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Foreign Subsidies Regulation

Impacts on mergers and acquisitions activity

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The Foreign Subsidies Regulation (FSR)[1] entered into force on 12 January 2023,[2] creating a new regulatory regime for companies which may have received subsidies from non-EU countries. It gives the European Commission (Commission) very broad powers to investigate foreign subsidies and to rectify any resulting distortions of the internal market through a variety of redressive measures from ordering repayment of subsidies or curtailing investments, to prohibiting mergers or awards of contracts and unwinding completed transactions.

The FSR addresses what is perceived as a regulatory gap in the EU’s ability to control distortive foreign subsidies granted by non-EU governments. While subsidies granted by EU governments have long been strictly regulated under EU state aid rules, foreign subsidies currently escape scrutiny under EU competition rules, public procurement rules, and foreign direct investment (FDI) control rules and are not subject to effective review or enforcement under international trade instruments. There has been political pressure on the Commission from EU member state governments for several years now to use merger control or other competition law enforcement in a way that would level the playing field, in particular, between Chinese companies benefiting from state support, and EU companies operating without the benefit of such support.[3] Ultimately, a separate legal instrument targeted specifically at foreign subsidies was considered more suitable to this objective and with broad application to financial contributions received from any country outside of the EU.[4]

Under the new FSR, as of 12 October this year, companies will be obliged to notify for prior approval by the Commission, certain mergers, acquisitions and joint ventures, as well as tenders for public contracts where the relevant financial thresholds are met and the parties concerned have received a certain level of financial contribution from a foreign government, or from a private entity whose actions can be attributed to a foreign country. The FSR also empowers the Commission to require parties to notify for approval, anticipated transactions and tenders below the specified thresholds. Importantly, beyond notification of transactions and public contracts, the Commission gains very broad powers through a catch-all tool allowing it to investigate on its own initiative any market situation where distortive foreign subsidies may be involved. This catch-all tool gives the Commission additional powers in relation to transactions, including the ability to investigate closed transactions which were not subject to the notification obligation. However, it goes well beyond investigation of transactions and public tenders, allowing the Commission to investigate a variety of economic activity including, for example, greenfield investments in the EU, or supply of goods or services in the EU where the Commission suspects the companies concerned may be benefiting from a foreign subsidy.

The FSR is a hybrid legal instrument, applying principles taken from both EU state aid law and EU trade policy. In relation to mergers and acquisitions, it also applies concepts and processes from the EU Merger Regulation. The FSR will impact investments in the EU by both third-country state-owned companies and private companies that have received direct or indirect financial contributions or benefits from non-EU countries. In practice, any company (foreign or European) active in non-EU countries involving state intervention in the economy whether through, for example, low interest loans to companies or sectors, or granting individual or broader fiscal incentives, can be subject to this new scrutiny.

The FSR introduces one of the most sweeping EU regulatory changes of the last decade and the Commission anticipates that it will require initially at least 120 staff in the dedicated unit being set up for FSR enforcement. To quote Executive Vice President of the Commission, Valdis Dombrovskis, it is a “game changer” for EU companies, aimed at creating fairer rules of engagement so that they “can compete on an equal footing with foreign competitors”.[5]

The present article focuses on the FSR as it impacts M&A activity including notification thresholds, substantive assessment, remedies, procedures under the draft Implementing Regulation, and implications for deals and how companies need to prepare for enforcement.

FSR application to M&A

The FSR creates a separate mandatory approval process for mergers, acquisitions and joint ventures ("concentrations") that is independent from the EU merger control regime. It applies a legal test based on the distortion in the EU internal market, rather than the "significant impediment to effective competition" test underlying the EU merger control regime. Under the FSR, the mandatory notification requirement applies to concentrations that meet the relevant revenues thresholds and where parties to the transaction have received aggregated foreign financial contributions in the three years prior to notification of more than €50 million. As the FSR is an entirely standalone legal instrument with a different objective than merger control, a transaction can be subject to two separate notification requirements and two parallel investigations by the European Commission, under the FSR and EU Merger Regulation respectively, which can in turn lead to different outcomes. In addition, national foreign direct investment notifications and investigations by EU member states, which are broadly aimed at screening mergers which can impact national security, are separate from any FSR or merger control review.

Concentrations which are subject to a notification requirement under the FSR must be suspended pending the outcome of the Commission's investigation, with obvious potential to impact the timing for closing of a deal. The Commission can conduct its review in two phases, namely a preliminary investigation to be followed by an in-depth investigation if the Commission has sufficient indications that an undertaking has been granted a foreign subsidy that distorts the internal market. The statutory time frame for the Commission's review under the FSR is similar to the timeframe for a merger investigation under the EU Merger Regulation with an overall duration of 150 working days, including extensions. However, similar, to merger review, there will be uncertainty as to the overall timeframe for review, as the Commission anticipates pre-notification consultations to discuss the draft filing and the statutory timeframe can be interrupted if the parties fail to respond in time and adequately, to the Commission's requests for information, or if the parties refuse to submit to an inspection by the Commission.

The investigation ends either with the approval of the transaction or, in case of a finding of distortion on the internal market where the positive effects do not outweigh negative effects, with the prohibition of the transaction or the adoption of remedies. The investigative powers of the Commission are similar to those under the EU Merger Regulation, including the power to issue requests for information, adopt interim measures, conduct inspections and impose fines up to 10 per cent of the company's global turnover including in case of implementation of the transaction prior to approval ("gun-jumping").[6]

Prior notification of concentrations

Notification thresholds

Concentrations need to be notified under the FSR if they meet the following cumulative criteria:

1. The acquired undertaking or at least one of the merging undertakings or the joint venture is established in the EU and generates an aggregate turnover in the EU of at least €500 million; *and*
2. Either the undertakings concerned, or the joint venture itself and its parent undertakings, received from third countries an aggregate financial contribution in the three calendar years prior to notification of more than €50 million.

Below thresholds

The EU turnover threshold of €500 million is relatively high and will filter out a lot of transactions from the mandatory notification obligation. However, the Commission may also request prior notification of any concentration below thresholds at any time prior to its implementation where it suspects that the undertakings concerned may have benefitted from foreign subsidies in the three previous years. It can also use its powers under the catch all tool for own-initiative investigations, to investigate completed transactions.

Definitions and steps in Commission's investigation

Foreign financial contributions versus foreign subsidies versus distortion of internal market

While there is some lack of clarity in the definitions set out in the FSR, there are three distinct concepts. The first, "financial contribution" is relevant to the assessment of whether a transaction meets the €50 million foreign financial contribution (FFC) threshold for mandatory pre-notification, (in addition, establishing an FFC is a first step in the Commission's investigation of whether a company is benefiting from a foreign subsidy). The second concept, "foreign subsidy", is not relevant to notification thresholds but rather to the Commission's investigation. In investigating a concentration where the parties have received an FFC, the Commission needs to establish whether the FFC meets the additional criteria to qualify as a "subsidy". If the Commission's investigation establishes the existence of a foreign subsidy, the Commission then needs to determine whether the subsidy gives rise to a "distortion in the internal market".

FFC and notification threshold

An FFC is defined to capture a broad range of support measures provided by a foreign country (through central government, or public authorities, or through public or private entities whose actions can be attributed to a foreign country) including:

- The transfer of funds or liabilities, such as capital injections, grants, loans, loan guarantees, fiscal incentives, setting-off of operating losses, compensation for financial burdens imposed by public authorities, debt forgiveness, debt to equity swaps or rescheduling;
- The foregoing of revenue that is otherwise due, such as tax exemptions or the granting of special or exclusive rights without adequate remuneration; and
- The provision of goods or services or the purchase of goods or services.

The third example above has created confusion as to whether revenues from any contract for goods or services with a public authority would need to be considered for purposes of determining whether the €50 million filing threshold is met. Logically, one would expect that such a contract would amount to an FFC only where it confers some benefit, for example, where it could not have been obtained under normal market conditions and the recitals to the FSR suggest this could be the correct reading.[7] However, it is not clear from the provisions of the FSR itself, or from the recitals, whether the benefit element would only be relevant to the Commission's subsequent investigation of the existence of a foreign subsidy.

Commission investigation of "foreign subsidy" and "distortion" in the internal market

Once a transaction is notified, or where the Commission has launched an investigation on its own initiative, the Commission needs to establish whether an undertaking benefits from a foreign subsidy, and whether such foreign subsidy distorts the internal market. Finally, the Commission will carry out a balancing exercise weighing positive and negative effects and decide whether redressive measures are necessary.

A foreign subsidy needs to meet three cumulative criteria:

1. A non-EU country provides, directly or indirectly, a financial contribution (FFC);
2. Such financial contribution confers a benefit on an undertaking engaging in an economic activity in the internal market. The existence of a benefit should be determined on the basis of comparative benchmarks, such as the investment practice of private investors, rates for financing obtainable on the market, a comparable tax treatment, or the adequate remuneration for a given good or service; and
3. The benefit is limited (in law or in fact) to an individual undertaking or industry or several undertakings or industries ie there is some element of selectivity.[8]

As a second step in its investigation, and contrary to EU state aid rules where the distortive effect is presumed as soon as a subsidy is found, the Commission will assess whether the foreign subsidy distorts the internal market by improving the competitive position of the undertaking concerned while at the same time actually or potentially negatively affecting competition in the EU. The assessment is performed on a case-by-case basis, taking into account indicators such as the amount and nature of subsidy, the situation of the company, including its size and the markets or sectors concerned, the level of economic activity of the company in the internal market and the purpose, conditions and use of the subsidy.

The FSR sets out categories of foreign subsidies most likely to distort the internal market including:

- Foreign subsidies granted to an ailing undertaking in absence of a viable restructuring plan;
- Unlimited guarantees for debts/liabilities of beneficiary undertakings;
- Export financing measures that are not in line with the OECD Arrangement on officially supported export credits;[9]
- Subsidies directly facilitating a concentration; or
- Subsidies facilitating the submission of an "unduly advantageous tender" that would enable the undertaking concerned to win a public contract**.**

The FSR provides that, in assessing whether a foreign subsidy in a concentration distorts the internal market, that "assessment shall be limited to the concentration concerned."[10] Again, there is some lack of clarity here as to what this means exactly but at least in establishing a distortion, there should be some link between the impact of the subsidy and the concentration. This should be an important limiting principle in the assessment, given that notification can be triggered based on an FFC granted to any activity of the company (including all entities in the corporate group), regardless of its link to the concentration.

The FSR also clarifies that, during its assessment on potentially distortive subsidies, the Commission will factor in the following situations in which subsidies will not, or are less likely to, cause distortions in the internal market,[11] namely:

- A foreign subsidy shall not be considered to distort the internal market if its total amount does not exceed the amount of a de minimis aid as defined in Regulation 1407/2013, ie €200,000 per third country over any consecutive period of three financial years;[12]
- A foreign subsidy is unlikely to distort the internal market if its total amount does not exceed €4 million over any consecutive period of three financial years;[13] and
- A foreign subsidy may be considered not to distort the internal market to the extent that it is aimed at making good the damage caused by natural disasters or exceptional occurrences.

Finally, where the Commission finds the existence of a foreign subsidy which distorts the internal market, the Commission will perform a balancing exercise to determine whether the positive effects outweigh the negative effects. The Commission will consider positive effects on the basis of evidence submitted during the investigation, in particular as they relate to the development of the relevant subsidised economic activity on the internal market, as well as contributions to broader EU policy objectives including a high level of environmental protection and social standards, and the promotion of research and development. In carrying out this balancing exercise, the Commission will decide whether remedies need to be imposed. Redressive measures can either be imposed by the Commission or, it can also accept commitments submitted by the parties to the concentration.

Remedies

Remedies imposed or accepted in order to address a distortion on the internal market, need to be proportionate and suitable to remedy the distortion in question. That said, the FSR envisages a broad array of remedies, including structural – for example, the divestment of assets or unwinding of a transaction which has been implemented. In terms of non-structural remedies, in addition to the types of remedies which companies are familiar with under the EU Merger Regulation such as licensing on fair, reasonable and non-discriminatory (FRAND) terms and provision of access to infrastructure, the FSR also envisages more novel measures such as, the reduction of capacity or market presence, refraining from certain investments and the publication of results of research and development. The Commission may also order or accept a commitment by the parties to repay the foreign subsidy.

The FSR draft Implementing Regulation

The draft FSR Implementing Regulation setting out the procedural rules was published on 6 February 2023 and is currently under stakeholder consultation.[14] The draft Implementing Regulation provides details on the information required in the notification forms for concentrations and public procurement procedures, calculation of time limits, procedural rules for the conduct of investigations, and the rights of the parties including in relation to access to file and the treatment of confidential information. The Commission aims to finalise and adopt the final version of the FSR Implementing Regulation in the second quarter of 2023 in time for its entry into force by 12 July.

The notification of a transaction under the FSR will require a substantial amount of detail regarding FFCs received by parties to a transaction (including all members of the corporate group) on a global basis. Companies are required to list all the sources of finance for the transaction and provide details on the bidding process (if applicable to the transaction), due diligence reports on the economic rationale of the transaction as well as details on the business lines or activities of the parties in the internal market and whether financial contributions they received are capable of improving their competitive position. The parties can also submit information on potential efficiencies.

What lies ahead?

In anticipation of prior notification requirements for transactions kicking in on 12 October and given the Commission can call-in below threshold deals meantime and investigate closed deals, companies need to start preparing for enforcement. In particular, large global companies will need to set up a system to monitor financial contributions from non-EU sources on a rolling basis, in order to establish whether prior notification of deals (or bids for public contracts), is required. This in itself is a challenging task given the broad definition of FFC, which goes beyond whether it qualifies as a subsidy, never mind a distortive subsidy, and the fact that FFCs received by any member of the corporate group are in scope.

Companies also need to factor in potential FSR investigations into their deal timing and documentation, including potential FSR approval as a condition precedent, and reflect potential for a prohibition or remedies in their risk-sharing and hell or high-water provisions. Foreign investors will need to allocate time and internal and external resources to the assessment and identification of the applicable pre-closing filing requirements as well as to the strategic coordination of any parallel filings with a view to aligning timings and outcomes as much as that is possible given the very different objectives pursued by FSR, merger control and foreign direct investment reviews.

As with any new measure, but particularly one with such a broad objective and a certain lack of clarity in the underlying regulation, the FSR gives rise to legal uncertainty, in particular as to its precise scope, as well as to how the Commission will seek to use its new powers, how quickly it can deal with complaints and investigations and how flexible it will be in granting waivers from some of the more extensive information requirements in filings. While the publication of the draft FSR Implementing Regulation is certainly a welcome development, further guidance is needed. The Commission is required by the FSR to adopt guidelines within three years, and it is normal for the Commission to wait until it builds up sufficient enforcement experience before issuing guidelines. However, with the lack of clarity here around some of the fundamental aspects of the FSR, including some of the key terms and aspects of the substantive assessment, it is hoped that the Commission can address these issues in the coming months.

Finally, further clarifications and guidance are needed concerning the application of the Commission's "ex officio" investigation tool. The Commission has remained silent on the details of the application of this tool, the scope of which is all-inclusive and covers every market situation that may involve a distortive subsidy including closed transactions which were below the prescribed thresholds for prior notification. In these instances, the Commission will be able to start investigations on its own initiative and may request ad-hoc notifications that could lead to the adoption of decisions requiring redressive measures. So far, it would seem that the Commission is waiting for the full launch of the application of the FSR and the receipt of the first notifications starting from October 2023 before it decides on how to optimally use the ex-officio tool. In any event, it is expected that a big part of ex-officio investigations will be launched on the basis of complaints received from third parties, which are already being submitted to the Commission.

Absent further clarifications or guidance from the Commission, all eyes will be on the first notifications and the first ex-officio investigations to provide a better steer for companies on the extent to which it will impact their M&A activity in the EU. Whatever happens, the adopted FSR is here to stay and will be a feature of deal planning and risk assessment in any transaction where the parties receive financial contributions from non-EU countries.

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Endnotes

1. Regulation (EU) 2022/2560 of the European Parliament and of the Council of 14 December 2022 on foreign subsidies distorting the internal market.
2. The prior notification obligation for transactions and public tenders meeting applicable thresholds, will apply only as of 12 October 2023.
3. See, for example, https://www.euractiv.com/section/competition/news/france-germany-call-for-a-change-of-european-regulatory-rules/.
4. This includes members states of the European Free Trade Association (EFTA) which are not members of the EU (namely, Norway, Iceland and Liechtenstein), as well as the UK.
5. "The Foreign Subsidies Regulation will help us to protect the integrity of the Single Market, our most precious economic asset. For EU companies, this is a game changer as it will create fairer rules of engagement so they can compete on an equal footing with foreign competitors", Valdis Dombrovskis, Executive Vice-President for an Economy that Works for People, 12 January 2023.
6. Certain foreign subsidies relating to goods will not be subject to investigation under the FSR to the extent that such investigation would be contrary to the EU's obligations under the WTO Agreement on Subsidies and Countervailing Measures where the EU has the possibility to initiate state to state dispute settlement (Article 44(9) FSR). However, the FSR does not exempt companies from the notification obligation in those circumstances.
7. See Recital 13.
8. The definition incorporates some elements of EU state aid law, governing subsidies granted by EU member states as well as elements from WTO rules.
9. https://www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?cote=TAD/PG(2022)1&docLanguage=en.
10. Article 19.
11. In the case of mandatory notifications of concentrations under the FSR rules, the companies in question will still need to notify the relevant financial contributions per the prescribed thresholds (see Section III below), thus allowing the Commission to assess their potentially distortive effects.
12. According to the explanatory notes under the Notification Form template published together with the draft FSR Implementing Regulation, financial contributions that meet this criterion do not need to be disclosed in the Notification to the Commission.
13. See above.
14. https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/13602-Distortive-foreign-subsidies-procedural-rules-for-assessing-them_en.

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