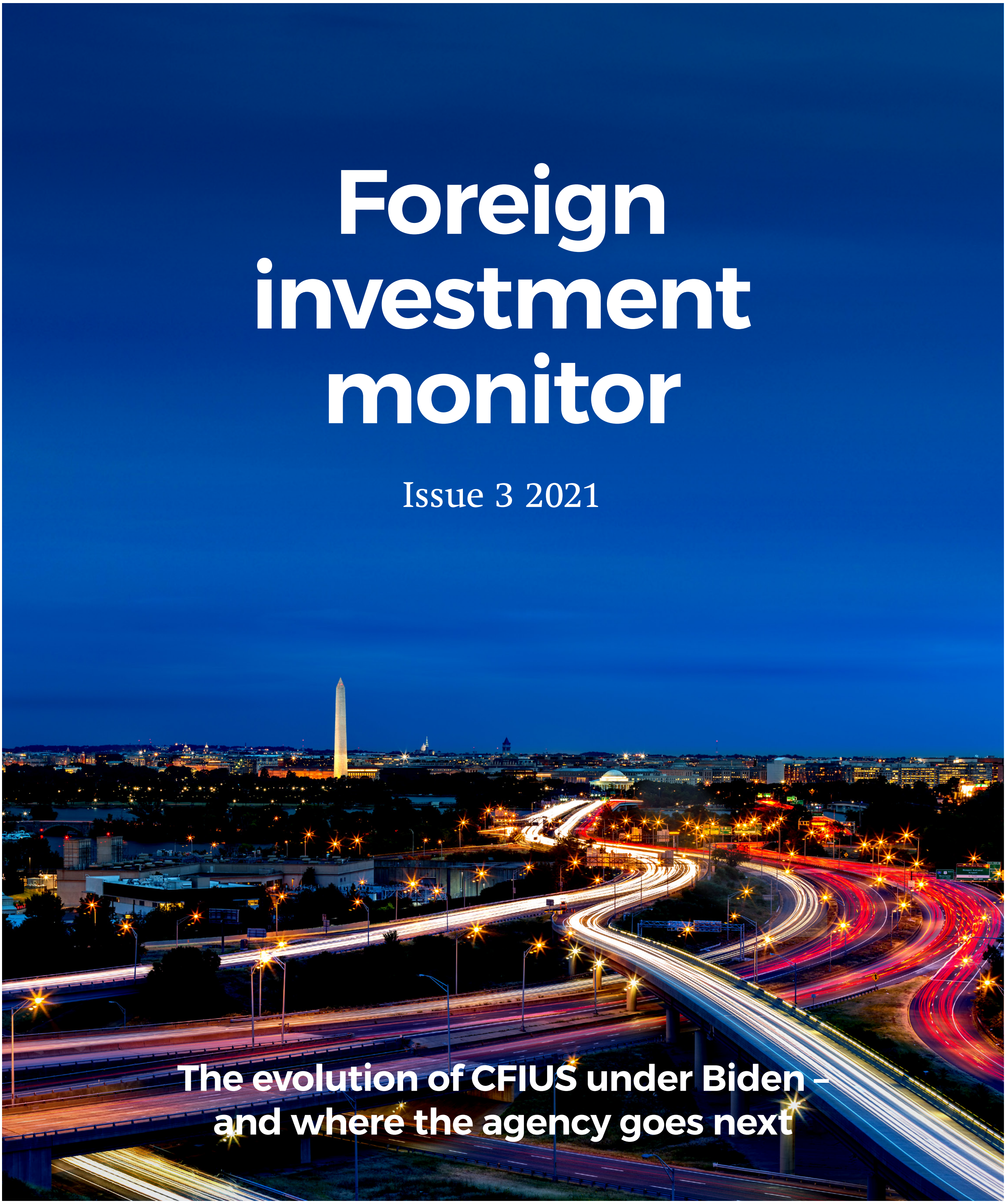
Reviewing the first year of the EU Screening Regulation

Sensitive technologies and sectors – where the lines are drawn

How do FDI rules interact with stakebuilding strategies?



Foreign investment monitor

Issue 3 2021

The evolution of CFIUS under Biden – and where the agency goes next

Freshfields

Welcome to the third edition of Foreign investment monitor

In our final report of 2021, we take a deep dive into three critical facets of foreign investment screening.

First, our team in Washington analyzes the evolution of the Committee on Foreign Investment in the United States (CFIUS) under the Biden administration. Since entering the White House, the president has continued his predecessor's assertive approach to China, while CFIUS's work to strengthen its bench and improve its processes has boosted its ability to identify and investigate deals regardless of their origins. Looking ahead, it's possible CFIUS will receive the power to review non-controlling investments in a broader range of sensitive technologies – and it's even possible the government may gain the ability to scrutinize US outbound investments into China as it doubles down on the security risks of domestic businesses with strong ties to the PRC.

Next up we review the European Commission's first annual report into the impact of the EU's FDI Screening Regulation. Published in late November, it paints a fascinating picture of inbound investment into the EU and points to future reforms that are set to transform Europe's notification process.

The issue of emerging technologies is the subject of our third article – specifically how foreign investment regimes assert jurisdiction over these transactions and how investors can assess whether their deal requires mandatory filing. We examine the core characteristics of national regimes from the United States to Australia, and pinpoint where the regulations in several important locations draw the line.

Then, we look at how foreign investment rules apply to companies pursuing stakebuilding strategies in the public markets. Corporate leaders buying listed securities are well versed in the requirements of mandatory offer regimes and merger control regulations, but it's often less clear how to navigate the rapidly evolving FDI landscape. Our experts clarify the filing thresholds in key jurisdictions around the world and offer practical tips for dealmakers on how to structure their M&A transactions.

Finally, we would like to extend our sincere thanks to you for reading FI monitor since we launched in April 2021. We hope you have enjoyed the articles, and as ever if you would like to discuss any FDI issue in more detail we would be delighted to arrange a meeting. Likewise, we would welcome your feedback on how to improve the monitor and your ideas for topics to cover in future editions.

One year on, China remains in CFIUS's sights

It's been a year since Joe Biden was elected to the White House. As expected, CFIUS under this administration has continued to act aggressively to address perceived risks related to China, although the process overall has become more robust regardless of any Chinese nexus. Here, we examine key developments from the president's first year in office and look ahead to how the transactional landscape is likely to evolve through 2022 and beyond – including the prospect of CFIUS being able to reach a broader range of emerging technology transactions and the US government gaining the authority to restrict outbound investment into China.

CFIUS continues to aggressively reach out with respect to long-closed Chinese investments that were not notified to the committee

China remains a key consideration

The number of new direct Chinese investments in the United States continues to be relatively low, due to both policy considerations in China and US regulatory scrutiny. But CFIUS scrutiny of Chinese investments in the United States still continues. For example, CFIUS has continued to aggressively reach out with respect to long-closed Chinese investments that were not notified to CFIUS, in some cases requesting the submission of a notice and imposing post-closing mitigation. CFIUS's reported ongoing review of the planned Chinese acquisition of Magnachip – a South Korean semiconductor company that has a holding company in the United States but few other assets – shows CFIUS's continued willingness to use its authority to address even risks that principally arise as a result of non-US activities.

China has loomed equally large even in transactions where there is no direct or indirect Chinese investment, but where the investor has a significant business presence in the PRC. CFIUS regularly scrutinizes transactions involving sensitive US technologies to assess whether the foreign investor's R&D relationships, joint ventures, manufacturing activities, sales activities and even its overall reliance on the Chinese market as a source of revenue could lead to risk of transfer of sensitive US technology to China. CFIUS diligence of any China nexus is becoming increasingly robust.

Regulatory change on the horizon?

Continued, deep concern in Washington over the risks posed by Chinese policies and competition could provide impetus for even more regulatory change. A number of proposals have been made in Congress to amend CFIUS authorities, including giving the committee the authority to review greenfield investment, and requiring it to review transactions involving sensitive personal data and address risk to food and agriculture, among a range of other proposals. Some do little more than codify existing CFIUS practice or are focused on Chinese government-related investors, but they are generally less than likely to be enacted. However, there is a greater chance that legislation or executive order will subject a broader scope of emerging and foundational technologies to CFIUS's "covered investment" (i.e., non-controlling but non-passive investment) jurisdiction (see our article on foreign investment jurisdiction on page 7) or give the government the ability to review US outbound investment into China through a CFIUS-like process.

> **Whether via law or executive order, it's possible the US government will be handed the authority to review outbound investments into China.**

More CFIUS resources equals more CFIUS scrutiny

CFIUS's increased resources have resulted in a series of changes, many of which are likely to have even more significant long-term impacts than the statutory developments in 2018. CFIUS staffing started to increase dramatically soon after the new CFIUS legislation became effective in late 2018. The 2018 statutory changes, however, resulted in a much more modest increase in CFIUS workload than many expected, rising from 250 reviewable filings in 2018 to only 313 in 2020. This gave CFIUS the breathing room it needed to implement new processes and improve overall performance. Specifically, during this time, CFIUS established its new accelerated declarations process, implemented a new electronic case filing system, significantly reduced the time for providing feedback on draft notices, established new capabilities to identify and call in non-notified transactions, increased its mitigation monitoring capabilities, and significantly expanded its outreach and assistance to foreign governments considering establishing or strengthening their own CFIUS-like regimes.

However, probably because of a combination of increased M&A activity and increased CFIUS scrutiny, the committee's case flow this year has grown dramatically. By our estimate, CFIUS will have considered approximately 40–50 percent more filings this year than last. Our general assessment is that the committee dives more deeply into each transaction, with the number of requests for information even in the abbreviated declarations system often matching what one would normally expect in the notice process, though in a much more compressed time frame. CFIUS is also very active in calling in transactions that have not been voluntarily notified, mostly (but not exclusively) with a China nexus, though only a portion of these result in initiation of a formal CFIUS review process. While the overall percentage (12–14 percent) of CFIUS notices that result in mitigation has not changed in the past few years based on statistics through 2020, the threshold for aggressive CFIUS action continues to be lower than in most non-US jurisdictions, where substantial mitigation or prohibitions are rare.

European Commission looks back on first year of EU FDI Screening Regulation

On November 23, the European Commission issued its first annual report on the screening of FDI into the European Union. The Screening Regulation establishes a cooperation mechanism for FDI screening between the Commission and EU member states but leaves the decision on which investments to screen, approve, condition or block to each country under their domestic rules. In summary, the Commission and member states view the regulation positively as an important tool for monitoring and assessing FDI into the EU.

The Commission notes that only 11 member states had a national FDI screening mechanism when the regulation was tabled in 2017. However, by July 1, 2021 that figure had risen to 18, and during the reporting period 24 of the 27 member states either adopted a new screening mechanism, amended an existing one, or initiated a process to adopt or amend a screening mechanism. Only Bulgaria, Croatia and Cyprus are identified as having no publicly reported initiative underway, though the Commission expects it will only be a matter of time until all 27 EU countries have screening mechanisms in place.

During the reporting period 24 of the 27 member states either adopted a new screening mechanism, amended an existing one, or initiated a process to this effect

Inbound FDI falls – but not evenly across the board

In terms of FDI flows, COVID-19 had a harsher impact on FDI into the EU than it did globally, with investments down 71 percent from 2019 compared to 35 percent globally. Importantly, when looking at the origin of EU inbound investment, FDI did not decline evenly across the board. Investments from the largest sources, the US and UK, decreased by 35 percent and 21 percent, respectively, while those from China dropped by 63 percent (although China's overall share of non-EU investments into the EU was only 2.5 percent). There are likely many reasons for this decline, not least the impact of the pandemic, but tougher FDI scrutiny may well have played a role.

Overall, 11 member states submitted 265 notifications under the cooperation mechanism, although more than 90 percent of those came from just five countries: Austria, France, Germany, Italy and Spain, all significant beneficiaries of foreign investment and countries that have the most active FDI regulators in Europe. The main sectors involved in the cases notified were manufacturing, ICT and financial services In total, 1,793 cases were reported to national screening authorities, 80 percent of which did not require formal screening. Of the remainder, only a relatively small proportion were prohibited (2 percent) or aborted (7 percent), while the remaining 12 percent were approved with conditions.

Forthcoming reforms set to transform the EU notification process

While around 30 percent of cases affected more than one member state, the Commission submitted opinions in less than 3 percent of all cases – which it says it will do only if required by the circumstances, the investor's risk profile or the criticality of an investment target. Nonetheless, some member states noted a number of practical challenges with the regulation, including the strain on resources, short timelines and the "overly burdensome" nature of information requests by the Commission and other member states. While the Commission has already taken steps to make improvements, for example by updating the notification form for investors and its FAQ document, it recognizes that more can be done. With this in mind, it has launched a comprehensive review and in due course will consider issuing guidelines for the benefit of member states and investors. This, and the expected convergence of national FDI rules in the next few years, is set to further transform the notifications of FDI in the EU and, hopefully, ease the administrative burden on investors who currently have to deal with a large number of parallel review procedures.

> More than 90 percent of notifications submitted under the cooperation mechanism came from just five countries: Austria, France, Germany, Italy and Spain.

Sensitive technologies and sectors: what's in and what's out of foreign investment regimes?

Understanding the jurisdiction of FI regimes when it comes to sensitive technologies and sectors is critical to deal execution. So, what types of regulation are in place around the world? How do they define "sensitive"? And how do they differ in terms of filing obligations? We round up the key points for investors.

A central focus of most foreign investment review regimes is the protection of companies that produce sensitive technologies or operate in sensitive sectors. However, what the presence of such technologies or activities means for jurisdiction and mandatory filing requirements differs. As far as jurisdiction is concerned, regimes generally take one of three approaches:

i) jurisdiction depends on the target business operating within certain technology or sector areas;

ii) jurisdiction is general and independent of technology or sector; or

iii) a hybrid of the two.

Most foreign investment review regimes are designed to protect companies that produce sensitive technologies or operate in sensitive sectors

Beyond jurisdiction, technology or sector may also determine whether a filing is mandated. The different approaches reflect different trade-offs for parties and the government.

> In some cases, we have obtained clearance from CFIUS in less time than it took to get a lack-of-jursidiction determination in France.

Sector/technology-dependent jurisdiction

Jurisdiction under some regimes (for example those in France, Italy and Spain) turns on broadly drawn "strategic sectors." Here, transactions that fall within a strategic sector (and meet any control or value thresholds) are often subject to a mandatory filing requirement. This approach has the advantage for parties and governments of entirely excluding transactions that fall outside of the sectors that the government deems most sensitive. However, for transactions within the designated sectors, parties cannot opt out of filing even when the transaction (whether because of the nature of the target or the identity of the buyer) is highly unlikely to raise concerns. For example, these regimes typically cover companies that resell goods in a strategic sector, even if they do not themselves develop or produce critical technology for use in that sector. Furthermore, because the government has no authority to review a transaction that falls outside of these sectors, the sectors' boundaries are not precisely defined.

As a practical matter, these soft sector definitions create uncertainty that itself often warrants a filing to obtain a formal jurisdictional determination as a prudential matter. This erodes the value of the sector-based approach for parties to some degree. For example, in some cases we have obtained clearance and safe harbor from CFIUS in less time than it took to obtain a lack-of-jurisdiction determination in France. Thus, the ability of authorities to provide a jurisdictional determination reasonably quickly is important to mitigating to some extent the uncertainty of the jurisdictional scope.

Sector/technology-independent jurisdiction

In some jurisdictions, the government has the authority to review transactions on national security grounds regardless of the target company's sector or technology. This is the case, for example, in Australia, Canada and the UK as of 2022. Only certain transactions, however, require pre-closing approval.

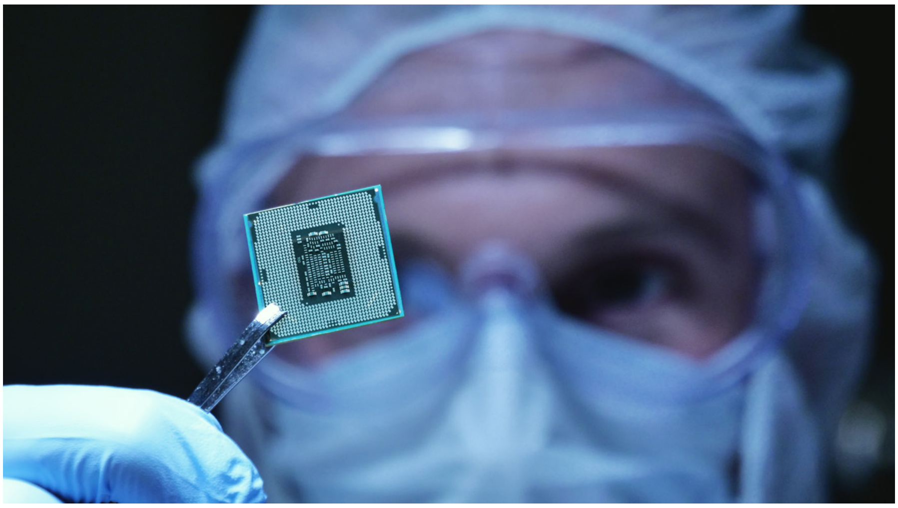
In Australia, all transactions are reviewable on national security grounds, but only direct investment in "national security businesses" requires a pre-closing filing (in addition to certain other land and media investments and certain other investments that exceed financial thresholds). The definition of "national security business" under Australian rules is generally made with reference to other regulatory regimes and involves relatively concrete criteria, creating somewhat less ambiguity than regimes that use vague sector labels. Canada mostly mandates pre-closing filings only with respect to a direct acquisition of a Canadian business that exceeds a certain value. However, Canada requires that most investments be notified to the government no later than 30 days after completing the transaction and can initiate a "national security review" of any transaction. In Canada, therefore, the principal decision for parties in most cases is whether the government is likely to have national security concerns with the transaction, in which case a pre-closing filing may be warranted even if it is not mandated.

Under the new UK National Security and Investment Act regime, which will commence on January 4, 2022, the UK government will have extensive powers to review any acquisition of "material influence" in a company, regardless of technology or sector. Notwithstanding the jurisdictional breadth of the regime, pre-closing filings will be mandated only for certain transactions involving targets that carry out specified activities in the UK in 17 sectors, which are defined in relative detail in 44 pages of secondary legislation (in some cases with reference to other regulatory regimes). For transactions that fall outside the scope of the mandatory regime, parties must make the same subjective determination as in Canada of the risk of a non-notifiable transaction being "called in," but with the overlay that acquisitions involving targets which undertake activities closely linked to one of the designated sectors are more likely to fall into this group than those that do not. Early indications are that many parties will choose to make precautionary voluntary notifications in the early days of the regime for legal certainty reasons given the five-year period for call-in of non-notified transactions post-completion.

Hybrid jurisdiction

The US regime uses a combination of the two approaches. CFIUS principally takes a sector- and technology-agnostic approach to jurisdiction; any transaction that results in foreign control of a US business is potentially subject to review and CFIUS, indeed, has reviewed transactions in a wide array of sectors. However, the committee also has authority to review non-controlling investments, but only in US businesses that design, produce or test critical technologies, those involved in critical infrastructure, and those holding certain types and volumes of sensitive personal data. A filing is mandated for non-government investors only with respect to critical technology companies.

Unlike regimes that have loosely defined sector categories, critical technology is categorized for CFIUS



Foreign investments in semiconductor businesses are heavily scrutinized by national authorities around the world

purposes with reference to products and technologies that are subject to existing, heightened export controls. Likewise, critical infrastructure and sensitive personal data are also defined relatively specifically. As a result, parties can have reasonable confidence in determining whether a filing is mandated (or CFIUS's expanded jurisdiction applies), though a US business that does not export its products or technologies may not have bothered to classify them in the ordinary course leading to an accelerated (and often very technical) classification exercise in the context of a transaction.

There is, however, some risk that this technical, bright-line approach could change. Congress directed the US export control agencies to define controls for so-called "emerging and foundational technologies," which would then become critical technologies for CFIUS jurisdictional purposes. These agencies have moved cautiously, implementing only limited additional controls to date. This delay has prompted interest in Congress and among some agencies in changing the process for defining emerging and foundational technologies, potentially resorting to more broadly defined concepts that would leave parties without a clear method of evaluating whether their technology falls within CFIUS's non-controlling jurisdiction or triggers a mandatory filing. This could add material uncertainty to the scope of the US mandatory filing regime.

CFIUS is a necessary consideration in almost all control transactions, given CFIUS's sector-independent control jurisdiction, but companies have the leeway to make a risk-based filing decision in most instances. And for mandatory filings and non-controlling investments, where sector/technology is relevant, the lines at the moment are relatively well defined.

Given the divergent jurisdictional approaches and mandatory filing requirements, it is important to consider all aspects of a target's business – including the sectors in which it operates and its technology.

Stakebuilding in public M&A – where to draw the line for foreign investment

The evolution of FDI review regimes presents an extra challenge for investors pursuing stakebuilding strategies

Dealmakers contemplating stakebuilding strategies in public markets have traditionally had to navigate a thicket of regulations, ranging from mandatory offer rules to merger control. However, the evolution of the foreign direct investment (FDI) landscape is now presenting an additional challenge – the need to obtain FDI clearance before proceeding with any share purchase that would bring the investor's overall shareholding above certain thresholds.

This is exacerbated by the fact that many jurisdictions lack bright-line guidance for foreign investment, while others have been lowering their thresholds for notification (some specifically aimed at minority acquisitions). A failure to understand which thresholds may be triggered – and when – can prove fatal as far as the deal is concerned. Recently, Yonghui Superstores had to abandon its proposed acquisition of an additional 10.14 percent stake in Zhongbai Holdings after building a material stake on the open market. Although the merger had been cleared by the Chinese competition authority, it ultimately fell through after being called in for a potentially lengthy national security review in China.

For dealmakers looking to engage in open market stakebuilding before proceeding with a formal bid, it's important to bear in mind that where such strategies have previously helped in securing foreign investment approval (see, for example, Midea's acquisition of Kuka) they may not present the same advantages in today's investment climate.

When does stakebuilding trigger the need for FDI approvals?

Compared to merger control rules, which tend to kick in when a party acquires control (or at least material influence), there is a significantly more varied approach for FDI review (see table on page 12). Public bids, for example in the EU, are sometimes exempt from the standstill obligation in merger control (which prevents parties from closing the deal until they have received regulatory approvals), but where foreign investment is involved, these waivers are less common. A case-by-case assessment for each jurisdiction is therefore essential to avoid inadvertently triggering a mandatory FDI filing, particularly when engaging in early-stage stakebuilding.

Key points to consider include:

- Who is investing – in certain EU member states, non-EU/EFTA investors will face lower ownership thresholds for triggering a filing, among other heightened restrictions.
- The target's activities/sector – the sensitivity of the target is key to assessing FDI filing requirements, and sector-based variation in notification thresholds are common.

> Merger control rules tend to kick in when a party acquires control; the approach is more varied for FDI reviews.

Indicative ownership thresholds* for merger control and FDI review (as of November 29, 2021 unless otherwise stated)

*Includes examples of shareholding, voting rights or control rights thresholds for select jurisdictions (including temporary rules introduced in France, Spain and Italy during the COVID-19 pandemic). Please note that other factors will need to be assessed to determine whether a transaction is subject to FDI/merger control review.

Jurisdiction	Merger control	FDI review
China	Control or decisive influence, with a broad interpretation in practice	Substantial influence, with no "bright-line" rule. For certain sensitive targets, shareholding thresholds can be zero
France	Control (ownership or decisive influence)	Currently 10%, 25% or the acquisition of control, depending on the nationality of the investor and whether the target is a French-listed company
Germany	Control, 50%, 25% or material competitive influence	10%, 20%, 25%, 40%, 50% or 75%, depending on the nationality of the investor and target sector or, in some circumstances, other forms of influence
Italy	Control (dominant or decisive influence due to voting rights)	Several notifiable thresholds between 3% and 50%, or the acquisition of a controlling interest, depending on the nationality of the investor, target sector and whether the target is a listed company
Japan	20% or 50% (or lower if acquirer holds more than 10% and is a top three shareholder)	For Japanese listed companies, 1% or more (subject to certain exemptions from pre-closing review), and for unlisted companies, one or more shares
Spain	Control (decisive influence)	10% or the acquisition of control
UK	50%, de facto control or material influence	Mandatory notification thresholds at 25%, 50% and 75% in key sectors; acquisition of material influence can be called in (in force from January 4, 2022)
United States	Control (50%) for foreign-to-foreign transactions, otherwise based on transaction value	No bright-line thresholds. Certain governance rights trigger non-control jurisdiction and control jurisdiction

What does this mean for dealmakers?

- **FDI analysis must be done up front and kept under continuous review**

  Failure to manage these processes proactively could also impact overall deal timetable strategy. It's important to remember that a limited increment in ownership through the purchase of a small shareholding can still trigger FDI filing requirements where it combines with an existing shareholding to cross a certain threshold – for example in Germany, Italy and the UK (under the incoming regime).

- **Managing multiple FDI filings**

  Where the target is engaged in sensitive activities, an incremental stakebuilding approach could mean that multiple FDI filings are triggered at different stages in the bid timetable – for example, for a listed target active in a defense or national security sector in Italy, acquisitions of shares may need to be notified separately for pre-clearance where the investor crosses 3 percent 5 percent, 15 percent, 20 percent, 25 percent or 50 percent shareholding thresholds.

- **Coordinating parallel FDI and merger filings**

  In most jurisdictions, the thresholds for merger control and FDI notification will be different. However, if both are triggered and the deal presents substantive antitrust and FDI risk, careful planning will be needed to align regulatory engagement and remedy strategies for both processes.

- **Keeping an eye on key risk areas and future developments**

  Governments around the world have increased their use of national security review procedures (for example Canada and China), tightened review thresholds or even introduced new regimes (the UK and a number of EU member states). Given the speed at which national governments have acted to close perceived gaps in foreign investment control, early awareness is critical to ensure the viability of stakebuilding and M&A strategy more generally.