The European FDI Regulation: What You Need to Know

Dechert LLP

The EU Foreign Direct Investment Regulation (EU FDI Regulation) will be in full force from 11 October of this year. We expect it will radically alter the dynamics of foreign investment review in Europe.

This report will detail what the new regulation does, and what you need to know. Over the next few months we will publish further comment on investment controls in the EU and its Member States, many of which have introduced new restrictions in response to the COVID-19 pandemic. We will consider also developments in the U.S., where the CFIUS regime is operating with renewed vigour, and in other countries across the globe.

What's new?

The new EU FDI Regulation[1] does not introduce a centralised EU review comparable to CFIUS. Instead it creates a mechanism for coordinating national screening of inward investments by foreign buyers, while giving the European Commission (EC) an important new central advisory role.

More than half of EU Member States already operate FDI screening mechanisms. "Screening" refers to any possible assessment mechanism, e.g., investigation, authorisation, conditions imposed, prohibition or even unwinding of direct investments. While the new FDI Regulation itself does not require Member States to introduce screening, the EC's March 2020 Communication with Guidance to the Member States on FDI[2] (EC March Communication) recommends that Member States do so in order to be able to thwart opportunistic buyouts of European businesses, notably strategic healthcare businesses, during the COVID-19 pandemic.

The existing Member State systems vary widely in their scope and level of enforcement, and countries do not currently coordinate their approaches, even where a given investment might affect several of them. The new EU FDI Regulation tries to address this patchwork by specifying a number of characteristics which existing and new screening mechanisms must meet. Importantly, it also creates an advisory role for the EC, as well as a role for other Member States in national screening processes. The EC can issue an opinion, while Member States can provide comments, to:

- Member State(s) screening a foreign investment
- a Member State in which an FDI is planned but there is no screening
- a Member State where an investment was completed within the last 15 months without a screening

The FDI Regulation will radically alter the dynamics of foreign investment review in Europe — while Member States retain the ultimate decision-making power, the EC will now play a crucial role and will increasingly constrain national screening procedures. In particular, there are specific situations where Member States have to take the "utmost account" of the EC's advisory opinion and justify any deviation from it. This is the case for targets that receive significant EU funding or operate critical infrastructure (transport, energy, telecoms), produce critical technologies (artificial intelligence, robotics, semiconductors) or manufacture inputs needed for security or public order (cybersecurity, satellite

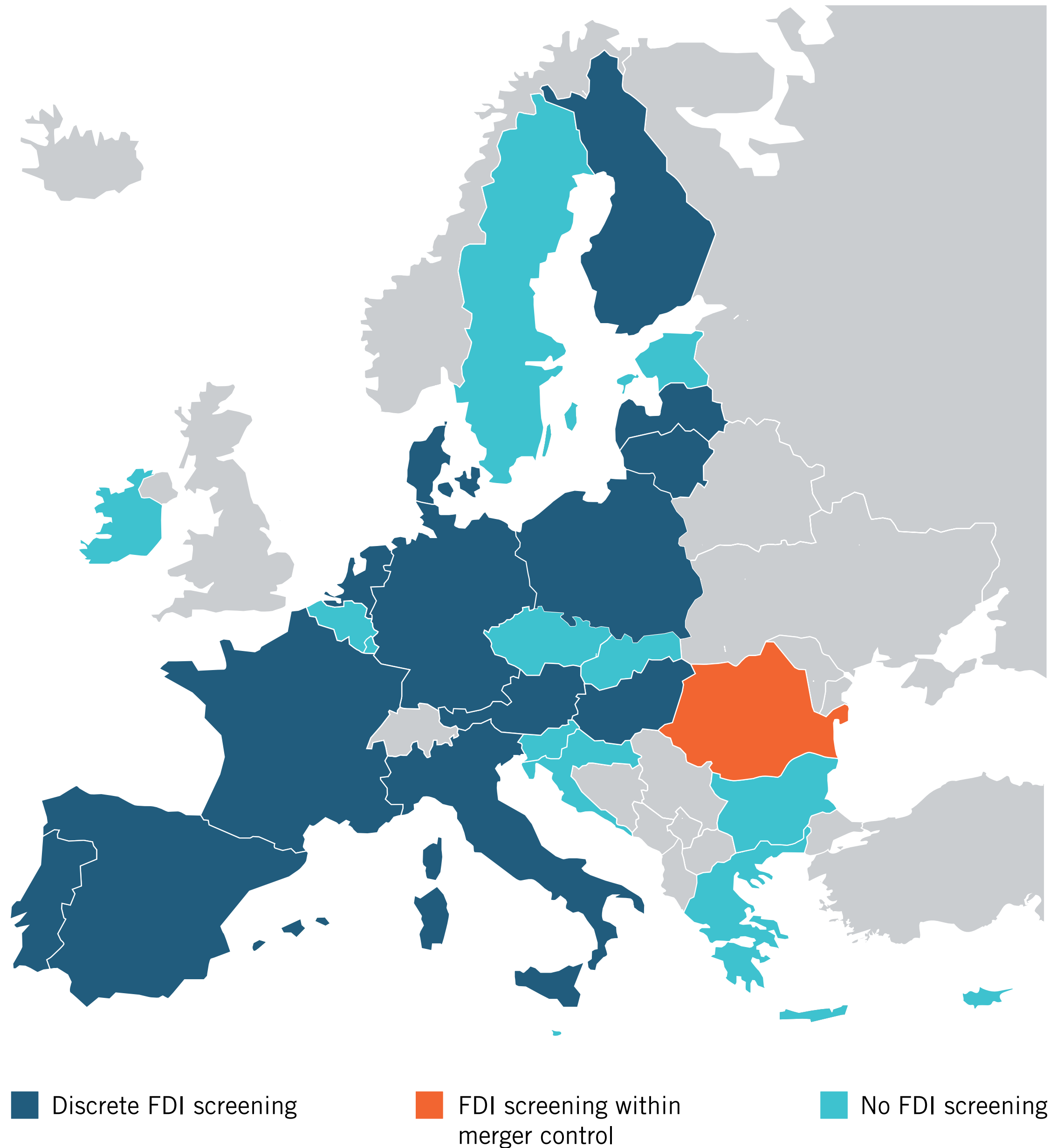
1. Regulation (EU) 2019/452 of the European Parliament and the Council of 19 March 2019 establishing a framework for the screening of foreign direct investments into the Union, available at this **link**.

2. Communication from the Commission: Guidance to the Member States concerning foreign direct investment and free movement of capital from third countries, and the protection of Europe's strategic assets, ahead of the application of Regulation (EU) 2019/452 (FDI Screening Regulation), 25 March 2020, available at this **link**.

navigation, earth observation and defence). The FDI Regulation calls out these instances specifically. "Utmost account" is undefined, although it is a term of art familiar from other areas of the EU law book.

The EC's ambition to become the FDI ringmaster is clear from the EC March Communication. These guidelines go beyond providing advice in specific cases and seek to stimulate adoption and development of Member State FDI regimes. It seems that the COVID-19 crisis is serving as an inflection point in the development of FDI review in Europe generally, with the EC in the lead.

Figure 1: Existing FDI Regimes in the EU Member States



1. The position is shown as at mid-May 2020, but changes in national regimes are currently multiplying in view of the pandemic.
2. The United Kingdom is no longer a Member State but is currently in a transition period after its recent exit. It operates a system of FDI within merger control. See p. 4 of this report for further information regarding the status of the UK under the EU FDI Regulation.

Who should prepare for the EU FDI Regulation?

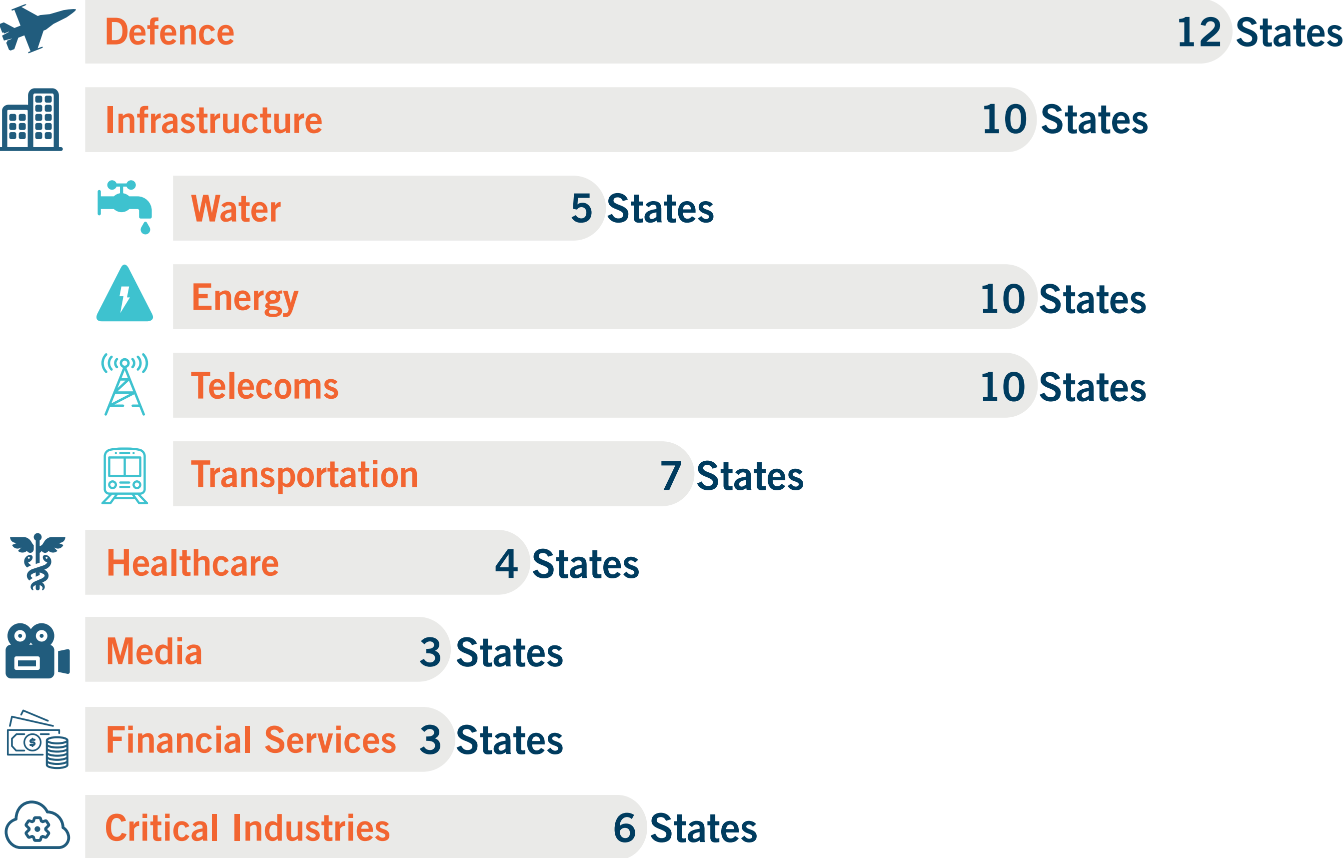
Any non-EU investor and any EU target company that is the subject of an investment from outside the EU, in any sector of the economy, should prepare for the Regulation.

FDI is defined as (1) an investment of any kind (2) aiming to establish or to maintain lasting and direct links between the foreign investor and the EU company (3) to carry on an economic activity in a Member State.

Plainly this is all-embracing, but the EC will not want to examine every FDI. The likely candidates for attention are however expanding, in real time. The Regulation itself identified some more obvious categories (e.g., defence, critical infrastructure, critical technologies) but added to these certain "European Programmes" of cross-border importance, notably involving infrastructure. The EC March Communication now adds to the areas likely in focus in the COVID-19 context — in particular healthcare, but also energy and finance.

High-profile cases may attract attention, but transactions that involve targets with a particular niche offering should also expect scrutiny, as well as investments by acquirers of certain nationalities. More generally, the pandemic has given birth to the concern that businesses generally may be sold on the cheap to foreign buyers while valuations are depressed, with this concern applying regardless of nationality.

Figure 2: Sectors in focus



Are investments through EU subsidiaries of foreign entities subject to the EU FDI Regulation?

Intra-EU investments are mainly governed by the rules on free movement of capital and freedom of establishment. However these freedoms are not absolute, with some limited scope for Member States to oppose cross-border activity. Historically it has been the role of the EC to ensure that Member States respect the limits of their power to interfere with free movement.

Intra-EU investments carried out by the EU subsidiary of a non-EU parent will readily attract scrutiny by Member States, notwithstanding the European incorporation of the acquisition vehicle. The FDI Regulation itself urges Member States to prevent circumvention of screening mechanisms through "artificial arrangements" when the ultimate owner is a non-EU entity. "Artificial arrangements" is a vague term, so absent any guidance acquirers ultimately owned or controlled by a non-EU undertaking or national (or having non-EU shareholders) may need to proceed with caution.

For example, there may be particular scepticism in relation to a newly incorporated acquisition vehicle. But there may be scepticism even where the acquirer is a well-established European business, if it has a foreign parent or foreign investors.

While intra-EU investments through an EU subsidiary of a non-EU entity are not shielded from investment screening by Member States, such an acquisition structure might appear to fall outside the FDI Regulation – which applies to non-EU investors without reference to ultimate beneficial ownership. This will likely become an area of contention at the intersection of the Treaty freedoms, national FDI screening mechanisms and the EU FDI Regulation. It is one of the curiosities of the EU FDI Regulation that it may fall to the EC to orchestrate interference with acquisitions by EU incorporated entities, where its previous concern has always been to restrain Member State enthusiasm for such interference.

Following Brexit: Are UK investors subject to the FDI Regulation?

The UK ceased to be a Member State from February 2020, but it is presently in a "transition" period. The principle of that period is that EU law continues to apply in the UK, but it is understood that the FDI coordination mechanisms between the EC and the EU 27 as foreseen in the EU FDI Regulation do not extend to the UK authorities.

The transition is currently set to run until the end of 2020, although at the time of writing speculation is mounting that the period may need to be extended. It is a separate question whether UK companies retain rights under EU law during that period; in principle this must be so.

What are the potential flashpoints between national reviews and the EC?

The FDI Regulation adds new complexity to the regulatory approvals already required for cross-border M&A transactions: merger review, sector-specific approvals, national FDI regulation—and now EU level review, too. This complexity may take a number of forms, as follows:

1. Member States will have to address retrospective opinions from the EC and other Member States. Courts may need to decide on this aspect of the EU FDI Regulation if, for example, the EC's advisory opinion on a completed transaction is to prohibit it or to invite remedial action. We do not expect this to prevent the EC from using its power to provide advice up until 15 months after completion of the transaction, since the EC March Communication specifically calls out that possibility.

2. An extra layer of regulatory oversight might delay national screening timetables. While the EU FDI Regulation does not require suspension and we are not aware of Member States planning to freeze their national reviews while the EC and/or other Member States are preparing their advice/comments, the EU FDI Regulation's clear intent is that Member States await the opinions/comments before taking a decision. This will be particularly challenging in Austria, France and Latvia where the decision-makers are normally required to close their reviews within 30 days, i.e., before the minimum five weeks which the Regulation foresees for the EC/Member States oversight process.

Figure 3: Is filing mandatory? Suspensory?

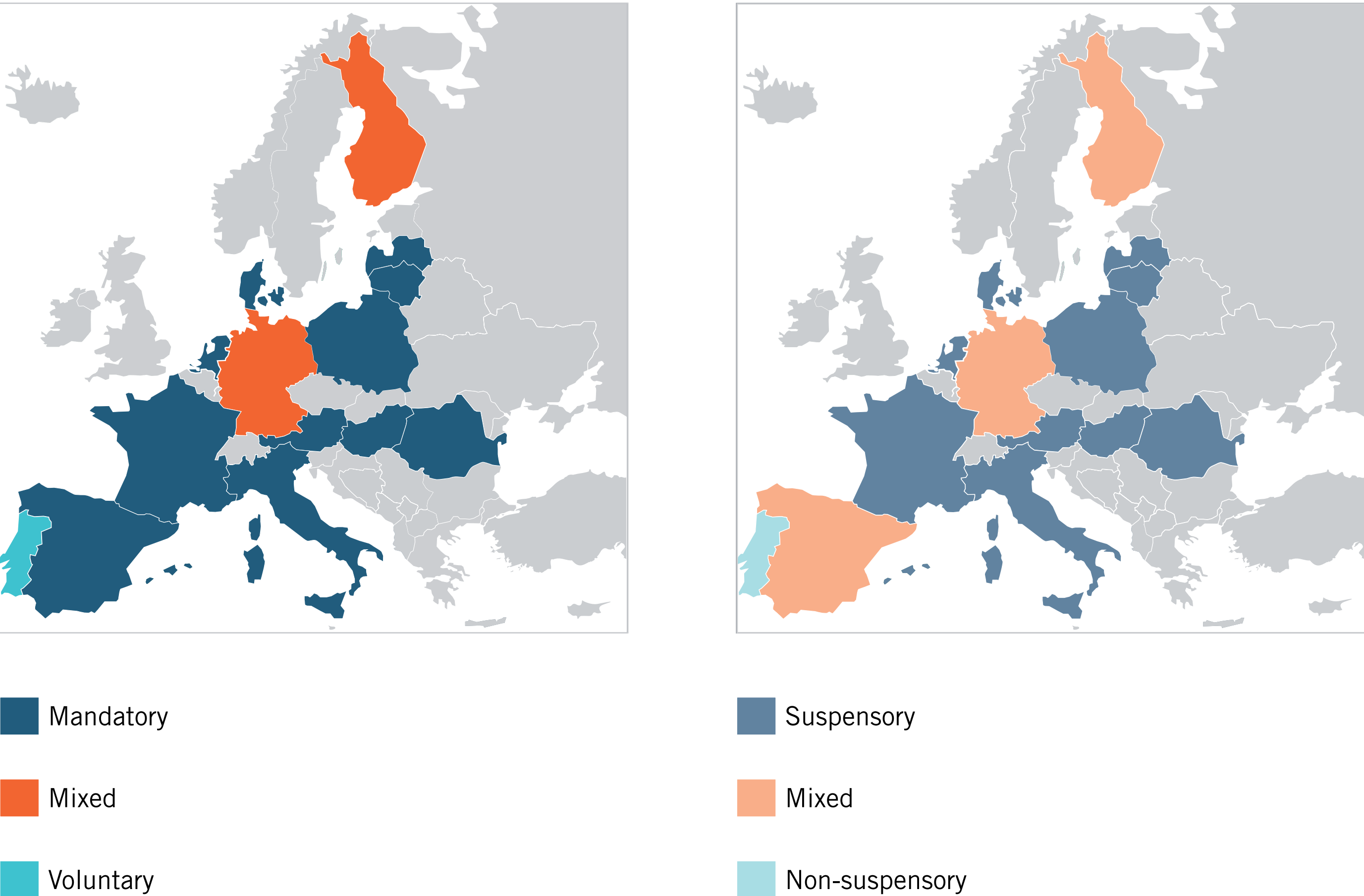


Figure 4: Statutory ex-ante screening timetables (simple reviews, without extensions) in selected Member States

Moreover, that five-week period will in practice often prove insufficient, and it may be extended, in particular through the use of requests for additional information. Indeed, the information that must be provided in the first instance is very basic:

- the ownership structure of acquirer
- the deal value
- all activities of acquirer and target
- the type and source of deal funding
- the planned date of deal completion

3. Although most Member States operate investment thresholds (i.e., the level of investment which triggers screening), the definition of foreign direct investment is very broad under the EU FDI Regulation and not subject to any minimum threshold. The EC and Member States may thus require information about transactions that would not fall under a Member State's jurisdiction based on its national FDI screening mechanism. This is certainly a disconnect potentially leading to controversies.

Figure 5: Investment thresholds at Member State level (based on lowest level of investment that triggers screening)

Controlling interest or material influence

4. While Member States must take account – and in certain circumstances the "utmost account" – of the EC's opinion, it remains possible that when multiple Member States are screening a single transaction, they adopt inconsistent decisions. Companies will need to manage this in the same way as they manage the challenges that have become familiar with multi-jurisdictional merger control. Investigations may indeed lead to different outcomes despite formal and informal cooperation and exchanges among FDI (and merger control) decision makers.

5. Deal documentation will need to provide for different scenarios. This may include not only pre-closing outcomes but also where the EC or other Member States suggest a retroactive screening of a completed transaction.

Potential flashpoints between the FDI Regulation and investor protection

Individual EU Member States are under certain obligations to foreign investors under bilateral investment treaties, typically with third States. While the standards of protection may vary, treaties provide that the State must refrain from measures which are unfair, inequitable, arbitrary or discriminatory towards foreign investors. If these standards are breached, the foreign investor can bring a compensation claim against the State before an international arbitration tribunal.

While nothing prevents States from screening FDI for reasons of public health, safety or national security, States which overreach and misuse these powers may be subject to claims from foreign investors. There are several ways in which States may incur liability under these treaties as a consequence of FDI review:

- If a State applies subjective criteria, as opposed to clear, reasonable and objective criteria
- If a State gives preference to national companies, or otherwise discriminates against foreign investors, purely on the basis of their nationality and without justification
- If a State has made specific promises to an investor with respect to the cooperation of the State in prioritizing and permitting a particular investment

It is important for both Member States and investors to be transparent with regard to any FDI review concerns.

What to expect from the new advisory role for the EC

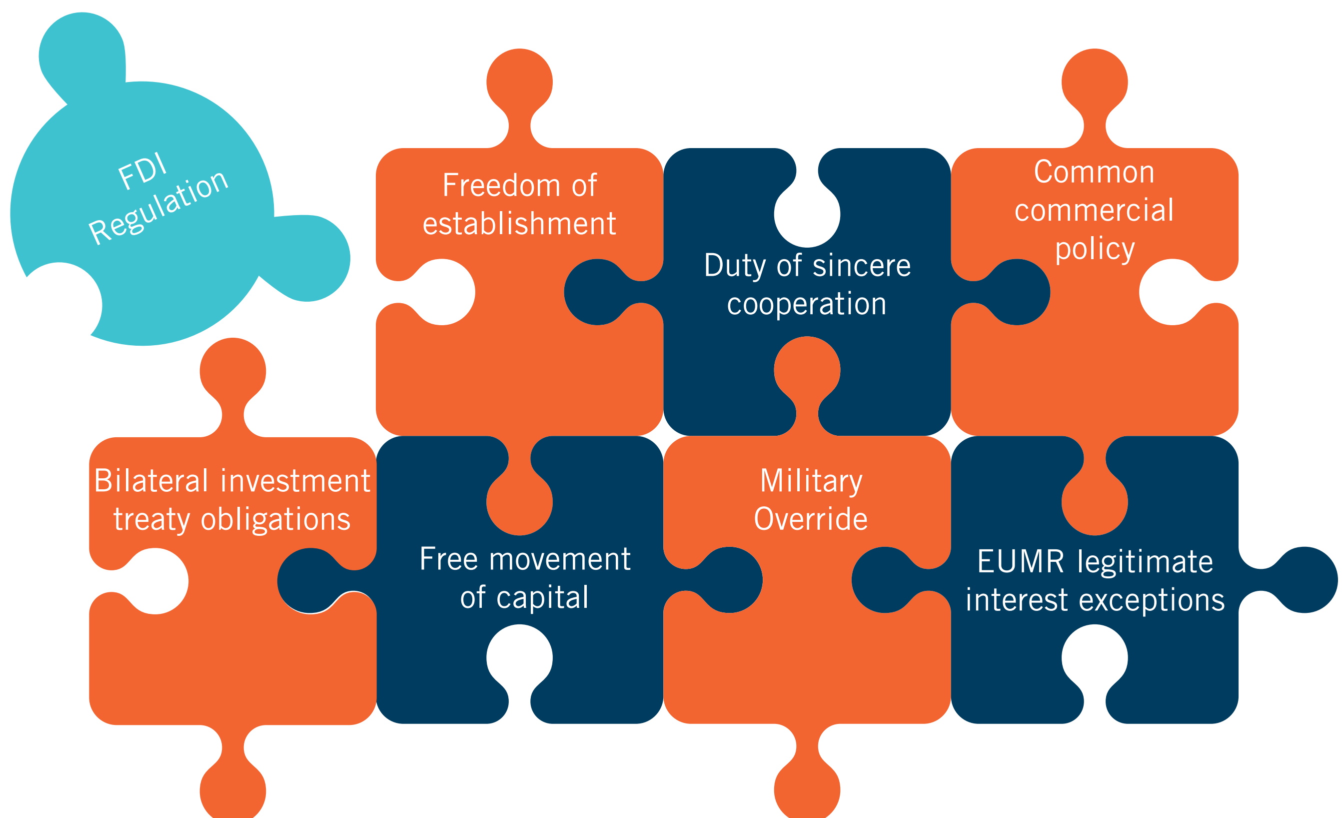
The Directorate General for Trade (DG TRADE) is in course of preparing its “Unit B2 – Investment” for the tasks ahead, building the resource and the appropriate internal procedures. While the EU FDI Regulation requires that opinions and comments are “duly justified,” it remains to be seen how detailed these will be. The Regulation itself is silent on the issue.

In its decision-making the EC will have to be mindful that the EU FDI Regulation is part of a much broader jigsaw puzzle where the pieces include the EU Treaties as well as regulations/directives adopted in pursuit of the different Treaty goals. The multiple pieces of this puzzle will need to fit seamlessly, but controversies seem inevitable as the EU FDI Regulation inserts itself into an EU law ecosystem where there is a pre-existing equilibrium between other rules of law, governed by their own hierarchy of legal norms and precedents.

In addition, non-EU investments which fall outside of the FDI Regulation, such as portfolio investments, might still be halted by the Member States on the basis of the Treaty provisions in relation to the free movement of capital. The EC March Communication explicitly highlights the possibility of restricting capital movements for reasons of public policy or security which are enshrined in Article 65 Treaty on the Functioning of the EU (TFEU).

The EC’s advisory role may become disproportionately influential over time, particularly in those areas where Member States have to take the “utmost account” of its opinion. The EC March Communication may signpost the way towards a more centralized system of EU-level FDI review.

Figure 6: The jigsaw puzzle of EU law applying to investments



How should companies engage with the EC and other Member States?

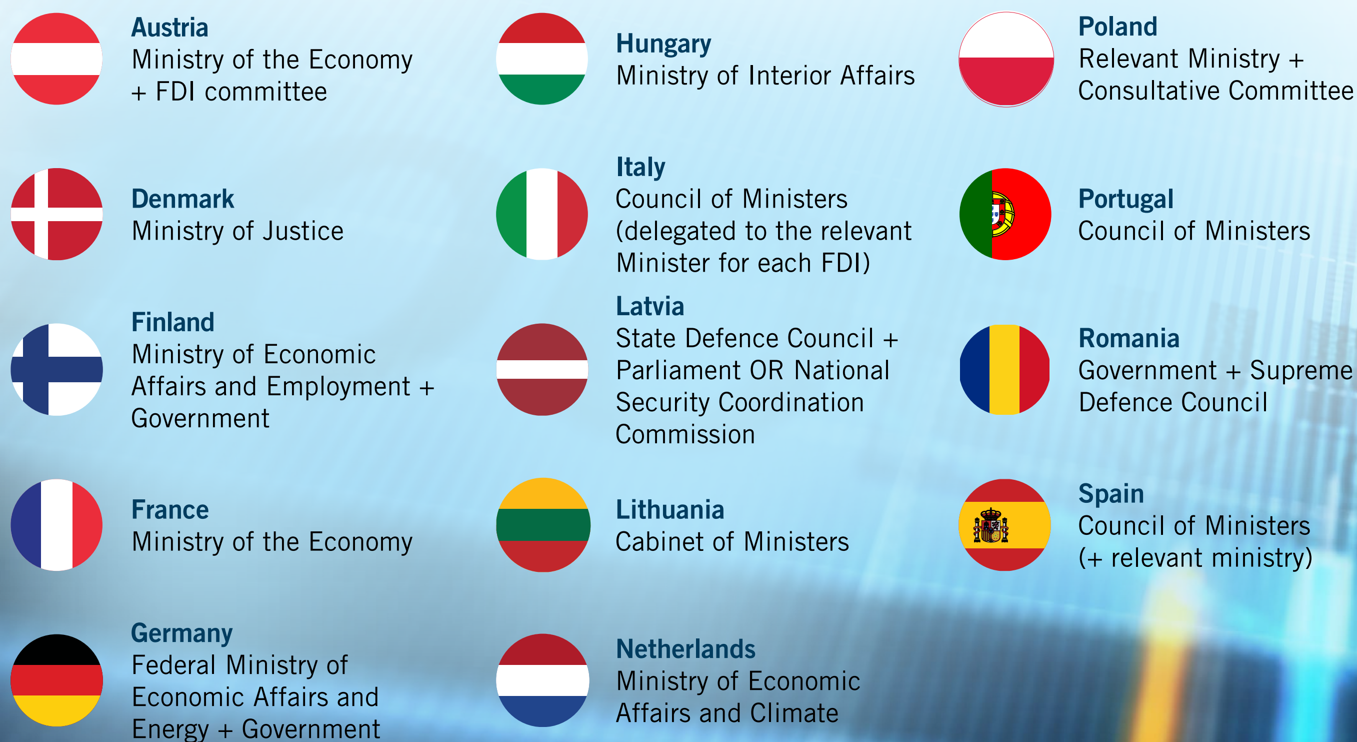
The Member States — rather than businesses — are the immediate interlocutors in the EC's FDI examination. The FDI Regulation does not foresee any formal role for the acquirer or the target in this process.

Since Member States screening the foreign investment are required to take the EC's advisory opinion into account, we expect that these opinions — or at a minimum, a summary of the reasoning and outcome — will at some stage be discussed with and/or disclosed to the parties by the screening Member State. The EU FDI Regulation does not explicitly or implicitly prohibit such disclosure. Classified information could be redacted as necessary.

Although the EU FDI Regulation does not create any standing for companies, we expect that the DG TRADE team might be open to informal contacts. In addition, since the EC's opinion will ultimately be adopted by the full College of Commissioners, other DGs and cabinets will be involved in the preparatory work. Such officials may be open to learning about the transaction, and it will be important to identify those with a likely interest. This will be a function, for example, of the industrial sector(s) and countries involved.

Finally, other Member States will have an opportunity to comment on particular transactions. Each Member State will have its own government departments and/or agencies responsible for such advisory comments. Similar to the EC process, it will be important to identify and discuss with relevant officials, even in the absence of formal procedural rights.

Figure 7: Relevant screening agency per Member State



Protectionism to the fore during – and after – the pandemic

Although the EU FDI Regulation will only enter into full force in October, the EC is already active in relation to national FDI screenings, with the backing of Member States, to defend strategic European companies from opportunistic non-EU takeovers amid the economic turmoil of the pandemic.

The EC has encouraged Member States to vigorously apply their national screening mechanisms. Countries without a screening mechanism should put one in place as soon as possible, and/or use any other means to block unwelcome foreign investment. For example, the EC March Communication envisages governments taking special rights ("golden shares") in critical companies facing financial difficulties. While the focus of the Communication is the pharmaceutical sector, the EC's guidance is not limited to this industry and also extends to e.g., finance, and more generally to companies that might be acquired cheaply at this time.

Several Member States are also strengthening their existing FDI laws, either permanently in response to the EU FDI Regulation (e.g., Germany), or more temporarily in response to the COVID-19 crisis (e.g., Spain), or both (e.g., Italy). In some cases the increased scrutiny also applies to intra-European investments, for example, in both Italy and Spain. Some new measures go beyond FDI screening: France is making additional funds available to assist listed companies in which it holds a stake to fend off foreign takeovers.

Any forthcoming cross-border EU investment in "critical sectors" will need to navigate strict scrutiny under relevant national screening mechanisms. This applies to investments from all countries: while the FDI Regulation refers to cooperation with "*like-minded third countries*" and implicitly targeted acquisitions from an (unspoken) set of third countries, investments of any origin may now be subject to screening. For example, France has recently opposed a U.S. buyer intending to acquire a French supplier of military equipment, in order to protect France's technological sovereignty.

CFIUS and expanded U.S. jurisdiction over U.S. FDI

In January 2020 CFIUS finalized two sets of regulations to implement the Foreign Investment Risk Review Modernization Act of 2018 (FIRRMA). The rules, which became effective in February, conclude a multi-year effort to expand CFIUS' jurisdiction and provide clarity regarding the process whereby CFIUS reviews foreign investments in the U.S.

CFIUS now has jurisdiction over:

- Mergers, acquisitions and takeovers that could result in a non-U.S. person acquiring control over a U.S. business
- Certain non-controlling investments by non-U.S. persons in U.S. businesses associated with critical technology, critical infrastructure and sensitive personal data
  - Note: certain mandatory filing requirements are in place for transactions involving certain U.S. businesses dealing in critical technologies or non-U.S. persons affiliated with non-U.S. governments
- Transactions involving the purchase or lease by, or concession to, a non-U.S. person of certain U.S. real estate that might raise national security concerns

The new regulations include a number of exceptions that could result in an otherwise-covered transaction being considered outside of CFIUS' jurisdiction, including investments by certain U.S. private equity funds that have non-U.S. limited partners.

The new regulations also, for the first time, set forth "Excepted Foreign Countries," which currently include Australia, Canada and the UK. Certain investors from Excepted Foreign Countries may receive preferential treatment, including exemption from CFIUS review in certain circumstances. The criteria for qualification as an Excepted Foreign Country include, among other things, the establishment of a robust foreign investment review process and coordination with the U.S on matters of investment security. This reflects a provision in FIRRMA that calls on the U.S. president to "conduct a more robust international outreach effort to urge and help allies and partners of the U.S. to establish processes that are similar to [CFIUS] to screen foreign investments for national security risks and to facilitate coordination." The new "white list" provides the U.S. government with an important diplomatic tool and an opportunity to push for the creation of CFIUS-equivalent mechanisms among allies and for coordination among such bodies going forward. Cross-border investors should consider future opportunities with such multilateral coordination in mind.

Our recent coverage of developments regarding FIRRMA and CFIUS is available **here**.

How Dechert can help

Your Dechert team will return to each of these topics and develop them further, together with comment on wider developments as FDI controls continue to proliferate internationally. And we are available to assist with your planning of deals likely to encounter the new reality of multiple FDI screenings.

Sign up **here** for Dechert foreign investment alerts to prepare for EU FDI and to stay informed about developments elsewhere.

ALEC BURNSIDE
Partner

Brussels | London
T: +32 2 535 54 33
alec.burnside@dechert.com

CLEMENS GRAF YORK VON WARTENBURG
Partner

Brussels | Frankfurt
T: +32 2 535 5411
clemens.york@dechert.com

SOPHIE PELÉ
National Partner

Paris
T: +33 1 57 57 80 98
sophie.pele@dechert.com

JEREMY B. ZUCKER
Partner

Washington, D.C.
T: +1 202 261 3322
jeremy.zucker@dechert.com

DÁNIEL DÓZSA
Counsel

London
T: +44 20 7184 7482
mdaniel.dosza@dechert.com

MARJOLEIN DE BACKER
Associate

Brussels
T: +32 2 535 5414
marjolein.debacker@dechert.com

MICHAEL I. OKKONEN
Associate

Brussels
T: +32 2 535 5416
michael.okkonen@dechert.com

DELPHINE STROHL
Associate

Brussels | Paris
T: +32 2 535 54 45
delphine.strohl@dechert.com