Risk Capital as State Aid: Revising the Commission's Market Failure Approach

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I. Introduction

Risk capital is a broad concept that includes a growing number of types of investment. In the EU legal order, it has been defined as *"equity and quasi-equity financing to companies during their early-growth stages (seed, start-up and expansion phases), including informal investment by business angels, venture capital and alternative stock markets specialised in SMEs including high-growth companies (hereafter referred to as investment vehicles)"*[1].

For over a decade, the European Union has understood that the reduced level of risk capital investment in Europe was placing its economy at a significant disadvantage in relation, in particular, to the United States and Japan.[2] Thus, in the general framework of strategies to promote employment in the EU, it set out to encourage these types of investments, namely by eliminating barriers that prevented the creation of a functioning and effective internal market for risk capital[3].

More recently, the global financial crisis increased the importance of such efforts, as was acknowledged in the European Economic Recovery Plan[4]. The European Commission has pointed out that it is necessary *"to bring together all the policy levers available at EU and national level"* to counter the effects of the crisis[5], and to promote *"«smart investment» to yield higher growth and sustainable prosperity in the longer term"*[6]. The temporary framework put in place as a reaction to the crisis showed that the Commission *"obviously sees sufficient and affordable access to finance as a precondition for investment, growth and job creation by the private sector"*[7].

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1 Community guidelines on State aid to promote risk capital investments in small and medium-sized enterprises, OJ C 194/2, 18 August 2006 [hereinafter "2006 Risk Capital Guidelines"], para. 2.2(k). See also Articles 2(27) and 28 of Commission Regulation (EC) No. 800/2008 of 6 August 2008 declaring certain categories of aid compatible with the common market in application of Articles 87 and 88 of the Treaty, OJ L 214/3, 9 August 2008 [hereinafter "General Block Exemption Regulation"]. For a comprehensive analysis of the concept and roots of *risk capital* see the seminal work *Venture Capital at the Crossroads* by William Bygrave and Jeffrey Timmons (Harvard Business School Press, 1992).

2 For data about the significant role played by risk capital in important economic sectors in Japan and, above all, in the USA see again William Bygrave and Jeffrey Timmons, *Venture Capital at the Crossroads*, especially pp. 76 et seq., pp. 227 et seq. Further elements of comparison between the situation of venture capital in the EU and in the US and other parts of the world may be found in Andreas Oehler, K. Pukthuanthong, Marco Rummer and Walker Thomas, *Venture Capital in Europe. Closing the Gap to the US* (August 15, 2007). *Venture Capital in Europe*, Gregoriou, Kooli, Kraeussl, eds., Elsevier, London u.a, 2007, available on the Internet at SSRN: <http://ssrn.com/abstract=1659311> (last accessed on 4 July 2011).

3 Conclusions of the Luxembourg European Council on Employment, 20–21 November 1997, para. 30; Conclusions of the Cardiff European Council, 15–16 June 1998, para. 21; Conclusions of the Lisbon European Council, 23–24 March 2000, paras. 20–21; Risk Capital: A Key to Job Creation in the European Union. Communication from the Commission. SEC(98)552 final, 31 March 1998 [hereinafter "1998 Risk Capital Communication"], p. 1 (see also the Reports on the implementation of this strategy: COM(2001)605 final, COM(2002)563 final, COM(2003)654 final, etc.); Information from the Commission – State aid and risk capital, OJ C 235/3, 21 August 2001 [hereinafter "2001 Risk Capital Communication"], paras. 1.1 and 1.2; 2006 Risk Capital Guidelines, section 1.1.

4 Communication from the Commission to the European Council – A European Economic Recovery Plan (COM/2008/800 final) [hereinafter "European Economic Recovery Plan"].

5 European Economic Recovery Plan, p. 6.

6 Communication from the Commission – Temporary Community framework for State aid measures to support access to finance in the current financial and economic crisis, OJ C 83/1, 7 April 2009 [hereinafter "Access to Finance Communication"], p. 1.

7 U. Soltész and C. von Köckritz, "The temporary framework – the Commission's response to the crisis in the real economy", *European Competition Law Review* (2010), p. 106, at p. 109.

An important way to facilitate access to risk capital, it was acknowledged at the turn of the millennium, is to simplify the use of public funds for this purpose, in light of restrictions imposed by EU State aid law. Indeed, such use of public funds increases the overall amount of risk capital available to EU undertakings and contributes to the overall objective of progressing towards *"a highly competitive social market economy, aiming at full employment and social progress"*[8]. Naturally, when a major and structural transition is required in order to enhance the levels of risk capital investment in Europe – in comparison with the USA – public funds may have an important role to play, which does not mean, conversely, that these markets will be structurally dependent on such funds. In fact, W. Bygrave and J. Timmons rightly point out that Europe has known a "*recent unprecedented mobilization of private risk and venture capital*", which is, in turn, largely associated with the global retreat of the State from important economic areas, leaving aside former "*monopolistic or at least quasi-monopolistic industries*".[9]

It goes without saying that Member States are free to invest in risk capital as long as they do so in accordance with the market economy investor principle. But the uncertainty in the fulfillment of the requisites of that principle, together with the Commission's approach that, when in doubt, such measures should be notified, meant that these investments generally had to be notified to and authorized by the European Commission. For the sake of expediency, the Commission began by clarifying the conditions under which it would authorise state aid in the form of risk capital[10], and eventually it established a block exemption for certain types of state aid that took that form[11].

Thus, today public investments in risk capital may generally fall in one of three categories:

(i) not qualified as state aid (when the market economy investor test is met), and therefore not subject to mandatory notification;

(ii) state aid within the scope of the block exemption[12], and therefore not subject to mandatory notification; and

(iii) state aid outside the scope of the block exemption and not meeting the market economy investor test, and therefore subject to mandatory notification. Aid measures that fall under this category may be authorized in accordance with the criteria defined in the 2006 Risk Capital Guidelines

However, the Commission's approach to these issues was erected around a *market failure theory* which seems to have led to conclusions it could not legitimately support.

Surprisingly, doctrine tends by and large to be distracted by the positive effects of this theory at the level of the compatibility assessment of state aid measures. It generally seems to take for granted the existence of a market failure as identified by the Commission, not addressing the negative consequences of the Commission's position at the preliminary stage of qualifying public investment as state aid[13].

This paper will argue that, as a result of the Commission's *market failure approach* to the analysis of State investment in risk capital, it has effectively excluded or affected the application of the market economy investor principle in this domain, as regards certain types of risk capital investments. Furthermore, it has done so, up to the present date, without the issue ever coming before the European Court of Justice.

II. Risk Capital and Market Failure

The European Commission has, since the end of the 90s, rightfully pointed out the existence of a *market failure* at the level of the offer of risk capital in Europe.

8 Article 3 TEU.

9 See William Bygrave and Jeffrey Timmons, *Venture Capital at the Crossroads*, p. 74

10 2001 Risk Capital Communication and 2006 Risk Capital Guidelines.

11 See *maxime*, Articles 28 and 29 of the General Block Exemption Regulation.

12 One should also consider the possibility of *de minimis* aid.

13 See, e.g., V. Zuleger, "State aid and risk capital", 27 *European Competition Law Review* (2006), p. 166; C. Quigley, *European State Aid Law and Policy*, 2nd ed. (Hart Publishing, 2009), pp. 228 *et seq.*; M. Heidenhain (ed.), *European State Aid Law* (Verlag C. H. Beck, 2010), pp. 302 *et seq.*; M. Dony, F. Renard and C. Smits, *Contrôle des aides d'État*, 3rd. ed. (Éditions de l'Université de Bruxelles, 2007), pp. 283 *et seq.*; R. Horacek and A. Jarosz-Friis, "Risk capital", in W. Mederer, N. Pesaresi and M. Van Hoof (eds), *EU Competition Law – Volume IV: State Aid* (Claeys & Casteels, 2008), pp. 963 *et seq.*

This market failure was first identified in the context of analysis spurred by concerns relating to employment policy and the development of new technologies[14]. At some point, however, the Commission transitioned from affirming the existence of a very specific market failure, relating to the private offer of risk capital to SMEs in the domain of new technologies, to affirming the existence of a *generalized market failure* in the offer of risk capital to SMEs, at earlier stages of their development (which imply higher levels of risk).

Thus, in 2001, while recognizing that there was no general risk capital market failure in the EU, the Commission identified a market failure by stating that *"SMEs, and in particular small enterprises and start-ups"* found it difficult to obtain risk capital, *inter alia* because of imperfect information, a risk-averse nature of investors, limited availability of guarantees offered by SMEs and relative high transaction and due diligence costs[15]. In arriving at this conclusion, the Commission defined market failure as:

> *"a situation in which economic efficiency is not achieved owing to imperfections in the market mechanism. A market failure may manifest itself either in the inability of the system to produce goods which are wanted (in this case a risk capital market), or by a misallocation of resources, which could be improved in such a way that some consumers would be better off and none worse off. As economic theory predicts that markets will usually fail in some sense except under conditions of perfect competition, the term market failure is reserved for cases where it is believed that a serious misallocation of resources has occurred"*[16].

Five years later, this assessment was reconfirmed, with the Commission indicating that the existing equity gap was persistent and concerned mainly *"high-tech innovative and mostly young firms with high growth potential"*, even though a broader category of undertakings might also be affected[17].

As far as we know, despite the above quoted abstract considerations, the enlargement of the scope of the market failure, as understood by the Commission, , from certain sectors to all sectors of SME activity, wasn't preceded nor backed up by specific market studies or other comprehensive empirical analysis – at least none that were made public. It should be noted that the market studies that had led to the conclusions in the earlier documents related exclusively to high risk investments in the field of new technologies. Furthermore, this extension also failed to address the fact that the concept of risk capital had significantly broadened (and continues to do so) and that the full scope of investments currently encompassed in that expression might not definitely involve such a high level of risk as in the earlier studies. Bygrave and Timmons and recurrent analysis published in the leading industry tracker "Venture Capital Journal" duly emphasize that, in the context of "*the growing size of (...) non-US venture capital pools",* the traditionally accepted definitions of joint venture have to be reviewed (since those definitions tend to "*overstate the amount of seed and startup investing*"). [18]

It is also unclear to what extent the Commission has taken into account an increase in the willingness of private investors to accept risk capital instruments since the end of the 90s.

Willingness to accept risks in high technology markets is logically reduced due to the drastic levels of uncertainty, resulting from the impossibility of statistically predicting results and profits with a significant level of comfort. Altogether different is the level of predictability of investments in well established and stable industries and trades, with far less factors of uncertainty to be considered.

For these reasons, we must consider that the affirmation, in absolute terms, of the existence of a *generalized market failure in risk capital to SMEs* (at earlier stages of their development), whatever the activity in question, is necessarily an extreme oversimplification which cannot adequately represent market realities (and its significant evolution since the turn of the century).

14 See, e.g., 1998 Risk Capital Communication; and Communication from the Commission – European capital markets for small and medium-sized enterprises: prospects and potential obstacles to progress (COM/97/187 final).

15 2001 Risk Capital Communication, paras. VI.1–VI.4.

16 2001 Risk Capital Communication, paras. VI.2–VI.3.

17 2006 Risk Capital Guidelines, section 1.1. See also recital 54 of the General Block Exemption Regulation.

18 See William Bygrave and Jeffrey Timmons, *Venture Capital at the Crossroads*, p. 73. See also European Private Equity & Venture Capital Association (EVCA) 1990 Yearbook.

III. Risk Capital and the Reaction to the Crisis

In April 2009, the Commission concluded that the global crisis had worsened the pre-existing scenario[19, 20]. A temporary framework was put in place to combat the crisis, until December 2010, whereby it was assumed that there was a market failure whenever the funding at stake did not individually exceed EUR 2,5 million, per year and per SME, while also allowing for the demonstration of the existence of market failure above these figures[21]. In a sense, this was, therefore, a mere *"slight relaxation of the already existing rules"*[22].

Upon the expiry of this temporary framework, the Commission considered that those temporary adaptations *"gave a positive signal to Member States and market participants"*. However, according to the Commission, the crisis has raised *"the upper boundary of the SME equity gap"*, and therefore the increased upper limit for the presumption of market failure in risk capital to SMEs should be included in the Risk Capital Guidelines[23]. Accordingly, it revised these Guidelines, so that the current maximum level of investment tranches covered by the safe harbour is *"EUR 2,5 million per target SME over each period of 12 months"*[24].

Two issues are most worthy of note in this regard. Firstly, the Commission has once again broadened its identified market failure in risk capital to SMEs without a public justification or reference to the specific data on which its assessment was based. According to the European Private Equity & Venture Capital Association, in 2009 there was a drop in 57% in total investments by European private equity firms, compared to 2008[25]. While it is entirely expectable for the crisis to reduce access to funding, *inter alia* in the form of risk capital, it does not seem necessarily true that it would particularly affect small amounts of investments in SMEs. Indeed, a crisis might foster in some operators a logic of dispersal of small investments in higher risk applications, as a manner of controlling potential losses while allowing for greater margins of return. It may also have the opposite effect. In the absence of specific data, it seems difficult to conclude either way.

Secondly, risk capital moved in an opposite direction to the general trend in State aid control under the revised temporary framework of 2011, which was meant to return the market to the pre-existing conditions governing state aid. Instead, there has been a consolidation of initially temporary figures in a more "definitive" format.

As a result, the number of potential public investments in risk capital automatically considered by the Commission as falling within the market failure margin has increased.

IV. Evolution of the Commission's Market Failure Approach

Not only is the alleged market failure identified by the Commission, in itself, subject to criticism, but the consequences derived from its existence have evolved in directions which were not necessarily expected.

Initially, the Commission would identify an *advantage*, leading to a qualification of the measure as state aid, when it was confronted with public measures in the form of risk capital that were explicitly aimed at tackling the difficulty of certain

19 Access to Finance Communication, pp. 2 and 11.

20 In general about the global financial crisis and the way it affected EU Member States – involving complex issues that we do not purport to examine in the context of this Article – see, *inter alia*, Daniel Gros and Stefano Micossi, *The Cost of 'Non Europe'*, CEPS Commentary, 7 October 2008; Daniel Gros and Stefano Micossi, *A Call for a European Financial Stability Fund*, CEPS Commentary, 30 October 2008; Karel Lannoo, *Restoring Confidence*, CEPS Commentary, 21 October 2008; Atkinson Blundell-Wignall, *The Subprime Crisis: Causal Distortions and Regulatory Reform*, Reserve Bank of Australia, Conference 2008 (*Lessons from the Financial Turmoil of 2007*); A. Blundell-Wignall, *Financial Innovation and Risks*, OECD Forum, April 2007; A. Blundell-Wignall, "The Subprime Crisis: Size, Deleveraging and Some Policy Options", 94 *Financial Market Trends* (Paris, 2008); Daniel Gros, Thomas Mayer and Angel Ubide, *A World Out of Balance? Special Reporto of the CEPS Macroeconomic Policy Group*, April 2006.

21 Access to Finance Communication, paras. 4.6.1 and 4.6.2.

22 U. Soltész and C. von Köckritz ,"The temporary framework – the Commission's response to the crisis in the real economy", *European Competition Law Review* (2010), p. 106, at p. 115.

23 Commission Communication Temporary Union framework for State aid measures to support access to finance in the current financial and economic crisis, OJ C 6/5, 11 January 2011, at p. 7.

24 Communication from the Commission amending the Community guidelines on State aid to promote risk capital investments in small and medium-sized enterprises, OJ C 329/4, 7 December 2010.

25 See on the Internet: <http://www.evca.eu/knowledgecenter/statisticsdetail.aspx?id=416> (last accessed on 5 July 2011).

companies in accessing this type of funding[26]. When that explicit objective was missing, the market economy investor test was applied, occasionally leading to the conclusion that there was no state aid[27]. In this phase, the existence of market failure was discussed essentially when assessing compatibility with the Treaty, i.e. after the qualification of the measure as state aid.

Subsequently, however, Decisions began to emerge that qualified as state aid certain public investments in risk capital in SMEs without any specific grounds being put forward to justify the existence of an "*advantage*" in the specific case. In other words, the Commission stopped applying the market economy investor principle as such, and instead began to refer simply to the existence of a general market failure.

In this new phase, it became common practice to simply sustain that the beneficiary undertakings could not have accessed that level of funding, in the same conditions, in the absence of the public intervention, while making no attempt to justify this conclusion for each case (and taking into consideration the prevailing conditions in each economic sector)[28].

We were able to identify one Decision that strayed from the general tendency in this latter phase, wherein the Commission stated that it could not presume the existence of an *advantage* to SMEs since, in the specific case, there had been no advantage at the level of investors or of the risk capital fund itself[29]. Nonetheless, this case, whose reasoning we would essentially follow, cannot safely be perceived, at this stage, as truly representative of the Commission's general understanding.

As a rule, from the beginning of this second phase, it can be said that the Commission has only excluded the existence of an "*advantage*" in the case of public investments in risk capital which were carried out in parallel, and in equal conditions, to those of private investors that contributed with identical or higher amounts[30] (*pari passu* principle).

V. Assessment of the Commission's Market Failure Approach

Ironically, these exceptional derogations from the main principle, in cases of (at least) equal participation by private investors, seem to demonstrate precisely the unsoundness of the Commission's chosen approach. If several cases are identified where private investors are willing to invest in risk capital in SMEs alongside public investors, in equal conditions, this suggests that there is no basis for a general presumption that any public investment in risk capital in SMEs (in initial phases of activity) necessarily falls within the scope of a market failure and cannot meet the market economy investor test. Indeed, it is evidence that private investors will, in some cases, be willing to make this type of investment.

The logical consequence seems to be that a case by case assessment should be carried out to assess acceptability of the terms of the public investment from the perspective of private operators, and from this assessment conclude on the existence or absence of an "*advantage*". In other words, the Commission should actually apply in this field – as the Court's case law indicates – the *market economy investor test*.

26 See, e.g., Commission Decision of 23 May 2001, N 448/2000 Régime cadre: fonds de capital-investissement (France), p. 5; Commission Decision of 4 February 2003, N 620/2002 Small and medium enterprise venture capital and loan fund (United Kingdom), p. 10.

27 See, e.g., Commission Decision of 17 September 2003, N 511/2002 Fonds capitalinvestissement – Sardaigne (Italy), pp. 5– 6.

28 See, e.g., Commission Decision of 2 June 2004, N 572/2003 The Wales Early Stage Fund (United Kingdom), p. 6; Commission Decision of 9 March 2005, N 173/2003 Regione Campania – Fondo Chiuso Regionale (Italy), p. 7; Commission Decision of 3 March 2005, N 601/2003 UK Special Purpose Equity Vehicle (United Kingdom), p. 7; Commission Decision of 5 August 2005, N 299/2004 Cooperatives equity financing – Regione Marche (Italy), p. 6; Commission Decision of 19 January 2005, N 306/2004 Modifications Western Investment Fund – Risk Capital Scheme (Ireland), p. 6; Commission Decision of 5 February 2009, N 226/2008 Extension to the Western Investment Fund (Ireland), para. 44; Commission Decision of 20 December 2006, N 496/2006 Cultuurinvest (Belgium), para. 38; Commission Decision of 20 May 2008, N 458/2007 Modification of State Aid Scheme "Risk capital intervention on cooperative companies" (Italy), para. 48 ("The measure facilitates the provision of risk capital to SMEs, which would otherwise not receive sufficient capital. The measure therefore confers an advantage to the investee companies").

29 Commission Decision of 12 December 2007, N 500/2007 Risk capital scheme «Technology sectors Fund Berlin» (Germany), paras. 73– 75.

30 See, e.g., Commission Decision of 28 October 2005, N 344/2005 NEOTEC Risk Capital Fund (Spain), p. 7; Commission Decision of 16 January 2007, N 330/2006 Berlin Kapital Fonds (Germany), paras. 60– 62; and Commission Decision of 7 June 2006, N 194/2006 Screen East Content Investment Fund (United Kingdom), paras. 31– 33.

It is thus more than slightly surprising that the European Commission has developed these two approaches simultaneously, seeing no inherent contradiction in them: to presume a *general market failure* in the offer of risk capital to SMEs, and to exclude the presence of state aid when public investment in such risk capital is made in parallel with private investors.

The basis of the Commission's general presumption seems to us to be lacking in justification. In particular, its compliance with the principle of *neutrality* seems difficult to sustain.

In essence, the Commission now believes that it needs no further basis, beyond the existence of a general market failure in the private offer of risk capital to SMEs, to conclude for the existence of an advantage to beneficiary companies whenever the state invests in SMEs through risk capital. What's more, it also apparently believes it need not demonstrate the existence of the alleged market failure in each case. Nor are we aware of any demonstration of this market failure, in the broad scope in which it is now understood, in any general and abstract document (it could be even construed that empirical, while not comprehensive or systematic, analysis of European market realities, as the ones that periodically appear in specialized publications, like the *Venture Capital Journal* and others, seem to point in the opposite direction).[31]

From the moment this becomes an absolute presumption – disprovable only, as the Commission would have it, in cases of parallel investment by private undertakings – an unacceptable distortion of the burden of proof occurs. Indeed, in cases of non-notified aid, it is for the Commission to prove that a given public measure constitutes an advantage to the beneficiary undertakings. But with this market failure theory, the Commission claims the right to shift the burden of proof to the Member States, often effectively requiring a *prova diabolica*. And it fails to put forward so much as indicia of the existence of market failure, much less of the economic irrationality of the investment.

It must also be noted that there does not seem to be any support whatsoever for such a presumption – or for such a reversal of the burden of proof – in the case-law of the Court, nor has the Commission ever attempted to invoke any such support.

The Court developed the market economy investor test largely as a necessary result of the neutrality principle and the principle of equality. EU Law must be neutral in what concerns public or private property and Member States' choices in that regard. This market failure theory entirely disregards these principles.

Firstly, it replaces a necessarily *qualitative* test by a purely *quantitative* assessment. Rather than inquiring whether the specific public investment was carried out in terms acceptable to a market economy investor, the Commission in fact merely assesses whether the State's investment was made in an area of the market in which there is, overall, insufficient offer. And it does so on the basis of a generalization of the (undemonstrated) unwillingness of private undertakings to invest in SMEs, in certain phases of their development, regardless of the levels of uncertainty associated to the economic activities in question.

Secondly, even the purely quantitative assessment rests on an infringement of the neutrality principle. What the Commission means when it says that there is insufficient offer on the market for certain types of risk capital investments is, actually, that there is an (alleged, and as we *supra* pointed out, not effectively demonstrated) insufficient *private* offer. In other words, its quantitative conclusion on the existence of a market failure is based exclusively on the availability of private capital. The availability of public capital – which may very well be invested in accordance with the market economy investor principle – is excluded from the assessment. This constitutes, in a very clear way, an unequal treatment of public and private capital, even in the face of equal conditions of investment.

The Commission's stand on this issue refuses the possibility that there may be a margin of demand met by sufficient offer, based on economically rational conditions, made up not only of private capital, but of State resources as well.

Finally, the Commission itself defines the market failure as an abstract area of investment where private undertakings are unwilling to invest, even though it would be economically rational to do so[32].

31 See, e.g., on this point, "A Global View of the Venture Capital Industry 1987–1988", *Venture Capital Journal* (December 1989), p. 10; Venture Capital in Europe: 1989 EVCA Yearbook (Zaventen, Belgium: EVCA Secretariat, 1990). See, also, 2008 EVCA Yearbook; 2009 EVCA Yearbook and 2010 EVCA Yearbook.

32 In the context of an analysis strictly limited to available private offer, the Commission stated that *"the matching of supply and demand of risk capital may be inefficient so that the level of risk capital provided in the market is too restricted, and enterprises do*

But the market economy investor principle, as it has been construed and recognized by the Court, does not require the actual existence of a private investor which intends to, or can, carry out the investment in question. It merely requires the demonstration that a *hypothetical* private investor could decide to carry out the same investment, on the same terms. In other words, its aim is to determine whether the public investment in question was economically rational, or if instead it can only be explained by an intention – or a necessary effect – of granting advantages to certain undertakings *vis à vis* their competitors.

Thus, the very use of market failure – when defined as the Commission has done in this context – to assess the existence of an "*advantage*" seems to have no place within the market economy investor test.

These observations may also justify a reconsideration of the manner in which the block exemption and the criteria for individual exemption of investments in risk capital have been structured.

Despite their appearance, it may be argued that they do not reflect an actual exemption of State aid. In principle, exemption criteria should be a way of allowing Member States to invest in risk capital instruments in situations which do not meet the market economy investor test. However, it would seem that any public investment in risk capital that meets all the criteria set out in the block exemption actually meets the essential conditions of the market economy investor test (and some additional ones). The only reason the Commission identifies an "advantage", despite meeting all those conditions, is precisely because of the alleged market failure.

Thus, the criteria for block or individual exemption include precisely the same requisits one expects to find when applying the market economy investor test. But that test is meant to identify the existence of an "*advantage*", not to exempt a measure – exemption is based on overriding policy considerations. In other words, criteria which should be found in an Article 107(1) analysis seem to have been unduly transferred to an Article 107(3) analysis.

VI. Conclusion

The market economy investor test is notoriously difficult to apply in practice. As regards investments in the form of risk capital, however, these challenges have been compounded by the development of a *market failure theory* by the Commission for which there seems to be no support in the caselaw of the European Court of Justice, and which is, so far, untested.

Certainly, as the European Commission has pointed out, *"sufficient and affordable access to finance is a pre-condition for investment, growth and job creation by the private sector"*, and an efficient reaction to the financial crisis requires Member States to use the leverage they have at their disposal[33]. It is also true that *"risk capital provision is essentially a commercial activity involving commercial decisions"*, and that *"economic and budgetary conditions are such that public funds on their own will not be able, and should not attempt, to provide the whole of the increase in risk capital activity which the Community seeks"*[34].

This being so, it is counterproductive to limit the possibility of promoting economic growth and innovation by imposing unjustified restrictions on public investments in risk capital. And yet, this appears to be the inevitable result of the Commission's market failure theory in this domain. Paradoxically, in its efforts to facilitate access to risk capital in the EU, the Commission has '*prima facie*' made such access harder (at least, as regards administrative hurdles), when it comes to investments in SMEs. Even though the introduction of a market failure presumption, as construed by the Commission in this domain, may seem to facilitate access to public funding in the form of risk capital, as it facilitates exemption, conversely it may often have a dissuasive effect, as it implies qualifying as a state aid public investments which could otherwise meet the market economy investor principle.

For the reasons outlined in this paper, we believe the European Commission should *rethink its automatic presumption* – supported in several cases, although there are also precedents that could be

not obtain funding despite having a valuable business model and growth prospects" (2006 Risk Capital Guidelines, section 1.3.2). Elsewhere, it stated: *"These market failures result from an imperfect matching of supply and demand of risk capital. As a result, the level of risk capital provided in the market may be too restricted, and undertakings do not obtain funding despite having a valuable business model and growth prospects"* (General Block Exemption Regulation, recital 56).

33 European Economic Recovery Plan, p. 11.

34 2001 Risk Capital Communication, section 1.6.

construed as paving the way for a different understanding in this field – *that any public investment in risk capital instruments aimed at SMEs, in their earlier stages of activity, constitutes an "advantage" and must as such be qualified as state aid.*

Sooner or later, the theory, if maintained in its current formulation by the Commission, will be tested before the Court. It should be noted that, while the Court may grant the Commission a large margin of discretion in assessing the *compatibility* of state aid measures, the same cannot be said of the *qualification* of a measure as state aid.

The Commission's market failure approach to risk capital effectively forces Member States to prove there is no market failure (measured only in relation to actually available private funding) in a specific case so as to avoid having their investment in risk capital to SMEs qualified as state aid. There is little in the current case-law that may lead us to expect an approval of this reversal of the burden of proof, based on a set of facts that has not been demonstrated, as far as we know, and on a theory that does not appear to be logically compatible with the market economy investor principle.