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Dealmakers Beware of a New Regulatory Hurdle: the European Foreign Subsidies Regulation is Here

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Companies looking at M&A deals with an EU exposure, or preparing to respond to an EU public tender, will face a new regulatory constraint as the European Commission has enacted its long awaited (and criticised) Foreign Subsidies Regulation. In addition to merger control and foreign direct investment, this new filing obligation may create additional regulatory uncertainty and timing constraints. Companies are advised to collect all data relating to direct or indirect financial contributions received from non-EU countries in the last 5 years.

Introduction

- In 2021, the European Commission published a draft Regulation on Foreign Subsidies ("FSR").[1] The FSR entered into force on 12 February 2023,[2] and will start to apply as of 12 July 2023, with mandatory notification obligations effective as of 12 October 2023. The European Commission published its "Draft Implementing Regulation" on 6 February 2023, clarifying a number of practical and procedural aspects. Stakeholders are currently invited to submit their feedbacks on this draft regulation.

- The FSR is meant to address perceived distortions to the EU internal market caused by financial contributions granted by non-EU countries ("foreign subsidies"), thereby closing an enforcement gap as foreign subsidies have so far escaped the European Commission's control, contrary to EU subsidies which have been subject to (the quite stringent) EU State aid rules for many years.

- Under the FSR, the European Commission has the exclusive competence to investigate and assess if businesses operating in the EU have received foreign subsidies that are likely to distort competition in the internal market. The European Commission is granted far-reaching investigative powers to do so (including an *ex ante* mandatory filing regime and *ex officio* investigation regime).

- The compliance risks and burdens for multinational businesses, **including EU companies** receiving foreign subsidies from non-EU governments will be considerable. Multinationals considering M&A deals with EU exposure should conduct a **group-wide mapping of foreign subsidies**. Paul Hastings has prepared a "Foreign Subsidy Scorecard" for its clients, which is intended to guide companies in navigating this environment, by identifying new FSR reporting and compliance obligations.

Scope of the FSR

- The FSR targets EU and non-EU-based multinational companies that are active in the EU and have received direct or indirect financial contributions from a non-EU government, including the UK (i.e. foreign subsidies).

- The scope of financial contributions that qualify as "foreign subsidies" is very broad. The FSR covers any financial benefit conferred to a business or businesses on a selective basis. Inspired from EU State aid rules, foreign subsidies include the:

  - Transfer of State funds/liabilities (capital injections, grants, loans, fiscal incentives, guarantees, etc.);

  - Foregoing of State revenue (tax exemptions, etc.); and

  - Provision or purchase of goods or services.

- The financial contribution must be provided by: (i) the central government; or (ii) any other authority at other levels of government; or (iii) public or private entities whose actions can be attributed to the central government of a non-EU country (which may target sovereign wealth funds or publicly backed PE houses).

M&A deals will face a third category of *ex ante* regulatory approval in the EU, adding to existing FDI and merger control requirements

- The FSR imposes **mandatory *ex ante*** filing and suspensory obligations (i.e., the transaction cannot complete until approval has been received from the European Commission) for companies engaging in deals that meet the following thresholds:

  - At least one of the merging companies, the target or a JV (i) is established in the EU and (ii) generates an aggregate EU-wide turnover of at least **EUR 500 million**;[3] and

  - The parties to the transaction were granted combined aggregate financial contributions of more than **EUR 50 million** from non-EU governments in the previous three years.

- The structure of FSR review proceedings is modelled on the EUMR. Companies can engage in pre-notification discussions with the European Commission about the transaction and its likely impact on competition in the EU. After the formal notification, the European Commission has an initial 25 working-day period (same as Phase 1 of EUMR filings) to check if there are indications that the parties have been granted a foreign subsidy that distorts the internal market. If so, the European Commission can open an in-depth investigation (Phase 2) of up to 90 additional working days (extendable by 15 working days in case of remedies) (same as Phase 2 of EUMR filings). This alignment with EU merger control should allow parties to coordinate their FSR and EUMR filings.[4]

Public tenders: beware of this brand new enforcement area

- The FSR also imposes an entirely new, **mandatory *ex ante*** filing and standstill obligation for companies engaging in EU public tenders.

- Responses to EU public tenders will need to be notified where the following factors are met:

- The value of the EU public tender is at least **EUR 250 million** (and in case the procurement is divided into lots, the value of the lot(s) applied for is at least **EUR 125 million**); and
- The company engaging in the EU public tender (including its subsidiaries, holding companies, and its main subcontractors and suppliers involved in the same tender) received a subsidy of at least **EUR 4 million** per non-EU country in the three years prior to notification.

- Regardless of the notification requirements, companies engaging in EU public tenders must list foreign subsidies received in a declaration attached to their response.
- The initial review period is 20 working days (extendable by 10 working days), following which the European Commission may initiate an in-depth investigation that cannot exceed 110 working days from date of completed notification (extendable by 20 working days).

Power to call in "below the thresholds" M&A deals and public tenders and to conduct *ex officio* investigations

- Clearly inspired by another "enforcement gap" initiative (being the European Commission's position on Article 22 EUMR on which our team commented[5]), the European Commission can call-in M&A deals and public tenders that are below the FSR mandatory notification thresholds.
- The European Commission may also investigate *ex officio* any market situation, if it considers that it is backed by distortive foreign subsidies, **up to 10 years** from the date when they were given. These *ex officio* investigations can be based on information from any source, including Member States, natural or legal persons, or information gathered during a market investigation. The European Commission will endeavour to close any such investigation in less than 18 months (a best effort similar to the European Commission's in-depth review of State Aid), a period longer than in *ex ante* cases.

Substantive analysis and remedies

- The European Commission will first assess whether the foreign subsidy has distortive effects on the internal market. If so, it will check whether this distortion can be counterbalanced by positive effects before deciding on the outcome. This reasoning is strictly comparable to EU State Aids reviews.
- A foreign subsidy is considered distortive if it is liable to improve the competitive position a company in the EU internal market and in doing so, may negatively affect competition in the EU internal market. The European Commission will determine the existence of a distortion on the basis of several indicators including, *inter alia*, the amount and nature of the foreign subsidy, the size of the company concerned and the sector in which it is active.
- The FSR lists foreign subsidies likely to be distortive (Article 5 of the FSR): those that support failing businesses; are in the form of unlimited guarantees; facilitate a concentration; amount to an export financing measure that is not in line with the OECD Arrangement on officially supported export credits; or those (in the context of EU public tenders) that otherwise enable a company to submit an unduly advantageous tender.
- Conversely, the FSR provides a few safe harbours:

- Foreign subsidies less than EUR 4 million in the past 3 years or otherwise aimed at repairing damage caused by natural disasters or exceptional circumstances are **unlikely to be distortive**; and
- Foreign subsidies below EUR 200,000 per non-EU government in the previous 3 years are considered as non-distortive (known as *de minimis* subsidies).

- In considering whether a distortion exists, the European Commission has extensive investigative powers, including powers to request information and conduct dawn raids in the EU and verification visits outside the EU.
- Following an in-depth investigation, the European Commission can issue: (i) a no objection decision; (ii) a commitments / redressive measures decision; or (iii) a prohibition decision.
- Similar to merger control remedies, redressive measures and commitments can be *structural* (divestment), or *behavioural* (such as licencing under FRAND conditions or repaying of the foreign subsidy with an interest rate).
- If the parties breach the standstill suspensory obligation or fail to notify a notifiable transaction (which are two distinct infringements), the European Commission may impose a fine of up to 10% of the parties' worldwide aggregate turnover. Where a company supplies incorrect, incomplete, or misleading information, it may be subject to fines up to 1% of its worldwide turnover and periodic penalty payments up to 5% of its average daily aggregate turnover for each working day of delay. These levels of fines are the same theoretical maximums as under the EUMR.

Transitional provisions

- The FSR does not apply to concentrations (i.e., transactions) concluded and EU public tenders initiated before 12 July 2023.
- However, for concentrations concluded and EU public tenders initiated after 12 July 2023, the FSR will **retroactively apply** to foreign subsidies granted prior to 12 July 2023: (i) up to (i) three years back for M&A deals and public tenders concluded or initiated after that date; and (ii) five years back in the case of an *ex officio* investigation.

UK and US approaches

- The UK has a subsidy rule relating to UK aid only. It has not adopted a foreign subsidy regime. Instead, with respect to foreign investment in the UK (including M&A transactions), the UK's focus remains on ensuring such investment is pro-competitive and does not impede the UK's national security efforts. Where a transaction triggers a UK national security filing, notifying parties will be required to provide details about the role of any non-UK government both with respect to the acquiring parties and the target entity.
- In the US, disclosure of foreign subsidies during merger reviews is limited. The Consolidated Appropriations Act passed in December 2022 for the first time calls for reporting of certain subsidies in the context of notifications filed under the Hart-Scott-Rodino Antitrust Improvements Act. However, this reporting is limited to subsidies from "foreign entities of concern," rather than all foreign subsidies. Rules implementing these requirements have yet to be adopted, but are expected later in 2023.
- Apart from this new reporting requirement, the US has no systematic review of foreign subsidies for M&A transactions. The US antitrust agencies are empowered to consider foreign aid as a factor in merger review investigations on a case-by-case basis. However,

there is little evidence that they do so with regularity. Moreover, where there have been calls for increased scrutiny of foreign subsidies, they have often focused on national security interests rather than simply improving market outcomes, seemingly differing from the EU approach.

Challenges and Conclusions

- **The FSR has been the subject of uphill debates**, with concerns around the challenges of a reform of this magnitude. In an event held early February 2023, Mr Olivier Guersent, Director-General of the DG Comp of the European Commission pointed out that there will be "severe problems" enforcing the FSR if the European Commission is not given sufficient resources (the European Commission will create a task force of 40 to 50 full-time employees by mid-2023 compared to 120 initially foreseen). As Guersent noted, the European Commission will have to prioritize its cases.

- **Still, there will be more filings affecting M&A transactions**. The FSR creates a new filing obligation for companies contemplating M&A transactions. Where there is significant EU exposure coupled with financial contributions from non-EU governments, parties should be prepared for an FSR review, in addition to potential merger control and FDI reviews. Due diligence processes must now include a list of targeted FSR questions. Deal documentation will have to be adapted and deal timings may be affected.

- **Prepare your own Subsidies Scorecard**. Paul Hastings has developed a Foreign Subsidy Scorecard to help its clients in complying with the FSR's burdensome requirements. Companies should start collecting information concerning public financial contributions on a group-wide basis **regardless of whether they constitute foreign subsidies** (as this is for the European Commission to assess). Companies should go back at least 5 calendar years. It is advisable not to wait until the obligation to notify arises before such data is collected.

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[1] See our previous PH staycurrent

[2] https://eur-lex.europa.eu/eli/reg/2022/2560/oj.

[3] The method for calculation of turnover, and the notion of undertakings concerned are similar to those in the EU merger regulation ("EUMR").

[4] The European Commission has no competence with respect to foreign direct investment proceedings. Parties should be aware that different timelines may apply if parallel FDIs filings must be made.

[5] https://www.paulhastings.com/insights/client-alerts/european-commissions-position-on-merger-control-referrals-a-small-revolution.

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