letter, the private operators, if they have concerns about the compliance of a particular state guarantee with the state aid regime, should be able to request an "opinion" from the Member State concerned that the state guarantee is, in view of the Member State, in compliance with the state aid regime. If the Member State provided such an "opinion" or if it refused to act on the request, the risk would shift from the investors to the Member State.

This means that if the state guarantee was subsequently found by the Commission or a national court to be illegal state aid, it would still be valid and enforceable by the investors against the guarantor. The illegality would therefore primarily affect only the borrower and the Member State concerned.

We would like to emphasise that we do not seek absolute protection of all lenders from the illegality of a state guarantee in all circumstances.

Additional observations on January Letter

Clearly, if the proposals in the January Letter were to be adopted, safeguards would need to be put in place ensuring that the Commission is made aware of any "opinion" provided by a Member State so that it can take action where necessary. Such an "opinion" could, for example, be required to be copied to the Commission.

The proposals in the January Letter are based on the principle that a lender who has (broadly speaking and, in case of bonds, through the arranging banks) taken all reasonable steps to ensure compliance of the state guarantee with the EC state regime should not be penalised if the state guarantee is nevertheless found to be illegal state aid. We would be happy to explore with the Commission other possible solutions based on this principle.

The discussion will need to include situations where a state guarantee which is lawful at the time it is provided becomes illegal subsequently. This may happen, for example, where the guarantee does not constitute state aid because a full market price is paid, but the Member State concerned subsequently waives the premium payable, or where the state guarantee is approved by the Commission but the borrower or the Member State concerned fail to meet any conditions imposed by the Commission. There appears to be no justifiable policy reason why the lenders should bear the risk in such circumstances.

The recent market turbulences clearly illustrate the risk of "contamination" of securities markets mentioned in the January Letter, where problems affecting a small number of products lead to overall loss of confidence and widespread market disruptions. We would strongly urge the Commission not to adopt an approach which, by creating legal uncertainty or by being difficult to apply in practice, potentially undermines market stability in this manner.

Specific comments

State guarantee as aid to lender (2.3.2 of Draft Notice}

This provision of the Draft Notice significantly expands the possibility that a state guarantee might be considered aid to the lender. We are concerned by the lack of detail of this formulation and the legal uncertainty it is likely to give rise to. We suggest that the Draft Notice is revised to include more detailed guidance on the application of this principle.

We would also encourage the Commission to clarify the meaning of *"[the state guarantees being] made available through the whole financial sector"*. Concerns have been expressed that this formulation may require the parties involved to resort to competitive tendering in accordance with EC public procurement rules. Such an interpretation would be inconsistent with established market practices which usually follow a two-stage process:

- In the first stage, the issuer engages a financial advisor to assist in identifying the optimal parameters of the bond issue. No state guarantee is provided at this stage.

- In the second stage, the issuer selects and "mandates" a financial institution which offers to arrange the bond issue on the most suitable terms. It is the arranging bank and not the lenders (investors) who is so selected. The process is normally a competitive tender (the market being very competitive, it is in the issuer's interest to select from among several financial institutions) but is rarely subject to the full EC public procurement rules. These currently exclude "*financial services in connection with the issue, sale, purchase, or transfer of securities or other financial instruments*" from its scope – see footnote 4 in Annex IIA of the Directive 2004/18/EC. In addition, it is the entire product (for example a guaranteed bond with the hedging and other ancillary arrangements) which is put out to the competitive tender and not the guarantee or any other of its components separately.

It is currently unclear whether this practice would pass the test of the Draft Notice. We believe that it should be acceptable and that the Draft Notice should make it clear.

Pan-European approach to impact of illegality of state guarantee on lender (Footnote 5 of Draft Notice)

The proposals in the January Letter were largely the product of the current uncertainty about the impact of illegality of a state guarantee on lenders. At present, there is no clear guidance by the Commission or the European Court of Justice and the approach taken by the various Member States is inconsistent.

As mentioned, we strongly support a solution based on the principle that a lender who has taken all reasonable steps to ensure compliance of the state guarantee with the EC state regime should not be penalised if the state guarantee is found to be illegal. It is, however, equally important that whatever approach is eventually taken, it applies in a consistent manner across the EU. It cannot, therefore, be left to the laws of the Member States but needs to be set out in the Draft Notice or another EU instrument.

We are concerned to see that the Draft Notice not only does not change the substantive approach of the existing notice 2000/C 71/07 to this crucial issue but it also addresses it very briefly in a mere footnote.

State guarantee to be for a fixed maximum amount (3.2(b) of Draft Notice)

In principle, we understand the reason for the suggestion that a state guarantee must be "for a fixed maximum amount" – the need to prevent Member States from granting "open-ended", unlimited guarantees. The requirement for a fixed maximum amount in its current form is, however, technically impossible to comply with in practice in relation to bonds (and, we suspect, in relation to other forms of borrowings as well).

Even on a simple "floating rate" bond, the rate of interest paid by the issuer will be periodically re-set in line with market interest rates. It is clearly impossible to predict these in advance. In practice, the return on the bonds may be calculated in even more complex manners, being linked for example to the rate of inflation or changes to another index. Sometimes, the principal to be repaid may also be similarly readjusted. The guarantee will usually also cover default interest, the amount of which will depend on the length of time the issuer is in default before the guarantor pays, or charges for early repayment. It will similarly cover the hedging arrangements which are in place on almost all bond issues to protect the issuer from interest rate or exchange rate volatilities and the value of which can only be estimated in advance. In practice, investors expect all of these payments to be covered by the guarantee, just as they would be in case of a bond guaranteed by a private operator.

We are aware of several instances where the Commission has approved state guarantees of indefinite amounts where a guarantee fee/insurance premium has been calculated on a commercial basis.[1] We believe that the Commission should build on this experience and provide, in the final Notice, for indefinite amount guarantees in exceptional circumstances provided that the initial amount of the principal guaranteed is known and all other amounts (such as those under hedging arrangements) relate to that principal or the fees of parties involved.

There are many possible ways in which this principle could be expressed. When interpreted properly, it would seem that the requirement for the state guarantee to be "*linked to a specific financial transaction*" should be sufficient to ensure that it is "*properly measured when it is granted*". We would be happy to explore with the Commission the various possible approaches.

80% coverage limit of the state guarantee (3.2(c) of Draft Notice)

We note that the Draft Notice does not adopt the exemption for "*bonds and similar instruments*" from the "80% limit" rule which appears in the existing notice 2000/C 71/07. We believe that this change of approach, not explained in the Draft Notice, should be reconsidered as it would, in our view, be prejudicial to the markets as well as unnecessary from the policy perspective.

In practice, the issuers currently concerned normally issue bonds subject to a full 100% state guarantee cover. Under the Draft Notice, this would no longer be possible unless the Member State concerned applied for and received the approval by the Commission for each such issue.

It should be noted that if every bond issue subject to a full 100% state guarantee cover was to be notified to the Commission, the resulting number of notifications would significantly strain Commission's resources, further extending the current length of the approval process.

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[1] For example the Commission decisions on the hedging guarantee for the Channel Tunnel Rail Link in 2002 and 2003.

The new approach, based on a partial guarantee cover, would significantly alter the investors` views of such issues which are currently viewed, bought and traded as equivalents to the credit of the relevant Member States. Investor demand for partially guaranteed bonds would be significantly lower than their current demand for fully guaranteed ones which would need to be counterbalanced by a higher rate of return payable by the issuer.

Equivalent bonds issued by the same issuers in the past with a full guarantee cover and those newly issued with a partial one would not be "fungible" – the same. This would reduce the liquidity of such bonds, further increasing the costs of financing to the issuer and cost of trading to the investors.

We are also not certain whether the proposed principles of the 80% limit following the decreasing amount of the outstanding borrowing and of the lender and guarantor sharing any losses proportionally would in all cases work in practice.

More generally, we question whether the limit is justifiable by policy considerations in the first place.

Investors in bonds do not participate in structuring and documenting of the transaction and have limited possibilities to intervene in the business affairs of the issuer. The limited un-guaranteed exposure is therefore unlikely to have a major impact on the transaction.

In the context of bond issues, the limit is also not necessary to ensure that the transaction is not unfairly prejudicial to any of the parties involved. Its terms and conditions, including any risks, will be detailed in a comprehensive offer document which will be made available to the investors and usually also to the public at large. The interest rate will be set at the market level to reflect all the relevant information about the transaction, the issuer the guarantor and the market conditions. The guarantor will be compensated by a premium which will usually reflect market rates. It would seem that expositing the investors to more risk does not add any additional protection.

Finally, this approach would effectively operate in a discriminatory way, preventing a Member State (or another public body) from doing (where appropriate) what is commonly done by private operators, namely parent companies, commercial banks or, monoline insurers, unless the State has prior consent from the Commission.

We therefore believe that the exemption for "*bonds and similar instruments*" in the existing notice 2000/C 71/07 is based on sound considerations and that it should be retained.

<u>Transitional provisions (7 of Draft Notice)</u>

The Draft Notice, when finalised, is likely to differ from the existing notice 2000/C 71/07 in a number of important aspects. A number of state guarantees, assessed by market participants as not requiring a Commission approval under the existing notice 2000/C 71/07 which might be assessed differently under the finalised Draft Notice are likely to continue under the new regime.

In accordance with the principles of predictability, legal certainty[2] and unacceptability of retroactive application of legal obligations, the Draft Notice should confirm that it does not apply to state guarantees granted prior to its publication. We are concerned at the

[2] We note that legal certainty is interpreted to be one of the "*general principles of the Community law*" recognised by Article 14 of the Council Regulation (EC) No. 659/1999.

suggestion that the Member States would be required to revisit existing guarantee measures.

Statutory state guarantees

We note that the Draft Notice does not discuss "statutory" state guarantees, arrangements where under general law or its by-laws, an entity benefits from a state guarantee or is protected from insolvency proceedings. It is unclear how the principles set out in the Draft Notice would apply to such entities.

Requirements for a fixed maximum amount or for a 80% coverage limit, for example, would appear impossible to comply with unless the relevant law or by-laws were adapted. This would effectively preclude such entities from issuing any bonds (and presumably from other borrowings) in the meantime. If, on the contrary, such entities were to be treated differently from other entities issuing bonds subject to a state guarantee, the question of discrimination of private operators and compliance of such a situation with the Treaty Article 295 would inevitably arise.

Whichever approach is taken to such entities, its consequences are so important that they should be clearly spelt out in the Draft Notice.

Need for inter-institutional consultations

With the risk of stating the obvious, we would like to highlight that, as far as state guarantees of obligations under bonds are concerned, the discussion about the Draft Notice involves a number of other considerations for which other DGs of the Commission or other European institutions are responsible. These include namely operation of the single securities market, investor protection, systemic stability or criteria which an instrument must satisfy to become or continue to be eligible as collateral for Eurosystem operations. The need for balancing of the various considerations and co-ordinated approach by the agencies involved cannot therefore be overstated.

Concluding observations

To conclude, the securities markets require stability, predictability, transparency, legal certainty and recognition of legitimate market practices. We encourage the Commission to take these considerations into account when finalising the Draft Notice. We would be happy to provide the Commission with further information on the way in which the capital markets operate in this area and the potential implications of the Draft Notice.

ANNEX 2
EXCTRACT FROM THE JANUARY LETTER

Background

European securities market

Over the last decade, the European Community (**EC**), its Member States and market participants have been working together to create a single European securities market. It is a widely accepted preposition that an efficient, liquid, transparent and integrated securities market contributes to a genuine single EC market in the wider sense, economic growth and job creation by better allocating investment capital and reducing financing costs. Systemic stability of the market and protection of investors are among they key concerns within this new framework.

Debt securities

Debt capital markets are an important segment of the securities market. There, borrowers (**issuers**) issue debt securities (**bonds**) to a multitude of lenders (**investors**) who may be financial institutions, retail investors or both. The issue is normally conducted by one or more investment firms (**arranging banks**) who help the issuer structure and document the issue, find the investors and market the bonds. Investors are not involved in structuring the issue but they are provided with a prospectus – a comprehensive and up-to-date information set on the issue, the issuer and the associated risks.

The bonds are freely tradeable. While some of the investors hold them to their maturity, others may – and often do - choose to sell them. This means that the composition of the investors changes over time. The bonds are traded for a fluctuating price which reflects primarily the creditworthiness of the issuer (usually summarised in a rating from an independent rating agency), prevailing market interest rates and other factors. Investors purchasing the bonds on these secondary markets are unlikely to be familiar with the circumstances under which the bonds were issued and are not provided with any similar comprehensive information document.

The bonds are also capable of being used for other purposes, in particular as collateral against a loan. Collateral transactions are not only frequent in commercial dealings but they also underpin monetary policy operations of central banks, including the European Central Bank.

Guarantee of issuer’s liability under bonds

An entity with a better creditworthiness and rating than the issuer may agree to guarantee the liability of the issuer under the bonds. Such a guarantee reduces the credit risk of holding the bonds and consequently makes the bonds more attractive to investors. Reflecting the reduced risk, the return on the bonds may be lower, which in turn reduces the cost of the borrowing to the issuer.

There is a wide variety of forms which a “guarantee” may take. It may be based on statute, administrative regulation/decision or contract. It may be a “direct” guarantee in the strict legal meaning of the term, or an “indirect” guarantee, a legally different arrangement which nevertheless has the economic effect of a guarantee. The guarantee may be in place already before the bonds are issued (for all or some obligations of the issuer generally) or it may be provided only for the purpose of the particular issue.

State aid aspects of guarantee

For various reasons, the issuer's obligations under the bonds may be guaranteed by a public sector entity. A non-comprehensive review we have conducted suggests that the total amount of bonds with a state guarantee which are outstanding in international capital markets is currently at least 300 billion Euro.[3]

We explain below how in such cases the issuer and arranging banks strive to ensure that the EC state aid regime is complied with and what the practical limits of these efforts are. In this process, the Notice has proved a very helpful guidance. From the viewpoint of arranging banks and investors, however, its application is not without difficulties.

Allocation of state guarantee risk between the parties involved

Nature of state guarantee risk

State guarantee risk is one of the legal risks of a bond issue, i.e., the risks that some aspect of the issue might be in conflict with the applicable law.

In particular, it is the risk that the guarantee is not valid and enforceable by the investors against the guarantor at the time of its issue or that it ceases to be valid and enforceable subsequently (e.g., if the issuer breaches any of the conditions imposed by the Commission in the approval of the guarantee), in both cases because of its incompatibility with the EC state aid regime. If such a risk (**guarantee failure risk**) materialises:

- The obligation of the issuer under the bonds ceases to be supported by an obligation of the guarantor and the credit risk of the investors increases accordingly.

- The rating of the bonds falls, possibly to non-investment grade.

- The price of the bonds falls.

- Various contractual protection mechanisms may be triggered, e.g., the right of the investors to have the bonds repaid early or indemnity claims against the issuer by arranging banks.

These consequences have a substantial adverse impact on the issuer, investors and arranging banks which was not anticipated when the bonds were issued or purchased by an investor.

Even the mere existence of an uncertainty about compliance of a guarantee with the EC state aid regime (**guarantee uncertainty risk**) may mean that the position of the issuer, arranging banks and the investors is affected. In particular:

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[3] 302,027.8 million Euro as of 1 December 2006. The figure is based on the data available to ICMA in its database of, broadly speaking, international bond issues arranged by investment firms (EU-based or foreign) operating from London. This database enables us to identify issues with a "direct" guarantee by a Member State. In reality, there are a number of other issues effectively supported by an "indirect" public sector guarantee. The figure above contains several such issues which have been identified by our members during the discussions over this letter. We have reason to believe, however, that the actual number of issues with "indirect" public sector guarantees and consequently the total amount of outstanding bonds is considerably higher than the figure above. The figure above is therefore a minimum figure, rather than actual estimate. The figure above includes all issues with a state guarantee we have identified, without suggesting that there is a problem with compliance with the EC state aid regime in case of any of these issues.

- The bonds are riskier and possibly less attractive to the investors than they otherwise would have been.

- The risk may be reflected in the terms of the issue, for example the total amount borrowed may be lower, interest payable by the issuer higher and terms of the issue stricter than they otherwise would have been.

Position of private parties

Investors, arranging banks and the issuers are substantially affected by the state guarantee risk:

- If the guarantee fails, the value of investors` investment is reduced and their risk of holding the bonds increases.

- The obligation to repay the bonds early or make other payments in connection with the guarantee failure will usually adversely affect the issuer's financial position and may even bring it into insolvency. It should be remembered that the guarantee is normally provided exactly because the issuer itself is not expected to be in the position to repay the bonds in all circumstances.

- If the issuer enters insolvency, the investors have no recourse to the assets of the (solvent) guarantor and (contrary to their initial expectations) become only general unsecured creditors of the (insolvent) issuer. This in practice implies a very low recovery rate.

- Some investors may be forced to divest of the bonds, incurring loss. This may be, e.g., because their investment policy allows them to only hold investments above certain rating or because they need to comply with capital adequacy requirements and would have to provision extra capital against non-guaranteed bonds or bonds with lower rating.

- Some investors may have to terminate their collateral transactions or provide additional collateral to support them, incurring loss.

- The issuers obtain financing on worse terms than might have been the case or lose the opportunity to access international capital markets in the future on favourable terms or at all.

- The arranging banks may be, with the benefit of hindsight, blamed for not remedying or not properly disclosing the risk of non-compliance with the EC state aid regime.

Other private parties may be affected as well. A good example would be the institutions who have accepted the bonds as collateral – private financial institutions or central banks. If the price of the bonds falls, their value will not cover the amount of the secured claim, increasing their credit risk against the counterparty to the collateral transaction.

Failure of the guarantee, however, does not only affect the investors holding the affected bonds, their issuer and the banks who have arranged the issue, but also the market as a whole:

- Failure of the guarantee of one or two bond issues would inevitably decrease market confidence in all the outstanding issues with a state guarantee and state aid elements, whether there was a rational reason for that or not, with similar consequences as if those issues themselves lost a state guarantee. The investors and other participants across a whole segment of the securities markets would be adversely affected. In the past, for example, defaults by Russian issuers during the 1998 crisis depressed prices of bonds of all (non-defaulted) emerging market issuers. On a more relevant note, when in the 1980`s UK courts found that certain derivative contracts entered into by UK municipalities were invalid because the municipalities did not have the capacity to enter into them, the entire derivatives market was affected.

- Market disruptions would be exacerbated in case the benefits of a state guarantee would be lost to a particularly large issue.[4]

Aware of these risks, arranging banks seek to address them (together with other legal risks). Their legal counsel is expected to review the facts of the case and (any concerns having been addressed) issue a legal opinion to this effect. Any residual legal risk is expected to be disclosed to the investors in the prospectus.

In this respect, the market practice fully meets the expectations expressed by the Commission in the Notice. The arranging banks and investors therefore play an important role in ensuring compliance with the EC state aid rules.

These efforts, however, do not in practice ensure that the risk can be fully addressed. This is due to a combination of several factors:

- Lack of clarity about some aspects of state guarantees. The Notice does not provide sufficiently detailed guidance on some important aspects of state guarantees, in particular on the calculation of the premium or application of par. 4.4 of the Notice. In this letter, we do not elaborate in detail on the aspects of the Notice which could be improved but would be happy to discuss them with you at your convenience.

- Frequent unwillingness of Member States to comply with the request of the issuer to seek formal or informal comfort from the Commission regarding a particular state guarantee if there are doubts about its compliance with state aid rules. This means that the investors and arranging banks not only do not have the right to address a formal notification to the Commission directly but they also practically cannot approach the Commission on an informal basis.

- Frequent uneasiness of the issuers, the guarantors and (where involved) the Member States about disclosure of the state guarantee risk in the prospectus. This may be motivated by the perception that the risk is highly theoretical (and therefore immaterial) or its disclosure commercially sensitive.

- Lack of clarity about the effect of possible illegality of the guarantee on the position of the investors. The Notice recognises that illegality of a state guarantee (whether determined by the Commission or a national court) affects not only the issuer but also the investors. The determination of precise consequences, however, is left to national law. In addition to the guarantee failure described above, the issuer may also be ordered to repay the state aid. The absence of guidance in the Notice is coupled with unhelpful case-law on both the EC and Member States` level and a lack of detail in some negative Commission decisions which often only order suspension of the state guarantee in question without giving further directions regarding the

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[4] Out of 49 (EEA, not solely EU) issuers within the scope of the state guarantee regime identified within the ICMA database, there are 11 issuers with issues with a total outstanding amount between 1 and 5 billion Euro, 5 issuers with issues with a total outstanding amount between 5 and 10 billion Euro and 3 issuers with issues with a total outstanding amount above 10 billion Euro. The total outstanding amount of the issues by the largest issuer on the list is more than 197 billion Euro (we understand, however, that the state guarantee supporting this particular issuer is undoubtedly in compliance with the EC state aid regime).

implementation of the order and sometimes merely declare illegality of the state guarantee without ordering suspension or recovery.

In practice, therefore, the assumption in the Notice that the arranging banks will play the role of “gatekeepers”, effectively ensuring compliance of state guarantees with the EC state aid regime on behalf of the EC, is an incomplete response to the issue.

Position of public sector

Under the EC Treaty, the Member State concerned is responsible for ensuring compliance with the EC state aid regime. Only Member States have the right to notify the state guarantee to the Commission with a view of obtaining its formal clearance and the respective decision of the Commission is only addressed to the Member State concerned. In practice, however, Member States are often unwilling to meet this obligation. This may be motivated by a desire to avoid Commission interference or simply to avoid a delay to a particular project.

The Member State in question has no real incentive to notify because the immediate risks associated with the state guarantee being or becoming illegal are borne by the private sector as described above. With a certain degree of simplification, it could be argued that the Member State actually benefits from breach of the EC state aid rules and the guarantee failure: It achieves the purpose of the state guarantee (obtaining financing for a particular purpose which would otherwise probably have to be provided from public funds) and, at the same time, it - in effect - reserves the option to avoid the payment under the guarantee - which the investors who had provided the financing relied on - with reference to its incompatibility with the EC state aid rules. The approach differs among the Member States but it is clear that Member States most inclined to provide illegal state guarantees benefit the most from this situation.

Whether the (former) guarantor could be required to compensate the investors on other legal grounds depends on the applicable national law. To our knowledge, general private law of a number of Member States appears to exclude this possibility. It would in any case be questionable on the state aid grounds (its objective being to preserve the validity of an illegal state guarantee).

Summary of current situation

We believe that there is, at least in relation to “difficult” state guarantees, a gap between the policy objectives, allocation of risks and the risk-mitigation tools.

Private operators (in practice arranging banks because investors are not involved in structuring the issue) are expected to ensure compliance of a transaction with the EC state aid regime. To motivate them to do so, the arranging banks and the investors bear the risk of non-compliance. At the same time, however, they are unable to obtain formal or informal clearance of the transaction when there is uncertainty about the compliance.

Public operators, which usually benefit from the transaction, do have the tool to obtain the clearance from the Commission but are not motivated to use it because, if the guarantee proves to be illegal, they do not bear any risk or they even actually benefit from the guarantee failure.

If the risk cannot be meaningfully addressed by the private operators, it is unrealistic to expect that only transactions with no risk will proceed. Quite to the contrary, the reality of commercial transactions is such that a number of transactions involving “difficult” state guarantees will be brought to the market. The debt securities market, or at least its important segment, will consequently be “contaminated” with issues which are capable of causing the widespread disruptions described above.

Proposed solution

Sharing of risks and responsibilities

The solution to this most unwelcome situation must, in our view, involve better alignment of the policy objectives, allocation of risks and the risk-mitigation tools.

In practice, the arranging banks will make every effort to address the legal risks of the bond issue for the benefit of the investors. The private operators accept that, under the Notice, they should play a role in effectively policing the compliance of the Member States (which have the obligation under the EC Treaty) with the EC state aid regime and bear the risk if they fail to do so. It would, however, be fair and appropriate if the private operators were given the right tools to be able to fulfil this “policing” role efficiently.

We would propose that, if the issuer (in practice the arranging banks) has justified concerns about the compliance of the state guarantee with the state aid regime, it has the right to request an opinion[5] from the Member State concerned that the state guarantee is, in view of the Member State, in compliance with the EC state aid regime.[6]

The Member State could provide such an opinion with or without first obtaining the Commission notification. If the Member State provided such an opinion or if it refused to act on the request, the state guarantee risk would shift from the investors to the Member State.

This means that if the state guarantee was subsequently found by the Commission or a national court to be illegal state aid, it would still be valid and enforceable by the investors against the guarantor. The illegality would therefore primarily affect only the Member State concerned, who would be held responsible for the breach of the EC Treaty obligations.

Under such an arrangement, arranging banks would find it more meaningful to investigate the compliance of the guarantee with the state aid regime because they would not only be able to identify the risk but also to actually deal with it. In addition, the Member State would be better motivated to address the state aid concerns because it would bear a (financial) risk if it did not utilise the tools it has at its disposal. This solution is also consistent with the current trend of providing Member States with more powers and responsibilities in enforcement of the EC competition rules. It could be expected that Member States would provide the opinions without notifying the Commission if the particular state guarantee was clearly compliant with the EC state aid regime in light of the Commission’s guidance and case-law and notify when in doubt.

[5] We do not comment on the precise form the “opinion” should take. In practice, it would clearly be some sort of an administrative decision or certificate. We use the term “opinion” only to emphasise the fact that its issuance does not affect the right of the European Commission to make a substantive decision on the compliance or non-compliance of the particular state guarantee with the EC state aid regime.

[6] We would suggest that, within the framework of any Commission guidance, the Member States are able to create the legal framework for provision of such opinions which would correspond with their overall legal and administrative system and market environment. In some Member States, for example, debt issues are often made off programmes. This means that the national securities markets regulator approves a framework (base) prospectus on the basis of which the issuer makes individual issues suitable in the given market environment. It would clearly be impossible to expect an administrative authority to give an opinion on a particular issue under a programme within the few days or even hours it takes to launch such an issue. In such Member States, an opinion on the entire programme could be provided in advance.

We believe that the proposed arrangement strikes the proper balance between, on one hand, the principles of the EC state aid regime (namely the requirement that no illegal state aid is provided and that which is provided is recovered) and, on the other hand, the principles of the single EC securities market (namely the importance of systemic stability of the markets and protection of investors) as well as the general principles of legal certainty and legitimate expectations.

To further motivate the Member States and ease the burden on the Commission, the Commission should encourage private actions for damages against Member States who have provided or tolerated illegal state guarantees and indicate that it would not hesitate to impose fines on such Member States.

Additional and alternative solutions

The proposed solution could helpfully be complemented with other measures, in particular:

- Clarification of certain aspects of the Notice. If the Commission clarified certain aspects of the Notice, in particular those mentioned above, the scope of “difficult” state guarantees could be significantly reduced.

- Speeding up the notification procedure for state guarantees. If the notification of the state guarantee would be handled speedily, the Member States might be more easily convinced to seek clearance of a state guarantee. To this effect, we would suggest the adoption of specific notification forms for state guarantees and/or an accelerated procedure for their review.

Even by themselves, these measures would be helpful. They would not, however, fully address the risks described in this letter.

As an alternative to the proposed solution with broadly the same effect, the issuer could be granted the right to formally notify the state guarantee to the Commission or (newly) the national competition authority to obtain its formal clearance. Either of these two solutions, however, would in our view require much more wide-ranging modifications to the existing EC state aid regime and we therefore find them less desirable.