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Understanding The EU's New Foreign Subsidies Regulation

By **Peter Camesasca and Sophie Bertin** (December 9, 2022, 7:26 PM GMT)

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On Nov. 10, the European Parliament adopted the Foreign Subsidies Regulation with an overwhelming majority.

This regulation is game-changing as it means that the European Commission can take measures against companies that have received subsidies from countries outside the European Union when those subsidies are perceived to distort the competition in the EU. This is de facto an extension of the already very wide-ranging EU state aid powers to now cover the rest of the world.

Understanding the FSR is important because for several reasons. First, the definition of foreign subsidy is very broad and covers any intervention of a foreign state entity in a company — be it through provision of unlimited guarantees to support the company, tax advantages and tax breaks, state-funded research and development, or exclusive rights.

This definition means that the commission will have ample opportunities to review and investigate companies already active or willing to be present in the EU, be that through an investment or the participation in public procurement — without there needing to be a link with the subsidy.

Second, in addition to a broad definition, the powers of the commission are also vast. The companies will be required to notify of mergers and acquisition activity and public procurement bids above a certain threshold of turnover and cumulated received foreign subsidies.

In addition, the commission will be able to start ex officio investigations or request a notification, even when such is not mandatory, when it has concerns that subsidies may have been given.

The result is that this new regulation adds a whole new layer of deal conditionality and associated complexity.

However, there are ways to prepare beforehand and to limit the risks and consequences of the actions of the commission. Additionally, there are ways to properly prepare both for notifications and when an ex officio investigation has been started.

The Foreign Subsidy Regulation — the New State Aid Rules for the World

The European Commission unveiled its proposed regulation on foreign subsidies distorting the internal market in May 2021. The regulation creates a new tool to address what the commission sees as a regulatory gap in avoiding potential distortions caused by companies receiving non-EU subsidies and ensuring a level playing field in the EU.

The Foreign Subsidies Regulation will de facto extend the existing EU state aid regime, which controls subsidies given by member states, to now also control subsidies granted by non-EU countries to companies, to contribute to the proper functioning of the internal market by establishing a harmonized framework to address distortions caused, directly or indirectly, by foreign subsidies.

Perhaps emblematic of its perceived importance at a time when calls from member states to tackle potential distortive foreign investment have multiplied, it took the commission less than a year from the publication of the white paper on leveling the playing field with respect to foreign subsidies to analyze the results of its public consultation and to put this proposal to the EU legislator.

Even more importantly, the three EU institutions — the European Parliament, the European Council and the Council of the EU — approved the final text at the political level on June 30, with only minor amendments.

The text was subsequently approved by the EU Parliament with a landslide majority of 598 votes to five, and nine abstentions, and was adopted by the EU Council on Nov. 28.

The Commission's New Powers

The proposed Foreign Subsidies Regulation adds a new layer of scrutiny to transactions and public procurement bids in the EU. It is wide-ranging and will apply in addition to the existing merger control and Foreign Direct Investment screening mechanisms, as well as other regulatory clearances.

The Foreign Subsidies Regulation targets both EU and non-EU companies that are present in the EU, plan to invest in the EU, or participate in EU public procurement, and have received a foreign subsidy.

Wide Definition of Foreign Subsidy

A foreign subsidy exists where a third country provides, directly or indirectly, a financial contribution which confers a benefit on one or more undertakings engaging in an economic activity in the internal market. It includes a wide range of support measures such as:

- The transfer of funds or liabilities, e.g., capital injections, grants, loans and guarantees;
- The foregoing of revenue that is otherwise due, e.g., tax exemptions and advantages, as well as the granting of special or exclusive rights without adequate remuneration; and
- The provision or purchase of goods or services.

It is important to note that the concept of financial contribution includes a number of support measures that are not limited to monetary transfers — for instance, the granting of special or exclusive rights to a company without receiving adequate remuneration in line with normal market conditions.

This definition means that the commission will have ample opportunities to review and investigate companies already active or willing to be present in the EU.

The other key element of the definition is that a foreign subsidy may be given not only by a central government, but also by any public authority at all levels, or any public or private entity whose actions can be attributed or linked to the non-EU country.

Assessing the Distortion of Competition and Tools at the Disposal of the Commission

The EC will be empowered to investigate foreign subsidies and will have at its disposal two prior authorisation tools in the form of notification requirements for M&A and public procurement procedures, as well as a second tool – the possibility to start an ex officio investigation into all other market situations and lower-value mergers and public procurement procedures.

The ex officio investigative powers are wide, not least by allowing it to scrutinize support provided up to 10 years before the start of the investigation and imposing remedies to correct any subsidies it will have found distortive. That said, the EC considers that where the amount of foreign subsidy does not exceed EUR 4 million over three consecutive years, that subsidy is unlikely to distort competition.

If an investigation concludes that there is a distortive foreign financial support, the Commission may balance the negative and positive effects of a foreign subsidy. If the negative effects outweigh the positive, the company may be subject to remedies (e.g., undo its acquisition of an EU target, repayment of the foreign subsidy to the foreign state, refrain from certain investments in the EU, license on FRAND terms assets developed with foreign subsidies) or propose commitments to restore the competitive landscape.

The companies can request prenotification consultations for guidance on whether the thresholds for notification are met. The EC may request prior notification of any M&A which is not notifiable, where the EC has concerns that foreign subsidies may have been granted in the three years prior to the concentration.

In the absence of proper information or refusal to submit the requested information to the EC, the EC will take a decision on the basis of available facts. This is important, as the burden of proof lies with the company to demonstrate that a foreign subsidy is not leading to a distortion of competition.

Notification Thresholds

Under the FSR, companies should report a planned M&A if at least one of the merging parties, the target or the joint venture is established in the EU and generates an aggregate turnover in the EU of at least €500 million, and any of the companies involved has received foreign subsidies of at least €50 million in the three years prior to the notification.

For public procurement, the threshold is a contract value of at least EUR 250 million and the tenderer received foreign subsidies of at least 4 million in the three years prior to the submission of the tender. It is important to note that the threshold for subsidies received for public tenders is substantially lower than for M&A.

When a Foreign Subsidy Does Not Pose a Problem

As with state aid, a foreign subsidy does not pose a problem when it is granted a market terms. This is the so-called market economy operator principle. The FSR states:

A financial contribution ... should not be considered as conferring a benefit when the benchmark assessment shows that the undertaking would have obtained that benefit under normal market conditions.

This means that if a foreign state or state-controlled entity[1] has behaved as a rational market operator and can demonstrate it, then there will be no benefit to the company.

This also means that companies that suspect they may have received foreign subsidies would need to carefully review the basis on which they have received them.

Another point to consider carefully is that "transfer pricing in the context of goods and services exchanged within an undertaking can confer a benefit if that transfer pricing is not in line with normal market conditions."[2]

This is important, as it will require that companies that have received foreign subsidies would need to review their internal pricing policies, similar to EU state aid approach, to eliminate the passing of the foreign subsidy.

The commission clarifies that "the benefit conferred by a financial contribution may be passed to an undertaking engaging in an economic activity in the Union."[3]

Next Steps

Since its approval on Nov. 28, the remaining steps are now the publication in the Official Journal of the EU.

Then, the new regulation will enter into force 20 days after its publication. It will start applying six months after its entry into force, most likely towards the middle of 2023.

However, the notification obligations will start applying nine months after the entry into force.

Publication of Guidelines

In order to foster predictability and support companies in understanding what the requirements are, the commission will publish and regularly update guidelines regarding, among other things:

- The form, content and procedural details of notifications;
- The criteria for determining the existence of a distortion caused by a foreign subsidy on the internal market;
- The precise application of the balancing test; and
- The application of its power to request a prior notification of any concentration or public procurement procedure.

Limitation Period and Transitional Provisions

The powers of the commission to review foreign subsidies will be limited to 10 years from the granting of the subsidy.

However, while the FSR does not have retroactive effect, the commission may review foreign subsidies granted up to five years prior to the entry into force of the regulation, in case these subsidies distort competition. The five-year period is limited to three for notifiable transactions.

The commission clarifies that the regulation does not apply to concluded M&A transactions, a controlling interest acquired or public procurement awarded prior to the date of application of the regulation.

This limitation does not mean, however, that the commission cannot initiate an ex officio investigation into the resulting entity operating in the EU, even if the M&A deal itself is not questioned.

How to Be Prepared

Companies that receive foreign support in any shape or form will need to carefully consider how the FSR may affect their EU-bound activities.

This means, among other things, reviewing their current and past relationships with non-EU governments and assessing their level of risk to potential investigation, in addition to building internal review and compliance mechanisms to assess whether any of their planned acquisitions or bids in the EU require upfront notification.

Companies may also want to consider preparing relevant documentation and justifications to support their position in the event of an investigation, which may go a long way in achieving successful outcome.

In addition, companies with complex structures may want to review their internal transfer pricing models to ensure that no benefit received somewhere else is passed into their EU-bound operations.

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[1] A state-controlled entity would be for instance the state sovereign wealth fund; a municipality; a state university or a state-owned development bank. These are not exhaustive examples.

[2] Preamble to the Foreign Subsidies Regulation, recital 13.

[3] Idem.