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European Commission targets foreign government subsidies with wide-ranging new tool

The European Commission's controversial 'White Paper on levelling the playing field as regards foreign subsidies' published on 17 June identifies a regulatory gap which it looks to fill. That gap relates to distortions of competition occurring in the EU as a result of State subsidies granted by non-EU States. The Paper proposes an extremely far-reaching new legal instrument to tackle the issue. The Regulation envisaged would target foreign-subsidised acquisitions, but also any kind of subsidised commercial activity affecting EU markets, including participation in public procurement and access to EU funding. The Commission seeks views on the various options set out in the Paper, to inform its subsequent choice of precisely what kind of legal instrument to propose.

The Paper raises a vast number of questions as to the exact scope and content of the new instrument which will ultimately be adopted, and how it will work in practice. Below we summarise its content and then consider in more detail some aspects of the proposal and its potential implications for different types of businesses.

We also explore some of the points that companies looking at this proposal from different perspectives may consider drawing to the Commission's attention when responding to its consultation, which is open until 23 September.

Summary of proposals

Why is a new instrument needed?

The Commission observes that State subsidies granted by EU Member States are controlled under State aid rules, but that in many situations similar subsidies granted by non-EU governments escape control. Existing EU and international regulatory tools (multilateral and bilateral trade defence instruments, Member State foreign direct investment rules, and EU antitrust, merger control, State aid and public procurement rules) only deal with the issue to a partial and unsatisfactory extent.

In what sectors and situations will it be used?

The new instrument will apply to ***all sectors*** and a wide variety of situations. The Commission proposes a three-part framework, to address foreign subsidies (i.e. subsidies granted by a non-EU government):

- to businesses established, or maybe just active, in the EU market (Module 1);
- facilitating acquisitions of EU targets (Module 2); and
- providing an unfair advantage in public procurement (Module 3).

In addition to Modules 1, 2 and 3 described below, measures are also proposed in relation to foreign access to ***EU funding***.

How would Module 1 work?

Module 1 would be a general instrument empowering the ***Commission or Member State authorities*** to act on their ***own initiative*** to investigate possible ***distortions of the proper functioning of the EU internal market*** caused by a foreign subsidy to a business established, or maybe even just active, in the EU (there would be a cooperation mechanism for case allocation). There would be a preliminary review to decide whether an in-depth investigation was warranted, and this in turn could lead to the imposing of 'redressive measures' (ordering repayment of the subsidy, behavioural or structural changes, or payment by the undertaking concerned to the EU or Member States), or alternatively the taking of binding commitments, with financial penalties for non-compliance.

Certain types of subsidy would normally be considered distortive, and there would be a *de minimis* threshold of €200,000. Other cases would be assessed on the basis of criteria such as the size of the subsidy and the situation of the beneficiary. Distortive effects found would then be weighed against a possible positive impact within the EU (for example on job creation or environmental goals), with the Commission having exclusive competence to apply this 'EU interest test'. All enforcing authorities would have information gathering powers backed by strict sanctions.

And Module 2?

Module 2 would require ***prior notification*** to the ***Commission*** of a ***'potentially subsidised'*** acquisition of ***control*** of, or a specified percentage of shares or voting rights, or otherwise ***'material influence'*** in, an EU undertaking. A preliminary review would establish whether the acquirer may benefit from direct or indirect foreign subsidies facilitating the acquisition. If so, it would be followed by an in-depth investigation into whether there are subsidies distorting the internal market, which could lead to the taking of commitments or prohibition of the transaction. Completed deals could also be investigated and unwound.

A two-step notification process is envisaged, with a short information notice required at the outset. Notification thresholds could be set, which might be quantitative or qualitative, or a combination. Criteria, similar to those in Module 1, would be set for evaluating whether subsidies distort the EU market. Again, there would be a balancing of any distortion against positive effects, and also information gathering powers backed by financial sanctions.

And Module 3?

Module 3 would require public procurement bidders to declare certain foreign subsidies and would set up a two-stage investigation procedure. If it was found that a foreign subsidy made the procurement procedure unfair this could result in the bidder being excluded from either that specific tender or from tenders generally for a period of up to three years.

More in-depth analysis of points we consider noteworthy

... in relation to existing antitrust investigation powers

- **An additional antitrust investigation tool?** Both EU antitrust rules set out in Articles 101 and 102 TFEU and the envisaged foreign subsidies instrument apply to distortions of competition in the internal market. The foreign subsidies instrument is meant to complement general antitrust rules specifically in cases in which an economic operator may have benefited from foreign subsidies. Thus, an investigation under the foreign subsidies instrument will focus on potential distortions of competition caused by foreign subsidies.
- **Without a clear limitation of its scope?** Clearly, the *ex officio* investigation mechanism under Module 1 has a lot of parallels to a general antitrust investigation. The White Paper itself does not draw a clear distinction between the two tools. For example, the White Paper acknowledges that whether an undertaking has benefited from foreign subsidies may already form part of the assessment under Articles 101 and 102 TFEU. An investigation under the foreign subsidies instrument will address potential distortions of competition with 'a specific focus on' distortions caused by foreign subsidies. Thus, the risk of parallel investigations is high.
- **What does this mean in terms of risks and opportunities?** From the perspective of a subsidised undertaking, the foreign subsidies instrument entails the risk of being scrutinised for potential breaches of antitrust rules under two regimes in parallel. This may result in an additional procedural burden as well as the risk of diverging outcomes. Thus, any subsidised undertaking facing antitrust proceedings should assess early on whether scrutiny under the foreign subsidies instrument could be an additional challenge. At the same time, the foreign subsidies instrument may provide non-subsidised undertakings with the opportunity to address distortions of competition directly linked to foreign subsidies with the competent authorities, where these issues would not be sufficient to justify a review under general antitrust rules.
- **Who will be the enforcing authority?** Both the Commission and Member State authorities will be granted powers to enforce Module 1 (and there will be a cooperation and coordination mechanism). However, the Commission will have exclusive competence to balance any distortive effect of a subsidy against possible positive impact. Within the Commission it is not clear yet whether this will be DG Competition (and within that the existing merger, antitrust or State aid units or newly created foreign subsidies units), DG Trade or another part of the Commission. Depending on who will ultimately be the enforcing authority, aligning a Module 1 investigation with a parallel antitrust investigation will be more or less challenging, and issues as to overlap and contacts between the investigating teams will arise. Case allocation between the Commission and Member States will work broadly similarly to the existing cooperation in antitrust as set out in Regulation 1/2003. When a national supervisory authority wants to adopt a decision with redressive measures or a commitments decision it has to consult the Commission and inform the other national authorities prior to adopting such decision. But it can be questioned whether it is desirable for there to be such shared enforcement responsibilities in the case of a

new tool where there is no prior experience or case law to guide enforcers.

… in relation to merger control

- **Introduction of merger control-like additional review mechanism.** The proposed Module 2 is largely modelled on the Commission's existing merger control regime under the EU Merger Regulation (EUMR). It consists of a mandatory *ex ante* notification obligation for acquisitions of EU targets with a standstill obligation. The two-step approach (preliminary review and in-depth investigation) matches the procedural phases under the EUMR. As to the supervisory authorities, the Paper discusses the extent to which enforcement should take place at EU and/or at national level and suggests the introduction of a 'one-stop-shop' mechanism. This mirrors the existing EUMR procedure and should be introduced to avoid burdensome parallel reviews in several jurisdictions.
- **Very low thresholds entail risk of 'catch all' scenario for acquisitions of EU targets.** The Paper (i) includes a low proposed threshold of €100 million target turnover in the EU, or even a qualitative approach, for instance referring to all assets 'likely to generate a significant EU turnover in the future'; and (ii) would catch certain non-controlling minority shareholdings or any other 'material influence' in an undertaking.
  This combination risks catching a vast volume of transactions under the Module 2 notification system. The only limiting factor seems to be the trigger of a 'subsidised acquisition' for which no concrete financial volumes have been proposed yet. Again, this opens up a vast number of transactions to falling under these thresholds and calls for careful consideration as to the appropriate definitions of the triggering events.
- **Risk of diverging outcomes in case of parallel review.** Where a transaction is subject to both merger control review at EU or national level and Module 2, notification and assessment under the two regimes would be dealt with in parallel, but separately from each other. While Module 2 is meant to target a different objective from merger control (distortions of the internal market caused by foreign subsidies versus the significant impediment to effective competition or equivalent test) both aim to prevent a distortion of competition. Thus, it will be important to align both procedures early on to limit the risk of diverging outcomes, for example if remedies are required.
- **Alignment on timing and formalities will be key in limiting the additional burden for notifying parties.** It will be crucial that the authorities harmonise their approach for both merger control and the foreign subsidy notifications under Module 2. This will allow the parties to efficiently manage review processes, including preparation of notification documents and responding to requests for information, and enable consistent outcomes.
- **Interplay between Module 1 and Module 2 of the Paper.** Module 2 targets transactions potentially involving foreign subsidies. In parallel, Module 1 is intended as a 'safety net' applicable to all transactions falling below the thresholds of Module 2. Very small transactions and those with little or no EU nexus and acquisitions of low minority shareholdings could be subject to an *ex officio* investigation, possibly years after the transaction has closed. This would cause fundamental deal uncertainty which the Paper does not resolve. Possible solutions could include a voluntary notification system for deals below the relevant thresholds, or a comfort letter by the relevant supervisory authority not objecting to the transaction.

… in relation to Foreign Direct Investment (FDI) control

- **Additional screening mechanism adds to bureaucracy for international M&A**. From an M&A perspective, the introduction of the modules suggested by the White Paper would introduce another regulatory review hurdle. This comes at a time when the EU FDI Screening Regulation is about to fully apply and where the majority of EU Member States already have screening regulations in place. Currently foreign investments are screened by Member States; while the Commission may comment on investment reviews, it does not itself decide whether or not an investment is permissible. This power rests with Member States, which are unlikely to give it up. Instead of providing a one-stop-shop for FDI into the EU, the proposed mechanism would therefore add yet another review to inbound M&A.
- **Proposed test differs in scope from FDI review**. The current FDI tests focus on public order and security interests, i.e. the authority must show that an investment will have negative effects on these interests. Conversely, the proposed module hinges only on the question of subsidies. Also, EU FDI tests typically have some sort of sector focus. The investment test under Module 2 of the White Paper would apply regardless of the industry.
- **New test applies to all investors, not just those owned or governed by a foreign State**. While the Commission's main concerns likely rest with State-owned investors, the rules apply to companies and investment funds across the board, where such investors have received funding from public sources that fall within the broad 'subsidy' category.
- **Investments may have to be monitored post-closing**. The White Paper suggests that investments may be screened even after closing where subsidies

from foreign States may distort competition within the EU. This essentially extends EU State aid law to foreign actors' EU investments. It may therefore be useful to monitor capital flows from a foreign investor to its EU subsidiary/investment.

… in relation to State aid control

- **Extension of Commission powers to review non-EU State aid.** Module 1 is largely modelled on the Commission's existing enforcement powers under EU State aid and antitrust rules. In particular, the proposed procedural phases (preliminary review and in-depth investigation) match the Commission's two-step review in EU State aid cases. From an EU State aid perspective, it very much looks as if the Paper is in effect an extension of the Commission's existing powers of enforcement, going beyond its review powers under Article 107(1) TFEU. It would now cover cases in which the aid stems not from Member State resources but from 'a government or any public body of a non-EU State'.
- **Risk of diverging interests between Member States and Commission in individual cases**. Module 1 makes both national supervisory authorities and the Commission competent to review individual cases of foreign subsidies (with the caveat that any in-depth review with an EU dimension shall be conducted exclusively by the Commission). This differs from the Commission's exclusive competence in EU State aid matters; the possibility of multiple agencies reviewing a case bears the risk of inconsistent findings and outcomes in individual cases. As can be observed from the recent implementation of the Commission's COVID-19 Temporary Framework for State aid, Member States' implementation of public spending under the Temporary Framework varies in scope and volume.
- **The beneficiary of an alleged foreign subsidy as an official party to the procedure**. In EU State aid cases, the Member State and the Commission are official parties to the procedure. The beneficiary (i.e. the company) is merely an interested third party with limited procedural rights. Module 1 seems to suggest that the procedure in foreign subsidies cases is directly between the undertaking allegedly having received foreign subsidies and the Commission. In this respect, the procedure is more closely aligned with antitrust rules than with the State aid framework. This will make it easier for the undertaking in question to be directly involved in the procedure. Conversely, it is difficult to see how the respective government or public body (of a non-EU State) could play an active role in the procedure, given that the foreign subsidy (which is the subject matter of the investigation) stems from that very government or public body – and not from the beneficiary itself.
- **How to distinguish 'good' from 'bad' foreign subsidies?** The legal test under Module 1 is formulated as capturing '*foreign subsidies that cause distortions in the internal market and are provided to a beneficiary that is established or, in some instances, active in the EU*'. The Paper gives an initial indication of what the substantive assessment will look like when distinguishing the 'distortive' from the 'less distortive' subsidies: the idea is to work with pre-set categories of foreign subsidies that are either (i) generally considered distortive or (ii) subject to actual assessment in individual cases against a number of indicators (such as the relative size of the subsidy, the situation of the beneficiary and the market concerned). Some of these indicators, and types of subsidies, are familiar from the Commission's EU State aid practice. From a practical perspective, the following points are noteworthy:
  - can a harmonised application of the rules and review procedure at Member State level (for the initial review period) be ensured when there is effectively no precedent at EU level for an assessment of foreign subsidies; and
  - how will the EU interest test proposed under Module 1 play out, in particular with a view to EU public policy considerations (such as job creation, environmental considerations) which are required to be taken into account in the assessment.
- **Broad definition of foreign subsidies poses threat to numerous enforcement areas**. The broad definition of foreign subsidies in Annex 1 to the Paper will, in practice, pose a threat to numerous areas of economic conduct in the internal market. For example, the proposal to include financial contributions in the form of '*foregone or not collected public revenue, such as preferential tax treatment or fiscal incentives such as tax credits*' opens up the potential for investigations into an undertaking's tax compliance outside the EU in their tax residence country. This would require the Commission or the competent national supervisory authority to be equipped with very broad enforcement tools to gather (potentially highly sensitive) information from undertakings and public authorities outside the EU.

… in relation to trade defence instruments

- **Identification of foreign subsidies would require complex legal and economic analysis, and thus increase compliance risks for undertakings.** In order to identify foreign subsidies, the Commission intends to rely on its findings and experience under the EU Anti-subsidy Regulation. In the context of its previous investigations under this Regulation, the Commission has so far considered some distinct types of subsidies which may be difficult for the undertakings involved to identify. For instance, a third-country manufacturer may be found to have

received financial contributions from its government through the inputs it purchases from privately-owned unrelated suppliers on the same domestic market if the prices of those inputs are found to be depressed as a result of export taxes imposed or general policies implemented by the government. Such a broad definition of foreign subsidies has the following implications:

- it may increase the complexity of the compliance assessments the undertakings may want to conduct as well as the margin of error in those assessments; and
- it may increase the risk of failure to disclose certain financial contributions in the proceedings under the new tool, resulting in measures against the undertaking involved. This is of particular importance in Module 2 which relies on the undertakings involved to report financial contributions they have received as part of their preliminary notification.

- **The new tool would place onerous cooperation requirements on undertakings involved in light of the Commission's practice under the EU Anti-subsidy Regulation.** The new tool intends to capture not only direct financial contributions but also those that might be passed on from related companies through related party transactions. Such an analysis – to be as accurate as possible – is likely to cover all related companies that feature in the supply chain of the undertakings involved. Moreover, the Commission would likely follow its practice under the EU Anti-subsidy Regulation and request all those related companies to provide extensive information regarding their purchases, sales, financing operations and tax declarations. Such extensive information requests under the EU Anti-subsidy Regulation are known to be particularly challenging for large companies due to the Commission's strict approach, even though such requests generally concern related companies in a specific country. As the new tool does not make a distinction based on the country granting the subsidies, the Commission's information requests under the new tool could be expected to cover even more related companies in several other countries. This would in turn increase the risks of failure to cooperate and result in the use of best facts available which would normally be to the detriment of the undertakings involved.
- **The new tool may facilitate knock-on anti-subsidy investigations into imports of goods into the EU.** By accumulating information in the proceedings under Module 1 and Module 2, the Commission would be able to expand its knowledge of foreign subsidies provided by other governments, some of which might be available also for imports of goods into the EU. The Commission may then potentially use this information to investigate those foreign subsidies in a separate anti-subsidy investigation under the EU Anti-subsidy Regulation and impose countervailing duties on imports of the goods concerned. Such an investigation would cover all imports of the goods concerned originating in the country of subsidisation and would also have knock-on effects on importers and users of those goods in the EU. This interconnection may thus lead to an increase in the number of anti-subsidy investigations as the new tool would equip the Commission with necessary information to facilitate the initiation of anti-subsidy investigations on its own initiative (whereas currently the Commission mostly relies on complaints and evidence gathered by EU producers manufacturing similar goods).
- **The new tool may result in the application of double remedies in certain situations.** The interplay between the new tool and the EU Anti-subsidy Regulation may result in concurrent application of redressive measures and anti-subsidy measures in response to the same subsidies identified under each system. For instance:
  - especially under Module 2, subsidies granted in relation to imports of goods into the EU would also be taken into account for the purpose of determining whether redressive measures are necessary. The new tool would not prevent the Commission from investigating the subsidies granted in relation to imports of goods separately under the EU Anti-subsidy Regulation and imposing concurrent countervailing measures; and
  - under Module 1, a company which does not export goods to the EU by the time redressive measures are imposed may later start doing so and subsequently face an anti-subsidy investigation, which would likely cover the schemes that were addressed in the context of the redressive measures under Module 1.

What issues are affected companies likely to raise in the consultation?

Potentially affected State-invested or subsidised companies

- For State-invested/owned companies, the proposals are potentially very far-reaching especially in an M&A context. They introduce another regulatory hurdle for M&A by State-backed investors, at a time of increased tightening of foreign investment controls across the EU, obliging State-backed companies to disclose any foreign subsidies received in the three calendar years immediately preceding the reportable transaction if they exceed a set threshold. The instrument seems intended to address an underlying concern in Europe

which is the lack of information on foreign subsidies and the perceived competitive edge that foreign subsidies give State-backed investors. Whilst not all State-backed investors will be subject to a foreign subsidy review, the proposed exemptions are unlikely to stem the anticipated flow of notifications. For example, the proposed €100 million target turnover threshold is very low, and may have little practical relevance based on experience of average deal sizes generally pursued by say, Chinese State-invested investors in the EU.

- The disclosure obligation is broad and covers financial contributions received not only for the envisaged investment but also any financial contribution received by the foreign investor (including intra-group funding benefitting from a foreign subsidy) in the preceding three years. This inevitably covers a broad range of foreign subsidies and captures a very wide range of State-backed companies, such as those active in the aluminium and semiconductors sectors, which the White Paper suggests are susceptible to foreign subsidies. The reference to these sectors may signal heightened scrutiny of M&A by State-backed investors in these sectors.
- Procedurally, the foreign subsidy review is expected to run alongside any required merger control and foreign investment review. There are clearly potential timing implications for deals involving State-invested/owned investors which may place such companies at a competitive disadvantage, especially in auction situations. The financial disclosures will also be new for many State-invested/owned companies accustomed to keeping internal financing arrangements and their governance confidential. To the extent that some disclosures amount to State secrets, there is clearly a potential tension between the proposed EU disclosure requirements and foreign State secrecy rules.
- In short, State-invested companies may find it more difficult to obtain clearance to merge with or acquire EU-based businesses. Further, State-invested companies may be less attractive to sellers of EU businesses given the additional regulatory hurdle. Careful deal planning and coordination of parallel regulatory procedures will become critical for deal certainty, and sellers to State-backed investors can be expected to require additional comfort to address the increased deal execution risk (e.g. in the form of best efforts obligations or break fees). In addition, the ability to look back three years during a foreign subsidy review means that State-backed investors may need to start a careful review already now of how they finance their businesses and future M&A in the EU.
- The proposals related to business conduct likely mean that State-backed companies will no longer be able to submit bids for public contracts at exceptionally low prices, unless they can show that they can do so without the backing of a foreign subsidy and, if with the backing of a foreign subsidy, that this has no material distorting effect on competition.

Non-subsidised competitors

- **The proposal is not only relevant for (potential) beneficiaries of foreign State support.** The White Paper makes clear that the success of the tools is dependent upon market players pro-actively providing information to EU Member States or the Commission to highlight suspected benefits arising from non-EU State support. Companies and investors that do not receive State support from non-EU States would be able to call upon use of the enforcement tools to protect themselves against distortions of competition from non-EU State support beneficiaries. For example, if an investor is participating in a competitive M&A auction process and suspects that a competing bidder may be able to outbid the other bidders as a result of State support, it could contact the Commission, highlight the concern and encourage the authority to investigate. Similarly, market players that feel disadvantaged as a result of operating aid received by a competitor from a non-EU State could request a Member State or the Commission to look into this. While the final scope of the enforcement tools and the willingness of Member States and the Commission to put them to use in practice remains to be seen, there is potential for these tools to be pro-actively used by companies and investors to protect them from distortive competition from third party beneficiaries.

US-based companies/groups

- The proposal mainly raises the question how broadly the term ‘subsidy’ will be understood. Federal and State government agencies use a number of support measures for US companies, some of which would pass the test of ‘compatible State aid’ if granted by EU Member States. These may include:
  - R&D grants provided by the federal government (e.g. by the Departments of Energy and Defense);
  - State level tax incentives given to locate a manufacturing facility in a given State as a job creation tool;
  - assistance to small businesses trying to expand into overseas markets;
  - subsidised loans and government contracting preferences available to small businesses and women and minority-owned businesses (recipients not necessarily active internationally); and
  - Covid-19 related deferred payment/low interest loans for small businesses (recipients not necessarily active internationally).

- Therefore, US companies will be concerned about the uncertainty created by the potential scope of the proposal. As some of this support would be perfectly compatible under EU State aid rules, the question arises whether there is an element of ‘un-levelling’ the playing field.

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