CLIENT ALERT

EU's Foreign Subsidy Regulation to Introduce Additional Approval Processes for M&A

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The European Commission's forthcoming Foreign Subsidies Regulation (***FSR***) is expected to introduce additional approval requirements for a large number of M&A deals and, in particular, for transactions that involve private equity firms or other financial investors.

The FSR is likely to enter into force by mid-2023, with the notification obligations for M&A transactions applying from around Q3 2023.

Proposals for the Foreign Subsidies Regulation

The European Parliament and the Council of the European Union reached a political agreement to introduce a new EU FSR earlier this year.[1] The proposed FSR was approved by the European Parliament on 10 November 2022, and by the European Council on 28 November 2022.

The aim of the FSR is to close a perceived 'regulatory gap', whereby subsidies granted to EU companies by EU Member States are subject to close scrutiny pursuant to state aid rules while subsidies granted by *non*-EU Member States go largely unchecked.

[1] See Willkie's client alert dated 11 July 2022, here.

The FSR will therefore empower the European Commission (***EC***) to (i) identify foreign subsidies received by undertakings engaging in business activities in the EU, (ii) determine whether such subsidies distort the EU internal market, and (iii) if so, impose appropriate remedies to restore a 'level playing field'.

FSR Approval of M&A

Amongst other functions, the FSR will introduce a new substantive approval requirement for concentrations (i.e. acquisitions of control, mergers or joint ventures) if:

(i) either the target of an acquisition, at least one of the parties to a merger, or a joint-venture company itself (if relevant) generate an EU turnover of at least **€500 million**; and

(ii) The parties in aggregate (i.e. including target, plus any acquirer of control / all JV parents) have received combined financial contributions of more than **€50 million** from non-EU 'foreign subsidies' in the last three financial years.

This filing requirement will apply in addition to any applicable merger control (e.g. under the EU Merger Regulation[2]) or national foreign investment filing obligations.

The timetable will closely resemble the existing merger control regime under the EU Merger Regulation; namely a 'Phase 1' review of up to 25 working days, followed by either clearance or the initiation of a more detailed 'Phase 2' investigation lasting up to 90 working days.[3]

Transactions will be approved provided the foreign subsidy will not "*negatively affect competition in the internal market*". More detail will hopefully come in future guidance, but the FSR expressly identifies a foreign subsidy that directly 'facilitates' a transaction as being one of those 'most likely' to cause distortion.

Should the EC consider a 'subsidy' to have distortive effects, the EC is able to prohibit the transaction, or allow it only subject to certain conditions. Such conditions may include divestments, but also a requirement to repay the foreign subsidy with interest, or to comply with specific market behaviours such as reducing capacity or market presence, limiting investments, granting access to infrastructure or assets under fair, reasonable and non-discriminatory terms, or publishing R&D results.

[2] Council Regulation (EC) No 139/2004 of 20 January 2004 on the control of concentrations between undertakings (OJEU L 24, 29.01.2004, p. 1-22).

[3] The EC will also have the power to require notification of concentrations below the above-mentioned thresholds if it suspects that a distortive foreign subsidy may be involved. This 'safeguard' is in some ways similar to the EC's ability to review concentrations under Article 22 of the EU Merger Regulation. It is therefore likely to entail a similar degree of legal uncertainty.

Sanctions for failure to notify a qualifying transaction or for closing prior to the EC's approval include a fine of up to 10% of the parties' aggregate worldwide turnover. Additional fines of up to 5% of worldwide turnover can also be imposed until the parties comply with their obligations, and fines of up to 1% of worldwide turnover can be imposed for procedural infringements (e.g. supplying incorrect, incomplete or misleading information, refusal to submit to an inspection).

Significant Impact on Private Equity Deals

The key issue for private equity firms and other financial investors is the wide definition of 'foreign subsidies' in the FSR.

On its face, the FSR captures situations in which a 'third country' provides a 'financial contribution' which benefits an undertaking engaged in economic activity in the internal market. 'Financial contribution' is broadly defined, expressly capturing a range of fund transfers including capital injections and debt for equity swaps. 'Third country' is defined even more broadly, capturing not only government authorities, but also (emphasis added):

> *foreign public entities, whose actions can be <u>attributed to [a] third country</u>, taking into account elements such as the <u>characteristics of the entity</u>, the <u>legal and economic environment</u> prevailing in the State in which the entity operates including the government's role in the economy; [and]*
>
> *any private entity whose actions can be attributed to [a] third country, taking into account <u>all relevant circumstances</u>.*

While further guidance is expected from the EC, this wide definition of 'third countries' would appear to include not only non-EU state-owned enterprises and sovereign wealth funds, but also very possibly public pension schemes and investment vehicles from other less obviously 'state-backed' entities such as universities. The subjective nature of the definition also introduces a degree of uncertainty which will need to be addressed by guidance.

In this sense, the FSR regime would resemble the broad interpretations of 'Foreign Government Investors' in the existing foreign investment regimes in Australia and New Zealand.

The wording of the regulation further fails to take account of any substantive differences between an *active* investment by such an entity and a merely *passive* investment such as in a third party-managed fund; nor does it address the logical consequence of the terms used that a relevant entity acquiring an interest in one fund would result in implications for transactions entered into by all other unrelated funds controlled by the same asset manager.[4]

[4] This result would flow from the FSR's consideration of 'undertakings' to a transaction (e.g. as opposed to specific legal entities), which mirrors the approach under the existing EU Merger Regulation. Given that all funds managed by the same management group would count as the same 'undertaking' under the EU Merger Regulation, the application of the FSR thresholds to 'undertakings' might consequently mean that all funds would be considered to have received a 'third country subsidy' simply because a relevant entity had invested in one of them.

Consequently, it appears that the FSR will result in significant -and arguably unwarranted- implications for the majority of PE firms who manage funds which include investment by very commonplace market participants, such as non-EU pension funds.

In fact, if a PE firm manages a fund which has received €50 million or more of investment from a non-EU public pension fund, it would appear to trigger a notification <u>every time</u> either that fund -or any other funds managed by the same PE firm- acquired a target which generates EU turnover of €500 million or more.

Implications for Asset Managers

The FSR has several significant implications for asset managers and other financial investors.

- Given that most asset managers may not have existing ways to monitor and track the level of 'third country' investment in their funds and/or portfolio companies, nor any other relevant 'subsidies' they may receive, new systems may be needed in order to ensure compliance with the notification regime in future transactions. These would likely need to track, for example, the relevant 'third country' investors and their total 'contributions' within the last three years, on a rolling basis.
- For notifiable transactions, both acquisitions and exits will become more complex, due to the increased regulatory burden imposed by the FSR regime. It is therefore notable that the thresholds for notification are set at a level at which there is a strong likelihood that the transaction would trigger a parallel notification to the EC under the EU Merger Regulation, such that there may be a degree of efficiency in data collection as regards filing preparation.
- For non-notifiable transactions that still involve parties with the requisite level of third country 'subsidies', parties must still assess the risk of own initiative investigation by the EC.

Timing

The FSR will enter into force on the 20th day following its publication in the Official Journal of the European Union. The FSR will then apply from six months after its entry into force, (i.e. expected around mid-2023), with the notification obligations starting three months later (i.e. expected in Q3 2023). The Parliament has directed the EC to issues guidelines on how it will enforce the new regime, which relevant stakeholders will doubtless review with significant interest. This is due at some point in the new year.

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