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CLIENT MEMORANDUM

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EU Foreign Subsidies Regulation (FSR) and What You Need to Know for M&A

Introduction

The EU's FSR regime is designed to enable the European Commission to investigate and remedy possible distortive effects of foreign subsidies in the EU. In notifiable transactions, this means **extensive disclosure obligations** with potential transaction timeline implications. The mandatory and suspensory filing process runs in parallel with merger control and foreign direct investment filings.

Since the regime came into effect in October 2023, many elements of the substantive assessment have remained unclear. However, on July 26, 2024, the Commission published a Staff Working Document which, although not binding, provides a useful road map on how the Commission will conduct the substantive aspects of an FSR assessment.

The memo provides an overview of what you need to know about the FSR for M&A and how the Commission will conduct its substantive assessment.

What is a "Notifiable Transaction"?
Mergers, acquisitions, and full-function joint ventures must be notified where: ▪ the target or the joint venture is established in the EU and generated EU gross revenue of at least **€500m** of in the last full financial year; and ▪ the companies involved in the transaction received aggregate foreign financial contributions ("FFCs") of more than **€50m** from non-EU governments or state-controlled entities in the three years prior to notification.

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Impact on Transaction Timing

In practice, we are experiencing protracted processes in which the EC is requesting additional data over and above strict notification requirements. Parties should provide for at least six months to complete a Phase I FSR process (without significant non EU sovereign backed investment; more if there is), but assume that this timeline will reduce for most cases once the regime is more established.

Best practices for FSR planning

Document hygiene	The EC requires submission of deal documents (including IC decks, diligence reports, finance documents) as part of the notification. IC decks and other documents considering the transaction should not discuss other potential bidders or point to any form of financing/co-investment as "unique" or not on market terms.
Co-investors	Investments made by non-EU sovereign wealth funds and public pension schemes will come under scrutiny. When FSR is in play on a deal, parties should have discussions with co-investors up-front to ensure that they are prepared to cooperate with the process and are up to speed with the process and potential disclosure requirements.
Record FFCs on a portfolio company basis	Over the last three financial years and assess whether they were received on market terms. Going forward, put in place a tracking system and a reporting obligation to monitor the receipt of any non-EU financial contributions (we can provide detailed guidance on this if useful).
Ensure counsel are aware of the active deal pipeline	Disclosures will need to be made in respect of any new portfolio companies where closing occurs before formal notification.

Disclosure requirements

- **Any individual FFC of €1 million** or more from a non-EU country that has granted more than €45 million in FFC's to the parties over the previous 3 years.
- Certain contributions deemed "most likely to distort," such as aid to ailing firms or unlimited guarantees for debts or liabilities, are subject to more onerous disclosure obligations.
- Consider information to be provided where a party is a minority investor in a transaction. For example, as part of the FSR notification, parties must disclose all sources of financing, including conditions attached to any equity financing.

Disclosure requirements

What is an FFC?

The definition is intentionally broad and includes: the transfer of funds or liabilities, such as capital injections, co-investment, grants, loans, loan guarantees, fiscal incentives, setting off of operating losses, compensation for financial burdens imposed by public authorities, debt forgiveness, debt to equity swaps or rescheduling; the foregoing of revenue that is otherwise due; or the provision/purchase of goods or services not on arms-length terms (note the provision/purchase of financial services is captured even if supplied on arms length terms) . There is no express exclusion for passive LPs.

Additional disclosures – PE context

Generally speaking, a filing is concerned only with the acquiring fund and its controlled portfolio companies. However, the ultimate parent company can expect additional requests for information relating to all of its active funds, including:

- To confirm that funds are not majority owned by the same LPs. This requires an analysis of each fund.
- To confirm that each of the funds are subject to AIFMD or equivalent rules.
- To provide an anonymized breakdown of all LPs and co-investors on a fund-by-fund basis to include: investor type, country, absolute value of their investment and corresponding share of capital (and entitlement to profit if different) in the fund, whether they have the right to opt out from certain investments, and whether they have voting rights in the advisory committee or any similar body of the fund.
- To substantiate that FFCs made by LPs and/or co-investors which are attributable to third countries on market terms, and in particular by justifying that those contributions entitle them to the same rights and obligations as other limited partners.
- To provide substantiated explanations of rules against cross-subsidisation between portfolio companies.
- To explain the different classes of investors within each fund (e.g., Class A, Class B) if applicable.

Implications for failure to file

- **Fines of up to 1% of the aggregate turnover** for process errors.
- **Fines of up to 10% of the aggregate turnover** for non-compliance (e.g., with a Commission decision imposing commitments, interim or redressive measures, or for certain infringements relating to notifications of transactions).
- **Periodic penalty payments of up to 5%** of the average daily aggregate turnover of the undertaking in the preceding financial year for each working day of delay or non-compliance.

The substantive assessment: How will 'Distortion' be assessed?

The FSR regime is designed to investigate and remedy 'possible distortive effects' of foreign subsidies in the EU, but what does this mean in practice?

The Commission will assess whether a foreign subsidy distorts the internal market by examining two conditions:

- Whether the foreign subsidy improves the competitive position of an undertaking in the internal market. It requires that there is a relationship between the subsidy and the activity pursued in the Internal Market (e.g., if the subsidy is granted and consumed directly for the purpose of an activity in a third country, this condition is not met); and
- whether in doing so it actually or potentially negatively affects competition in the internal market.

The Commission has clarified that its substantive assessment will differ in the context of public procurement and concentrations (M&A):

- In the context of concentrations, the Commission will assess not only the acquisition process but also whether the foreign subsidy affects the acquisition process itself or the merged entity's activities. The Commission's review under the concentration module is limited to assessing foreign subsidies granted within three years prior to the agreement, public bid or acquisition of a controlling interest.

The substantive assessment: The role of indicators

- Article 4(1) of the Regulation provides a non-exhaustive list of indicators to determine the negative effect on competition from the subsidy.
- Therefore, unlike state aid under Article 107 (1) of the TFEU, there is no presumption that the subsidy distorts the internal market merely because the beneficiary is engaged in an economic activity in the Internal Market. This concept will be further developed through case practice.
- However, for certain categories of foreign subsidies that are most likely to distort the internal market, such as those listed in Article 5 of the Regulation, the Commission will not need to perform a detailed assessment based on indicators, unless the undertaking can show that the foreign subsidy does not distort the internal market in the specific case.

The substantive assessment: Unlimited Guarantees in the spotlight

- The Guidance highlights unlimited guarantees as one particularly distortive subsidy under Article 5, no doubt because the first and only in-depth FSR investigation focuses on such distortion.
- Unlimited guarantees extend to all obligations of the beneficiary and therefore are liable to improve the competitive position of that undertaking in various situations.

Emirates Telecommunication Group acquisition of telecom business from CZ group PPF:

- Emirates Telecommunication Group (ETG) has offered a remedies package (which is currently being market tested) to meet the Commission's concerns. ETG will change its rules of association to render the unlimited guarantee inapplicable and it has offered to keep at arm's length the European telecom business it will acquire from PPF.
- ETG aims to achieve this by committing not to undertake favorable intra-group transactions. It will not finance the European telecom business at all going forward, other than for acquisitions taking place outside the EU. This would be combined with up-front disclosure obligations on high-value transactions, even when below the threshold of the FSR.
- The outcome of this case will provide useful guidance as to the types of remedies acceptable to resolve distortive subsidies in the form of unlimited guarantees. The Commission has extended the review deadline until 4 December 2024.

The substantive assessment: Application of the balancing test

- The Commission will take into account whether and to what extent the foreign subsidies have positive effects on the development of the relevant subsidised economic activity on the internal market, as well as broader positive effects in relation to the relevant policy objectives of the Union, such as environmental protection, social standards, or research and development.
- The Commission will then consider whether, and to what extent, the positive effects offset the negative effects caused by the foreign subsidies.

The Guidance document provides two broad indications for this assessment:

- Foreign subsidies that are most likely to be distortive under Article 5 are less likely to see their negative effects outweighed by positive effects. There is a presumption of a negative outcome of the balancing test.
- Where foreign subsidies generate positive effects which have been acknowledged under EU state aid rules, such positive effects will likely be taken into account in the assessment.

The substantive assessment: Application of the balancing test

What does this mean in practice?

Exactly what this means remains to be seen. For example, will foreign subsidies that are granted for the purpose of environmental protection (for example, some features of the US Inflation Reduction Act) be considered simply because they pursue this objective or, alternatively, only if certain principles and conditions are complied with as set out in EU state aid guidelines on environmental protection?

To provide further clarity, the Commission explicitly invites interested parties to submit comments in the procedure to help the Commission in applying the balancing test.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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