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The Foreign Subsidies Regulation and Foreign Direct Investment: How to Reconcile?

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"All animals are equal but some are more equal than others" (George Orwell, 'Animal Farm')

On 28 November 2022, the Council of the European Union gave its final approval to the new EU Foreign Subsidies Regulation 2022/2560 (the **FSR)**. The regulation addresses distortions created by subsidies that are granted by non-EU countries to companies operating in the EU single market. It lays down the procedural rules for investigating these subsidies mainly in the context of large concentrations and bids in large public procurement procedures, together with an ex officio tool to investigate also other measures. In doing so, the regulation aims to restore fair competition between all companies operating in the internal market, "both European and non-European alike", claims the Council of the European Union. However, in the wake of the heightened attention to FDI screening and national security in the EU, it is legitimate to ask whether the Council's assertion is credible. Will a subsidy from, say, Russia, or North Korea actually be treated equally to a subsidy from the UK? To this, and other emerging interactions between FSR and FDI, we devote the following pages.

The Subsidies Regulation: A Recap

The regulation proposes a number of tools for the Commission to investigate financial contributions by a public authority in a non-EU country:

- Two prior authorization tools, to ensure a level playing field for the largest mergers and for bids in large-scale public procurement procedures;
- A general ex officio market investigation tool for investigating all other market situations as well as lower-value mergers and public procurement procedures.

Companies will have to notify the Commission of mergers and acquisitions if one of the parties involved has an EU turnover of at least €500 million and there is a foreign financial contribution of at least €50 million. For tenders in public procurement procedures, the threshold for procurement is set a minimum of €250 million. If a company fails to comply with the notification rules, the Commission will be able to impose fines and examine the transaction as if it had been notified.

As a general rule (and subject to exceptions where applicable), the Commission will be empowered

to investigate foreign subsidies granted up to five years prior to the entry into force of the regulation where such subsidies distort the internal market after the regulation's entry into force.

As is the case under the EU State aid rules, if the Commission finds that a foreign subsidy exists and that it distorts competition, it will perform a balancing test. This is a tool to assess the positive and negative effects of a foreign subsidy.

If the negative effects outweigh the positive effects, the Commission will be empowered to impose redressive measures including structural and non-structural remedies and the repayment of the foreign subsidy or to accept commitments from the undertakings concerned in order to remedy the distortion caused by the foreign subsidy.

If the Commission finds a distortive foreign subsidy, it may conduct a balancing test (taking into account both the positive and negative effects of the subsidy) and impose redressive measures on companies to remedy the distortion, or accept them as commitments. The redressive measures and commitments can be structural (such as an acquisition ban, divestment of assets or reduction of capacity or market presence), or behavioural (such as offering access or licencing at FRAND conditions to an infrastructure, publicising R&D results, repaying of the foreign subsidy with an interest rate or making adaptations in the governance structure).

The FSR will enter into force 20 days after published in the Official Journal, on January 12 2023, and be applicable six months after its entrance into force.

The Foreign Subsidies Regulation and FDI: Parallel Lines Do not Intersect?

One cannot but wonder what the effect of three cumulative sets of controls (merger control, FDI and now FSR) will have in foreign investment in the EU.

Moreover, the coexistence of the two sets of rules elicits a number of analytical points: First, the two regimes are indeed meant to coexist. Recital 3 FSR expressly provides that "This Regulation covers all economic sectors, including those that are of strategic interest to the Union and critical infrastructures, such as those mentioned in Article 4(1), point (a), of Regulation (EU) 2019/452 of the European Parliament and of the Council".

Second, both sets of rules will inevitably be perceived as protectionist by the non-EU Member States. Potential buyers of corporations in the EU / participants in tenders in the EU face at the very least delays and potentially remedies for, say, tax breaks given in Mountain View or Seoul that are completely unintended to have effects in Europe.

Third, both sets of rules undermine at least the spirit and probably the substance of the WTO. The EU could have chosen to rely on / strengthen the SCM Agreement. However, it did not. Under the WTO Subsidies Agreement, the Union has the possibility of initiating State-to-State dispute settlement procedure against certain foreign subsidies granted by WTO members and limited to goods. Article 44(9) FSR provides that "this Regulation shall not prevent the Union from exercising its rights or fulfilling its obligations under international agreements. An investigation pursuant to this Regulation shall not be carried out and measures shall not be imposed or maintained where such investigation or measures would be contrary to the Union's obligations emanating from any relevant international agreement it has entered into. In particular, *no action*

shall be taken under this Regulation which would amount to a specific action against a subsidy within the meaning of Article 32(1) of the Agreement on Subsidies and Countervailing Measures and granted by a third country which is a member of the World Trade Organisation" (emphasis added).

However, the sheer truth is that, together with the recent wave of sanctions on Russia, the proliferation of rules whereby regulators in Europe unilaterally scrutinize activities worldwide rather than relying on the feeble WTO system is not a good omen for the cause of multilateral trading rules.

Fourth, both set of rules raise interesting applications at the level of the national courts. Is it possible to challenge the validity of a transaction before a civil court because it has not been notified pursuant to a mandatory FDI regime? (Yes, at least in Spain, the system we are more familiar with). How about the case when a transaction has not been notified to the European Commission in application of the FSR? The FSR does not have a provision curtailing the powers of the Member States similar to Article 21 EUMR. It should be recalled that EU Regulations have direct effect. Similarly, in the recent *Aegon* case, the European Commission invoked Article 21 EUMR to oppose to an attempt by Hungary to unduly prohibit a transaction in application of its FDI rules. An open point arises as to whether the application of the FSR to an M&A transaction will also curtail the powers of the Member States to intervene against the same transaction pursuant to national FDI screens.

Fifth, one cannot but wonder whether national security and public order considerations will play a role in the review. Let's imagine a privately held company heavily subsidized by the Government of the People's Republic of China (but not to the extent of granting the Government EUMR control over the entity) intends to buy say Airbus or EDF. Will the review of the European Commission take into consideration national security/FDI considerations? The following thoughts come to the fore:

- The cross fertilization between subsidies and national security is not unheard of in EU law. State aid control is unequivocally a political enterprise and, e.g., the Commission enacted on 23 March 2023 the Temporary Crisis Framework for State Aid measures to support the economy following aggression against Ukraine by Russia.
- FSR is an EU regulation and secondary EU legislation and, like any secondary legislation, is to be interpreted pursuant to the EU Treaties. There are e.g., merger control cases where the Commission took into account considerations other than competition in its review (cultural diversity in *Universal/EMI* and, more broadly, the case-law of the EU Courts has confirmed that other Treaty objectives may be taken into account in the context of the assessment of a concentration, such as *Société Génerale des Grandes Sources and Others/Commission* and *Association belge des consommateurs test-achats/Commission*). National security and public order could thus potentially play a similar role interpreting the FSR.
- Article 52(3)(c) FSR appears to consider subsidies to strategic industries and critical infrastructures as more sensitive for the internal market. Indeed, pursuant to this provision, the Commission is empowered to establish "specific thresholds for notifications for certain economic sectors or differentiated thresholds for different types of public procurement contracts, especially where the practice of the Commission enables the identification of economic activities where foreign subsidies are more likely to distort the internal market, *including as regards strategic sectors and critical infrastructure*" (emphasis added). If our understanding of this sentence (as implying that subsidies to strategic sectors and critical infrastructures are problematic for the

internal market) is correct, the very text of FSR opens the door to FDI considerations being relevant in FSR review.

- The FSR closes a potential gap left by FDI screening. The use of foreign subsidies in transactions is rarely a triggering event for FDI review. It might play a role in the substantive FDI assessment but foreign subsidies in and of themselves seldom lead to a filing (exceptions include the instances where the subsidy confers control on the State). Some FDI authorities (ours, Spain's that is, comes to mind) try to interpret the notion of control widely to avoid false negatives. The new FSR could be used to closes this gap, allowing the European Commission to review this kind of transactions.
- However, there are international law arguments in favor of keeping the FSR focused only on competition and the level playing field. The obligations of the EU under WTO law might be one such reason. The peculiar constitutional architecture of the EU is another one. Pursuant to Article 4(2) TEU: "[The EU] shall respect their essential State functions, including ensuring the territorial integrity of the State, maintaining law and order and safeguarding national security. In particular, national security remains the sole responsibility of each Member State".
- Finally, the outcome of the foreign subsidy review is similar to those of FDI review: an authorization, an authorization subject to conditions, or a prohibition. However, more importantly, in accordance with Article 1(2) FSR, it applies to "foreign subsidies granted to an undertaking, including a public undertaking which is directly or indirectly controlled by the State". This kind of investor might be caught under the national FDI regimes. This means, in the worst case, a transaction might be reviewed under the FDI and FSR regimes due to the same reason but leading to different, maybe even contradictory, outcomes. Concerns for national security might not coincide with concerns regarding the distortion of the internal market. This might lead to remedies complicated to reconcile.

Conclusion

The Commission markets the FSR as a tool to create a level-playing field for companies that receive EU and third country subsidies, and it remains to be seen how it will be implemented once in practice.

FSR is a tool that can be used to close gaps left by the current FDI regime subjecting companies to extensive (political) review. Applying what we learned in the context of FDI screening, it will be interesting to see the application of the FSR in practice. If the effects on the level playing field are the only consideration, it is the subsidy itself and its economic impact that shall be assessed whereas it should arguably play no relevant role whether the subsidy is granted by country X (an ally) or country Y (a strategic rival). By contrast, the nationality of the investor is a crucial to FDI screening.

De jure, FSR applies to all foreign investments from third countries without distinguishing between the residence or nationality of the investor. However, the "Chinese state capitalism, and the increasing presence of Chinese SOEs on the EU internal market was a trigger for the discussion on the foreign subsidies in the EU." (see, Lena Hornkohl, The EU Foreign Subsidy Regulation – What, why and how?, p. 5). Even though FSR will formally apply independently of nationality to foreign as well as European companies, for good or ill the regulation forms part of a trend towards protectionist and politicized investment control and it is reasonable to anticipate that subsidized companies from certain jurisdictions will by definition be considered more problematic than

others.

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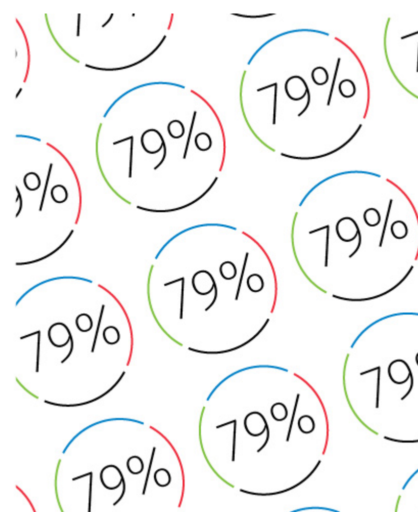

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