MUCH TO BE WORKED OUT: THE EUROPEAN COMMISSION'S PROPOSAL FOR A REGULATION ON FOREIGN SUBSIDIES DISTORTING THE EU INTERNAL MARKET

BY MATTHEW HALL[1]

1 Partner, McGuireWoods London LLP.

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The European Commission's May 2021 Proposal for a Regulation on Foreign Subsidies Distorting the EU Internal Market is an eye-catching measure due to its expressly extra-territorial nature. It applies to any business – including EU businesses – engaged in an economic activity in the EU and lays down rules and procedures for investigating subsidies from a non-EU Member State that distort the EU internal market and for redressing such distortions. Included are compulsory notification regimes for acquisitions and when engaging in certain public procurement procedures in the EU. The Proposal would extend in part the EU State Aid regime (which controls the grant of subsidies by EU states) to subsidies granted by non-EU countries (foreign subsidies). If adopted, companies should expect active enforcement as the Commission will allocate some 145 FTEs to enforcing the rules. Companies should consider the implications and start collecting relevant information in order to comply now.

Among the various new obstacles to foreign direct investment worldwide, probably the most eye-catching is the European Commission's May 2021 Proposal for a Regulation on Foreign Subsidies Distorting the EU Internal Market.[2] The Proposal stands out in particular due to its solely extra-territorial nature, which was made explicit in the Commission's accompanying press release:[3]

> [The Proposal] aims at closing the regulatory gap in the Single Market, whereby subsidies granted by non-EU governments currently go largely unchecked, while subsidies granted by [EU] Member States are subject to close scrutiny. The new tool is designed to effectively tackle foreign [i.e. non-EU] subsidies that cause distortions and harm the level playing field in the [EU] Single Market in any market situation.

The Proposal applies to any business – including EU businesses - engaged in an economic activity in the EU. This includes a company making an acquisition or participating in a public procurement procedure. It lays down rules and procedures for investigating subsidies from a non-EU Member State that distort the EU internal market and for redressing such distortions.[4] In practice, to some extent it extends the EU State Aid regime (which controls the grant of subsidies by EU states) to subsidies granted by non-EU countries (foreign subsidies).

As the Commission sees it, foreign subsidies may give companies an unfair advantage, crowd out non-subsidized companies, harm innovation and damage the quality and choice of goods and services for consumers in the EU.

According to the Commission, the regulatory gap arises due to foreign subsidies that fall outside the existing EU State Aid, merger control, antitrust and public procurement rules. The State Aid rules only cover support given by EU Member States. The merger and antitrust rules do not enable the Commission (or EU Member States) to consider whether a company may have benefitted from distortive foreign subsidies and similarly the EU public procurement framework does not specifically address distortions to the EU procurement markets caused by foreign subsidies. By applying only to extra-EU subsidies, the Proposal is designed to "complement" and be "fully coherent" with those rules.

The Proposal would also complement the existing WTO subsidy rules and EU trade defense instruments, since those apply to the import of subsidized goods, but do not apply when foreign subsidies support investments, acquisitions or bids in procurement procedures, or when services and financial flows are concerned. Finally, the framework in the EU for screening foreign investments (in parallel to merger control) tackles threats posed by foreign takeovers and investments to Member States' security and public order, but not to the level playing field.

So far as concerns its language and general structure, the Proposal achieves its intended complementarity and coherence with the EU State Aid, merger control and public procurement rules in particular. However, there are many uncertainties and practical issues arising which are readily apparent even now. In addition, the general concepts will be alien to many non-EU lawyers, who will often need to interpret the rules for potentially affected companies. Significant lawyers' and company time will be spent understanding and grappling with the issues, some of which are summarized below.

2 European Commission, Proposal for a Regulation of the European Parliament and of the Council on foreign subsidies distorting the Internal Market (SWD(2021) 99 final, SWD(2021) 100 final, SEC(2021) 182 final), May 5, 2021, available at https://ec.europa.eu/competition/international/overview/proposal_for_regulation.pdf.

3 European Commission press release, Commission proposes new Regulation to address distortions caused by foreign subsidies in the Single Market, May 5, 2021, available at https://ec.europa.eu/commission/presscorner/detail/en/ip_21_1982.

4 It is notable that, from January 1, 2021, the United Kingdom has been a foreign country so far as concerns the EU.

I. DEFINITION OF A FOREIGN SUBSIDY

According to the Proposal, a foreign subsidy will exist where:

> … a third country provides a financial contribution which confers a benefit to an undertaking engaging in an economic activity in the internal market and which is limited, in law or in fact, to an individual undertaking or industry or to several undertakings or industries.

A "third country" is any non-EU Member State, including governmental authorities at any level, or public or private entities whose actions can be attributed to the non-EU country.[5] Only financial contributions provided by a non-EU country are relevant, so that if an undertaking obtains such partly from an EU country and partly from a non-EU country, then only the element from the non-EU country (or countries) is relevant. In most cases, this should not give rise to an issue, but when calculating the contributions received, a large group will need to make sure that it captures and combines these from any country worldwide (outside the EU).

"Financial contribution" is defined in the Proposal and includes a wide range of possibilities which are familiar to EU State Aid practitioners (including the transfer of funds or liabilities, the foregoing of revenue that is otherwise due (i.e. tax breaks) and "the provision of goods or services or the purchase of goods and services"). The Commission's press release refers specifically to zero-interest loans and other below-cost financing, unlimited state guarantees, compensations, zero-tax agreements, preferential tax treatment, tax credits, direct financial grants and export financing that is not in line with the OECD Arrangement on official supported export credits.

So far as concerns whether that financial contribution provides a "benefit," similarly State Aid principles will be used. Thus, this will be determined on the basis of comparative benchmarks, such as the investment practice of private investors (often referred to as the "market economy" principle), rates for financing obtainable on the market, a comparable tax treatment, or whether adequate remuneration for a given good or service has been provided. Although well-established and litigated principles in the EU, these are still highly complex issues.

The reference to "limited" means that the financial contribution must also be selective. This is also a difficult topic in State Aid law (for example in relation to tax breaks or tax rulings provided by individual countries in favor of particular businesses).

Applying the relevant EU principles in order to determine the position in all relevant countries around the world where a business may have received a financial contribution of any nature (including for example an individual tax ruling) will be a significant task. This is not something that a company will want to carry out in a short timescale when it becomes necessary under these EU rules. It would be much preferable to know the situation already, which will require investigating and recording the position and updating it on an ongoing basis. This is particularly the case since a given foreign subsidy could be assessed more than once under the various heads of review considered below.

II. THE FOREIGN SUBSIDY MUST DISTORT THE INTERNAL MARKET

As noted, the Proposal is aimed at investigating foreign subsidies that distort the internal market and redressing such situations. It is clear that a subsidy must be more than *de minimis* in order to distort the internal market. However, beyond an express carve-out for subsidies totaling less than EUR 5 million over a consecutive period of three fiscal years, there is a lot of room for argument as to when a distortion arises.

In practice, companies monitoring and recording subsidies granted to them will need to take account in particular those which fall within the categories identified as "*most likely to distort the internal market.*" These are: subsidies granted to an "ailing undertaking" where there is no restructuring plan (that includes a significant own contribution by the undertaking); a subsidy in the form of an unlimited guarantee for debts or liabilities of the undertaking; a subsidy directly facilitating a "concentration" (i.e. acquisition or merger); and a subsidy enabling an undertaking to submit an "unduly advantageous tender" in a public procurement procedure, on the basis of which the undertaking would be awarded the public contract.

These are all familiar concepts in EU competition, State Aid and public procurement law, but they are only examples and the Commission will be able to identify a distortion in a very wide range of cases. In that situation, the next question is "balancing." If there is a distortion, the

5 The regime is likely to be extended to the European Economic Area ("EEA"), which includes the EU plus Norway, Iceland and Liechtenstein.

Commission will balance the "negative and positive effects" when deciding whether to impose redressive measures against the undertaking in question or to accept "commitments." This means changes to the operation of the business, or potentially repayment of the subsidy plus interest.

The problem is that there is no attempt in the Proposal to define on what basis this balancing will be carried out. The Proposal simply states that the Commission shall balance the distortion on the internal market with positive effects on the development of the relevant economic activity. Those positive effects must presumably be in the EU, but that is not stated.

It's also unclear whether beneficial external effects can be included, most obviously in the sustainability, particularly climate change, area. Given the EU Green Deal and the level of discussion of this issue in relation to general EU antitrust law, this is surprising. An argument against these being relevant is that in the first preparatory document before the Proposal itself, the Commission had referred to a "European interest" test, which clearly allowed broader EU interests to be taken into account so as to counterbalance any distortions. However, this was removed in the Proposal, therefore suggesting a narrower focus.

This is without doubt an area where there will be much lobbying of the Commission and in relation to which litigation is ultimately likely. Creative thinking will be required in many cases to identify positive effects in the EU and how to measure these against the distortion in the EU. Companies will need to be ready to prepare detailed reports dealing with this balancing and in many cases will need to enlist the EU country in which an investment is being made in order to back them up.

It's interesting that, in providing examples of distortive foreign subsidies that might be investigated by the *ex officio* tool discussed below, the Commission singles out the case of an EU subsidiary of a non-EU-country parent which has access to cheap, state-supported financing from the non-EU country and which can therefore unfairly outcompete non-subsidized EU competitors. This makes the point that EU companies also need to consider the implications of the rules.

III. WHAT CAN THE COMMISSION DO IF THERE IS A SUBSIDY? THE *EX OFFICIO* REVIEW

Having established the general principles of what a foreign subsidy is, the Proposal moves on to how and when the Commission can investigate these and therefore when it potentially can accept voluntary commitments given by the recipient or (in the absence of commitments) can take redressive measures against the recipient.

This is the first taste of the procedural provisions, and they follow traditional EU lines. The Commission may examine information from any source and seek "all the information it considers necessary" to assess, on a preliminary basis, whether a financial contribution constitutes a foreign subsidy and whether it distorts the internal market. It can use written information requests and "inspections in and outside the [EU]."

It's clear that competitors of businesses that may have received subsidies will be able to complain to the Commission and try to convince it to examine the situation. As with complaints and litigation about State Aid within the EU, this will become a new avenue of attack against competitors. The Proposal does not require a "formal" complaint, so the Commission might be deluged by a large number of informal letters and complaints about allegedly subsidized third parties.

"Inspections" are commonly referred to as "dawn raids" and under the Proposal the Commission will be able to carry these out not only within the EU but also, remarkably, in other countries. The Proposal does accept that these extra-territorial dawn raids can only take place if "the undertaking concerned has given its consent and the government of the third country has been officially notified and has agreed to the inspection." It is difficult to imagine a situation in which an undertaking (not to mention a third country) will agree to a voluntary dawn raid of this nature. These types of extra-territorial inspections do exist, for example in the medical device sector when products are being considered for approval for sale in the EU. However, a contentious situation such as this, when the undertaking will always have the option of replying to written questions, is entirely different.

This general market investigation tool will allow the Commission to investigate situations such as greenfield investments or acquisitions and procurements below the thresholds for compulsory notification which are discussed below. A standstill obligation will apply.

If, following its preliminary review, the Commission considers there are sufficient indications that an undertaking has been granted a foreign subsidy that distorts the internal market, it is required to initiate an in-depth investigation. This stage ends with a decision that there are no issues (i.e. no distortion or any distortion is outweighed by positive effects), a decision identifying issues and requiring redressive measures or a decision identifying issues and accepting voluntary commitments.

These commitments and measures can include a range of structural or behavioral measures, including amongst other options the divestment of assets, the prohibition of certain market behavior, the repayment of a foreign subsidy (plus interest), the reduction of capacity or market presence and giving access to infrastructure. As with merger control reviews, it is inevitable that there will be a significant amount of negotiation of these remedies with the Commission and the subsidized business will need to put forward an analysis of the impact of its proposals.

Importantly, the Proposal allows the Commission to take these decisions based on the "facts available" to it (which may be limited). In addition, the Commission would be able to assume, where an undertaking fails to provide necessary information, that a financial contribution did indeed confer a benefit to it. This puts pressure on a company to cooperate with the Commission and answer its questions, since otherwise the Commission may just proceed on the basis of information provided by complaining competitors. It also puts pressure on a company to understand the scope of the law and what it is intended to achieve. Only then will a company be able to answer in the "correct" way (i.e. tactically to its benefit).

When presenting the Proposal, the Commission recognized that its ability to proceed on the basis of "facts available" would encourage investigated entities to make sure that the Commission has the correct evidence for its decision. The text of the Proposal itself expressly provides that "when applying facts available, the result of the procedure may be less favorable to the undertaking concerned than if it had cooperated."

There is no time limit for these *ex officio* investigations. Therefore, in addition to litigation about whether or not in-depth investigations should be started and their results, it's clear that there will be litigation about their length. Timing of the in-depth investigation in an *ex officio* situation is surely something that must clarified.

IV. WHAT ARE COMPANIES OBLIGED TO DO? COMPULSORY NOTIFICATION OF CERTAIN TRANSACTIONS

The Proposal introduces an additional compulsory notification and pre-closing clearance regime for certain transactions (i.e. a standstill obligation). This will operate in parallel with existing foreign direct investment and merger control notification obligations in the EU.

The new regime closely follows the well-known jurisdictional and procedural rules which already apply under the EU Merger Regulation (as well as the rules for *ex officio* investigations outlined above). In practice, therefore, when analyzing the applicability of the EUMR to a transaction, the jurisdictional review under the new subsidies regime will be overlayed on top of it.

The main differences between the two regimes are: the need for one or more of the parties to be "established in the [EU]"; the EU turnover requirement for the parties which must be met for a filing to be required; and the additional requirement for there to have been a subsidy from non-EU states of more than EUR50 million in the three calendar years prior to notification (the "financial contribution from third countries").

The question of whether a party is "established" in the EU needs clarification. In the case of a simple acquisition, this refers to the "acquired undertaking," which presumably is the parent company of the target group, but this is not clear. Calculation of the required turnover level is relatively easy, with this being set at EUR500 million for the target group in the case of a simple acquisition.

The foreign subsidy level is set at EUR50 million; in a simple acquisition this applies to both the target group and the acquiring group in the three calendar years prior to notification. This is a surprising formulation, since it means that subsidies given to the target are relevant (when the regime is apparently intended to catch subsidies which benefit a purchaser in acquiring an EU target), but it does widen the scope of the regime.

As with *ex officio* investigations, the result of the Commission's review will be that there are no issues (i.e. no distortion or any distortion is outweighed by positive effects), a decision identifying issues and requiring redressive measures or a decision identifying issues and accepting voluntary commitments. All of this will be analyzed as for an *ex officio* investigation and therefore subject to the same concerns.

It's notable that the Commission also has the authority (prior to closing) to require notification of transactions falling below the new jurisdictional thresholds when it suspects that the parties benefitted from foreign subsidies in the three years prior to the transaction. This makes it even clearer that companies active in the EU in mergers and acquisitions must keep good records of all subsidies received so that they are able to deal with questions and issues raised.

V. WHAT ARE COMPANIES OBLIGED TO DO? COMPULSORY NOTIFICATION IN PUBLIC PROCUREMENT PROCEDURES

In some cases, a foreign financial contribution must be notified to the purchaser in a public procurement procedure (i.e. those cases where a public or similar body puts out a contract for tender in accordance with the EU public procurement rules). This is the case when the estimated value of the procurement is at least EUR250 million. That is clearly a significant purchase and therefore the notification obligation will not be relevant in most procurement processes.

Where it is relevant, the notification obligation applies at the time the tender is submitted. All foreign financial contributions received in the three years preceding that notification must be identified or the bidder must confirm that it did not receive any in that period. The purchaser must then inform the Commission about any notification it receives so that the Commission can start a preliminary review (except in relation to timing, again the rules for *ex officio* investigations outlined above will apply).

A difficulty is that, in addition to the lead tenderer, the notification obligation extends to "main" subcontractors and suppliers and the lead tenderer in that case is required to ensure that notification takes place. This puts a significant burden on the lead tenderer, which in this situation is in effect representing third parties and may be providing confidential information the source of which it is not privy to and which it will not be able to verify. Fines can be imposed for intentionally or negligently supplying incorrect or misleading information in a notification, so this is a real concern. It will presumably become standard for individual contractual protections to be put in place to deal with these issues.

Notification of a foreign subsidy does not suspend the public procurement procedure, but under the Proposal the purchaser would not be allowed to award a contract to a company under investigation by the Commission following a purchaser informing it of a notification (standstill obligation). Remarkably, the in-depth investigation in a public procurement case can run up to 200 days. That seems unnecessarily drawn out and it is difficult to understand why it is so much longer than the period for a full preliminary and in-depth review of subsidized acquisitions.

As with transactions, it's notable that the Commission also has the authority to require a notification in any case (even below the thresholds) where it suspects that the bidder has benefitted from foreign subsidies in the three years prior to the tender. Again, therefore, companies active in public procurement procedures in the EU should, if only for this reason, keep good records of all foreign subsidies received so that they are able to deal with questions and issues raised.

VI. CONCLUSION

For many companies engaged in mergers and acquisitions in the EU, the Commission's proposal on foreign subsidies will become a mandatory third tier of regulatory review (alongside the foreign direct investment and merger control rules). However, the scope is wider than that due to the mandatory notification regime for companies bidding in certain public procurement procedures and the ability of the Commission to instigate *ex officio* investigations.

The Proposal is backward looking since it allows the Commission to consider foreign subsidies granted in the 10 years before it comes into force and since for the purposes of the mandatory notification regimes it takes into account foreign financial contributions granted in the three years before it comes into force. This means that, starting now, companies would be well advised to identify and record relevant foreign subsidies on an ongoing basis and going back at least nine years (so that when the Proposal is in force they will be in a position to deal with questions under the Proposal as implemented).

The Proposal now faces a lengthy review process before it becomes law, which (assuming it does) is unlikely to take place before the end of 2022. It is likely to be controversial, in particular since it adds to the increasing complexity of transaction review in the EU. Companies could end up having to file under three regimes (potentially in multiple countries for merger control and foreign direct investment review) which consider different issues and which are operated by different officials and which could require different remedies (or commitments). The Commission should publish guidance on how the different procedures will or should be coordinated at Commission and/or EU Member State level.

In addition, many will argue that the Proposal is too wide-ranging and should be focused on companies from non-market economies with well-funded state-owned enterprises where subsidies (State Aid) are subject to limited oversight. A legitimate question is why it should apply to a third country (such as the UK for example) with which the EU has a strongly-negotiated trade agreement dealing with subsidy control.

Despite this, and the likely length of the review process, it would be surprising if the final text included material changes from the Proposal, since it's understood to have general support amongst EU Member States.

If adopted, companies should expect active enforcement as the Commission will allocate some 145 FTEs to enforcing the rules; quite a significant amount of manpower. The Commission expects to initiate between 30-45 *ex officio* investigations per year and review 60-70 compulsory notifications under the rules concerning acquisitions and public procurement procedures.

Now is a good time for potentially affected companies based outside the EU to consider the implications and start collecting relevant information. They should consider what foreign state support they have received (in any form), assess the risk of potential investigation, prepare justifications to support their position and build internal mechanisms to ensure compliance with the rules going forward.