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Shifting Landscapes in Foreign Investment Controls

2020

The growing tension: globalisation versus protectionism

As economies around the world begin to grapple with post COVID-19 recovery plans and investors eye up opportunities, one area is emerging as a heightened regulatory risk for cross-border deals: foreign investment controls.

Inward foreign direct investment (FDI) brings significant benefits to economies, and often represents a material proportion of GDP. Many jurisdictions pride themselves on being open economies, including the EU which is both the leading source and destination of FDI.

But the last ten years or so have also seen a change in FDI patterns, with the emergence of 'new investors' from a growing diversity of countries (including a surge from China), and an increase in investments by state-owned enterprises.

Governments, realising that many of these investments are in sectors that are critical to economies, have found that their powers to vet them are often limited. Meanwhile political agendas have become increasingly protectionist. This has led to governments around the world scrutinising their screening measures and, in many cases, enhancing them.

Screening of foreign investment is not a new phenomenon. Controls have been in place in jurisdictions for many years. Until recently, these controls have been limited, being largely focused on national security concerns. However, in recent years there has been a consistent pattern of foreign investment controls being expanded and tightened. And with COVID-19, the focus has heightened with governments reacting by imposing more stringent controls to protect broader national economic and social concerns.

The largest European economies such as France, Germany and the UK are amongst those jurisdictions, as well another 12 EU countries. With the advent of the new EU FDI Regulation other EU countries are expected to follow suit.

As a result, navigating complex foreign investment controls, together with other regulatory and merger control approvals, is becoming increasingly complex. Foreign investment controls now need to be considered a key regulatory issue, as well as a potential deal risk, for investors when considering strategic investment plans and executing transactions.

The COVID-19 acceleration

The COVID-19 pandemic has accelerated this trend. Many countries are now focusing on strategic sectors and critical infrastructure as well as the security of supply of critical inputs, for example in the healthcare sector, and the protection of research and development capabilities.

There are also underlying concerns about opportunistic acquisitions by foreign investors of businesses likely to be undervalued in the context of depressed stock markets and economic uncertainty.

In March 2020 in response to the COVID-19 crisis, the European Commission took the unusual step of expressly calling on EU Member States to set up "fully fledged screening mechanisms" and use all other available options (including 'Golden Shares') to protect against risks to critical supplies and infrastructure.

In guidance issued to Member States, the Commission "*urges Member States to be particularly vigilant to avoid that the current health crisis does not result in a sell-off of Europe's business and industrial actors, including SMEs*". The EU Trade Commissioner has also invited Member States to begin cooperating on a voluntary basis under the new FDI Screening mechanism due to be implemented in October 2020 (see further below).

Several countries have introduced temporary measures. These include widening the scope of existing regimes to apply to acquisitions by EU/EEA investors, lowering the thresholds for intervention and/or increasing the scope of sectors likely to be scrutinised.

A snapshot of measures in place in a handful of countries as at July 2020 is set out below. While these have been prompted by the COVID-19 crisis and dubbed 'temporary', in some cases it seems these measures are likely to stay.

Examples of temporary measures introduced to tackle COVID-19 concerns

France

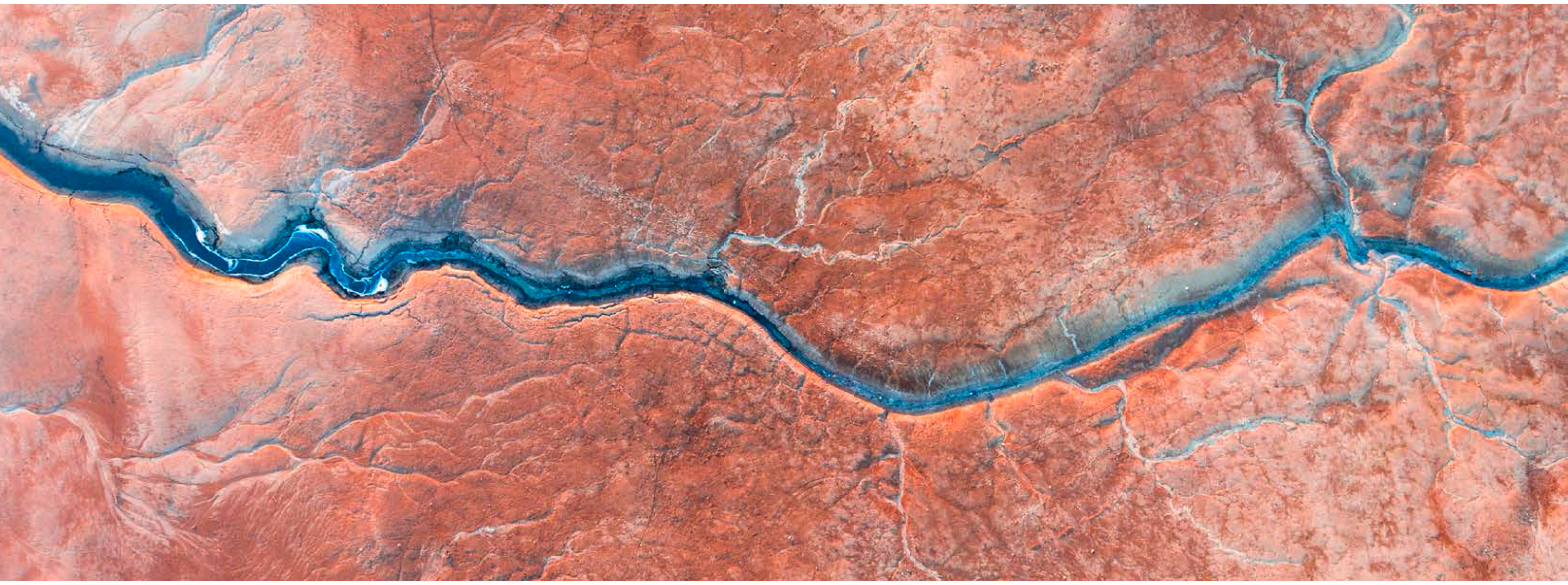
- Threshold for investments by non-EU/EEA investors in a French entity lowered from 25% of voting rights to 10%+.
- Biotechnology added as an area subject to control (note this measure is not temporary).

Hungary

- Prior approval required for acquisitions by non-EU/EFTA investors of 10%+ (and subsequent acquisitions over certain thresholds) of 'strategic companies' for a value of at least HUF 350m (c. EUR 1m) or where the investor together with other foreign investors would hold 25%+ of the company.
- Prior approval also required where ownership or rights to use or operate infrastructure essential for certain 'strategic activities' are transferred or provided as security for non-EU/EFTA investors.
- Non-EU/EFTA investors include domestic, EU and EFTA investors majority owned by a third country investor.
- 'Strategic companies' include Hungary incorporated companies involved in listed 'strategic activities' including critical infrastructure (e.g. communications, chemicals, wholesale trade, defence, energy, financial, hotels), critical technologies, supply of critical inputs, access to sensitive information and media (among others).

Italy

- Expansion of sectors subject to review to include any critical infrastructure (e.g. health, water, data processing, sensitive facilities etc.), supply of critical inputs, and critical technologies and dual-use items (among others).
- Mandatory pre-approval of acquisitions over EUR 1m by EU investors of a controlling interest in any of the sectors above.
- Mandatory pre-approval of acquisitions over EUR 1m by non-EU investors of a 10%+ interest (and subsequent acquisitions over certain thresholds) in any of the sectors above.



Poland

- Prior approval required for acquisitions by non-EU/EEA investors of (i) a business; (ii) 20%+ or (iii) the ability to decide on business direction, of certain target companies active in Poland.
- Target companies subject to these rules include entities with revenue over EUR 10m in the last 2 years AND (i) which are listed; (ii) which own property listed as critical infrastructure, or develop/modify software in certain listed areas; OR (iii) which carry out certain specified business activities, which include production of electricity, chemicals, medicine and pharma products, processing of meat, milk, cereals, fruit and vegetables.

Spain

- Prior approval required for acquisitions over EUR 1m by non-EU/EFTA investors of 10%+, or effective participation in management or control, of Spanish companies active in sectors including critical infrastructure (e.g. medical, financial, energy etc.), critical technologies and dual-use products, supply of critical inputs, access to confidential information and media.
- Prior approval required for acquisitions over EUR 1m of Spanish companies in any sector by non-EU/EFTA investors controlled by a third country government, who have invested in one of the above sectors in another Member State or involved in proceedings in another Member State for illegal activities.
- These rules capture investments made through EU vehicles ultimately controlled by a non-EU/EFTA investor.

Non-EU Example Australia

- Monetary notification thresholds in the foreign investment rules reduced to AUD 0. Most proposed foreign investments will require notification to the Foreign Investment Review Board (FIRB) and Treasurer approval, regardless of value or nature of foreign investor.
- Extension of the FIRB review periods from 30 days to 6 months, with an intention to prioritise deals that support Australian businesses and jobs.

A complex regulatory jigsaw

Foreign investment controls have long been in place in countries such as the US, Canada and Australia. In the EU, 14 Member States currently have foreign investment screening measures.

Many countries' measures have been introduced and/or tightened in the last three to four years, and there are proposals for reform in several others including the UK and Germany.

What is the usual scope of foreign investment controls?

Foreign investment reviews involve the scrutiny of a transaction from a public interest angle. The definition and scope of the relevant public interest varies by regime, but usually includes national security, public order and/or media plurality among others.

The review is typically carried out by a Ministry or relevant Government Department. Processes tend to be less transparent and predictable than in merger control or regulatory approvals, with often uncertain timelines and a wide scope for Government discretion in the assessment. There is often limited information in the public domain about the Government's assessment of a transaction and even the parties involved will often not receive access to information which is deemed sensitive.

Different rules can apply depending on the nationality of the investor. For example, in the EU, non-EU/EEA investors are often subject to stricter rules and/or lower thresholds for intervention. This means UK investors may be subject to stricter rules post-Brexit. The rules can also vary depending on the affected sector and are most often triggered by investments in defence, infrastructure and technology sectors but these categories are expanding, reflecting the increasing trend towards protectionism.

Some regimes require mandatory notification, suspending completion pending clearance, while others only require voluntary notification but are backed with strong powers to unwind any problematic transaction for a period post-completion.

The EU FDI Regulation

In April 2019, a new EU FDI Regulation came into force introducing a cooperation mechanism for screening FDI which will apply fully from October 2020. This is not a separate new screening tool at EU level, but a framework for cooperation and information exchange between Member States and the European Commission.

The Regulation makes very clear that national screening regimes apply, but for FDI which may affect security or public order or certain EU projects, Member States and/or the European Commission will have the opportunity to make comments and/or request information about a transaction, regardless of whether it is being reviewed at national level. The mechanism will therefore allow the Commission and EU Member States to consider the impact of an investment across several Member States and/or the EU.

The Regulation also makes clear that Member States are under no obligation to introduce screening measures where none exist – but the Commission's COVID-19 'call to arms' has put a different complexion on this. As noted, the Commission is explicitly calling for Member States to introduce new measures where these do not exist or have limited scope. Of note, under the Regulation, Member States and/or the Commission will have the opportunity to comment and/or request information for a period of up to 15 months post-completion – which means that once it fully comes into force, transactions completing during the current pandemic may still be subject to review.

The Regulation comes at a time when the EU is seeking to address the broader impact of foreign state ownership and state financing on the Single Market. In June 2020, the European Commission issued a White Paper on levelling the playing field as regards foreign subsidies.

The White Paper identifies the legal gaps in the existing EU toolbox for tackling foreign subsidies and proposes a legal framework to address these gaps. The White Paper is broad-ranging covering a number of policy areas, including competition law, state aid and procurement. But it concedes that the scope of foreign investment screening is largely limited to grounds of national security and public order and does not address the issue of distortions caused by foreign subsidies.

As such, the Commission's proposals include a new notification procedure under which companies which benefit from financial support of a non-EU government would be required to notify any acquisition of an interest in an EU company, above a given threshold, to a competent supervisory authority, such as the European Commission. The relevant supervisory authority would be given powers to prohibit or impose conditions on any acquisition that is found to be facilitated by foreign subsidies and to distort the Single Market.

These proposals, if implemented, continue the trend towards more protectionism: FDI control will more and more develop from a tool meant to protect core security interests of a nation to a Swiss army knife for industrial policy. Differentiating between security interests and economic interests will become more and more difficult.

Spotlight on the UK

The UK's current regime for national security reviews operates through UK merger control: the UK Government can only formally intervene in a transaction which meets UK merger control thresholds.

Since June 2018, these have been significantly lowered for target businesses active in three areas: in brief, developing or producing items subject to export control, aspects of computing hardware and quantum technology. And in June 2020, the UK Government announced that it was seeking to expand the areas subject to the lower thresholds to include artificial intelligence, advanced materials and cryptographic authentication technology.

The period since the introduction of the 2018 changes has seen almost the same number of Government interventions as the entire period of the previous regime (2004 to 2018). This includes acquisitions by US and Canadian pension and/or private equity funds. Most have resulted in detailed and wide-ranging undertakings, such as to maintain UK nationals on the board and maintain activities in the UK (among others). The UK Government has also intervened informally in several additional transactions.

But there are significant changes in the pipeline as foreign investment controls remain a priority area for the current UK Government. Proposals for reform would introduce a standalone regime, with a voluntary notification system supported by extensive Government call-in powers for up to 6 months post-completion. The proposed regime is broad: it is not limited to 'foreign' investors or certain areas of the economy and leaves much discretion to the Government in the definition of issues and their assessment. Transactions in 'core' areas of the economy, traditionally expected to raise such issues such as critical infrastructure and defence, are expected to fall within scope, as are advanced technologies but also acquisitions of assets strategically located near sensitive sites.

Meanwhile, as a response to the COVID-19 pandemic, the UK Government introduced a new public interest ground on which it can intervene in mergers: to maintain UK capability to combat and mitigate public health emergencies.

Spotlight on Germany

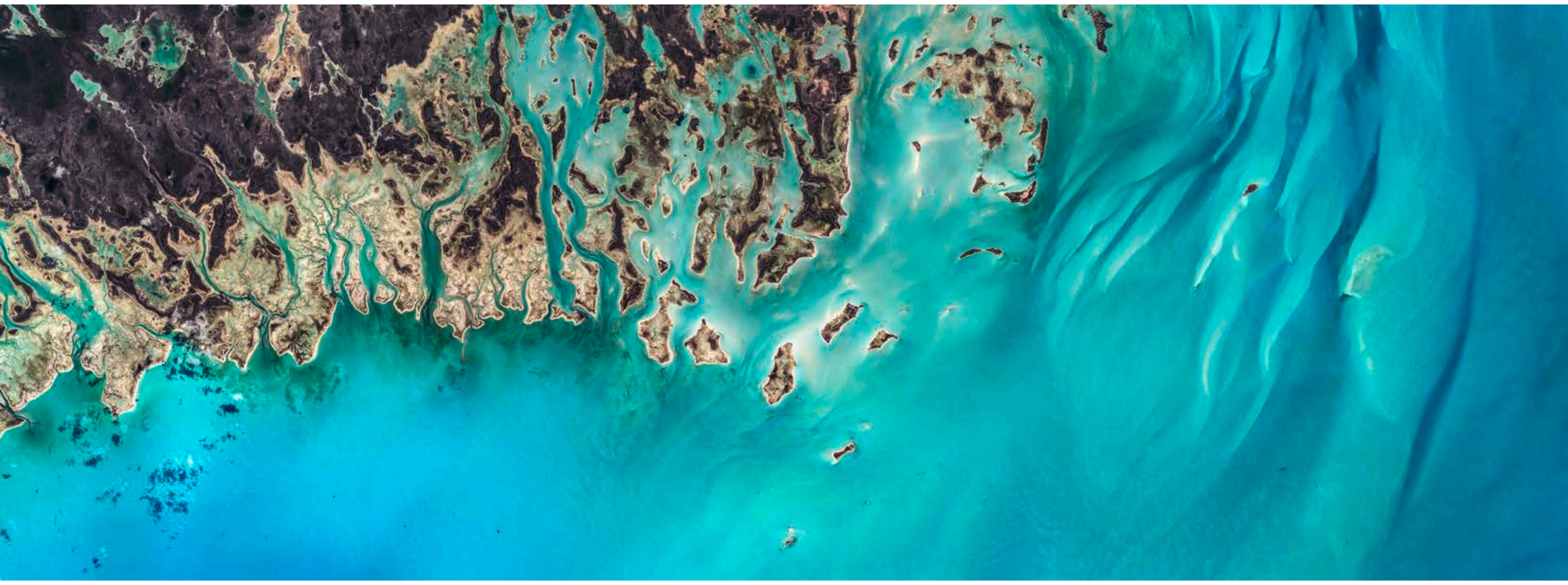
Germany's regime is independent of merger control. It is administered by the Ministry of Economy, which may investigate any direct or indirect acquisition of at least 25% of the voting shares in a German target by a non-EEA/EFTA person. Investigations can be initiated ex officio for a period of up to five years after signing, but companies may voluntarily apply for clearance to have legal certainty.

Investments by non-EU/EFTA investors in specific sectors, such as critical infrastructure, media or certain healthcare companies, require mandatory notifications and the triggering threshold is lowered to 10% of the voting rights. Investments by non-German investors in some areas of the military sector must equally be notified, with the threshold also being 10% of the voting shares.

Importantly, German law does not only cover foreign *direct* investments but also *indirect* investments. This includes situations where one foreign company acquires another foreign company which holds 25% of the voting rights in a German legal entity, or where a German company is bought by another German company which has a non-German 25% shareholder.

While prohibitions under German investment control are very rare, a substantial number of transactions are now only cleared on the basis of a mitigation agreement in which the parties accept certain commitments.

With no less than 10 amendments in the past three years, German investment control remains a moving target. Major changes entered into force in July 2020: Most importantly, the introduction of a standstill obligation for many transactions will dramatically change the scene, as infringements will be punishable by prison sentences. A new assessment standard will make interventions more likely. New timeframes hopefully will allow for faster, more predictable proceedings. Later in 2020 new sectors will be added to the list of investments which require mandatory notification and are subject to the standstill obligation.



Trends

A noticeable trend in recent years is the expansion of sectors subject to review. Traditionally limited to areas which more obviously raise national interest considerations such as defence, many regimes have expanded to include a broad range of sectors listed as ‘critical’. It is fair to say that investment control has increasingly become a tool for industrial policy and is no longer limited to safeguarding national security.

The EU FDI Regulation for example, which has inspired reforms in several EU Member States, lists areas as broad as ‘water’, ‘health’, ‘data processing or storage’ and ‘financial infrastructure’ within ‘critical infrastructure’. New sectors often also include advanced technologies, such as artificial intelligence, biotechnologies, robotics and quantum technologies, aiming at the protection of domestic capabilities in key technologies.

In addition, new measures often widen the definition of who is regarded as a ‘foreign investor’. Rather than a formalistic test based on country of incorporation or citizenship, regimes have often refined the test to capture domestic or EU/EEA vehicles beneficially owned or ultimately controlled by a third country investor. This can have the effect of significantly widening the pool of investors subject to controls and can obviously make the assessment of foreign investor controls in transactions in which parties have complex holding structures, difficult.

Another trend is the constant lowering of the intervention thresholds. While in many merger control regimes authorities may only intervene when there is a change of “control”, investment control regimes tend to apply much lower thresholds, sometimes as low as 10 % of the voting rights – with the European Commission suggesting that even a 5 % shareholding could be relevant in terms of security or public order.

The COVID-19 pandemic has also prompted issues relating to security of supply and resilient supply chains to be scrutinised more closely and/or subject companies involved in key supply chains to greater scrutiny. As a result, it can be expected that closer scrutiny is likely within sectors such as healthcare and food production.

Lastly, whilst foreign investment rules still remain a patchwork of different rules from jurisdiction to jurisdiction and will differ materially in terms of types of transactions which are caught, there is increasing international alignment in the form of common rules (such as the EU screening framework) and cooperation between regulatory authorities.

The EU White Paper on foreign subsidies of June 2020 might turn out to be a new attempt by the EU to bring investment control within its competences – after some Member States fiercely objected to such ideas when the EU FDI Regulation was drafted. In any event the White Paper shows that the pendulum keeps swinging towards more, not less control of foreign investments.

What does this mean for transactions?

Parties to transactions in potentially 'red-flag' sectors need to be alive to the possibility of increased scrutiny at the outset of the deal, and factor this into their planning and timelines.

Investors need to ensure early and thorough due diligence of possible foreign investment issues; vendors need increasingly to be alive to deal risks attaching to potential buyers.

As such, it is essential that foreign investment risks are addressed early in a transaction lifecycle given that they can significantly influence the attractiveness of bidders, the deal structure and timing.

Assessment

Transactions should be subject to a thorough foreign investment review in the same way as a multi-jurisdictional merger control assessment. This will require careful analysis of the identity of all direct and indirect investors involved, transaction structure and the sector to which the investment relates. It should not be assumed that only the involvement of investors from higher risk jurisdictions will face scrutiny. Recent examples in the UK have shown that US and Canadian buyers can be looked at just as closely. And whilst lower value deals may often escape merger control reviews, since turnover thresholds may not be exceeded, this may not be the case for foreign investment approvals.

Consider your transaction structure

Aside from assessing whether a transaction structure may trigger formal approvals, parties will need to consider, particularly in deals which may attract scrutiny and may require remedies or undertakings, whether the proposed holding structure and operation of the target entity post-completion will satisfy regulator's requirements or satisfy the investment objectives. For example, will it be workable for the relevant investors for a majority of the board to be domestic nationals or for the headquarters to remain in the same jurisdiction? Will controls around intellectual property or R&D, continued security of supply to certain customers and access to information jeopardise the potential commercial value from the deal?

Assess early the impact on timing

Foreign investment approvals can take significant time to secure and are typically subject to less transparent and efficient reviews than found in merger control. This will impact on any long-stop dates and conditionality.

Communication and stakeholder engagement

Parties might also consider proactively engaging with the relevant authorities to pre-empt foreign investment concerns. Aside from offering voluntary undertakings, parties may want to consider how best to engage with government bodies to provide information and reassurance.

Investment strategy

Whilst foreign investment controls will impact on individual deals, they will increasingly shape investment strategy, particularly in areas which traditionally have been relatively free from regulatory oversight. Investors are encouraged to review their long-term strategic goals and sectors of interest against the expanding set of controls and assess whether their objectives may be jeopardised by national governments stepping in.

> Foreign investment controls also have an impact on exit strategies, since they may narrow the pool of potential buyers for a business involved in activities perceived to be critical for the national interest. This may be further complicated by the interplay with antitrust – the sale to a domestic buyer may address foreign investment concerns but raise additional antitrust risks.

How CMS can help you

CMS has an international team of local experts who can assist in advising on foreign investment issues.

Local Expertise

With 75 offices in 43 countries, our lawyers are well placed to advise on the circumstances in which foreign investment measures may apply to a transaction and the impact on transaction structures and timing. Our local lawyers are experienced in preparing notifications and negotiating commitments and are used to dealing with the relevant local authorities and ministries.

International co-ordination

Our international team allows us to readily advise on obtaining foreign investment approvals in a coordinated manner across jurisdictions. And with our broader competition and regulatory teams, we can help you devise and align a regulatory filing strategy to meet your deal objectives.

One-stop solution

Because we are a full-service corporate law firm, we can fulfil all your legal requirements on complex transactions. Not only is this convenient, it also means that against the backdrop of our lawyers' sector knowledge and expertise, we can readily understand your business and manage the risks faced in order to achieve your desired results.

We are business advisers, not just lawyers. We work in partnership with all our clients in order to support them.

For further information on how CMS can assist with foreign investment control advice, please get in touch with your usual CMS contact or contact **Kai Neuhaus** or **Caroline Hobson** below.

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