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EU PROPOSAL FOR SCREENING OF FOREIGN DIRECT INVESTMENTS

— THOUGHT LEADERSHIP

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EU PROPOSAL FOR SCREENING OF FOREIGN DIRECT INVESTMENTS

The European Commission has presented proposed legislation that would create an EU framework for screening of foreign takeovers and investments on grounds of security and public policy.

The draft Regulation would allow the Commission to review (but not block) certain investments of "Union interest" and to issue a non-binding opinion to the member state in which the investment takes place. It would also clarify the scope of the issues that member states may take into account when applying their national screening regimes without falling foul of EU law, set certain common standards for those regimes and implement a system of cooperation and information exchange between member states and the Commission.

The legal confirmation that member states may legitimately block foreign takeovers involving critical infrastructure, technologies, raw materials and sensitive information could lead to some member states introducing new foreign investment screening regimes or broadening the scope of their existing regimes and, in either case, reviewing transactions that are not, at present, caught.

Policy development

In his State of the Union speech to the European Parliament on 13 September 2017, Jean-Claude Juncker, presented a proposed Regulation establishing a framework for screening of foreign direct investments into the EU.

The proposal is the culmination of recent policy development in response to concerns "voiced about foreign investors, notably state-owned enterprises, taking over European companies with key technologies for strategic reasons" (as per the Commission's May 2017 "Reflection Paper on Harnessing Globalisation"). France, Germany and Italy have been at the forefront of those calling for further screening of foreign acquisitions, pointing out that the US, China and Japan, among others, already have similar systems in place. Mr. Juncker warned foreign governments and investors that the EU is not and will not be a "naive free trader" and remarked upon the EU's political responsibility to know what is going on in its own backyard to protect its collective security.

The proposed Regulation

The proposed Regulation would allow the Commission to carry out a limited review of certain foreign investments and would also clarify and harmonise certain aspects of the national foreign investment screening regimes that are operated by member states (i.e. mechanisms allowing the State to monitor foreign investments in companies/sectors considered of strategic importance and to oppose them under certain conditions).

The scope of "foreign direct investment" that is covered by the draft Regulation is broad and includes any investment by a non-EU investor aiming to establish or to maintain lasting and direct links with the investee in order to carry on an economic activity in an EU member state, including (but not limited to) investments which enable effective participation in the management or control of a business. This would appear to catch not just direct investments in a company registered in the EU, but also acquisitions of non-EU parent companies with subsidiaries in the EU.

European Commission review of certain foreign investments

The Commission would have powers to review specific foreign direct investments that it considers likely to affect projects or programmes of "Union interest", but only on public security or public order grounds. However, it will have no direct powers to block or impose remedies on such transactions. Instead, it may issue an opinion addressed to the member state where the foreign direct investment is planned or has been completed. Member states would be required to take "utmost account" of the Commission's opinion and provide an explanation if they do not follow it. Similar consultation procedures in the

telecoms and energy sectors have been protracted and highlighted differences in approach between Brussels and national governments.

Projects or programmes of "Union interest" are those that:

- involve a substantial amount or a significant share of EU funding; or
- are covered by EU legislation and relate to critical infrastructure, critical technologies or critical inputs. The draft legislation contains an indicative list of programmes of Union interest, which includes satellite programmes (the Copernicus earth observation programme and the Galileo and EGNOS satellite navigation systems); R&D programmes under the EU's Horizon 2020 programme (in particular, "key enabling technologies" such as micro- and nano-electronics, photonics, nanotechnology, biotechnology, advanced materials and advanced manufacturing systems) and transport, energy and telecoms infrastructure within the EU's Trans-European Networks programmes.

The regulation does not provide for any obligation for merging parties to notify their transactions to the Commission or to suspend them pending the outcome of the Commission's review. However, it does provide binding deadlines for the Commission to issue its opinion which merging parties may decide to take into account when planning timetables for potentially affected deals. The Commission would have powers to request from the member state where the investment is taking place any information it considers necessary to issue its opinion and would be required to issue its opinion within 25 working days following the receipt of that information.

Framework for member states' review

The proposals would not require member states to adopt or maintain a mechanism to screen foreign direct investment (at present, only twelve member states operate some form of foreign investment screening). They merely confirm that member states may screen foreign direct investments provided these comply with certain requirements. The screening mechanisms must be transparent and establish clearly the grounds for screening and the timeframe for issuing screening decisions. The screening process must also be non-discriminatory between investors of different non-EU countries and allow for the decisions to be judicially reviewed.

Although the proposed Regulation gives member states full discretion to decide what factors can trigger a screening process, the Regulation provides a non-exhaustive list of factors that may be taken into consideration, which includes the potential effects on:

- critical infrastructure, including the energy, transport and communications sectors as well as data storage;
- critical technologies, such as artificial intelligence, robotics and cyber security;
- the security of supply of critical inputs; and
- access to sensitive information or the ability to control sensitive information.

In assessing these effects, the control of an investor by a foreign government, including through significant funding, may be taken into account.

In practice, the list above is likely to have the most far reaching implications of all the draft Regulation's provisions. Many member states have refrained from reviewing foreign takeovers of targets active in areas such as robotics and artificial intelligence, in part due to uncertainty as to whether any attempt to block or impose conditions on such transactions would infringe EU law. The legal certainty provided by the proposed regulation could, therefore, lead to member states broadening the scope of existing regimes and reviewing transactions that, at present, are not typically caught. It may also prompt those member states without a regime for reviewing foreign investments to introduce one.

Cooperation and information sharing

The proposed Regulation also imposes information sharing and notification requirements whereby member states would have obligations to:

- appoint a point of contact responsible for engaging with the Commission on foreign investments;

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- respond to requests for information by other member states and/or the Commission without undue delay;
- notify to the Commission the screening mechanisms implemented, if any, and any amendments made to these thereafter; and
- provide to the Commission an annual report detailing either the implementation of screening mechanisms, the decisions taken and investments under review by the member state, or all of the foreign direct investments that took place in their territory, if no screening mechanism has been implemented.

In addition, regardless of whether member states have screening mechanisms in place, the proposed framework provides a feedback procedure which allows member states the right to provide comments if they feel that a foreign investment in another member state raises concerns for public order or security. The Commission will also have a right to issue an opinion in cases falling outside the "Union interest" screening regime described above. In either case, the member state in which the investment is taking place will be required to take "due account" of the opinion/comments.

Interaction with other EU legislation

The proposed legislation would not affect the Commission's "one-stop-shop" jurisdiction under the EU Merger Regulation (EUMR). If a foreign takeover is notifiable to the Commission under the EUMR, then any decision of an EU member state to take action against the transaction to protect its legitimate interests must be communicated to, and approved by, the Commission, unless the invoked interest relates to public security, plurality of the media or prudential rules. That will remain the case, even if the decision is taken in accordance with the proposed legislation.

However, at present it is rare for member states to ask for permission to block or impose remedies on a foreign takeover that falls under the EUMR and the Commission has on a number of occasions taken action against member states for having done so without permission. The clarification in the proposed regulation that member states may legitimately consider a transaction's impact on critical infrastructure, technologies, inputs and sensitive information may lead to an increase in the number of such requests. However, while the explanatory note to the draft legislation states that the Commission will ensure consistency in the application of the proposed Regulation and the EUMR, it remains to be seen whether the Commission will take a less strict approach towards protectionism by member states of national champions that are active in strategic sectors.

The proposed legislation would also sit alongside and complement other specific EU regimes that provide for the identification of critical infrastructure and resources in the energy, raw materials and electronic communications sectors and, in some cases (e.g. for gas and electricity transmission systems), require an assessment of the implications of foreign ownership. It would also not affect existing restrictions of foreign ownership of holders of operating licences for certain air transport services, or the EU rules for the prudential review of acquisitions of qualifying holdings in the financial sector.

Complementary measures

A communication accompanying the draft Regulation sets out certain other steps that the Commission intends to take, including:

- an in-depth analysis of foreign direct investment flows, with a focus on strategic sectors and assets and investments by enterprises that are owned, controlled or subsidised by a foreign State; and
- the creation of a "coordination group" comprising representatives of the Commission and member states, with a remit to identify sectors and assets of strategic importance, exchange information, promote best practices

and convergence in foreign investment reviews and discuss issues of common concern (such as subsidies granted by foreign States for outbound investment and jurisdictions where EU investors lack reciprocal investment opportunities). It will also "further reflect" on the desirability for an EU-wide screening mechanism.

Comment

The proposals come at a time when a number of countries are implementing foreign investment review systems, or strengthening their existing regimes, primarily (but not exclusively) in response to a wave of outbound foreign investment by Chinese investors. Paradoxically, they also come at a time when China is restricting such outbound investment through a tightening of its approval and filing regimes.

Recent reforms of foreign investment regimes include those in:

- Germany, where the federal government recently widened the scope of application of foreign investment control and introduced new filing requirements for certain transactions (see our July 2017 briefing);
- the UK, where the government is pressing ahead with significant reforms to its approach to the ownership and control of critical infrastructure – including telecoms, defence and energy assets – to ensure that foreign ownership "does not undermine British security or essential services" (see our July 2017 Corporate Update);
- the United States, where proposed legislation has been announced that would expand the jurisdiction of the Committee on Foreign Investment in the United States (CFIUS) to review certain foreign investments involving access to technology, overseas joint ventures and real estate and would apply greater scrutiny of transactions involving investors of certain countries; and
- Australia, where in January 2017 the Government launched a "Critical Infrastructure Centre", which will develop a register to capture and track ownership of critical infrastructure assets (see our March 2017 briefing).

The EU's proposals could accelerate and broaden the pace of such reforms in EU member states and create additional legal uncertainty for foreign investors. However, the draft legislation is significant for what it does not do. Despite calls by France, Germany and Italy for an EU-wide foreign investment regime, that proposal was rejected at a June meeting of the European Council by a number of smaller member states, who were keen not to deter investment into their countries. This suggests that the impact of the reforms, if implemented, will vary greatly between EU countries, with some continuing to welcome investment in domestic owners and suppliers of "critical" technologies, infrastructure and inputs and others seeking to exercise broader screening powers, in line with the proposed legislation. The lack of a harmonising obligation will allow member states each to decide for themselves whether they will participate in the proposed framework for screening foreign investment merely by sharing information or will become active participants in the cooperation system and adopt formal review mechanisms on grounds of safety and public order.

Any final version of the Regulation is unlikely to come into effect until 2019, following approval by member states and the European Parliament. During this process the draft Regulation will be subject to much discussion as member states and the EU debate where to strike the balance between protecting key national interests while remaining open to trade and valuable foreign investments. In particular, they will have to consider if these proposals move counter to other EU efforts to achieve greater trade liberalisation through the negotiation of a network of preferential trade agreements (including finalising the EU-Japan free trade agreement and reaching an agreement with the Mercosur trade bloc, among others).

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