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The EU is set to control foreign subsidies

BY ATTILA BORSOS

For decades, the EU has been entirely open for investments from outside the now 27-strong block. While its rules regarding the free movement of people, goods and services only cover its member states, capital – including foreign, i.e., non-EU direct investment (FDI) – has enjoyed virtually unlimited access to the EU since 1993 (when the Maastricht Treaty entered into force).

Until recently, save for a few sectors such as defence, security, energy and regulated industries such as finance, merger control represented the only regulatory hurdle for M&A activity in Europe. The last few years, however, and 2020 in particular, has seen a number of initiatives at EU level, which may bring a permanent structural change to how acquisitions by non-EU buyers can be executed in the EU and how some foreign-owned companies can conduct business in Europe.

In addition to the increasing level and widening scope of FDI screening at national level and the EU-level initiative for enhanced coordination and information exchange among member states to facilitate the screening of non-EU investments, the leadership of the EU has signalled its intention to introduce new legal mechanisms to tackle the effects of foreign subsidies in the markets of the bloc. On 17 June 2020, the European Commission (EC) published its proposal in the form of a white paper for new legislation. Once introduced, the legislation will make it more complex both to acquire and to operate businesses in the EU. Under the projected timeline, the new tools, which the EC refers to as modules, would enter into force in the second half of 2021.

Module 1 would introduce the possibility for the EC, as well as authorities at the level of member states, to investigate distortions caused by foreign subsidies provided by non-EU states to companies active in the EU. As a result of the investigation, the EC or the competent authorities of the member states could decide to impose redressive measures with the aim of eliminating the financial benefit of a foreign subsidy through payments to the third country in order to restore the level playing field.

The competent national authority may be given the power to impose a variety of alternative redressive measures, including structural remedies, behavioural measures and redressive payments to the EU and the member states (e.g., divestment of assets, prohibition of certain investments, third-party access and licensing on fair, reasonable, and non-discriminatory (FRAND) terms, among other things). It appears that the procedure as it stands now will also include the possibility for the companies caught by this legislation to offer commitments to mitigate the distortion.

Module 2 would introduce a mandatory prior notification obligation for acquisitions where the target company is located in the EU and the acquirer received financial support from a non-EU government during the three years prior to the acquisition, or expects to receive such support within a year following the acquisition.

This prior notification obligation would be similar to merger control filings to the extent that the acquisition or merger could not be closed without the EC first approving it. The EC would also be empowered to block acquisitions. This filing obligation would not replace any merger control filings but would be an additional requirement to any such filings. This means that the parties to an M&A deal could end up with two parallel filings (one for merger control, one for foreign subsidy control) before the EC, or with parallel merger control filings before national competition authorities and a foreign subsidy filing before the EC.

The thresholds that would trigger the filing obligation are yet to be determined. It is likely that the filing obligation could be triggered by the acquisition of a certain level of shareholding (as low as 25 or 35 percent), coupled with a target company turnover threshold or a threshold linked to the amount of the subsidy that the acquirer received.

The exact test that the EC would use to review and eventually block acquisitions is yet to be determined beyond the stated principle that it is meant to tackle the distortions caused by acquisitions facilitated by foreign subsidies either directly (by explicitly linking a subsidy to a given acquisition) or indirectly (by increasing the financial strength of the acquirer). It is clear from the proposal that with module 2, the EC would specifically target situations where a potential acquirer could outbid others as a result of subsidies from a non-EU government.

Module 3 covers public procurement and would make it more difficult for companies to bid for government contracts in cases where they received subsidies from non-EU governments.

The EC's white paper has been welcomed by national governments and EU industry as a crucial building block for a future EU-wide industrial policy. There has been growing frustration within the EU: while subsidies provided by member states, including to or through state-owned companies, are subject to far reaching and strictly enforced EU state aid control, state-owned enterprises and sovereign wealth funds of non-EU countries could invest and operate businesses in the EU without any limit as to how much taxpayer money they spend on subsidies. This may have led to situations where companies subsidised by foreign states could outcompete their European peers, not on the merits but through foreign financial support.

In practice, the impact of the proposed legislation will depend on the scope and specific details of the new tools. Once adopted, the new instruments will likely add to the red tape and increase the execution risk around M&A deals in Europe. They will also increase the administrative burden for certain companies to run their business operations in the EU.

The disruption that the new measures, and in particular module 2, will cause in the European M&A space will also depend on how broadly the legislation defines what constitutes a subsidised acquisition. If only acquisitions which directly benefit from non-EU subsidies are made subject to the mandatory filing obligation, the number of transactions concerned and the overall impact of the measures will be limited, but it will also be relatively easy to circumvent the filing obligation.

If, on the other hand, indirect subsidies (i.e., subsidies that are not linked directly to the acquisition but benefit the acquirer, thereby reinforcing its financial position) are also captured by the new measures, the number of notifiable transactions will likely be significantly higher, which in turn can have a chilling effect on at least some of the investors. It remains to be seen, for example, to what extent sovereign wealth funds, or private equity funds with a significant sovereign wealth fund investor, will be affected.

While the measures are understood to be aimed at investments from China and the Middle East, the new instruments, and in particular module 1, will be a powerful tool in the hands of the EC to oversee subsidies that the UK may provide to companies operating in the EU post-Brexit. The EU has pushed for the UK to introduce a state aid control regime, similar to the one that the EC administers regarding EU member states, as a condition of any future trade deal. In the case of a no-deal Brexit at the end of 2020, the UK is unlikely to introduce strict control of government subsidies. Module 1 could address concerns that the UK government, benefiting from the geographic proximity and the now integrated supply chains, would engage in a strategy of subsidising UK companies in order for them to gain a competitive advantage in EU markets over their European rivals.

The EC will have a lot of leeway when investigating foreign subsidies under module 1. According to the proposal, investigations will only be initiated on the EC's own initiative, which also means that competitors of subsidised companies will be unable to submit a formal complaint. Stakeholders will be able to raise concerns with the EC, but in the absence of a formal complaint mechanism, the EU executive will have no obligation to address, or even to consider, the information that is brought to its attention.

Further, the EC is expected to be empowered not only to initiate but also to terminate investigations on the basis that they are no longer a priority, which will likely create a substantial amount of uncertainty around any such investigation. This also means that the EC will be able to pick the companies and foreign subsidies that it considers a priority in line with its broader policy or political objectives.

It remains to be seen how foreign governments, especially those which the measures are aimed at, will react when the EC starts applying the new tools. The EC's expectation that the extraterritorial

application of its new subsidy control mechanism will be accepted by its major economic partners may be overly optimistic. The extraterritorial application of antitrust laws is widely accepted across the globe, as most countries have antitrust laws with an extraterritorial effect. The idea of controlling subsidies, other than in the context of trading goods under the auspices of the World Trade Organization (WTO), is a concept that is unique to the EU.

The EC's proposal is far from final. The public is invited to comment on the proposal by 23 September 2020. Given the potential far-reaching consequences of the tools that it proposes to introduce, the EC will likely receive a high volume of comments which may significantly shape the legislation. ■

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