ALERT MEMORANDUM

The European Commission Proposes A Far-Reaching Regulation To Tackle Foreign Subsidies

May 19, 2021

On May 5, 2021, the European Commission ("**EC**") proposed a new draft regulation that, if adopted, would introduce sweeping measures aimed at controlling the impact of foreign subsidies on the EU single market ("**Proposed Regulation**").[1] The Proposed Regulation reflects the EU's policy priority to pursue an "*open strategic autonomy*" and fits into the EU Industrial Strategy, updated on the same date.[2]

The Proposed Regulation follows the June 2020 White Paper[3] on foreign subsidies and a public consultation process. It (i) introduces a merger control regime for vetting transactions affected by foreign subsidies; (ii) grants the EC broad powers to investigate and impose remedies concerning foreign subsidies that distort competition in the EU; and (iii) allows the EC to suspend or block public procurement in the EU.

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[1] Commission Proposal for a Regulation of the European Parliament and of the Council on foreign subsidies distorting the internal market (COM(2021) 223 final).

[2] Commission Communication "Updating the 2020 New Industrial Strategy: Building a stronger Single Market for Europe's recovery" (COM(2021) 350 final).

[3] *See* Cleary Gottlieb alert memo "EU White Paper on Levelling the Playing Field as Regards Foreign Subsidies".

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1. Introduction

The Proposed Regulation seeks to address foreign subsidies that provide recipients with an unfair advantage when acquiring or merging with companies, participating in public procurement, or engaging in any other "economic activity" in the EU.

The EC proposal fills a perceived regulatory gap concerning foreign subsidies that are not addressed by EU state aid, merger control, antitrust, trade defense, and public procurement rules.

The EC, however, explains that its proposal only complements the existing body of EU law and in substance preserves the application of the rules in force.[4]

The Proposed Regulation will enable the EC to review foreign subsidies in the context of concentrations (mergers and acquisitions) and public procurement procedures that exceed certain thresholds. It introduces mandatory notification and will be enforced exclusively by the EC, without sharing this competence with the EU Member States' national competition authorities as was envisaged in the June 2020 White Paper.

The Proposed Regulation will apply to all subsidies and other financial contributions that are granted by all non-EU countries and have a distortive effect on the EU single market, regardless of the recipient's country of incorporation. As a result, even companies established in the EU (including European group companies) will be subject to scrutiny under the Proposed Regulation if they or their subsidiaries receive foreign financial contributions.

The EC's Impact Assessment Report[5] that accompanies the Proposed Regulation gives a flavor of its significant impact on the expected regulatory burden and the EC's own workload. The EC plans to allocate between 115 and 145 full-time equivalent employees to this new initiative, which is the size of several units within a major Directorate General, and to handle around 90 cases a year, including 30 notifications of possibly subsidized acquisitions.

The Proposed Regulation will be issued on the basis of Article 207 TFEU that grants the European Union competence in relation to is common commercial policy and Article 114 TFEU that relates to the internal market. This suggests that it is conceived as much as an internal market as a trade tool.

The Proposed Regulation is open to feedback until July 4, 2021. The feedback will be published and followed by discussions at both co-legislative branches of the European Union, the European Parliament and the Council, which are expected to adopt the EC's proposal in the context of the EU ordinary legislative procedure.

2. Notion of "foreign subsidy"

Under the Proposed Regulation, a foreign subsidy exists "*where a third country provides a financial contribution which confers a benefit to a recipient in the EU and which is limited, in law or in fact, to an individual undertaking or industry or to several undertakings or industries*."[6] The key elements of this definition are:

- a financial contribution provided, directly or indirectly, by the public authorities of a third country;
- resulting in a benefit that is:
  - conferred to an undertaking engaging in an economic activity in the EU internal market; and
  - limited to an individual undertaking or industry or several undertakings or industries.

The relevant financial contribution may take various forms such as transfers of funds or liabilities (capital injections, grants, loans, loan guarantees, fiscal

[4] *See* Article 40 of the Proposed Regulation. The relationship between the Proposed Regulation and other EU law instruments is discussed in our June 2020 alert memo "EU White Paper on Levelling the Playing Field as Regards Foreign Subsidies".

[5] *See* Commission Staff Working Document Impact Assessment accompanying the Proposed Regulation (SWD/2021/99 final).

[6] *See* Article 2 of the Proposed Regulation.

incentives, setting off of operating losses, compensation for financial burdens imposed by public authorities, debt forgiveness, debt to equity swaps, or rescheduling) and foregone public revenue otherwise due. This definition tracks the proposal in the White Paper and is similar to the concept of state aid under EU state aid rules.

3. Distortions and balancing test

Once the existence of a foreign subsidy is established, the EC would have to determine whether it has distortive effects in the internal market.

According to the Proposed Regulation, such distortive effects shall be assessed by reference to the amount and nature of the subsidy, the purpose and conditions attached to the foreign subsidy, as well as its use in the internal market.[7]

The Proposed Regulation establishes a *de minimis* threshold of € 5 million over any consecutive period of three fiscal years under which foreign subsidies are considered unlikely to be distortive.[8]

Where distortive effects are established, the Proposed Regulation provides for a "balancing test". The White Paper initially referred to an "EU interest test", a concept derived from EU trade policy, which included the assessment of EU public policy objectives (*e.g.*, jobs, environmental protection, digital transformation, security, or public safety). The Proposed Regulation establishes a duty for the EC, "*where warranted*," to balance between "*negative effects of a foreign subsidy in terms of distortion on the internal market*" and "*positive effects on the development of the relevant economic activity*."[9] Accordingly, the new test is simplified and aligned to the balancing test that is applied to the assessment of compatibility of state aid under Article 107(3)(c) TFEU.

If positive effects of a foreign subsidy outweigh its negative effects, the balancing test may eventually lead to the conclusion that no redressive measures should be imposed.

4. Commitments and redressive measures

The Proposed Regulation provides that to remedy the distortions caused by the foreign subsidy, the EC may impose redressive measures or seek commitments that range from structural to behavioral remedies.

Possible commitments and redressive measures include: (i) third-party access on fair and non-discriminatory terms to a subsidized infrastructure; (ii) reduction of capacity or market presence; (iii) prohibition of certain investments; (iv) licensing on fair, reasonable, and non-discriminatory (FRAND) terms; (v) publication of certain R&D results that allow other undertakings to reproduce them; (vi) divestment of certain assets; (vii) dissolution of the concentration; and (viii) repayment of the foreign subsidy with an appropriate interest rate.[10]

5. Fines and periodic penalty payments

The EC may impose severe fines and periodic penalty payments in a wide range of situations that are broadly inspired by fines levied in antitrust investigations.

Fines may amount to up to 1% of the aggregated worldwide turnover if, for instance, the undertaking under investigation supplies incomplete, incorrect, or misleading information or refuses to submit to inspections.[11] Periodic penalty payments for failure to timely supply the requested information or for supplying incomplete, incorrect, or misleading information may be up to 5% of the undertaking's average daily aggregate worldwide turnover.

A fine can be as high as up to 10% of the undertaking's aggregated worldwide turnover if, for instance, the undertaking does not comply with the redressive

[7] *See* Article 3 of the Proposed Regulation. The Proposed Regulation also lists certain subsidies (such as export financing that is not compliant with OECD standards, subsidies to ailing companies, unlimited guarantees, or subsidies directly facilitating an acquisition) that are "*most likely*" to be distortive (*see* Article 4 and Recitals 12-15).

[8] The Proposed Regulation raises the *de minimis* threshold compared to the White Paper that put forward a € 200,000 threshold over a period of three years.

[9] *See* Article 5 of the Proposed Regulation.

[10] *See* Article 6 of the Proposed Regulation.

[11] *See* Article 15(1) of the Proposed Regulation.

measures imposed or the commitments offered and accepted, or if it fails – when required – to notify a subsidy during the public procurement procedure or to file an acquisition reportable under the Proposed Regulation.[12]

6. Three tools to address distortive effects of foreign subsidies

Consistent with the approach outlined in the White Paper, the Proposed Regulation envisages three tools to address foreign subsidies that the EC has found to have distortive effects. These may be complementary and include the following:

- a general market investigation tool that the EC may use *ex officio* in a wide range of market situations where the EC suspects that a distortive foreign subsidy affects the operation of companies established or active in the EU (Tool 1);
- an *ex-ante* notification and approval by the EC of certain mergers and acquisitions; (Tool 2) and
- an *ex-ante* notification to the contracting authority[13] and approval by the EC of participation of subsidised bidders in public procurement in the EU where the the estimated value of the public tender is at least € 250 million (Tool 3).

The Proposed Regulation also sets out the possibility for the EC to carry out general market investigations into specific sectors or types of economic activity to identify possible distortions and practices that are specific to such a sector or activity.[14]

6.1 Ex-officio review of foreign subsidies (Tool 1)

This tool gives the EC broad discretion to investigate *ex officio* distortive foreign subsidies that affect a company's operations in the EU internal market and to impose repayment of the foreign subsidy or other commitments. The EC will also be able to use this tool in concentrations and public procurement procedures that are not captured by the thresholds set by Tools 2 and 3.

Similarly to state aid proceedings, the investigation will begin with a preliminary review phase, where the EC may request information and conduct inspections in and outside the EU. Where the preliminary review suggests that a foreign subsidy may distort the proper functioning of the internal market, the EC can launch an in-depth investigation.

Conversely, where there are no sufficient grounds to initiate an in-depth investigation, the EC will close the preliminary review and inform the undertaking concerned.

Notably, where the undertaking or the third country concerned do not cooperate, the EC may take a decision on the basis of the facts that are available—a procedural concept inspired from trade law.[15]

6.2 Foreign subsidies facilitating the acquisition of undertakings established in the EU (Tool 2)

Tool 2 is specifically intended to address distortions caused by foreign subsidies facilitating the acquisition of undertakings that are established in the EU. The objective is to ensure that no unfair benefit is conferred on the subsidies' recipients, either directly by linking a subsidy to a given acquisition, or indirectly by *de facto* increasing the financial strength of the acquirer. The EC's concern is that the foreign subsidy may enable the subsidized investor to pay a higher price for the assets in question than it would otherwise have paid, thus distorting the valuation of EU assets and preventing non-subsidized would-be acquirers from achieving efficiency gains or accessing key technologies.

This tool provides for a compulsory notification mechanism and an *ex ante* review by the EC of concentrations above certain thresholds, in parallel with the existing competition law-based merger control and foreign investment review proceedings.

[12] *See* Articles 15(5), 25, and 32 of the Proposed Regulation.

[13] The relevant public authority that awards public contracts.

[14] *See* Article 34 of the Proposed Regulation.

[15] *See* Article 14 of the Proposed Regulation.

It captures the same type of transactions (*i.e.*, concentrations involving an acquisition of control on a lasting basis) that are reportable under the EU Merger Regulation ("**EUMR**"). On this, the EC departed from its initial suggestion in the White Paper to also encompass acquisitions of "*material influence*" short of control.

The notification obligation will be triggered if two cumulative thresholds are met:

- the acquired undertaking – or at least one of the merging entities, or the joint venture or one of the parents of a joint venture – is established in the EU and generates a turnover in the EU of at least € 500 million;[16] and
- the undertaking concerned (or the JV and its parents) received from third countries an aggregate financial contribution in the three calendar years prior to notification of more than € 50 million.[17]

For purposes of applying the second threshold, there must be a "financial contribution" received from a third country, which arguably is a broader standard than a "foreign subsidy." If confirmed, this would imply that non-selective financial contributions received from foreign governments on market terms may also in principle trigger a notification obligation, which might considerably increase the number of companies caught by the threshold.

The procedural rules governing the EC's review broadly mirror the EUMR. In particular:

- The EC will have the right to *ex officio* review a concentration which should have been notified but was not, including after its completion.
- The transactions falling into the Tool 2 threshold are subject to a standstill obligation and may not be closed pending the EC's review. The EC will have 25 working days to complete Phase 1 review. This time limit starts to run only when the EC deems the notification complete.
- The EC may open a Phase 2 (in-depth) investigation, which would add another 90 working days, which can be extended by 15 working days if the undertaking offers commitments (no commitments are envisaged for Phase 1).

The EC may prohibit the transaction if, at the end of the in-depth investigation, it finds that the transaction is facilitated by foreign subsidies, it distorts the internal market, and no suitable commitment is offered.

6.3. Foreign subsidies in public procurement (Tool 3)

Tool 3 addresses the concern that foreign subsidies may be granted or used to enable or facilitate the participation of bidders in public procurement in the EU.

Even though contract awards to subsidized bidders in procurement may lead to short-term advantages (*e.g.*, decrease in tender prices offered), the Impact Assessment Report highlights a number of adverse consequences of foreign subsidies. Key concerns include:

- an uneven playing field that may over time discourage unsubsidized bidders from competing, thus reducing the level of competition in procurement markets;
- the risk of a broader strategy on the part of the subsidizing country to obtain control over key public infrastructure (in particular railways, telecommunications, and utilities); and

[16] This has been considerably raised compared to the much more modest turnover threshold of €100 million suggested in the White Paper.

[17] Contrary to the position of the White Paper, the Proposed Regulation does not require taking into account financial contributions that are expected in the coming year or that are not yet paid to the undertaking.

- formation of unrealistic and false perceptions about prices of materials, technology, salaries, or the number of companies active in a market.

Companies participating in public procurement—where the estimated value of the public tender is equal to or greater than € 250 million—would be required to notify the contracting authority all foreign financial contributions received (or confirm in a declaration that they did not receive any foreign financial contributions) within the last three years preceding participation in the tender.[18] Again, the relevant standard is "foreign financial contributions" and not "foreign subsidies", which implies that financial contributions received on market terms may have to be notified.

Tool 3 does not provide for specific thresholds concerning the amount of the foreign subsidy, which means that companies would be required to notify any foreign financial contribution (even if below the € 5 million *de minimis* threshold), provided that the value of the public tender exceeds € 250 million.

The contracting authority shall transmit all complete notifications to the EC which will have exclusive jurisdiction to investigate and assess the existence of a foreign subsidy.

The evaluation carried out by the EC may significantly delay the procurement procedure because the contracting authority would be barred from awarding the contract for 60 days from the notification. During this period, the EC would have to complete a preliminary review.

If the EC opens an in-depth investigation, the contracting authority would be barred from awarding the contract to the investigated undertaking for another 140 days (200 days from notification). By the end of this period, the EC has to adopt a decision finding that: (i) the undertaking does not benefit from a foreign subsidy that distorts the EU internal market; (ii) imposing commitments to address effects of the foreign subsidy; or (iii) prohibiting the award of the contract to the undertaking if the undertaking does not offer commitments or the EC considers that the proposed commitments do not remove the distortion.[19]

7. Conclusion

The Proposed Regulation is an ambitious attempt at handling a highly politically-charged topic in the EU. It would introduce a new regulatory regime that would operate in parallel to the EU merger, antitrust, state aid, and foreign investment frameworks as well as the already existing EU anti-subsidy regulation.[20] If adopted, it will add a significant regulatory burden for companies where they have relationships with, or receive financial contributions from, governments of non-EU countries, regardless of whether or not they are headquartered in the EU. For these companies, the Proposed Regulation would introduce complexity and potential delays when pursuing large M&A deals and public contract awards in the EU.

The Proposed Regulation gives rise to substantial uncertainty about its application and impact. A number of points are unclear and will need to be clarified:

- **Linkage between foreign financial contribution and an economic activity in the EU.** The affected companies can expect discussions with the EC about whether a given financial contribution by foreign government qualifies as "*a foreign subsidy*" and, if so, whether it: (i) improves the recipient's position in the EU internal market; (ii) actually or negatively affects competition; and (iii) has an effect on the concentration, the public tender

[18] *See* Articles 26-27 of the Proposed Regulation. Contrary to the White Paper, the Proposed Regulation no longer provides for an obligation to notify prospective foreign subsidies that the company is expected to receive during the term of the public procurement contract.

[19] *See* Article 31(1)(2), and (5) of the Proposed Regulation. Pursuant to Article 31(3), the contract may be awarded to an undertaking submitting a declaration that it did not receive any foreign financial contributions in the last three years if the tender evaluation has established that the undertaking in question has in any case submitted the most economically advantageous tender.

[20] Regulation (EU) 2016/1037 of the European Parliament and of the Council of 8 June 2016 on protection against subsidised imports from countries not members of the European Union, OJ L 176, 30.6.2016, p. 55–91.

offer, or any other "economic activity" by the recipient in the EU. While the Proposed Regulation clarifies that the assessment is limited to the concentration or the procurement procedure at stake,[21] it does not establish straightforward rules for assessing the causation between the subsidy and the future economic activity in the EU (other than excluding subsidies granted more than three years prior to the notification).

- **The balancing test.** The Proposed Regulation does not provide guidance on how the EC shall conduct its substantive assessment balancing the negative effects of a foreign subsidy with positive effects on the relevant economic activity. We expect the EC to draw on the experience codified in the numerous implementing regulations and communications issued in the state aid area. As currently drafted, the balancing test might arguably encompass positive effects that are generated in the country granting the subsidy and not just within the EU, but this would probably require clarification.
- **Bifurcation of merger control rules.** The Proposed Regulation, while closely tracking the rules of the EUMR, provides for a new self-standing merger control regime on top of competition law-based merger control under the EUMR and foreign investment review in a number of EU jurisdictions. It remains to be seen to what extent the notions of the Proposed Regulation that originate from the EUMR will be interpreted based on the case-law and decisional practice developed in the traditional EU merger control regime.

Even if these issues are clarified during the legislative process, we expect that the Proposed Regulation will represent a major overhaul of the EU's approach to industrial policy, giving rise to the following outcomes:

- **Asymmetry with other EU regimes that address government subsidies.** Tools 1 and 2 of the Proposed Regulation are openly modelled on EU antitrust law instead of trade or state aid rules, which have evolved over decades to achieve the same objective as the Proposed Regulation of addressing market distortions caused by government support. The result is that the Proposed Regulation imposes more constraints on companies that are subsidized by foreign companies relative to those subsidized by EU Member States. By way of example, companies that benefit from state aid by EU Member States (i) are not subject to an *ad hoc* merger control or procurement notification obligation; (ii) benefit from a broader base of exemptions (including government support measures provided by Articles 107(2)(b) and 107(3)(b) TFEU that have been commonly used during the COVID-19 pandemic); (iii) may not be subject to a compulsory commitment that can replace the obligation to recover the government support; and (iv) are not direct addressees of EC decisions that rule on the legality of the government support.

  Conversely, the latter point may have procedural implications. The EC and EU Courts have recognized that a beneficiary of state aid granted by an EU Member State has limited procedural rights in state aid proceedings because it is not a direct addressee of the EC's decision. However, as a direct addressee of the EC's potential decision under the Proposed Regulation, a beneficiary of foreign government support is likely to benefit from higher procedural protections and due process rights than companies in state aid proceedings. This may prompt a debate on whether the state aid framework should also enhance due process rights.
- **Capture of a broad range of transactions.** The subsidy threshold that triggers a merger notification obligation (€ 50 million in

[21] *See* Articles 17 and 26 of the Proposed Regulation.

aggregate during three calendar years) would be comparatively low if one takes into account the broad (and loosely defined) notion of what constitutes a financial contribution by a foreign government. We expect it to capture many companies, which would have to report every acquisition of, or a joint venture with, a company that generates more than € 500 million in EU turnover. Potentially affected companies will need to be prepared for the extra scrutiny and potentially extensive requests for information. It will be advisable to have in place a system that keeps records of, and can readily collect, data and documents on financial support received from governments outside the EU.

- **Knock-on effects in other jurisdictions.** The EU regulatory approach often inspires other jurisdictions. An expansive anti-subsidy regulation that comprises elements of traditional merger control and public procurement rules may prompt other jurisdictions to adopt similar regimes in order to protect the local market or to retaliate against an EU's approach that other countries may view as interventionist. Article 40 of the Proposed Regulation provides that no measure shall be adopted that would be contrary to the EU's international obligations, in particular under WTO law, but it remains to be seen whether this will be sufficient to avoid possible retaliation or litigation, in particular in the WTO.

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