EU to Establish a Framework for Screening Foreign Direct Investment

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On September 13, 2017, the European Commission issued a proposal for a Regulation establishing a framework for screening foreign direct investment ("FDI") in the European Union (the "Proposal" or "Proposed Regulation"). The Proposal, which came the same day that the US prohibited acquisition of Lattice Semiconductor by a Chinese-backed private equity fund, would apply to FDI, broadly defined as investments that establish or maintain lasting and direct links between investors from third countries and companies carrying out an economic activity in European Union ("EU") Member States. However, it would not apply to purely financial ("portfolio") investments. In his speech on the State of the European Union given on the same day the Proposal was issued, European Commission President Jean-Claude Juncker highlighted the Proposal as a top priority for the European Commission.

Unlike in the United States, where the Committee on Foreign Investment in the United States ("CFIUS") reviews the national security implications of transactions that could result in control of a US business by a foreign entity, the EU does not have any legislation in place on the review of foreign investments. Instead, about half of the EU's Member States have their own national screening mechanisms in place, which vary widely but generally can lead to the modification or prohibition of certain investments on grounds of public policy and security. These mechanisms differ in scope and procedure, e.g. general cross-sectoral coverage vs. specific coverage of the defense sector; ex-ante vs. ex-post review mechanisms; voluntary vs. mandatory notification, etc.

There is an active discussion going on in several Member States about further strengthening such mechanisms, either at the national (i.e., EU Member State) level, the EU level, or both. This is the case, for example, in France, the Netherlands, and the UK (which is still an EU Member State at the time of writing). Germany already adopted an amendment to its Federal Foreign Trade Regulations on July 12, 2017, allowing for wider control of foreign corporate takeovers in security-sensitive areas and/or relating to critical infrastructure. (See our client alert on the new German regulation, available here.)

The Proposal will be critical to follow for companies and investors with interests in the EU, as well as for foreign governments. Ultimately, however, the devil will likely be in the proverbial details. That is, whether or not one believes as a matter of principle that the EU and/or EU Member States should have an FDI screening mechanism at all, it is the actual mechanisms and principles that emanate from the Proposal, the way the Member States implement them, and the way they further develop in practice (and as the Proposal makes its way through the legislative process) that will ultimately be determinative. Companies and governments with an active interest are well-advised to monitor further developments closely, and get involved at both the Member State and EU levels if they wish to protect their interests.

Reasons for and Objectives of the Proposal

The Proposed Regulation is the European Commission's response to a joint request by France, Germany and Italy in February 2017 for the adoption of rules to enable screening and potential prohibition of foreign acquisitions of sensitive technologies and know-how. This was in response to a series of recent takeovers of leading European companies by state-controlled foreign investors. Chinese investors, in particular, have been actively pursuing European companies that develop technologies or maintain infrastructures that are viewed as essential to critical functions in society and the economy. This has led to political and security concerns in certain cases. Ernst & Young issued a report recently that 164 Chinese companies bought or took over European companies, investing around 60 billion euros, in the first half of 2016. German companies have been the primary target of these investments, but there have been (attempts at) takeovers in sensitive sectors of the economy in several other EU Member States as well. Some of these initiatives have been blocked or “dissuaded” outside of the public view.

A prominent recent example is the acquisition of Kuka, a German high-tech robotics manufacturer, by Midea, a Chinese company that reportedly has strong backing by the Chinese government. Germany's regulators approved the transaction after a great deal of domestic political debate and international attention to the acquisition. Prior to the German approval, Kuka sold its US aerospace division to a US-controlled company to secure CFIUS approval for the transaction. The Kuka acquisition led to the German foreign trade regulations amendment referred to above. Another example is the attempt of a Chinese investment fund to purchase Aixtron, a German semiconductor manufacturer that also held US assets. The German authorities withdrew their approval of the acquisition after President Obama blocked it because of security concerns raised in the CFIUS process.

The key concern is that some of these investments could be detrimental to security or public policy in the EU or in individual Member States and that, right now, only very limited or relatively unsophisticated mechanisms are available for the EU and its Member States to deal with this. There is also a specific concern with Chinese investors, since EU investors would like reciprocal access to the Chinese market. The Proposed Regulation would provide mechanisms for the EU to protect strategic companies. A well-designed investment review mechanism could also help increase legal certainty and provide a more transparent and fairer process to foreign investors, rather than what at times becomes an entirely political decision. The European Commission has also pointed out that since 2016, restrictions on FDI are increasing at a national level, so it makes sense to create a regulatory framework with common principles to screen FDI at the EU level.

The Proposed Regulation also seeks to address growing concerns with security in the EU. Although the EU Member States retain their rights to protect national security under the EU treaties, the EU has been taking a more active role in this area. For example, in 2008 the European Commission launched the European Raw Materials Initiative as a strategy to secure and improve access to critical raw materials (e.g., rare earths) in the EU. In 2016, the EU adopted legislation on cybersecurity preparedness requirements for its Member States, imposing data breach notification requirements on operators of essential services and, more controversially, on digital platforms. In his speech on the State of the European Union, European Commission President Jean-Claude Juncker also called for a European intelligence unit that would ensure that data concerning terrorists and returning foreign fighters be automatically shared among intelligence services and with the police.

Finally, the Proposal should be seen in the context of broader trade and investment strategies as well. Many have interpreted the Proposal as being part of an effort to develop a more robust and powerful trade policy, particularly with a view to China, but also in response to the more aggressive trade policies currently pursued by the United States under President Trump. In this context, there is also a link to negotiations between the EU and China on a potential new bilateral investment agreement. These negotiations, to date, have not been successful, which may be a reason for the European Union to want to bolster its FDI review mechanisms.

Competence of the EU to Adopt the Proposed Regulation

The EU is traditionally one of the most open markets for inbound FDI, and competes for such investment with other advanced economies worldwide. Article 63 of the Treaty on the Functioning of the EU ("TFEU") prohibits new restrictions on capital movements, including direct investment, between EU Member States and third countries (restrictions imposed before 1994 are grandfathered, subject to EU legislative action). However, Article 65 TFEU contains a safeguard clause that allows national restrictions where justified on public policy or security grounds.

In 2009, when the Lisbon Treaty amendments took effect, FDI was expressly added to the list of matters falling under the common commercial policy ("CCP") of the EU (Article 207(1) TFEU). The EU has exclusive legal competence for the CCP, as part of its responsibility for trade policy. This clarification to the treaties was made mainly so that the EU could negotiate investor protection treaties with third countries for the entire trade block (ending a patchwork of national bilateral investment treaties or BITs).

The European Commission now asserts the EU's exclusive competence for the CCP, which is defined to include FDI under Article 3(1)(e) TFEU, as the legal basis for the Proposal. In recognition of Member States' responsibility for the protection of national security, the Proposal would create a set of common principles for national FDI screening mechanisms, but would expressly authorize the Member States to continue to operate them at the national level "under the conditions and in accordance with the terms set out" in the Proposal (Article 3(1)). This is a fine line for the EU to walk between national and EU sovereignty. This inherent tension may explain why the Proposal focuses mainly on coordination rather than on creating a CFIUS-like review mechanism at the EU level, which earlier had been rumored to be the EU's ultimate objective.

The Legislative Process: What Can We Expect?

The Proposed Regulation now enters the EU legislative process. It requires qualified majority approval in the European Parliament and the Council of the EU (simple majority in Parliament and 16 out of 28 Member States in the Council, representing at least 65% of the EU's population). Legislation that is not so controversial generally is voted on after a single reading, on average requiring a year and a half for adoption. More controversial proposals can go into a second reading with a final vote after three years.

It remains to be seen how the Member States other than France, Germany and Italy will react to this initiative. EU countries with a strong appetite for FDI and strong ties with China include Greece, Portugal and Slovakia. According to the Chinese Ministry of Commerce, China has invested more than one billion euros in Greek projects in areas such as ports, shipping, telecommunications and photovoltaics. Recent examples include the sale of the port of Piraeus (the largest port in Greece) to the Chinese shipping group COSCO and the acquisition of a 24% stake in the Greek power grid operator ADMIE by China's largest utility, State Grid. Differences in views of the risks presented by third-country FDI among EU Member States may be another reason that the European Commission opted to harmonize screening principles rather than create an EU-level screening mechanism.

How the Proposed Regulation Would Work

As noted, early rumors mentioned the possible creation of an EU mechanism to vet and block foreign takeovers. The Proposed Regulation represents a less-intrusive option. It would create a framework for information sharing between Member States and the European Commission; ensure that screening mechanisms meet common basic criteria concerning transparency, nondiscrimination and judicial review; and establish common criteria that Member States should consider in any screening process they operate, including whether a foreign investor is controlled by the government of a third country. A Member State that currently does not have an FDI screening mechanism in place is not required to establish one, but it is obliged to consider the views of another Member State or the European Commission on an FDI in its jurisdiction, and to provide information in that respect to other Member States and the European Commission. The final decision on whether to restrict a given investment remains with the Member State in which the investment is planned.

Screening criteria. The Proposed Regulation authorizes EU Member States to establish an FDI screening mechanism “on the grounds of security or public order.” A recital clarifies that a Member State should have the flexibility to take into account its individual situation and national circumstances in interpreting these grounds. This is consistent with EU Court rulings that generally leave Member States a fair amount of discretion to determine what their essential public policy concerns are, provided that they are not discriminatory.

The Proposal lists the following nonexclusive criteria that may be used to assess the effects of FDI on security or public order:

- impact on “critical infrastructure, including energy, transport, communications, data storage, space or financial infrastructure, as well as sensitive facilities;”
- impact on “critical technologies, including AI, robotics, semiconductors, technologies with potential dual use applications, cybersecurity, space or nuclear technology;”
- impact on “security of supply of critical inputs;”
- impact on “access to or the ability to control sensitive information;”
- in assessing these effects, “whether the foreign investor is controlled by the government of a third country, including through significant funding.”

Cooperation mechanism. A Member State that is screening an FDI would be required to inform other Member States and the European Commission of such a review.

Regardless of whether a Member State in which an FDI is planned has a screening mechanism in place, if another Member State considers that this FDI is likely to affect its security or public order or the European Commission considers such an effect likely in one or more Member States, then it can provide comments (or an opinion in the case of the European Commission) to the Member State where the FDI is taking place. Another Member State or the European Commission may also request the information it needs to make its assessment from that Member State, which must provide this information without undue delay.

Requested information can include (i) details of the ownership structure of the foreign investor, including its ultimate controlling shareholders; (ii) the value of the investment; (iii) the activities of both the foreign investor and the company in which the investment is planned; (iv) information on the Member States in which the investor and the target each conducts its business; and (v) how the investment will be funded.

The reviewing Member State must “give due consideration” to any comments or an opinion it receives, but it keeps the authority to make the final decision on a foreign investment. This cooperation mechanism thus allows other Member States and the European Commission to ensure at least a minimal review of an FDI even where the Member State in which the FDI is occurring does not have its own screening mechanism in place. A potential disadvantage may, of course, be that the process would become more rather than less political in situations where the Member State in which the FDI occurs does not have a formal review mechanism in place.

Projects of EU interest. For projects of EU interest that an FDI is likely to affect on security or public order grounds, the European Commission would have the authority to issue an opinion addressed to the Member State where that investment is to take place. Projects of EU interest are those that receive substantial EU funding or are covered by EU legislation on critical infrastructure, technology or inputs. They include the EU's satellite programs; key enabling technologies funded by the EU like artificial intelligence; robotics, semiconductors and cybersecurity; and trans-European networks in the transport, energy and telecommunications sectors that are regulated at the EU level.

A Member State that is the addressee of an FDI impact opinion from the European Commission must “take utmost account of the Commission's opinion and provide an explanation to the

Commission in case its opinion is not followed." Again, the final decision on the investment lies with that Member State, however it can be expected that the transparency and political pressure this mechanism creates will have influence on that Member State's decision-making process, and may also create potentially significant public and political pressure on the foreign investor to withdraw its offer or otherwise adjust its plans. The screening mechanism for projects of EU interest applies to all Member States, whether or not they have their own screening mechanism in place.

Anti-circumvention. Under the Proposed Regulation, Member States are specifically authorized to adopt provisions that prevent circumvention of their screening mechanism. This provision could apply, for example, to a cross-border investment within the EU by a company that is established in a Member State but that is owned or controlled by a foreign (i.e., non-EU) investor.

Interaction with EU Merger Regulation. Under Article 21(4) of the EU Merger Regulation, Member States may protect their "legitimate interests" even for transactions subject only to EU (and not national) clearance. These legitimate interests can overlap with the grounds for screening set out in the Proposed Regulation, since they include security concerns. The Proposal clarifies that where the same concerns are raised in both an EU merger proceeding as "legitimate interests" and in a national FDI screening mechanism on grounds of security or public order, they should be interpreted the same way.

Other Provisions

The Proposed Regulation would require Member States to (i) notify the European Commission of their existing screening mechanisms and any changes made to them, (ii) provide an annual report on their application; and (iii) appoint a central FDI review point of contact. The European Commission must evaluate the application of the Proposed Regulation three years after it entered into force and propose any amendments that it views as warranted. The European Commission would also set up a coordination group with Member State representatives on FDI screening that would provide a forum to address issues under the Proposed Regulation, exchange information and discuss best practices for screening FDI.

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