Linklaters

4 Things to Know

Regulatory and antitrust issues for financial sponsors to be aware of.

With scrutiny by antitrust and foreign investment regulators getting ever more intensive, we have identified four things that financial sponsors need to be aware of to ensure their deals progress smoothly to clearance, completion and beyond.

1

Bolt-on strategies that have previously fallen below the threshold for review are now under scrutiny by regulators. The US Federal Trade Commission (FTC) and UK Competition and Markets Authority (CMA) are increasingly using their powers to review a series of deals leading to greater concentration. The European Commission (EC) and other regulators seem likely to follow suit. China is also able to rely on its low control threshold to review deals involving financial investors. Proceed, but with increasing caution.

2

The European Foreign Subsidies Regime will take effect in July adding another regulatory hurdle that (where applicable) will need to be satisfied before completion. PE and financial sponsors need to assess whether they are affected (spoiler: almost certainly for their larger deals) and, if so, begin gathering the information needed now to be prepared for its application and to avoid potential delays in deal timetables once effective.

3

Foreign Investment Regulation continues its expansion around the world. PE and financial sponsors face being caught by an array of increasingly expansive regimes, with rules that are often unclear and apply to a wide range of activities. Investors should consider FI issues upfront and manage risks/timing in their deal documentation. Beware of unexpected transaction types and harsh penalties for non-compliance.

4

Antitrust enforcement is booming with dawn raids enjoying a renaissance following a lull in the years preceding (and during) the pandemic. This serves as a timely reminder that financial investors can be liable for antitrust infringements by their portfolio companies, and so careful due diligence to detect emerging areas of risk in new and existing investments is a must.

1 Bolt-on strategies – has the horse bolted?

Most private equity deals have long been viewed as straightforward from an antitrust perspective: technical filings which were a shoo-in for simplified unconditional Phase 1 clearances or, better still, the ability to take a punt on not having a filing altogether in voluntary regimes such as the UK. But is the tide now turning? And do the various private equity strategies of roll-ups, bolt-ons and carve-outs justify greater scrutiny?

US

In the US, regulators have been extremely vocal about the concern caused by acquisitions followed by a series of bolt-on deals which all individually avoid merger scrutiny but which overall result in, sometimes significant, concentration within the market. This concern has manifested in examples of the FTC requiring the submission of certain future acquisitions for FTC prior approval regardless of whether a merger control filing is triggered or not, such as in the case of PE house JAB Consumer Partners in relation to its acquisition of several veterinary clinics. This type of prior notice provision, which has not been used by the FTC for almost 3 decades, is viewed by the majority of FTC commissioners as an appropriate tool "to better address stealth roll-ups by private equity firms" which often occur in local markets and can give PE firms high market shares in these local areas.

UK

In the UK, the elastic "share of supply" jurisdictional test enables the CMA to intervene when PE houses employ roll-up strategies that the CMA thinks may lead to too much market concentration, and they have used these powers to review PE acquisitions in a number of sectors, including dentistry, laundry services and, similarly to the FTC, veterinary clinics. At present, the CMA is reviewing multiple deals in the veterinary sector, by two separate buyers (IVC and Medivet), both of which have PE backing. The CMA, in its Phase 1 decision for the IVC deal, identified competition concerns in relation to all eight targets that were subject to review and IVC has since offered to divest all of these to avoid a Phase 2 (in depth) review. The review in Medivet is ongoing, albeit the CMA has announced that it will be reducing the number of completed deals subject to review from 17 to 15.

EU and member states

Despite the established merger control thresholds giving the European Commission jurisdiction at EU level, bolt-on deals falling below the EU jurisdictional thresholds are not necessarily safe from scrutiny either, since deals could be reviewed by 1 or more national EU Member States. Further, the European Commission's relatively new take on "Article 22" powers, which enable them to review transactions that fall below the EU-level and national Member State-level thresholds, could well be a tool employed by the Commission to review roll-ups by PE firms that lead to high levels of market concentration but escape review based on traditional revenue thresholds.

China

Following intensive enforcement since 2020 and the amendment to the Anti-Monopoly Law in 2022, the enforcement of China's merger control has now entered a "new normal" in which is increasingly standard practice for PE firms, pensions funds, sovereign wealth funds and other financial sponsors to notify their global transactions (including bolt-ons) to the State Administration for Market Regulation (SAMR). SAMR has frequently penalised missed filings by PE firms, including multinational, Chinese state-backed and domestic PE firms. Over the years, the Chinese merger control regime has developed certain distinct features, which make PE filings likely to be required even for deals that don't usually require notifying elsewhere because:

- Minority investments commonly trigger a China filing due to the lower bar for finding "control" than exists in other jurisdictions (particularly the EU approach); and
- Unlike in the EU and many other jurisdictions, SAMR does not recognise the concept of full functionality. This effectively means that creating or investing in a jointly controlled investment platform/vehicle or fund of funds itself could trigger a technical filling, even if there are no underlying assets or the purpose is to make passive investments only.

As with many other jurisdictions a filing can be triggered by the turnover of the controlling shareholders alone, even if the target company or the joint venture to be formed has no nexus to China at all (i.e. an "offshore transaction").

So where does that leave us?

Partly driven by a growing belief among global regulators that antitrust M&A enforcement has been too lenient in the past, authorities appear to be in constant search for novel ways of interpreting their jurisdictional reach so as to demonstrate that companies cannot avoid the scrutiny of merger control review. Throughout the world, private equity is very much in the spotlight at present. Do not assume that transactions are too small to attract antitrust scrutiny, especially in China. All transactions, but especially bolt-ons, should be carefully assessed to see if they pose antitrust risks.

2 Countdown to the EU Foreign Subsidies Regulation

The broadly crafted nature of the EU foreign subsidy regulation means, in addition to merger control and ever burgeoning FDI filing requirements, financial investors will soon likely need to obtain foreign subsidies clearance for their largest European deals (i.e. where the business being acquired has EU turnover over €500m).

The disclosure requirements associated with the mandatory notification form are extensive (unless significant changes are made before June 2023) and consequently investors need to begin preparing for this exercise well before a deal is in contemplation. Failure to do so may risk significant delays in preparing the filing form and ultimately in obtaining the necessary approval.

What is it?

The EU Foreign Subsidies Regulation (FSR) will apply from 12 July 2023. The FSR grants the EC broad powers to review (and, where necessary, address) the impact of non-EU States' financial contributions on the EU internal market.

Financial contributions constituting "foreign subsidies" can be assessed by the EC in 3 ways:

1. Mandatory pre-closing approval for M&A deals signed on/after 12 October 2023, where the target has an EU turnover of ≥€500m (the EC can also 'call in' deals falling below the thresholds) and the companies involved have received at least €50m in combined financial contributions from non-EU countries;
2. Mandatory pre-approval obligation for participation in public procurement, if the estimated contract value is ≥€250m and the bid involves financial contributions of at least €4m from non-EU countries;
3. A wide residual investigatory power with respect to any foreign subsidies. This power also applies retroactively for subsidies granted in the previous 5 years which continue to have an impact on the EU's internal market after 12 July 2023.

The definition of financial contributions is all-encompassing, including equity injections, grants, loans, guarantees, the supply/purchase of goods/services, tax benefits, and public contract awards involving (directly or indirectly) any non-EU government. These do not need to confer a benefit compared to market rates/availability. The wide-ranging scope of the "financial contribution" concept combined with comparatively low thresholds suggests these will be satisfied by most financial investors having interests outside the EU.

Should the EC conclude that a financial contribution amounts to a subsidy that distorts the internal market, it will have the power to require remedies (e.g. repayment or divestment) and prohibit participation in the affected M&A or public procurement.

Why is this important?

The breadth of the financial contribution definition can catch financial sponsors from both a "top-down" and a "bottom-up" perspective:

- **Top-down:** Acquisitions by investment funds with any of the following characteristics:
  - *The fund has capital (or debt) from a non-EU State*, e.g. if the LPs are State funds or State controlled funds themselves;
  - *Corporate tax incentives in non-EU countries*, e.g. where the fund benefits from beneficial tax status.
- **Bottom-up:** Controlled portfolio companies which benefit from (as examples) any of the following in non-EU countries:
  - *Industry initiatives*, e.g. the Biden administration's Inflation Reduction Act subsidising clean energy investments through tax breaks;
  - *Employment initiatives*, e.g. to hire apprentices or individuals from disadvantaged backgrounds;
  - *Loans/guarantees*, e.g. those made available during the COVID-19 pandemic;
  - *Public procurement contracts*, even for e.g. supplying furniture to a local authority;
  - *Public purchase contracts*, e.g. where the portfolio company is purchasing product from SOEs or public utilities companies.

When assessing whether a notification is required, all the above (and anything else that might be a "financial contribution") from the 3 years preceding the transaction will need to be aggregated to assess whether the financial contribution threshold may be met and if so, disclosed in the notification.

The EC's draft Implementing Regulation and draft Notification Forms were published for consultation until 6 March. While some attempt has been made to mitigate the potential administrative burden (e.g. de minimis thresholds for disclosure of financial contributions) the Notification Forms still require extensive itemisation of all financial contributions received by the investor group.

The consultation period saw extensive submissions to the EC on the draft documents emphasising that the potential burden (still) far exceeds what is necessary for the EC to address the envisaged harm and that a more targeted approach is warranted. The final version will be published in June 2023 but it remains to be seen whether the EC will take material steps to lessen the potential burdens.

How should you prepare?

Given the potential breadth of its application and implications for M&A, financial investors should now:

- Establish a process to **identify "financial contributions" within the fund structure and controlled portfolio companies**. This will avoid delays when it comes time to assess notification requirements in new M&A projects, and, where necessary, prepare the notification;
- **Closely consider transactions that are expected to sign on or after 12 July 2023**. For these transactions an assessment should be undertaken whether there exists any residual investigation risk (albeit pre-closing approval shall not be required);
- **Be prepared** to submit notifications (consider impact on deal timetable and include a CP to closing) **for transactions that are expected to sign on or after 12 October 2023**.

3 Foreign Investment – buyer beware

Foreign investment control continues its expansion around the world and is increasingly biting financial investors, who face being caught by an array of different regimes, with rules that are often unclear and apply to a potentially wide range of activities.

US

In 2018, the United States enacted the Foreign Investment Risk Review Modernization Act (FIRRMA), a substantial revision of the law governing reviews by the Committee on Foreign Investment in the United States (CFIUS).

One of the major changes impacting financial sponsors is the expansion of CFIUS jurisdiction. CFIUS review is now triggered over noncontrolling foreign investments in U.S. businesses engaged in developing or producing "critical technologies", performing functions relating to types of critical infrastructure listed in the CFIUS regulations, and collection and maintenance of sensitive personal data. Jurisdiction is triggered if the investor receives board representation, substantial involvement in key decision making by the portfolio company, or access to "material nonpublic technical information" concerning critical technology or critical infrastructure.

With this change, CFIUS has become a factor in more fund investments. Even U.S. sponsors now have to be concerned if their non-U.S. limited partners hold governance or information access rights that are not sufficiently "limited."

Given the length and cost of the CFIUS process, the competitiveness of a sponsor's bid can be adversely affected if CFIUS is a factor. To mitigate risk, U.S. sponsors (and some non-U.S. sponsors) introduce language in fund agreements to prevent interests of non-U.S. investors triggering CFIUS jurisdiction or mandatory filings. Moreover, non-U.S. (and especially Asian) fund investors seeking to avoid CFIUS exposure may request fund agreement and side letter language limiting their rights with respect to the fund and portfolio holdings, or in some cases, allowing an "excuse right" in which the investor will not participate in a CFIUS-reviewable transaction.

China

Financial sponsors are also faced with growing national security scrutiny when acquiring target companies or operations in China. Compared with merger control, national security review involves different thresholds for triggering a filing (similarly expansive but less clear) and consequences for not making a filing (such as possibly restoring the situation prior to the investment, albeit no fines). As such, a differentiated risk analysis and approach is warranted.

UK

The National Security and Investment Act 2021 (NSIA)radically overhauled UK FDI rules by introducing one of the most expansive investment screening regimes globally. The NSIA introduced a hybrid mandatory/voluntary regime, requiring mandatory notifications under 17 sensitive sectors and giving the Government a call-in power for transactions that may give rise to risks to national security (including those falling outside the mandatory regime).

The scope of the NSIA is extremely broad, capturing a wide range of activities carried out by financial sponsors. For example:

> The NSIA doesn't distinguish between overseas and domestic investors, so a UK private equity fund could be subject to a mandatory notification obligation in a similar way to an overseas investor.

> The NSI regime captures low levels of minority shareholding – acquisitions of 25% of an entity may be subject to the mandatory regime and the voluntary regime employs a lower threshold of "material influence" (which, in the UK merger context, may be triggered as low as 10-15% when accompanied by additional governance rights). The high profile call-in of Altice's acquisition of an additional 5.9% shares in BT shows that BEIS will review transactions with shareholdings below the 25% level.

> Internal reorganisations are captured, even where the ultimate beneficial owner remains the same. This means that corporate reorganisations of a PE fund holding structure may give rise to a mandatory notification - even if the PE fund remains the ultimate controller both pre and post transaction.

Missing a mandatory NSIA filing results in transaction voidness – which represents a shared risk for buyers and sellers alike.

Germany

The German foreign investment rules have been strengthened over recent years. While the Federal Ministry of Economic Affairs and Climate Action (in charge of the foreign investment review) is less interested in purely passive investors of a fund, it reviews very carefully the control and voting rights in fund structures. Specifically, the Ministry does not stop at considering the general partners' influence, but will also carefully consider any voting or influence rights of limited partners in the structure and reviews the whole structure up to the ultimate controlling parent. Because of this, funds investing in critical infrastructure or sensitive sectors such as defence, technology, media and pharma should carefully consider the composition and information and influence of rights conferred to limited partners.

As regards the granting of security over shares (and similar to the UK) this does not trigger a mandatory filing requirement per se. However, enforcing security (i.e. acquiring the shares and exceeding the 10% threshold of voting rights) may itself become the notifiable event. Further, the Ministry can call in a transaction in cases of atypical control (e.g. board seats, financing arrangements, etc.) and voting rights below 10%. This can be prevented by a voluntary notification.

Italy

Since the outbreak of the Covid-19 pandemic, the Italian foreign investment screening mechanism (GPR) has undergone several reviews and now applies to a large number of sectors. Financial sponsors, such as funds, often find themselves facing GPR-related analyses and filings in the context of their investments.

Application of the GPR to funds is arguably disproportionate - funds are comparatively low-risk when it comes to threats to national interests (given their nature as well-known and highly reputed investors, and a lack of interest in impacting the business strategies of their investments). However, if funds do not file, they risk severe monetary sanctions (as the minimum fine for a missed filing is calculated based on the turnover of the companies involved in the infringement).

4 Duly diligent – detecting antitrust risk in an evolving enforcement climate

Regulators such as the European Commission and CMA have indicated that, in light of the cost-of-living crisis, the increasing concerns around climate change and the rising dominance of online/digital services, there will be a renewed focus on pursuing competition investigations going forward. We have already seen a number of new antitrust investigations and dawn raids (including of private homes) this year. The heightened risk environment makes it crucial to ensure effective antitrust due diligence for new acquisitions as well as ongoing compliance efforts for your existing portfolio.

Liability risk arising from portfolio company conduct

Financial investors will be well aware that, following the *Goldman Sachs* judgment in Europe, a purely financial investor can be held jointly and severally liable for antitrust infringements committed by portfolio companies (see more here). This means financial investors can be hit with significant fines by competition authorities in relation to their portfolio companies' actions. We are also seeing significant growth in private enforcement of antitrust law, in the UK and a number of European jurisdictions, where claim values can dwarf even significant administrative fines. It has never been more important to get a clear handle on potential risk exposure during due diligence.

Identifying antitrust risks during the bidding/diligence process ensures that investors can:

> Price in identified risks of an ongoing antitrust investigation and/or litigation;

> Identify conduct by the target company that could result in an antitrust investigation being launched and take steps to mitigate that risk e.g. through bringing the conduct to an end or considering a leniency application to relevant antitrust authorities;

> Ensure commercially strategic contracts that the target has entered into are legally enforceable; and

> Build in better protection against future undetected risks by careful negotiation of the scope and caps of the various reps and warranties, indemnities, and restrictive covenants.

New risk areas

Crucially, due diligence has to be tailored to the target's sector and activities and take into account areas which antitrust authorities are targeting for enforcement. In a dynamic enforcement environment, it is worth updating diligence questions regularly (at least annually).

Alongside traditional antitrust risks focusing on the target's interactions with competitors (horizontal risks – e.g. cartel behaviour) and its suppliers/customers (vertical risks – e.g. exclusivity arrangements), new areas of risk currently in focus include:

> **HR issues:** particularly wage-fixing practices (i.e., agreements between companies to fix their employees' remuneration or to exchange competitively sensitive wage/salary information) and non-solicitation (or "no-poach") agreements (i.e., agreements not to recruit each other's employees);

> **Trade associations:** as for bringing competitors together, attending trade association meetings will always carry antitrust risks. But the implementation of the ECN+ Directive has significantly increased the financial exposure of both trade associations and their members for antitrust infringements as well as antitrust authority appetite for enforcement. It is worth asking in DD whether the target is a member of any trade associations and to dig deeper into their activities to avoid unpleasant surprises down the track.

> **Sustainability:** businesses are under pressure to go green and many are considering joining forces to do so. While some antitrust authorities are adopting a more liberal approach to competition law to facilitate green co-operation, co-operations which act as a mask for cartel activity or which actively damage the environment will be clamped down on swiftly. Regulators are also looking closely at companies' use of green claims especially in consumer retail and fashion industries;

> **Sector focus:** antitrust authorities around the world are firmly focused on tech in terms of antitrust enforcement, but that is not to say other sectors are safe. Regulatory attention is also expected particularly on "essential" sectors such as food, clothing, retail and energy given the cost-of-living crisis and the need for antitrust authorities to focus resources where they will benefit the largest number of consumers.

Beyond M&A – assessing risk across your portfolio

Whilst the due diligence phase of a transaction is a good point to get a handle on antitrust risks for a (potential) new investment, financial sponsors neglect compliance of their existing portfolio companies at their peril. Regular consideration of antitrust compliance efforts of controlled portfolio companies is advisable. This might include:

> determining what compliance policies subsidiaries have in place and bolstering these if they are out of date or inadequate;

> identifying portfolio companies in target sectors that are at particular risk and considering targeted antitrust training or conducting a compliance audit to identify potential areas of concern and (possibly) actual competition law violations;

> ensuring dawn raid response policies are understood and up to date, particularly bearing in mind the increasing use of powers by authorities to conduct raids on private homes of senior executives.

Key contacts

Nicole Kar
Global Head of Antitrust and Foreign Investment, London
Tel: +44 20 7456 4382
nicole.kar@linklaters.com

Neil Hoolihan
Partner, Brussels
Tel: +32 2 501 91 35
neil.hoolihan@linklaters.com

Charlotte Colin-Dubuisson
Partner, Paris
Tel: +33 1 56 43 57 24
charlotte.colin-dubuisson@linklaters.com

Xi Liao
Partner, Shanghai, Zhao Sheng
Tel: +86 10 6535 0694
xi.liao@linklaters.com

Annamaria Mangiaracina
Partner, Brussels
Tel: +32 2 505 03 07
annamaria.mangiaracina@linklaters.com

Anna Mitchell
Partner, London
Tel: +44 20 7456 2801
anna.mitchell@linklaters.com

Antonia Sherman
Partner, Washington
Tel: +1 202 654 9268
antonia.sherman@linklaters.com

Jonathan Gafni
Senior Counsel, Washington
Tel: +1 202 654 9278
jonathan.gafni@linklaters.com

Emma Cochrane
Counsel, London
Tel: +44 20 7456 3155
emma.cochrane@linklaters.com

Marcus Pollard
Counsel, Hong Kong SAR
Tel: +852 2901 5121
marcus.pollard@linklaters.com

linklaters.com

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