SLAUGHTER AND MAY/

MARCH 2024

FOREIGN SUBSIDIES REGULATION: TOP 10 TIPS FOR M&A TRANSACTIONS

Introduction

Since October 2023, parties to M&A transactions have had to interact with the EU's new filing regime under the Foreign Subsidies Regulation ("**FSR**"). We have highlighted below some key lessons that can be drawn from our practical experience helping clients navigate the regime to date.

1. A filing is likely if the target's EU turnover is >EUR500m

A transaction will require prior notification and approval under the FSR where the target has EU-wide turnover of at least €500 million and where the acquirer and target in aggregate have together received more than €50 million of foreign financial contributions ("**FFCs**") from third countries in the three years prior to the transaction. The FFC threshold is very low and, together with the broad definition of FFCs contained in the FSR (see our previous briefing), the practical reality is that most parties to significant M&A transactions will satisfy the FFC threshold, meaning that the primary determinant of whether a filing will be required is whether the target exceeds the €500 million EU-wide turnover threshold.

2. A parallel EUMR filing is likely (and the objective should be to run both in parallel)

In many cases, an M&A transaction which triggers an FSR filing will also trigger a filing under the EU Merger Regulation ("**EUMR**"). In fact, the European Commission ("**EC**") has confirmed that around 80% of FSR filings to date have been subject to a parallel review under the EUMR. The EC has expressed a desire for FSR reviews to be conducted in parallel to EUMR reviews insofar as possible, to avoid a scenario where transactions are delayed as a result of the FSR process. Based on our experience to date, the EC has (so far) met this objective, and FSR clearance has been secured on a similar or shorter timeline to EUMR clearance.

3. Data gathering can be very burdensome - start now if you haven't already

An acquirer making an FSR filing for the first time will potentially encounter practical challenges with the data collection process required to complete the notification form. They may find the process to be onerous and unfamiliar, given the novelty of the concept of FFCs, the low (>€1m) threshold for reporting individual FFCs and the group-wide scope of the exercise. For these reasons, we would recommend that parties who anticipate the possibility of having to make an FSR filing in the foreseeable future start work on the data gathering exercise now. Parties who are engaged in frequent and significant M&A will also likely want to refresh this exercise periodically (e.g. every 6 to 12 months).

4. Establish clear audit trails

During the pre-notification phase, we have seen the EC issue several RFIs with requests for further detailed information on particular FFCs listed in the notification form, particularly those from high-risk countries. It will be important that a clear audit trail is established during the data gathering exercise to allow for follow-up questions from the EC to be answered quickly and efficiently.

5. Be clear on the methodology applied

In our experience there is likely to be a benefit in providing the EC with a reasonably detailed description of the methodology applied for the purposes of gathering information on FFCs received, to mitigate the risk of follow up questions during pre-notification.

6. Private equity buyers should anticipate additional challenges

The challenges described above in terms of data gathering are likely to be more significant for private equity acquirers, given the need to disclose FFCs for a potentially significant number of portfolio companies.

Where a notification is made by a private equity acquirer through a particular fund, an exception is available which allows for FFCs granted to other funds controlled by the same private equity group (and their portfolio companies) to be excluded from the scope of the required disclosures, provided certain conditions are satisfied. Those conditions are designed to give the EC comfort that a possible cross-subsidisation from other funds (or their portfolio companies) to the acquiring fund is unlikely. However, in practice, there will still be a reasonably significant amount of work required to prepare the filing and demonstrate that the conditions for exemption are satisfied. It is worth noting that an assessment of FFCs received by all funds within a private equity group is still required to establish whether the jurisdictional thresholds are met.

A further challenge exists where an acquiring fund has received FFCs from third countries as limited partner investments. The EC has been clear that these should be reported in the notification, on the basis that the purpose of these investments is typically to provide resources which are used by the funds to make acquisitions. This means that the notifying party will be expected to explain in the notification whether those investments have been made on market conditions.

7. Anticipate the need to disclose new categories of internal documents - in particular external advisor diligence and valuation reports

As is standard practice with many regulatory filings, the parties to an FSR filing are required to submit certain internal documents. In many cases, the required documents will overlap with those required to be submitted in the context of any parallel EUMR filing. However, in some cases the scope of internal document disclosures under the FSR is broader. In particular, the FSR requires disclosure of reports prepared by external advisors who assisted the acquirer in any due diligence exercise carried out on the target, as well as any documents where the value of the transaction is assessed or discussed. In addition, where any potentially distortive subsidies are identified in the notification form, the parties are required to disclose internal documents relating to those specific subsidies.

8. Expect a focus on FFCs from high-risk countries with a direct connection to the purchase price

During the Phase 1 FSR review process, the EC is required to consider whether there are “sufficient indications” that an undertaking has been granted a foreign subsidy that distorts the internal market. The FSR is clear that this assessment is limited to subsidies that arise in the context of “the concentration concerned” - rather than being a broad power to assess all subsidies that an undertaking may have received.

That said, the precise boundaries of the scope of the EC’s review are not entirely clear. When is a subsidy that has been received by an undertaking likely to be seen as distortive in the context of a particular transaction? In our experience, the EC is likely to focus on three elements in particular:

- **Significant FFCs received from high-risk third countries.** In our experience, the EC will closely scrutinise significant FFCs from high-risk countries (such as China), looking in particular at (i) whether the FFC represents a “subsidy” (or whether it has been received on market terms) and (ii) whether it has any connection (direct or indirect) to the transaction.

- **The source of the transaction financing.** Linked to the above, the EC will probe the source of financing for the transaction, and whether there is any direct or indirect connection with a third country FFC/subsidy. Transactions funded by way of an equity or debt raise on the public markets should therefore be lower risk in principle.

- **The counterfactual.** The EC will carefully assess what would have happened to the target absent the transaction. Transactions where the buyer has outbid other potential acquirers are likely to attract particular scrutiny from the EC, as it seeks to assess whether the acquirer was able to pay a higher price by virtue of FFCs received from a third country.

In addition to the factors above, the intensity of review is likely to be greater for transactions in sectors that are seen as politically important to the EU (such as energy, infrastructure, transport and defence). Conversely, transactions in less politically sensitive sectors (e.g. fashion) should expect to receive less scrutiny.

Indeed, the EC has recently opened its first formal investigation under the FSR’s public procurement notification regime, in respect of a public tender which falls squarely within the risk categories identified above: it concerns potentially distortive subsidies received by a Chinese state-owned rolling stock manufacturer (CRRC) competing for a tender for electric trains in Bulgaria (with the implication being that if CRRC wins the tender, European players may lose out).

9. EC resourcing - no immediate cause for concern

Prior to the coming into force of the FSR, some had expressed significant concerns that the EC would have insufficient internal resources to deal with the anticipated number of FSR filings. In our experience, these concerns appear to be less acute than expected. The EC appears to be reasonably well-equipped to review filings and progress cases through the pre-notification process (although parties should still allow for the usual period of several months of pre-notification discussions). Indeed, as evidence of the EC's commitment to ensuring it has sufficient resources in place to ensure the proper enforcement of the FSR, on 1 March 2024 a new Directorate K was established in DG Competition, headed up by a seasoned EC official with significant State aid experience.

This is all despite the EC's FSR case load being higher than initially anticipated. While the initial 2021 proposal for the FSR contemplated around 30 M&A filings per year, as of the end of February 2024, the EC had received case team allocation requests and engaged in pre-notification talks with the notifying parties in 53 cases. Out of those cases, 14 had been formally notified, of which 9 had been fully assessed.

10. No decisions or publicity at Phase 1 - unlike under the EUMR

Many parties who have made EUMR filings will be familiar with the EUMR process, including the publicity associated with formally filing and receiving a final decision, and the decision itself being fully reasoned (except where the simplified procedure applies).

The FSR procedure differs in two important respects:

- First, there is no public record of when transactions have been formally notified or where they have secured Phase 1 clearance. This reflects a perception that a greater degree of confidentiality is required for matters involving funding from third countries.

- Second, at Phase 1 the EC will also not issue a reasoned decision in order to clear a transaction. Parties will instead typically receive a letter on the final day of the Phase 1 period confirming that the EC will not be opening an in-depth Phase 2 investigation.

CONTACT

JONATHAN SLADE
PARTNER
T: +32 (0) 2 737 9436
E: jonathan.slade@slaughterandmay.com

London
T +44 (0)20 7600 1200
F +44 (0)20 7090 5000

Brussels
T +32 (0)2 737 94 00
F +32 (0)2 737 94 01

Hong Kong
T +852 2521 0551
F +852 2845 2125

Beijing
T +86 10 5965 0600
F +86 10 5965 0650