FEBRUARY 2023 II SERIES – NO 2

NEWSLETTER CVA

REGULATION (EU) 2022/2560 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL OF 14 DECEMBER 2022 ON FOREIGN SUBSIDIES DISTORTING THE INTERNAL MARKET

A constant topic of concern within the realm of European market law, the European Union's subsidy policy has historically served as a key component of attempts to work towards a more harmonious and fairer ideal of equal competition law across Member States. In particular, one term endemic to most discussion – and indeed most legislation concerning laws surrounding governmental subsidies as they relate to competition law – is the idea of a "level playing field". This gold standard serves as the main impetus for the proposal of such regulations by the European Commission (see more information on State Aid and the level playing field here), with the institutions of the European Union ('EU') aiming for reasonably equal market access for firms across the union without the undue intervention of state finances that might play a role in both large-scale growth of individual firm production through unbalanced subsidization and consolidation of firms in mergers that, without state aid, might not have been feasible.

Following the negotiation and its ratification in 1957, the Treaty of Rome established a standard for state aid control (now article 107 of the Treaty on the Functioning of the European Union, 'TFUE') that has generally barred Member States from providing state aid to individual firms operating within the internal market outside of limited exceptions, such

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as relief from a widespread disastrous economic circumstance or aid to promote the development of areas in a Member State where the standard of living is exceptionally low (see Article 107 TFEU here). This has allowed the EU to ensure a fairness in competition across Member States, targeting distortive subsidies and unfair market practices without entirely eliminating the utilization of subsidies as an instrument of policy from the arsenal of Member State's fiscal policy. Balancing need and market freedom, the EU has continually tried to strive for a reasonably "level playing field" when it comes from the intervention from direct subsidies in the internal market as it has expanded and amended the regulatory policy.

However, a notable gap has persisted throughout the lifespan of such restrictions on Member State subsidy policy, vested in the fact that external subsidies by third-party states have remained unaffected by regulatory law.

The most recent highest-profile case of such non-Member State aid with an associated potential distortionary outcome within the internal market was the United States' passage of the Inflation Reduction Act, which unevenly distributed large-scale subsidies and tax credits to US manufacturers and free trade agreement partners with industries in the production of a wide range of green energy-related machinery (see the Summary of the Energy Security and Climate Change Investments in the Inflation Reduction Act of 2022 here). The Act unleashed a particularly serious and politically sensitive clash between the competent European market authorities, both at the national and the European levels, and the USA, with proposals from the European Commission to address what is perceived as a protectionist move from the US administration.

Critically, the Inflation Reduction Act excluded EU companies from being able to access subsidies for goods manufactured in the US and sold in Europe or vice versa, unfairly shifting the "level playing field" strongly in the direction of US manufacturers within the EU's internal market, due to the foreign subsidy. Fortunately for some European multinational firms with final market sales within the EU, negotiations have opened the road for such manufacturers to receive the same production-side subsidies as US companies (see the European Commission press release of December 29, 2022, "EU welcomes access to US subsidy scheme for commercial vehicles" here).

However, this example only constitutes one of many such foreign subsidies by outside states that can have hugely disproportionate economic effects across the internal market.

As such, the EU has recently moved to fully adopt Regulation 2022/2560 of the European Parliament and of the Council of 14 December 2022 on foreign subsidies distorting the internal market ('FSR'), which entered into force on 12 January 2023 and wil start applying on 12 July 2023. The new Regulation aims to constrain the prevalence of foreign subsidies within the internal market through targeting companies operating within the EU that have

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received any form of direct or indirect “foreign financial contribution” (see Regulation 2022/2560 of the European Parliament and of the Council of 14 December 2022 on foreign subsidies distorting the internal market here). President of the Commission Ursula von der Leyden herself referred to this new Regulation as “de-risking” the future of European market from distortion as a counterweight to the new state subvention regimes across the world, along with a new wider subsidy strategy to benefit green energy, at the World Economic Forum in Davos (see the Special Address here). Particular reference and instruments are provided to combat the influence that can be uncompetitively extended over merger and acquisition transactions and bids for public tender due to the sensitivity of such sectors to capital inflows provided by foreign subsidies.

Under this new Regulation, the European Commission is provided with sole competence to interrogate and determine whether foreign subsidies by non-Member States are providing firms within the internal market with distortive market advantages over competitors so as to bring such firms into line with the rigorous limitations imparted by EU expectations of state aid originating from Member States. The Commission is additionally afforded extensive implements to realize market-based remediation in the event that foreign subsidies are found to exist that unduly empower specific firms in violation of the concept of the coveted level playing field.

Practical and procedural aspects related to the application of the FRS will be clarified by implementing legislation.

Procedure

The FSR establishes three tools for the Commission to assess and address distortive effects of foreign subsidies on the EU internal market:

A. Mergers and Acquisitions

FSR introduces a mandatory notification for deals where:

- The aggregate turnover generated in the EU of the joint venture or of the acquired undertaking is €500M or more; and
- The parties involved have benefitted from at least €50M in combined foreign financial contributions in the three years prior to the notification.

This prenotification requirement is independent of merger control or foreign direct investment ('FDI') filing requirements, and will run in parallel to them. The notification obligation will apply from 12 October 2023.

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The FSR review deadlines for determining the existence of distortive effects on the internal market by foreign subsidies in these proceedings is aligned with the timeline set out by the EC Merger Regulation (see Council Regulation (EC) No 139/2004 of 20 January 2004 on the control of concentrations between undertakings here), allowing time for a first decision within 25 working days of the notification of a concentration (phase I), extendable by 10 working days, and 90 working days, extendable by 15 working days, to declare a concentration compatible or non-compatible with the common market (phase II).

The Commission can identify concern surrounding a merger and acquisition deal within the phase I period and refer the market concentration for greater scrutiny in phase II, where it can prohibit the finalization of the transaction. The Commission also retains the right to request prior notification from companies involved in merger and acquisition deals that do not fall under both or either of the conditions for obligatory notification, providing it suspects subsidies within the three-year period leading up to the transaction would create an unfair market advantage.

B. Public Procurement Tender

Firms attempting to engage in public tender within the EU also are required to notify the Commission for review by the FSR in the event that the public procurement offer has a valuation of at least €250M and the bidding firm has received financial contributions from non-EU Member States with aggregate value of at least €4M over the three years prior to the notification.

The preliminary reviews may last up to 20 working days, extendable by 10 days, and the in-depth investigation may last up to 110 working days, extendable by 20 days. During the Commission's investigation, the firm may continue with the public procurement process. However, a contract cannot be awarded unless the Commission issues a favourable notification.

The European Commission also once again reserves the right to request information from and investigate firms involved in public procurement that do not meet the strict definitions outlined for mandatory review.

C. Ex Officio Proceedings

The Commission is also broadly empowered by the Regulation to review at its own discretion the distortive influence of foreign subsidies provided to firms by non-EU Member States, including merger and acquisitions and public tenders that follow below the pre-notification thresholds. The Commission can utilize a wide variety of exploratory methods to aid the gathering of information under the Regulation, including the dispatch of information

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requests to firms and large-scale market investigations into particular subsidy regimes across an entire economic sector. The Commission is also authorized to impose fines up to 1% of a firm's annual turnover for failure to fully comply with the exploratory methods of the regulation.

The Commission will be able to investigate any subsidies granted up to five years before the full entry of the Regulation into force on the 12th of July, 2023, after which it will be able to investigate any foreign subsidy up to 10 years after the date it was provided to a company. The Commission may enter into a preliminary review phase of any firm for foreign subsidies received, with an in-depth investigation to determine the nature and level of market imbalance engendered by the subsidies (much like ex ante proceedings).

Critically different, however, is the lack of a legal deadline for *ex officio* investigations to terminate, allowing the European Commission to continue investigations as long as deemed fit, but recommended to fall within 18 months of the inquiry's initiation.

Defining Subsidies and Distortion

The FSR provides the definition of subsidies broadly used in a modern sense encompassing, *inter alia*, the transfer of funds or liabilities, such as capital injections, grants, loans, loan guarantees, fiscal incentives, the setting off of operating losses, compensation for financial burdens imposed by public authorities, debt forgiveness, debt to equity swaps or rescheduling; foregoing of revenue that is otherwise due, such as tax exemptions or the granting of special or exclusive rights without adequate remuneration; or the provision or purchase of goods or services.

But how does the Commission strictly determine whether any given foreign subsidy crosses into the realm of market distortion that undermines the level playing field?

As a general rule of thumb, the Regulation lays out that most cases where a foreign subsidy is lower than €4M over a consecutive period of 3 years should widely be considered non-distortive within the meaning of the FSR (foreign subsidies can come into question for investigation under the FSR up to 5 years before the entry into force of the regulation, i.e. 12 July 2018, assuming such subsidies continue to distort the internal market at the time of the FSR's implementation).

In cases where foreign subsidies come under scrutiny by the Commission, the Regulation outlines the idea of a balancing test that may occur to determine whether subsidies merit redressive measures by the Commission. The balancing test will take into account the impact of the subsidy relative to the size of the overall market, the effect of the subsidy on

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unduly overcoming barriers to entry into a market, whether a company had undue access to a public tender or ability to engage in an acquisition, if an insolvent firm is being kept buoyant in the market, and other similar factors of competition.

On the other hand, the test also leaves room to consider what positive effects such subsidies may have in employment and product access within the EU market, as well as encourages actors in favour of foreign subsidies to advocate through formal notice to the Commission why such subsidies should be disregarded by the EU.

In the event that subsidies are found to have a greater negative impact than positive on the competition of the EU's internal market, the Commission is empowered to impose a range of redressive measures to the extent it deems full and effective for the reinstatement of fair competition into the market. Such measures can be imposed in a structural manner, which involves the Commission ordering an undertaking to divest assets, reverse an acquisition, reduce scale of operation, or other actions to directly alter the role of the company within the wider market share.

Alternatively, behavioural changes may be mandated, such as requiring the undertaking to repay foreign subsidies with an appropriate interest rate, publish widely private research and development holdings, or other actions to alter the intellectual capital or structure of a company without actively instructing a reduction in market share. The FSR generally delegates full discretion to the Commission and its balancing test on determination of redressive measures, but undertakings have the right to offer their own binding commitments to remedy the distortion on the internal market for Commission consideration (see Article 7 of Regulation 2022/2560). If the Commission finds such measures appropriate, it will investigate and monitor the undertaking for compliance. Otherwise, the Commission will impose redressive measures as it deems necessary to fully and effectively correct the distortion.

Companies receiving any sort of foreign subsidy, both directly or indirectly, must be prepared to take meticulous record of the financial valuation of such subsidies, lest they run afoul of the Commission and incur the fines and penalties associated with non-compliance over a potential inability to fulfil the notification requirement. Such fines can be substantial. For instance, if a party fails to fully notify the Commission before attempting to commence an action that requires reporting of foreign subsidies to the Commission, or if an action under *ex ante* procedure is continued before the Commission has completed its investigation, the Commission may fine the party for up to 10% of its aggregate financial turnover in the previous year.

Moreover, when a company presents incomplete, erroneous, or deceptive information when requested or required to supply foreign subsidy records, the Commission may impose a fine

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of up to 1% of global turnover and, additionally, intermittent fines up to 5% of the average daily aggregate turnover for each working day worth of delay.

Conclusion

The FSR constitutes a novel method to expand subsidy control across all actors within its borders, including those companies that have previously received significant financial assistance from outside governments through subsidies that create global market effects stretching into the EU's internal market. Much remains to be seen about the enforcement methods and particularly the ability of firms to fully comply with the Regulation due to the large burden of efficient record keeping on foreign subsidies that will be imposed within a relatively short time frame.

The focus on mitigating the adverse effects of subsidies of foreign governments compared to those of EU Member State governments is based upon sound principles of fair competition within the European single market and gives the European Commission, once more, a decisive role in contravening the effects of distortive government action on the European economy.

However, achieving the Foreign Subsidy Regulation's goals may be difficult for the Commission based simply upon the stark discrepancies in instruments available to address subsidies originating within the internal market versus subventions deriving from states outside the European Union. Many firms headquartered within EU partners including the United States, China, Japan, OPEC nations, and other states frequently employ subsidy structures that are clearly within the scope of this new Regulation on the control of foreign subsidies (see the IMF, World Bank, OECD and WTO "Subsidies, Trade, and International Cooperation" here).

The level playing field may be a commendable ideal, but it remains to be seen if the practicality of enforcement disappoints the targeted objective.

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