



EU framework for screening foreign direct investments

New Commission proposal

Executive summary

On 13 September 2017 the European Commission (the *Commission*), to coincide with Commission President Jean-Claude Juncker's State of the Union speech, unveiled a draft proposed regulation on foreign direct investments into the EU. The draft proposal sets out a clear framework according to which EU Member States may choose to screen foreign direct investments on a range of grounds linked to security or public order and appears not to be limited to acquisitions of control.

It also gives the Commission power to review and opine on investments 'of Union interest', although stops short of allowing the Commission to actually block such investments. The draft proposed regulation must now be approved by Member States and the European Parliament, meaning that it is unlikely to come into effect until late 2018 or 2019, and Member States will need to decide whether to legislate or amend their existing legislation.

Background and context

The Commission has in recent months been under significant pressure from certain Member States (notably France, Germany and Italy) to address concerns that foreign investors – in particular state-owned enterprises investing as part of that country's strategic industrial policy – are taking over European companies with key technologies, while there may be no such reciprocal rights to invest in the country from which the foreign investment originates. At the same time some of these Member States have been stepping up their own screening of foreign takeovers. For example, Germany tightened up its foreign investment rules in July 2017, while in 2016 it withdrew its approval of the acquisition of Aixtron by China's Fujian Grand Chip Investment Fund after US intelligence services warned the German government that Aixtron's chips could be used in nuclear technology.

Other Member States (particularly Nordic countries, Ireland, Greece, Spain and Portugal) have pushed back against this seemingly protectionist stance, yet even those free trade champions within the EU have recognised a need to at least address security concerns brought about by this kind of foreign direct investment. The draft proposed regulation should be seen as a significant part of the Commission's response to these varying degrees of concern.

Main elements

In his speech Mr Juncker reaffirmed the Commission's continued conviction as to the benefits of foreign investment into the EU, but cautioned that he is not 'a naive advocate of free trade.' The Commission and its Member States must be in a position to take determined and swift action where foreign investment may affect security or public order.

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The proposed draft regulation establishes a framework according to which Member States, and in certain cases the Commission, can screen foreign direct investments in EU assets, while still allowing individual Member States to determine their own approach and policies. The draft proposal envisages three principle channels through which foreign direct investments may be screened, and makes no distinction between whether or not the foreign investor is acquiring a controlling stake.

1. Member States may maintain, amend or adopt a mechanism to review foreign direct investments on the grounds of security or public order

The draft proposal looks to provide legal certainty for Member States that either already maintain a foreign investment screening mechanism or wish to adopt one in the future. However, crucially, there is currently no obligation for more reluctant Member States to legislate in this area.

The draft proposal states that in reviewing an investment on the grounds of ‘security’ or ‘public order’, a Member State may consider the potential effect of the investment on areas including:

- Critical infrastructure (including energy, transport, communications, data storage, space or financial infrastructure, as well as sensitive facilities);
- Critical technologies (including artificial intelligence, robotics, semiconductors, technologies with potential dual use applications, cybersecurity, space or nuclear technology);
- Security of supply of critical inputs; or
- Access to sensitive information or the ability to control sensitive information.

By way of further clarification, the draft proposal provides that in determining whether a foreign investment is likely to affect security or public order, Member States may take into account whether the foreign investor is controlled by the government of a third country, including through significant funding. In this sense, while the regulation would not be limited to covering investments by state-backed investors, such investors may find themselves subject to a greater degree of scrutiny.

Ultimately, the list is non-exhaustive and includes a broad framework against which Member States may choose to screen a planned foreign investment. There is currently plenty of scope for different interpretations of the provisions and the proposal appears not to be limited to acquisitions of control.

Nevertheless, the draft proposal does build in certain basic protections for foreign investors. This includes judicial review – although the extent of this will clearly differ according to Member States’ own legal systems – non-discrimination between different third countries and transparency.

To ensure the effectiveness of the review mechanisms, the draft proposal also allows Member States to maintain, amend or adopt measures necessary to prevent their circumvention. This would include, for example, the possibility for Member States to review investments by European-domiciled companies that are owned or controlled by a foreign investor, or artificial arrangements within the EU that do not reflect economic reality and that are designed to circumvent the review mechanism.

2. The Commission may carry out a review on the grounds of security and public order in cases where a foreign direct investment may affect projects or programmes of Union interest

Projects or programmes of Union interest would involve investments concerning substantial EU funds or investments covered by Union legislation regarding critical infrastructure, critical technologies or critical input, eg research programmes, energy programmes or the Galileo satellite programme. In such circumstances, the Commission would address an opinion to the Member State where the investment is planned or has been completed within a reasonable period of time. The Member State would then have to take ‘utmost account of the Commission’s opinion and provide an explanation to the Commission in case its opinion is not followed.’

3. Other investments will only involve a cooperation mechanism between Member States and the Commission

The draft proposal requires Member States to inform other Member States and the Commission of any foreign direct investment that is undergoing a review under that Member State's review mechanism. There is then a procedure whereby both other Member States whose security or public order could be affected by that foreign investment, and the Commission, may express their views: other Member States can provide 'comments' and the Commission can issue a non-binding 'opinion'. The Member State where the foreign investment is being proposed or implemented would be obliged to 'give due consideration' to these. The explanatory memorandum to the proposed draft regulation confirms that in this circumstance the Member States shall retain the ultimate decision-making power with respect to the foreign direct investment subject to screening. This is clearly a lesser burden on the Member State concerned as compared to the requirement for Member States to take 'utmost account' of an opinion issued by the Commission in situations of Union interest.

Next steps

The draft proposed regulation set out by Mr Juncker is just the Commission's proposal. The Commission does not 'make the regulation' but rather the content of the regulation will likely evolve as it will now go through the process of being negotiated, amended and finally approved by all Member States and the European Parliament. In total it will take at least one year from now but more realistically one and a half years for Member States and the European Parliament to agree and for the regulation to come into effect. This is particularly the case given the need to accommodate diverging opinions between Member States. On this basis, we might expect the new rules to finally take effect in late 2018 or 2019.

Impact on foreign investors

While the motivation behind the regulation has been to some degree the recent string of acquisitions of European assets by Chinese investors, particularly state-owned enterprises, the draft proposal does not distinguish between third countries. Investors from the United States, Canada, Brazil and others among the top foreign investors into the EU may well now take into account the draft proposal when assessing both their choice of investment destination (given that some Member States will certainly implement stricter screening regimes than others) as well as the types of assets in which they invest. This must also be a consideration for investors from the United Kingdom as it attempts to negotiate a future trading relationship with the EU. Ultimately, as with complex merger control, early preparation and consideration of the issues will be critical.

In addition, it is possible that the draft European proposal will prompt other governments to consider their own regimes. Those calling for a broadening of the CFIUS regime in the United States may feel emboldened given that the draft European proposal goes further than CFIUS currently does (for example it appears not to be limited to controlling stakes and seems to be broader in scope than CFIUS's focus on national security concerns). The recent decision by President Trump to block the acquisition of Lattice Semiconductor Corp by Chinese-backed private equity firm Canyon Bridge Capital Partners – after the parties failed to convince CFIUS to clear the transaction – certainly sends a strong message. On the other hand, confident European regulators blocking or otherwise restricting Chinese acquisitions in Europe may lead Beijing to realise that it needs to open up Chinese markets further to European investors if its investors want reciprocal treatment.

New powers to tackle state subsidies?

While the focus of the proposed draft regulation is on the strengthening of powers to screen foreign takeovers, there is also a nod to international subsidy policy.

When assessing a foreign direct investment, the proposed draft regulation states that Member States and the Commission 'may take into account whether the foreign investor is controlled by the government of a third country, including through significant funding.' One clear aim of this provision is to protect against foreign governments ultimately having control of, for example, critical infrastructure or gaining access to sensitive information as a result of an acquisition. However, it also feeds into a broader Commission drive to combat the distortive effects of foreign state subsidies.

The Commission's DG Competition has recently invited Member States to help form a new group, consisting of state aid and trade experts, to discuss how the Commission and Member States can do more to influence international subsidy policy, in particular by developing greater leverage in international fora such as the WTO and OECD.

Ultimately, the draft proposed regulation on foreign direct investments, together with the Commission's work on state subsidies and trade policy, should be seen as part of the Commission's drive for a fair and reciprocal international trading and competition environment.

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