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CLIENT ALERT

EU Institutions Reach Agreement on Foreign Subsidies Regulation

July 20, 2022

On June 30, 2022, the EU co-legislators (the European Parliament and the Council) reached agreement on a new, far-reaching Regulation aimed at tackling the distortive effects of subsidies from non-EU governments in the EU internal market. The Foreign Subsidies Regulation (FSR) adds three new tools to the European Commission's regulatory arsenal: a mandatory filing obligation for M&A activity fueled by foreign subsidies, a requirement to notify foreign financial contributions when submitting bids for public contracts, and a general investigation tool. The new regime is expected to become effective in mid-2023.

As we wrote in an earlier client alert, the European Commission proposed the FSR in May 2021 to close a regulatory gap and level the playing field between undertakings receiving subsidies from EU Member States, which are subject to strict state aid rules, and recipients of third-country subsidies, which so far escaped scrutiny. The proposal followed a public consultation on the European Commission's June 2020 White Paper on Foreign Subsidies.

Scope

The FSR addresses **foreign subsidies** granted to undertakings engaging in economic activities in EU markets and that are liable to distort competition in those markets. Note that the FSR applies to non-EU companies that receive state support in their "home" countries, and to EU-based companies or EU-headquartered groups that benefit from third-country subsidies. A foreign subsidy is defined as an intervention that must include three criteria.

1. **Financial contributions by a third country:** These encompass **direct financial contributions** (e.g., subsidies in the narrow sense) as well as **all kinds of transfers of funds or liabilities provided directly or indirectly by a third country** (i.e., non-EU country). The latter includes capital injections; grants; loans and loan guarantees; fiscal incentives; offsetting of operating losses; compensation for financial burdens imposed by public authorities; debt forgiveness and debt to equity swaps; and rescheduling. Financial contributions can also include **foregoing of revenue that is otherwise due**, such as tax exemptions or the granting of special or exclusive rights without adequate remuneration.
2. **Benefits:** According to the recitals, a foreign subsidy is considered to confer a benefit to an undertaking if it **cannot be obtained under normal market conditions**. The existence of a benefit can be determined based on a competitive benchmark, such as the investment practice of private investors.
3. **Selectivity:** The third-country support should be selective, i.e., **limited in law or in fact to specific undertakings or industries**.

The similarity between the FSR's definition of foreign subsidy and that of **state aid** in EU competition law is obvious. The latter also covers interventions that are granted directly or indirectly through state resources and confer an economic advantage to the recipients by selectively favoring certain undertakings, and are therefore liable to distort competition. The only essential difference is that the FSR addresses interventions by third countries, whereas state aid rules deal with support granted by EU Member States.

The FSR provides a **de minimis threshold of €4 million** over any consecutive period of three financial years. A foreign subsidy is considered unlikely to distort the internal market if its total amount does not exceed this threshold.

Regulatory Tools

The FSR introduces three new regulatory “tools.”

1. Ex officio investigation tool

The FSR empowers the European Commission to investigate —on its own initiative—information from any source regarding alleged distortive foreign subsidies. Importantly, this also enables the Commission to investigate foreign financial contributions in the context of concentrations or public procurement procedures below the thresholds of the notification-based thresholds discussed below.

If, after a **preliminary review**, the Commission has sufficient indications that an undertaking has been granted distortive foreign subsidies, it can open an **in-depth investigation**. Such an investigation may be concluded in one of three ways:

- A **no-objection decision** (the preliminary assessment is not confirmed or the distortion is outweighed by pro-competitive effects).
- A **decision declaring binding commitments** offered by the undertaking under investigation,which may include the repayment of the subsidy.
- A **decision with redressive measures.**

The FSR provides that the Commission “shall endeavor” to complete the in-depth investigation within 18 months, but this timetable is not binding.

Commitments or redressive measures may include, among others, offering access to an infrastructure or facility at fair, reasonable, and non-discriminatory (FRAND) conditions; reducing capacity or market presence; refraining from certain investments, licensing on FRAND terms of assets acquired or developed with the help of foreign subsidies; publication of R&D results; divestment of assets; adapting a governance structure; dissolving a concentration; or repaying the foreign subsidy.

Additionally, in case of serious risk of substantial and irreparable damage to competition through the implementation of a distortive foreign subsidy, the Commission may order **interim measures**.

2. Notification-based tool for concentrations

The FSR introduces a filing obligation for M&A activity fueled by foreign subsidies. In this context, concentrations encompass acquisitions, mergers, and the creation of full-function joint ventures. Two cumulative notification thresholds apply:

- At least one of the merging undertakings, the acquired undertaking, or the joint venture is established in the EU and generates an aggregate **EU turnover of at least €500 million**.
- The undertakings involved received combined **financial contributions of more than €50 million** from third countries in the three financial years prior to the notification.

The Commission can also require the parties to notify a concentrationthat does not meet the notification thresholdswhen it suspects that the undertakings concerned received distortive foreign subsidies in the three financial years prior to the concentration.

The notification entails a **standstill obligation**, meaning that the concentration may not be implemented until cleared by a Commission decision or, in the absence of a decision, by expiration of the legal deadline. The Commission has 25 working days from receipt of a complete notification to carry out a preliminary assessment. If it then decides to open an in-depth investigation, the standstill period is extended by an additional 90 working days, which can be extended by 15 working days if the parties offer commitments. The Commission can "stop the clock" if the undertakings fail to provide the requested information or to submit to an inspection. The time limits for the in-depth investigation can also be extended at the request or with the agreement of the parties. However, the total duration of such extensions shall not exceed 20 working days. If undertakings fail to meet their obligation to notify a concentration, the Commission can investigate the concentration without being bound by the above-mentioned time limits.

The in-depth investigation concludes by either one of the three decisions noted above in the context of the ex officio investigation tool, by a prohibition decision, or the expiration of statutory time limits. The Commission may also order the parties to unwind an already implemented concentration if it finds that the concentration distorts competition.

The Commission can impose **fines** of up to 10% of the aggregate turnover of the undertakings in the preceding financial year for violating the notification and/or standstill obligations ("jumping the gun"), or for implementing a prohibited concentration. It can also impose fines of up to 1% of the aggregate annual turnover for supplying incorrect or misleading information.

3. Notification-based tool for public procurements

The FSR imposes a requirement to notify foreign financial contributions when submitting bids for public contracts. As in the case of concentrations, the Commission can require a notification even in cases where the thresholds are not met, if it suspects that a bidder benefited from distortive foreign subsidies in the three years preceding the submission of the tender (without prejudice to the possibility to start an *ex officio* investigation). The notification requirement is triggered when two cumulative thresholds are met:

- **Estimated value** of the public procurement or framework agreement net of VAT amounts to **at least €250 million**.
- Aggregate **financial contributions of at least €4 million** per third country in the three financial years prior to notification are granted to the bidding company (including subsidiaries, holding companies and—where applicable—main contractors and suppliers) involved in the tender.

Where the procurement is divided into lots, there is an additional requirement that the value of the lot—or the aggregate value of all the lots—to which the tenderer applies, amounts to at least €125 million. Even if these thresholds are not met, participants must declare all foreign financial contributions received in the last three financial years.

The notification or declaration should be submitted at the same time as the tender to the contracting authority, who transfers it to the Commission without delay.

The Commission must carry out a preliminary review within 20 working days from the date of receipt of a complete notification (a time limit which can be extended only once by 10 working days in duly justified cases). If the Commission decides to open an in-depth investigation, it has 110 working days from the date of notification to complete such an investigation (a time limit which can be extended once by 20 working days in duly justified and exceptional cases). Pending the Commission's review, all steps in the public procurement procedure may continue, except for the award of the contract.

The in-depth investigation can be closed in the same ways as noted above in the context of the tool for concentrations.

As with the notification tool for concentrations, the Commission can impose fines of up to 10% of aggregate turnover in the preceding financial year on participants in public procurement procedures who fail to notify foreign financial contributions. It can also impose fines of up to 1% for supplying incorrect or misleading information in a notification or declaration.

Balancing test

When assessing foreign subsidies, the Commission may **balance the negative effects of market distortion against the positive effects of subsidized economic activity** in the EU, while also considering other positive effects of the subsidy on relevant policy objectives of the EU. The Commission shall take such balancing between negative and positive effects into account when deciding whether to impose redressive measures or accept commitments, and on the nature and level of those measures or commitments.

Market investigations

Apart from investigations into foreign subsidies to specific undertakings as described earlier, the Commission can also carry out broader market investigations where there is evidence that foreign subsidies into particular sectors or economic activities, or particular subsidy instruments cause market distortions. In this context, the Commission can also request undertakings to supply information or carry out inspections. The Commission may use the information obtained from such market investigations in the framework of procedures under the FSR (including to open an ex officio investigation into specific undertakings).

Enforcement

The European Commission will be the sole enforcer of the FSR, with sweeping investigative powers similar to the ones it has under competition law. This includes the power to **request information** from companies and carry out **inspections**, otherwise known as "dawn raids." The FSR even allows the Commission to carry out inspections outside the EU, provided that the government of the third country does not object.

In addition to the **fines** already noted above, the Commission is also empowered to fine undertakings up to 1% of aggregate annual turnover for failing to: provide correct and complete information within the prescribed deadlines; providing misleading information; or refusing to submit to inspections. It can also impose periodic penalty payments of up to 5% of average daily aggregate turnover to force compliance.

The powers of the Commission to carry out preliminary reviews and in-depth investigations is subject to a **limitation period** of ten years, starting on the day on which a foreign subsidy is granted to the undertaking (but opening a preliminary review, sending an information request, or carrying out an inspection interrupts the limitation period, after which a new limitation period starts to run afresh). The Commission's powers to impose fines and periodic penalty payments is subject to a limitation period of three years from the date for the infringement; the power to enforce fines or periodic penalty payments is subject to a limitation period of five years from the date of the decision imposing them.

Background and implications

The fact that political agreement on the FSR was reached within a record 14 months from the European Commission's initial proposal indicates there was widespread support for new regulation to address the distortive effects of foreign subsidies. There is no doubt that the broader context of a European economy heavily impacted by the COVID-19 pandemic and the effects of the sanctions against Russia due to the war in Ukraine have only heightened fears that unduly advantaged foreign firms could take advantage of depressed company valuations to gain more clout in EU markets.

While applicable to state support by any third country, it is hardly a secret that the FSR particularly targets Chinese state-backed undertakings engaging in M&A or bidding for government contracts in the EU. According to a recent study by the Center for Strategic and International Studies, a Washington-based think tank, the Chinese government spends hundreds of billions of dollars every year supporting its domestic industries. The study estimates that in 2019, the benefits—in the form of direct subsidies, below-market-rate loans and land sales, tax breaks, capital provided by State-run investment funds, etc.—amounted to at least 1.73% of China's GDP. This is equivalent to $248 billion at nominal exchange rates and $407 billion at purchasing power parity exchange rates. China's spending on industrial policy thus far outstrips spending by other industrialized nations. Brazil, France, Germany, Taiwan, South Korea and the United States were used for comparison, with the next largest spender being South Korea, at 0.67% of GDP. As comparison, the United States spent approximately 0.39% of GDP on subsidies and other benefits to private businesses.

The existence of state subsidies in China has also been diagnosed in EU anti-dumping and, since 2010, in anti-subsidy investigations. In 2017, the European Commission published the so-called first country report on China, which cites the "significant distortions" in China's economy as a result of state intervention for the purposes of trade defense investigations. The EU has been mapping market-distortive state interventions in China for quite some time and has already reached findings of market-distorting subsidies in anti-subsidy investigations.

Regardless of their origin, all companies—including EU-based companies—that have received some form of support from third countries going back three financial years and engage in any economic activity in the EU, will have to carefully assess whether they are caught by the new regime and its notification obligations. This is liable to add another layer of complexity to an already complex regulatory landscape for foreign investors in the EU. For instance, the same M&A transaction may in the future be subject to up to three regulatory procedures—merger control, FDI screening, and foreign subsidy controls—in addition to any other sector-specific controls. Each procedure comes with its own filing requirements and timetables.

Next steps

The FSR is expected to be adopted and enter into force by the end of 2022. With the exception of the notification obligations, it will become directly applicable by mid-2023, six months after its entry into force. Notification obligations will become applicable nine months after entry into force, likely towards the end of the third quarter of 2023. The FSR will apply to foreign subsidies granted in the five years prior its date of application where such foreign subsidies distort EU markets after the start of application of the FSR. However, the FSR will not apply to concentrations that have already been completed or public procurement contracts that have already been awarded before its date of application.

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