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EU PROPOSALS FOR NEW POWERS TO ADDRESS FOREIGN SUBSIDIES

The European Commission has published a White Paper with proposals for a new legal framework to address subsidies granted by non-EU governments that distort markets in the EU. Its main components comprise general powers to impose remedies to address distortive foreign subsidies, specific powers to prohibit subsidised acquisitions of EU businesses and changes to the EU public procurement rules to allow foreign subsidies to be addressed in individual public tenders.

If adopted, the proposals would create significant new risks and compliance costs for foreign State-owned entities and other foreign investors with links to non-EU public bodies.

Key issues

- Market-distorting subsidies could attract remedies such as divestments, restrictions on market conduct, third party access and "redressive" payments.
- Investors in receipt of certain "financial contributions" (including payments for goods or services) from any non-EU government would be subject to mandatory filing and standstill obligations for certain investments in EU businesses.
- Acquisitions that are funded by market-distorting subsidies could be blocked.
- EU public procurement rules would be adapted to allow for investigations of bidders that are suspected of using foreign subsidies to distort a tender. This could result in delayed awards, exclusion from the tender and a bar on participating in future tenders.
- The proposals would create another layer of filing cost and complexity for foreign investors, alongside merger control and foreign investment filings.
- They would also create new compliance costs and a risk of competitive disadvantage for State-owned entities and other businesses with links to non-EU governments and public bodies.

A BROAD SYSTEM FOR SUBSIDIES ABROAD

On 17 June 2020, the European Commission released a White Paper on levelling the playing field as regards foreign subsidies (**White Paper**). The White Paper intends to fill a perceived regulatory gap by proposing new tools to address distortions in the EU market created by foreign subsidies.

The White Paper was released against a background of a significant increase in foreign capital inflows, in particular, capital from State-owned entities (**SOEs**) from China, many of which receive State subsidies. This has given rise to concerns from many European countries, which have been advocating for the strengthening of control and review over such transactions. Since the existing EU trade defence rules and WTO rules mainly resolve subsidy issues in the context of subsidised products being imported into the EU market, and the EU state aid rules only apply to public support granted by EU member states, there is a perceived regulatory gap in protecting fair competition in the EU market against foreign subsidies, particularly subsidies in the form of financial flows supporting acquisitions or business operations in the EU. The White Paper proposed new tools to address these gaps.

The public consultation period is open until 23 September 2020. Based on the results of the consultation, the Commission intends to introduce legislation to implement the proposals in 2021.

BACKGROUND

Increased scrutiny of foreign investment in Europe

Tightening foreign direct investment (**FDI**) scrutiny has long been a topic of interest in the EU, in light of the increasing inflow of foreign investment (particularly from investors backed by foreign States) and the perceived threat to the security and public order of EU member states. The European Commission (the **Commission**) and the member states have in recent years proposed new rules on FDI screening and also reformed existing FDI mechanisms to widen their powers to intervene in foreign buyouts, especially during the period of COVID-19 pandemic.

In April 2019, the Commission introduced an EU-wide framework to coordinate the screening of FDI by governments of the EU member states, the EU Foreign Investment Screening Regulation (the **Screening Regulation**) which will be applicable from 11 October 2020. In response to the COVID-19 pandemic, the Commission published a communication in March 2020 providing guidance on the FDI control regime ahead of the application of the Screening Regulation (the **Guidance**).

Focusing on investors backed by foreign governments

Echoing the Commission's Screening Regulation and the subsequent Guidance, and also in response to the COVID-19 outbreak, a number of EU member states (such as Italy, France, Spain, Germany, Poland and Czech Republic) have been introducing new mechanisms or amendments to their current FDI screening rules. A summary of the new amendments, as well as a general overview of EU FDI regimes, can be found here.

Many of the new rules target investments by foreign SOEs, either by making the degree or nature of State control a triggering event for filing (regardless of the industry involved), or by scrutinising investors' links to foreign State governments during the review. For example:

- in Spain, as a response to COVID-19, new FDI measures became effective in March 2020 which require ex-ante approval for FDI in strategic sectors as well as any investment led by entities controlled by a foreign government, regardless of the sector/activities concerned;
- in France, the government introduced changes in its FDI rules in December 2019 and April 2020, which have broadened the scope of the FDI regime and expanded the filing requirements. In particular, information on non-EU investors' links to foreign governments or public bodies is now required to be provided, and such links are now explicitly a permitted reason to prohibit the investment; and
- in Germany, changes to the FDI regime took effect on 3 June 2020 which make transactions by non-EU SOEs subject to closer scrutiny, as well as those that are financed by non-EU countries. Further measures tightening the German FDI regime were approved by the German parliament on 18 June 2020.

Countries outside Europe have also been adopting more stringent government measures on foreign investment scrutiny, including Australia, Japan, Russia and the US.

Pressure for a mechanism against foreign subsidies

The White Paper was a response to ongoing pressure to introduce new mechanisms targeting companies receiving support from foreign governments. In July 2019, France, Germany and Poland put forward a proposal to the Commission to take into account foreign subsidies in merger control. In December 2019, in a proposal by the Netherlands to overhaul the EU competition rules, the Commission was asked to introduce another pillar to EU competition law, which would allow actions be taken if a company, irrespective of its nationality, distorts or threatens to distort the competition within the EU market, either because it receives government support or because it has an unregulated dominant position in a non-EU market.

THE WHITE PAPER

Currently, foreign subsidies are sometimes examined in merger control reviews, as a factor of indirect relevance to the merging parties' financial strength relative to their rivals, or in FDI screening procedures, as a factor relevant to an investor's connection to a foreign government. The White Paper proposes new mechanisms to directly assess foreign subsidies' distortive effects on the EU market.

How foreign subsidies distort the EU market

Foreign subsidies can take many forms, such as preferential financing, loan guarantees, dedicated tax rebates or selective tax reductions to promote activities or investment in the EU. The Commission's primary concern is that such subsidies - whether granted to a foreign parent company or its EU subsidiary - can distort competition by giving advantages to less efficient undertakings. For example, they may allow a business to submit bids for public contracts at price significantly below market price, or to pay a higher price to acquire EU businesses, thus precluding other bidders from achieving efficiency gains or accessing key technologies. Another concern, which relates to security and public order, is that foreign subsidies often come with political/strategic objectives, such as the transfer of technologies to other production sites outside of the EU.

The Commission considers that these concerns cannot be addressed by existing tools under the EU competition or trade defence regimes. The White Paper therefore proposes new tools to deal with foreign subsidies, in a legal framework consisting of (i) general powers to impose remedies to address distortive foreign subsidies; (ii) specific powers to prohibit subsidised foreign transactions; and (iii) changes to the EU public procurement rules to allow foreign subsidies to be addressed in individual pubic tenders. These are explained below.

There are also certain proposals in respect of foreign access to EU funding programmes which are not covered by this briefing.

General powers to impose remedies to address distortive foreign subsidies

The White Paper proposes that "supervisory authorities" be given powers to investigate foreign subsidies on *an ex officio* basis, and to impose remedies where subsidies are found to distort the EU market.

Supervisory authorities

The White Paper suggests that both the Commission and the EU member states should have the power to investigate foreign subsidies. Enforcement would be coordinated in a similar way to the current framework in EU competition law, i.e. with the Commission investigating subsidies that affect multiple EU member states, and cases with more localised effects being investigated by one or more national authorities.

Scope

The proposals would allow supervisory authorities to address foreign subsidies granted, directly or indirectly to undertakings established in the EU (and possibly also those established outside the EU, but active there) which could distort any aspect of the EU market, including production of goods, services or investments in the EU.

Assessment of distortions in the EU market

Certain categories of foreign subsidies would be presumed to create distortions in the EU market, such that a supervisory body could impose remedies without having to prove that they have had distortive effects. These include:

- subsidies in the form of export financing;
- subsidies to failing undertakings (unless granted to remedy serious economic disturbances);
- unlimited guarantees of debts or liabilities of certain undertakings;
- operating subsidies in the form of selective tax reliefs; and
- subsidies directly facilitating an acquisition.

Other forms of foreign subsidies would require a more detailed assessment to assess whether they distort the EU market. Relevant factors would include the size of the subsidy, the situation of the beneficiary, market conditions and the market conduct in question.

Once the authority determines that a foreign subsidy distorts the EU market, this distortion would then be balanced against any positive impact that the foreign subsidy might have within the EU (the EU interest test).

While not expressly stated in the White Paper, it is likely that if the subsidy is of a type and size that would have been permitted under the EU State aid rules, had it been given by an EU government or public body, then that will be good evidence that it does not distort the EU market when granted by a non-EU government or public body. For example, the White Paper proposes a *de minimis* exception for foreign subsidies below an amount of EUR 200,000 granted over a three year period, and this exception is consistent with the *de minimis* exemption that applies to EU governments under EU State aid laws.

Procedure

The White Paper proposes that supervisory authorities would investigate foreign subsidies on an ex officio basis. Unlike the proposals for a transaction-specific regime described below, there would be no mandatory notification obligation. If the enforcement model of EU competition law is adopted, there would also be no possibility to submit a voluntary notification to get an individual clearance or exemption of a funding arrangement.

If an authority opens an investigation, there would be two phases: first, a preliminary review of a possible distortion of competition caused by foreign subsidies and, if that review gives rise to a suspicion of distortive subsidies, an in-depth investigation. Supervisory authorities would have broad investigative powers, including powers to issue information requests to the concerned undertaking or other stakeholders, and to impose fines for failure to comply After in-depth investigation, if the authority finds a market-distorting foreign subsidy, it may impose a decision with remedies or a decision with commitments agreed with the undertaking concerned.

Remedies

The White Paper envisages that remedies could include both structural remedies or behavioural measures, and gives the following examples:

- divestment of certain assets or reducing capacity or market presence linked to subsidies;
- prohibition of certain subsidised investments;
- prohibition/unwinding of a subsidised acquisition;
- third party access;
- licensing on FRAND terms;
- prohibition of specific market conducts linked to the subsidy;
- publication of R&D results; and
- redressive payments to the EU or to Member States.

Specific powers to prohibit subsidised acquisitions of EU businesses

The White Paper also proposes separate, additional powers for the Commission to prohibit subsidised acquisitions of EU businesses, with a system of compulsory and suspensory prior notification for certain acquisitions by investors that have received funding or payments from non-EU governments or public bodies.

Supervisory authority

After considering various options, the White Paper recommends that the Commission is made exclusively competent for reviewing transactions that meet the relevant jurisdictional thresholds (one-stop-shop), in the same way as it is under the EU Merger Regulation (**EUMR**).

Triggers for the notification obligation

The White Paper proposes that a filing obligation would apply where the following three conditions are met:

- an investor acquires either a certain level of shareholding in an EU target or a certain degree of influence over an EU target. No specific figure is provided for the level of shareholding, but an earlier draft of the White Paper suggested 35%. As regards the required level of influence, the White Paper proposes a test based on "material influence", a threshold of control that is considerably lower than that which applies under most merger control regimes and which could be satisfied by veto rights that are commonly considered to be important for the protection of minority shareholders.

- the target is established in the EU and meets certain financial thresholds. The White paper proposes a threshold of EU turnover exceeding EUR 100 million, but also suggests possible thresholds based on the value of the transaction, or the target's capacity for significant future EU turnover; and
- the investor has received a "financial contribution" by any non-EU public authority. This would include funding, foregone public revenues (e.g. tax breaks) or the supply or purchase of goods or services, even if they grant no benefit to the investor, e.g. because they are on commercial, market terms. However, a filing would only be required if the financial contribution over the three calendar years prior to the notification is in excess of a certain amount (e.g., EUR 10 million, as proposed in a draft of the White Paper) or of a given percentage of the acquisition price (e.g., 5-10% as also proposed in that draft).

Assessment of distortions in the EU market

The legal test would be whether the acquisition is facilitated by a foreign subsidy and, if so, whether it would distort the EU market. To determine distortion, a list of factors similar to those described on page 4 of this briefing would be considered (size of the subsidy, the situation of the beneficiary, market conditions etc.) and any positive effects of the subsidy on EU interests would be taken into account.

Procedure

Similar to the other powers proposed in the White Paper, a two-step procedure would apply for notified transactions. First, the acquirer would need to submit an initial notification to the authority with basic information about the transaction and the subsidies involved. There would be a standstill period during which the transaction could not close, which would be extended if an in-depth investigation is opened.

The result of the review could be either clearance, conditional clearance (with commitments) or prohibition.

Remedies

The acquirer may offer commitments similar to the ones described on page 5 above to remedy the distortion.

Transactions falling below the notification thresholds

For subsidised transactions falling below the thresholds for notification to the Commission, the White paper envisages that national supervisory bodies could address any distortive effects of those transactions by using their separate, general powers to impose remedies on foreign subsidies (described on pages 3-5 of this briefing). However, it is possible that EU governments might instead decide to introduce mandatory filing requirements at the national level for such transactions.

Interplay with other instruments

Merger control reviews – if a transaction is subject to a subsidy filing and one or more merger control reviews, the acquirer would have to submit multiple notifications and the reviews will be carried out in parallel but separately. Although subsidies may also be considered in EU or national merger control reviews, it is usually considered in the context of assessing the merged entity's strength relative to its rivals (see e.g., the CRRC Zhuzhou/Vossloh case study below), rather than the subsidies' direct impact on the market. In this respect, it will need to be clarified whether the one-stop shop nature of the

Commission's subsidy reviews will preclude national competition authorities from blocking mergers under their merger control rules for reasons relating to subsidies.

Foreign investment review – it is also possible that an acquisition is subject to both FDI review and subsidy review, which again may lead to parallel procedures. Whether a foreign investor is controlled by a foreign government or has received any financial support from foreign government may also be considered in the FDI review. But FDI reviews typically aim to assess whether a foreign investment is likely to affect national security or public order, which is again different from the objectives of subsidy review. As such, the subsidy review system would be a complementary to the FDI review.

Case Study – CRRC Zhuzhou/Vossloh

Recently, State subsidies granted by Chinese government were considered by the German Federal Cartel Office (**FCO**) in its merger control review of the acquisition by CRRC Zhuzhou of Vossloh Locomotives. On 27 April 2020, the FCO announced its clearance of the case. However, it did so only after a Phase II investigation in which it carefully examined the transaction's effect on the market. When assessing the possible market practices that CRRC Zhuzhou may carry out, the FCO for the first time explicitly considered CRRC Zhuzhou's access to financial resources and subsidies from the Chinese government. The FCO pointed out that CRRC Zhuzhou is subsidised under the national "Made in China 2025" and "Belt and Road Initiative" schemes. The subsidies received also include financing from the Chinese government and those in the form of bank loans from State-owned banks. The FCO also mentioned that CRRC Zhuzhou had been strategically lowering prices to expand its market position and therefore, the FCO concluded that the possibility that it would implement a low-price strategy in the future was high.

Despite the above, the FCO cleared the case because it did not find distortion of competition post-merger, after analysing different scenarios. One of the main reasons was that Vossloh's technology was deemed not competitive in the long-term, with new competitors entering into the market offering innovative technologies. It was also concluded that CRRC was not considered to be a strong competitor in the EU market.

In a press release, Andreas Mundt, the President of the FCO, indicated that the FCO had very thoroughly examined all the particularities associated with the acquisition of a European company by a Chinese State-owned company. "Possible state subsidies, the availability of technical and financial means and strategic advantages from other shareholdings were considered in the competitive assessment of the merger." The threat of low-price and dumping strategies and the cost advantages resulting from CRRC's State-subsidised activities in many other markets were also examined

Changes to the EU public procurement regime

The White Paper proposes that bidders participating in public tenders are required to notify the contracting authority if they have received a financial contribution from a foreign public body or will receive one during the execution

of the contact. The White Paper proposes to limit this requirement to (i) tenders over a certain value, in certain sectors or in receipt of EU funding; and (ii) subsidies of over EUR 5 million, or 5-10% of the contract value, received in the three years before the tender or the year after completion of the contract.

Notifications would be transmitted to the supervisory body with general powers to investigate in respect of foreign subsidies. If that authority decides to investigate further, the contracting authority would be required not to award the contract to the bidder under investigation until the outcome of the investigation. If the supervisory body finds that the bidder has received a distortive foreign subsidy, and the contracting authority determines that the subsidy has distorted the procurement procedure, then the bidder will be barred from winning the contract, and might also be barred from participating in future tenders for a three year period.

IMPLICATIONS FOR STATE OWNED ENTITIES AND OTHER FOREIGN INVESTORS

Increased complexity and cost of filings

Should the White Paper proposals be adopted, the acquisition of an EU target by foreign investors, particularly SOEs receiving government subsidies, may be subject to three different types of mandatory filings in the EU: merger control review, foreign investment review and subsidy review. Several parallel filings with different assessment criteria, possibly at both EU and national member state levels, would significantly increase filing costs and complexity, with implications for deal certainty and closing timetables.

As well as being the focus of subsidy reviews as described in the White Paper, government subsidies will also be examined in merger control reviews (as the German FCO did in the CRRC Zhuzhou/Vossloh case), and in foreign investment reviews (to assess the company's relationship with foreign governments).

Consequently, having a strategic and coordinated approach to the various different filings would become more important than ever, not only to navigate the added complexity created by new requirements for subsidy filings, but also to ensure consistency in the way that subsidy-related issues are addressed before the various competent authorities.

Increased compliance risks for SOEs

The proposed general powers for EU and national authorities to investigate and impose remedies on businesses in receipt of distortive foreign subsidies would also create substantial additional compliance risks for foreign SOEs operating in the EU. In particular, conduct such as below-cost "predatory pricing" – which at present is usually only unlawful if carried out by businesses with a dominant market position – would give rise to a risk of enforcement action under the proposed regime. And if there is no possibility to obtain clearance or comfort that a funding arrangement is compliant, then SOEs may be forced to adopt a cautious approach that puts them at a competitive disadvantage to EU rivals that are able to obtain legal certainty in the form of clearances under the EU State aid rules. Those competitive disadvantages may be exacerbated for SOEs that participate in public procurement procedures, which face being subject to delayed awards and even exclusion from future tenders.

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