Foreign subsidies under the EU microscope

European Commission proposes new tools to redress EU market distortions caused by subsidies from non-EU entities

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The European Commission (the EC) is taking forward proposals for new regulatory tools to remedy market distortions caused by companies receiving subsidies from non-EU entities (foreign subsidies). It published on 5 May 2021 a draft Regulation on foreign subsidies distorting the internal market (the **draft Regulation**). Whilst these new tools intend to protect the level playing field in the EU's internal market, they could have profound effects on foreign companies active in the EU.

Closing the gap on foreign subsidies

In a **White Paper** published on 17 June 2020, the EC opened a public debate on new legal instruments to remedy market distortions caused by companies receiving foreign subsidies (see our **alert** on the White Paper). The EC mentioned several instances of such distortions, including cases in which foreign subsidies appeared to have facilitated the acquisition of European companies, impacted other investment decisions, or otherwise influenced the market behaviour of their beneficiaries. This, according to the EC, contrasts with the rigorous rules governing State aid granted by EU Member States, which effectively prevent any form of support that could hinder competition in the EU's internal market other than in very limited circumstances.

The EC also considered at the time of the White Paper that the current regulatory framework is not fit for protecting European interests because none of the legal instruments available properly address the issue of foreign subsidies. Merger control and antitrust rules focus on consumer welfare, whilst national foreign investment control regimes (including the EU's common screening framework) tackle the risk of threats to security and public order.

And EU trade policy instruments, including the EU anti-dumping and anti-subsidy rules, as well as WTO law, have considerable limitations.

The White Paper therefore proposed different ‘modules’ targeting possibly distortive foreign subsidies in the context of the acquisition of EU companies, of public procurement procedures, of access to EU-funded programmes, as well as a general ‘catch-all’ instrument to capture all other risks of distortive market behaviour.

The EC received 150 submissions in response to the public consultation on the White Paper. According to the EC, a very large majority of the contributions from respondents in the EU showed strong support for intervention against distortive foreign subsidies and were overall broadly supportive of the proposals set out in the White Paper (unsurprisingly, respondents based outside the EU were notably less enthused). The EC also indicated that there is a growing consensus in the EU Member States for the creation of legal instruments to scrutinise and redress potential distortions caused by foreign subsidies.

The draft Regulation, whilst generally following the framework proposed in the White Paper, appears to slightly reduce the initially envisaged scope of intervention of regulators against foreign subsidies and brings welcome clarifications on some of the most controversial substantive concepts and procedural points.

What are distortive foreign subsidies?

The draft Regulation casts a very wide net when defining foreign subsidies. Similar to the definition under the EU’s State aid rules, a foreign subsidy can be any form of financial contribution which confers a benefit to a company engaging in an economic activity in the EU’s internal market and which is limited, in law or in fact, to an individual company or industry or to several company or industries. The draft Regulation provides a list of financial contributions that fall within that scope, 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 revenues that are otherwise due, or the provision or purchase of goods or services.

The draft Regulation also clarifies that a foreign subsidy can be granted by a foreign State (including central or local government levels) as well as foreign public entities (including State-owned companies), and even any private entity whose actions can be attributed to a foreign central or local government.

Not all foreign subsidies would be automatically considered distortive. The draft Regulation provides that a distortion on the EU’s internal market shall be deemed to exist where a foreign subsidy can improve the competitive position of the recipient in the internal market and where, in doing so, it actually or potentially negatively affects competition on the internal market. This assessment relies on a series of factors, such as the amount and nature of the subsidy, the situation of the company and the market concerned, and the purpose and conditions attached to the foreign subsidy and its use on the internal market. A case-by-case analysis of relevant circumstances will therefore be required in any event, even though the draft Regulation lists certain categories of foreign subsidies (such as direct support to facilitate a concentration or unlimited guarantees for debts or liabilities of the recipient) as most likely to be distortive.

Finally, and importantly, the draft Regulation provides for a balancing test (originally called the ‘EU interest test’ in the White Paper) to assess whether the negative effects of a foreign subsidy are outweighed by positive effects on the development of the relevant economic activity.

Likewise, the EC will apply a balancing test when deciding whether to impose measures (or to accept commitments proposed by the subsidy recipient) in order to eliminate the distortion on the internal market caused by a foreign subsidy. As with the EC’s approach to remedies under **Regulation (EC) No 139/2004 on the control of concentrations between undertakings** (the Merger Regulation), these measures can be either structural (for instance, the sale of certain assets) or behavioural (for instance, granting access to an infrastructure, or licensing

on FRAND terms of assets acquired or developed with the help of foreign subsidies, or refraining from certain investments). A commitment to repay the subsidies received to the third country that granted it would also be considered a valid redressive measure, as long as the EC can be satisfied that the repayment is indeed effective and transparent.

A new notification regime for concentrations

International businesses are already familiar with the EC's merger control regime under the Merger Regulation. The draft Regulation proposes to put in place a new regime for certain transactions backed by foreign subsidies. Filings under this new regime would be separate from and run in parallel to any other filing under the Merger Regulation or EU foreign investment control mechanisms[1].

The White Paper had proposed a wide array of options on how the subsidy control mechanism could be framed in the context of concentrations and it was envisaged to introduce a number of new concepts. Thankfully, the concepts used by the draft Regulation are for the most part closely aligned with those of the Merger Regulation, in particular when defining the nature of transactions that could be caught by the new regime. The procedural rules and timelines are also very similar to those of the Merger Regulation.

In a nutshell, the draft Regulation intends to implement a new mandatory, *ex ante* filing obligation with the EC for concentrations where the EU turnover of the target exceeds EUR500 million and the foreign subsidy exceeds EUR50m.

Similar to the Merger Regulation, a concentration is defined as the acquisition of control of another business. The creation of full-function joint ventures would also be captured. And the rules on the calculation of turnover are identical to the ones applicable under the Merger Regulation.

The review process would happen in two steps:

1. **Preliminary review:** Parties to a reportable concentration would be subject to a filing obligation. The draft Regulation, however, does not set out what information will need to be provided to the EC and it is expected that an implementing regulation will create a notification form comparable to the Merger Regulation's Form CO. Closing of the transaction would not be permitted for a period of 25 business days from receipt of a complete notification. During that period, the EC may conclude that there is no foreign subsidy or no indications of an actual or potential distortion on the internal market; in such a case, the EC would close the preliminary review and inform the company concerned. Alternatively, the EC may conclude that there are sufficient grounds to initiate an in-depth investigation.

2. **In-depth investigation:** The duration of an in-depth investigation would be a further 90 business days – subject to possible extensions of (i) up to 20 business days if the parties or the EC seek additional time and (ii) 15 business days if the parties propose commitments. At the end of the in-depth investigation, the EC may find that an acquisition is facilitated by foreign subsidies and, in doing so, negatively affects competition on the internal market. In such a case, the EC may unconditionally clear the concentration, or clear it subject to structural and/or behavioural commitments (including the repayment of the subsidies received). If no commitments are proposed, or they are considered insufficient, the EC would prohibit the concentration.

[1] Regulation (EU) 2019/452 establishing a framework for the screening of foreign direct investments into the EU provides that, in determining whether a foreign investment is likely to affect security or public order, Member States and the EC may take into account, *inter alia*, whether the foreign investor is directly or indirectly controlled by the government, including state bodies or armed forces, of a third country, including through ownership structure or significant funding. National FDI regimes (for instance in Germany) thus effectively already require that information be provided on foreign subsidies. It will be critical to ensure that the assessment under FDI rules at national level and the assessment by the EC under the draft Regulation are properly aligned.

A breach of the obligations set out in the draft Regulation can lead to hefty fines, including a fine of up to 10% of turnover for failing to notify a reportable concentration or for closing before all relevant timelines have expired or the EC has issued a clearance decision.

Controversially, concentrations below the turnover thresholds could also be called in. The draft Regulation indeed provides that the EC may request that a concentration be notified, at any time prior to its implementation, where the EC suspects that one of the companies involved may have received foreign subsidies in the previous three years.

Notifying subsidies in public procurement procedures

The EC is also concerned about the risk of distortion in public procurement procedures because of the ability of companies receiving foreign subsidies to submit unduly advantageous bids that cannot be matched by EU companies. In order to tackle this risk, the draft Regulation provides for an investigative tool based on a notification for bids in public tenders with a contract value above EUR250m.

In practice, when submitting a tender or a request to participate in a public procurement procedure, companies shall either notify to the contracting authority all foreign financial contributions received in the three years preceding that notification or confirm in a declaration that they did not receive any foreign financial contributions in the last three years. Companies failing to do so shall not be awarded the contract. Upon receipt of the notification, the contracting authority shall transfer the information to the EC and delay the award of the contract until the EC has reached a view.

The EC would then have 60 days to complete a preliminary review, and, in the case of an in-depth investigation, an additional 140 days to adopt a final decision. This time limit, however, may be extended after consultation with the contracting authority. Following the in-depth investigation, the EC may adopt a conditional decision subject to the bidding company committing to remedial measures that fully and effectively remove the distortion on the internal market. Absent such commitments, the EC may adopt a decision prohibiting the award of the contract to the company.

Under the draft Regulation, the EC would also have the right to request that a notification be made, at any time before the award of the contract and irrespective of its value, if it suspects that a company may have benefitted from foreign subsidies in the previous three years.

Ex officio review of foreign subsidies

In addition to the mandatory notification regimes for concentrations and public procurement procedures, the draft Regulation also provides that the EC would have the right to investigate, on its own initiative, any instance of a suspicion that foreign subsidies could distort the internal market. Importantly, this may arise with respect to any economic activity, including concentrations or public procurement procedures that do not give rise to a filing obligation.

Contrary to what was initially proposed in the White Paper, the EC would have an exclusive competence to review foreign subsidies in that context – Member States would not be entitled to do so. Yet, since the EC would be entitled to rely on any source of information to initiate a review, Member States may nonetheless play a role by bringing specific cases to the EC's attention. Competitors are also likely to be a major source of complaints. And the fact that the EC could initiate a review up to 10 years after a subsidy is granted significantly increases this risk.

From a procedural perspective, *ex officio* reviews would follow the same model as reviews based on notifications, ie first a preliminary review followed, in the event of of sufficient indications that a company has received foreign subsidies that distort the internal market, by an in-depth investigation. One notable difference, however, is that the EC would not be bound by any time limit.

In order to conduct both the preliminary review and the in-depth investigation, the EC would be entitled to send requests for information to the companies concerned and other relevant stakeholders. The EC would also be entitled to conduct on-site inspections both within and outside the EU. Failures to cooperate with the EC could give rise to significant fines. It should be added that these investigative tools would also be available in the context of concentrations and public procurement procedures.

Next steps

The draft Regulation will now enter the formal legislative process. Its final adoption will require the agreement of the European Parliament and the Member States.

Whilst amendments to the text can be expected, it appears likely that the draft Regulation will be passed into law in light of the growing support in the EU for a more robust approach to alleged subsidies undermining the otherwise level playing field of the EU's internal market. As noted by the EC's Executive Vice-President Margrethe Vestager, in charge of competition policy and responsible for the cluster Europe Fit for the Digital Age, on 5 May 2021, "*Openness of the Single Market is our biggest asset. But openness requires fairness. For more than 60 years, we've had a system of State aid control to prevent subsidy races between our Member States. And today we are adopting a proposal to also tackle distortive subsidies granted by non-EU countries. It is all the more important to ensure a level playing field in these challenging times, to support the recovery of the EU economy*".

International businesses should brace themselves for a tougher climate in the EU in the years to come. The draft Regulation is indeed only one of the multiple initiatives undertaken in the EU to further regulate the internal market. Combined with the developing rules on **foreign investment control**, the **expansion of the Merger Regulation** to transactions that previously were not caught, new reporting obligations under the proposed **Digital Market Act**, the draft Regulation will only reinforce the need for businesses to consider carefully in advance the approvals necessary (or even advisable) for doing business in the EU.

Please get in touch with your usual Allen & Overy contact if you would like to discuss the implications of the draft Regulation for your business.

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