CMS Funds Group

Investment Control
Foreign direct investment

The latest webinar in our ***Focus on Funds | Risk, Resilience and Reputation*** *series saw CMS partners Benoît Vandervelde, Kai Neuhaus and Russell Hoare discuss the latest developments covering foreign direct investment. Here is a high level write up from our event. The full recording is available here.*

Foreign direct investment controls play a vital role in merger and acquisition risk assessment.

Yet the rules are not harmonised across the EU. Corporates face a multitude of regimes, each with complex rulesets. In our experience, this is adding time and cost to qualifying transactions. So much so, that we believe investment controls are now requiring a comparable level of attention in the transaction process to merger controls.

EU members are subject to new regulation (2019/452) that establishes a framework for member states implement FDI control mechanisms. It establishes the principle for co-operation – but there's no obligation for countries to implement it.

There are also outliers in terms of rules, notably Germany within the EU and the UK without.

High level considerations

Best practice, irrespective of jurisdiction, is to consider the impact of FDI controls as early as possible in the transaction process.

- Is the target active in sectors likely to trigger FDI controls?
- Would an interested national government view the purchaser as a foreign investor?

If the answer to either question is yes – even at the margins – then governments are likely to view the transaction as falling under relevant FDI rules. The process is now as much about politics as it is legality.

For example, the German government has essentially prohibited Chinese buyers from making high tech purchases. One recent example saw a Chinese entity proscribed from buying a bankrupt medical devices manufacturer, given concerns about security of supply in a continued pandemic scenario.

In a similar vein, the UK taken high profile steps to curb Chinese interests in strategic sectors such as telecommunications (Huawei) and nuclear power (Hinkley Point C).

In such a politicised environment, sellers rather than buyers should consider taking a lead on FDI considerations. Talking to relevant authorities about potential buyers can generate a level of comfort about strategic assets in the eyes of governments (although these conversations can be a one way street, given governmental reluctance to disclose decision-making rationale on sensitive subjects).

This is where legal counsel can add particular value – not only in drafting briefing notes and filings but also in advising on coordination between multiple FDI regimes.

Legal counsel can likewise help with mitigation strategies. Hypothetically, what if a UK board director is required to get a transaction over the line? Or what is production must remain in Germany, not elsewhere as planned?

Due diligence

Such national considerations are also a good place to start due diligence processes. Many government departments, irrespective of the flag they serve, will look first at where subsidiaries and branch offices are located.

An alternative starting point is the sector in which the target sits. The UK, for example, has earmarked 17 high risk sectors, from advanced materials to synthetic biology. The latter is a particularly hot topic – partly because the way the rules were drafted leaves much open to question. In many cases the sector definitions are complex and untested.

Moreover, some sectors are in scope in some jurisdictions – but not in others. For example, France includes supermarkets and the US educational software. Neither appear in UK or German sights.

And, like many aspects of FDI controls across Europe, *indirect* investment is frequently in scope.

For example, a US buyer of 10% of more of a German target will naturally be in scope. But so will a Chinese entity with a 10%+ holding in *a German entity buying 10%+ in another German entity*. Given the complexity of legal structures in the international funds sector it is vital to look at every layer of every legal structure of every link in the transaction chain.

Other due diligence considerations are similarly important. Companies must supply specific technical details concerning products and services, targets must call on local subsidiaries to for information about activities and the process might lead to knock-on scrutiny of other regulatory areas. All this takes time – and has implications for transaction secrecy.

Successful transactions

Most national regimes have significant criminal penalties for malfeasance. Five years imprisonment is not uncommon.

However, a more common outcome would be an acquisition becoming void. National authorities can make this decision if they believe a company should have submitted a mandatory filing, but did not do so.

But despite this, the complexity of myriad national rules, *and* the shifting political sands behind deliberately vague definitions of national security, it is possible for direct and indirect investments to navigate a safe path – starting with clarity over who the investor is, where they are based and what percentage of voting shares are involved.