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Reform of the EU Foreign Direct Investment Screening Regulation – How might Transactions be impacted?

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INTRODUCTION

On 24 January 2024, the European Commission ("Commission") unveiled its proposals to reform the current EU Foreign Direct Investment Screening Regulation 2019/452 ("FDI Screening Regulation"). This forms part of a wider package of five initiatives to strengthen economic security in the EU following the "growing geopolitical tensions and profound technological shifts".[1]

Factors such as the desire to protect critical industries and infrastructure, cybersecurity threats and other geopolitical concerns have resulted in the global proliferation of foreign direct investment reporting, screening, and review mechanisms, with the EU and its Member States playing an important part of this picture. In this context, recent news of reforms in Europe is not surprising, but likely to have a significant impact on M&A transactions in sensitive sectors. Indeed, if authorities continue their recent pattern of willingness to make use of FDI regimes to review and potentially block or impose conditions on cross-border deals, those involved in global M&A deals should take note.

FDI screening is now a major element in the planning of M&A transactions that involve target companies with operations within the EU that are active in the relevant sectors. This comes on top of the existing merger control regimes at EU and Member State level, and the newly enacted Foreign Subsidies Regulation (which requires certain transactions and public procurements to be notified with the Commission). Investors must therefore navigate through a web of increasingly complex regulatory regimes when making investments in the EU.

The proposed reform of the FDI Screening Regulation ("Proposed Reform") comes in response to the Commission's consultation on the Regulation's effectiveness and efficiency, which followed the OECD's report on the Framework for Screening Foreign Direct Investment in the EU from 2022. The latter addressed key shortcomings in the national FDI regimes, including in relation to:

- the scope of the sectors subject to FDI screening;
- the types of information to be gathered on transactions;
- divergent timelines across the Member States; and
- the need for a higher degree of harmonization across the EU.

The Proposed Reform seeks to go some way to addressing these points, taking a significant step towards a more harmonized and coherent application of the various FDI regimes in place within the EU. As such, as a result of these reforms, whilst in many ways we expect the process for gaining FDI clearance to be more predictable and streamlined, in practice, careful navigation will be required to ensure effective transaction planning.

REFORM PROPOSALS

The Proposed Reform aims to close apparent gaps which might arise by screening foreign investments only at national level, as compared to an EU-wide basis. At the same time, the Commission has reiterated its openness to foreign investments. In this vein the Commission underlines that foreign investments should be prohibited only exceptionally and where mitigating measures are not sufficient to address the risks to security or public order. The EU Member States will retain sole responsibility for their own national security and maintain the right to protect their essential security interests.

The Proposed Reform is an "evolution, not a revolution"[2] when compared to the current FDI screening Regulation. It is nevertheless envisaging significant changes in relation to both substantive and procedural aspects of FDI screening in the EU. Key points include:

- all Member States must introduce an FDI regime;
- indirect acquisitions by foreign investors must be in scope of the screening process;
- investments in certain sectors must be screened as a minimum sectoral; and
- the applicable timelines and co-operation procedure will be streamlined.

The revised Regulation is not expected to enter into force before 2026. Between now and then, it will work its way through the legislative process in the European Parliament and the Council, which is expected to start towards the end of 2024. After its eventual entry into force, the new regime will apply in full after a transitionary period of 15 months.

ALL MEMBER STATES MUST INTRODUCE AN FDI REGIME

The Reform introduces an obligation for all EU Member States to implement an FDI screening regime. To date, 22 out of 27 EU Member States have adopted an FDI screening regime, while other Member States are in the process of adopting such regimes or have initiated steps to do so. When the original FDI Screening Regulation started to apply 2020, only 13 Member States out of 27 had an FDI regime in place. However, given the geopolitical tensions in recent years, the outbreak of Covid-19 and the war in the Ukraine, many EU Member States followed the Commission's guidance of 2020 and 2022 respectively, to introduce and/or update their national FDI screening mechanisms.

We expect that all EU Member States will have an FDI screening regime in place once the Proposed Reform enters into force. Nevertheless, the Commission is evidently minded to use the opportunity of these reforms to close any outstanding loopholes. It is trying to put an end to the practice of foreign investors making significant investments into Europe via a Member State with no screening mechanism in place (see Commission's Staff Working Document (2024) 23 final on the evaluation of the FDI Screening Regulation, section 3.2).

INDIRECT ACQUISITIONS BY FOREIGN INVESTORS ARE CAUGHT

A major change contemplated in the Proposed Reform is that the ***indirect*** acquisition of control over an EU target company by a foreign investor will also be subject to the FDI Screening Regulation. This change is in line with many FDI regimes at national level that already cover indirect acquisitions by foreign investors.

Under the current FDI Screening Regulation however, only the ***direct*** acquisition of control over an EU target company by a foreign investor comes within the purview of the FDI Screening Regulation, but not indirect acquisitions. What this means in practice could be recently observed when the European Court of Justice, in its *Xella* decision of 13 July 2023 (case C-106/22), decided that the FDI Screening Regulation, in its current form, does not apply to direct acquirers already registered in the EU and that have economic operations in the EU, even if such acquirers are ultimately controlled by foreign entities (see more on this case below).[3]

The Commission has yet to define the concept of control over an EU target in the context of an FDI review. In the Proposed Reform it has continued to leave open the precise definition and whether or not it will follow the concept of control regularly applied under the EU Merger Regulation. It is hoped that as the Proposed Reform passes through the legislative procedure, we will gain more clarity on this concept. However, the Commission has already said that the FDI Screening Regulation should not cover purely:

- financial investments that are not aimed at influencing the management and controlling the relevant target company (portfolio investments); or
- internal restructurings, provided that there is:
  - no increase in the shares held by foreign investors, or
  - no additional rights are conferred to the investor that may lead to a *de facto* participation in the management or control of the target company.

MANDATORY SECTORIAL SCREENING

The current FDI Screening Regulation does not require Member States to screen investments in particular sectors. It merely stipulates that they may consider the potential effects of an investment on, *inter alia*, critical infrastructure (including energy, transport, water, health, communication, media, data, etc.); critical technologies and certain dual use items; the supply of critical inputs (including energy or raw materials) and food security; and access to sensitive information, etc. In this context, the Commission has identified that under the current national FDI regimes there are significant differences between the sectors and activities of investors screened by the Member States. It is concerned that this might be taken advantage of as a loophole for entry by foreign investors into the EU. It therefore proposes that a minimum core of sectors become subject to ***mandatory*** FDI review. These include investments where a target company is part of, or participates in, projects or programs of Union interest, such as for example, the Space Program, Trans European Networks, European Defense Fund, etc., as set out exhaustively in Annex I of the Proposed Reform ("Annex I EU Programs").

In addition, investments where the target is active in critical technologies and other sectors of particular importance for the security or public order of the EU listed in Annex II of the Proposed Reform are also subject to mandatory FDI screening by the Member States. These include dual-use items, military technology and equipment and artificial intelligence amongst others and are all together known as "Annex II sectors".[4]

The Proposed Reform does not include any specific definitions or thresholds that would apply to some of these sectors (particularly related to technology), but which apply in certain EU Member States. Therefore, it is likely that going forward more investments will come within the purview of FDI screening than is currently the case.

In addition to the Annex II Sectors, the Member States are free to extend the list of sectors subject to their national FDI screening if they are of particular importance for their specific national security or public order. However, the screening of transactions that fall within the scope of Annex I EU Programs and certain investments into Annex II Sectors must be notified to the cooperation mechanism between the Commission and the Member States (see further below).

CRITERIA FOR SUBSTANTIVE ASSESSMENT

Another major change which might be brought about by the Proposed Reform is that a requirement on Member States to uniformly apply the test for what could constitute a risk of "public order and security". This is key to the substantive assessment of a foreign transaction under the FDI regime. More precisely, under the FDI Screening Regulation, EU Member States are required to assess whether an FDI is "likely to affect" security or public order. This leaves the door open to varying interpretations and has led to Member States applying different standards. As a result, the screening of investments might be considered as somewhat arbitrary across the EU.

Under the Proposed Reform, the substantive test will be narrower and require that national screening authorities determine whether there is a "likely negative impact on security and public order". To this end, they must consider in particular, aspects such as, for example:

- the security, integrity and functioning of critical infrastructure;
- resilience of the critical, essential and important entities as defined by the relevant European legislation;
- availability of critical technologies;
- continuity of supply of critical inputs; or
- the disruption, failure, loss or destruction of assets which would have a significant impact on the security or public order in one or more Member States or the Union as a whole.

Screening authorities must also take into account information related to the foreign investor such as, for example, past investments that were not authorized or authorized only with conditions, engagement in illegal or criminal activities, pursuing policy objectives of a third country, or engaging in the development of a third country's military capabilities. A more uniform application of the substantive test across the EU is a much welcome change.

The lack of a common standard in assessing the risk for public order or security could be seen in *Xella*, a rare decision handed down in 2023 on the interpretation of the FDI Screening Regulation. In this case, the national authority undertaking the FDI screening prohibited the envisaged acquisition on the ground that the supply to the construction sector, in particular at the local level, with respect to ***basic*** raw materials such as gravel, sand and clay would be at risk. The European Court of Justice disagreed however, and could not find any justification that the envisaged acquisition was capable of giving rise to a "genuine and sufficiently serious threat to a fundamental interest of society". First, the investor Xella already purchased approx. 90% of the raw materials from the target company in the past (while the remaining 10% were purchased by other local companies). Second, the raw materials have "by their very nature, a relatively low market value compared […] with their transport cost", meaning that the risk that those materials would no longer be available locally was non-existent.

MORE STREAMLINED COOPERATION

The Proposed Reform introduces additional important procedural changes that impact transaction planning. All Member States must introduce a standstill obligation for the duration of FDI screening. This means that a transaction must not be closed without prior clearance of a mandatory FDI filing. Currently, not all EU Member States apply such a standstill obligation. In addition, transactions that have been completed but not notified can be called in up to 15 months after their completion if the relevant authority has grounds to consider that the security or public order may be affected.

The already very elaborate cooperation mechanism in place between the Commission and the Member States under the FDI Screening Regulation will likely therefore be more effective and efficient under the Proposed Reform. Member States must notify other Member States and the Commission of proposed investments in sectors involving Annex I EU Programs, and any of the Annex II Sectors subject to a mandatory FDI screening where the foreign investor is controlled by a foreign government (or subject to restrictive measures under European Union laws). These will be important changes in practice. We expect that fewer cases will be notified to the cooperation mechanism, thus giving the Commission the opportunity to focus on the key cases that may impact the Member States' and Union's public order or security.

Also relevant for the deal team is that transactions which are subject to simultaneous reviews in more than one Member State ("multi-country transactions") must be filed with the relevant authorities at the same time. This will enable the cooperation mechanism between the Commission and the Member States to be triggered at the same time so as to align deadlines and procedures. Member States undertaking a screening of Annex I EU Programs or Annex II Sectors, or in cases where they consider that the transaction could be of interest to other Member States or the Commission from a security or public order perspective, will have to inform the Commission and other Member States within 15 calendar days of the relevant filing being made. Where an in-depth investigation has been initiated, such information must take place within 60 calendar days after having received the filing for screening. Member States may provide "duly motivated comments" and the Commission a "duly motivated opinion" to the Member State undertaking the screening. The latter shall give "utmost consideration" to these.

KEY TAKE-AWAYS

The Proposed Reform is a welcome step towards a more common and coordinated approach towards FDI screening at EU level. This is especially timely given the environment where parties to M&A transactions have to navigate an ever more complex regulatory web. The Proposed Reform is expected to provide more legal certainty for potential investors in critical infrastructure and other sectors of high relevance for the EU Member States and the EU as a whole, and allows for a more uniform substantive assessment of the "likely negative effects" on security or public order. Questions however remain, with clarity over key concepts such as control still outstanding.

Businesses are encouraged to pay close attention to the Proposed Reform as it moves through the EU legislative process, with chances to monitor the development of the rules in this area, and prepare accordingly. An eye should also be kept at what is going on in other jurisdictions where an FDI filing might be required. Reforms are afoot around the world and a global approach is vital.

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[1] Commission, press release of 24 January 2024 "Commission proposes new initiatives to strengthen economic security", which also includes links to the five initiatives proposed by the Commission. The other initiatives focus on enhancing coordination on export controls, identifying potential risks arising out of outbound investments, supporting research and development in respect of technologies with dual-use potential, and enhancing research security across the EU.

[2] Damien Levie, Head of Unit Technology & Security, FDI Screening" at Commission's DG TRADE, on 30 January 2024 at an event in Brussels.

[3] Exceptions apply where transactions are part of a scheme to circumvent the application of the Regulation, that is, if a direct EU acquirer (a subsidiary) has merely been set up by a foreign investor for the purpose of acquiring a European target company.

[4] Also includes advanced semiconductors; quantum technologies; biotechnologies; advanced connectivity, navigation and digital technologies; advanced sensing technologies; space & propulsion technologies; energy technologies; robotics and autonomous systems; advanced materials, manufacturing and recycling technologies; certain critical medicines; and payment systems and institutions (altogether "Annex II Sectors").

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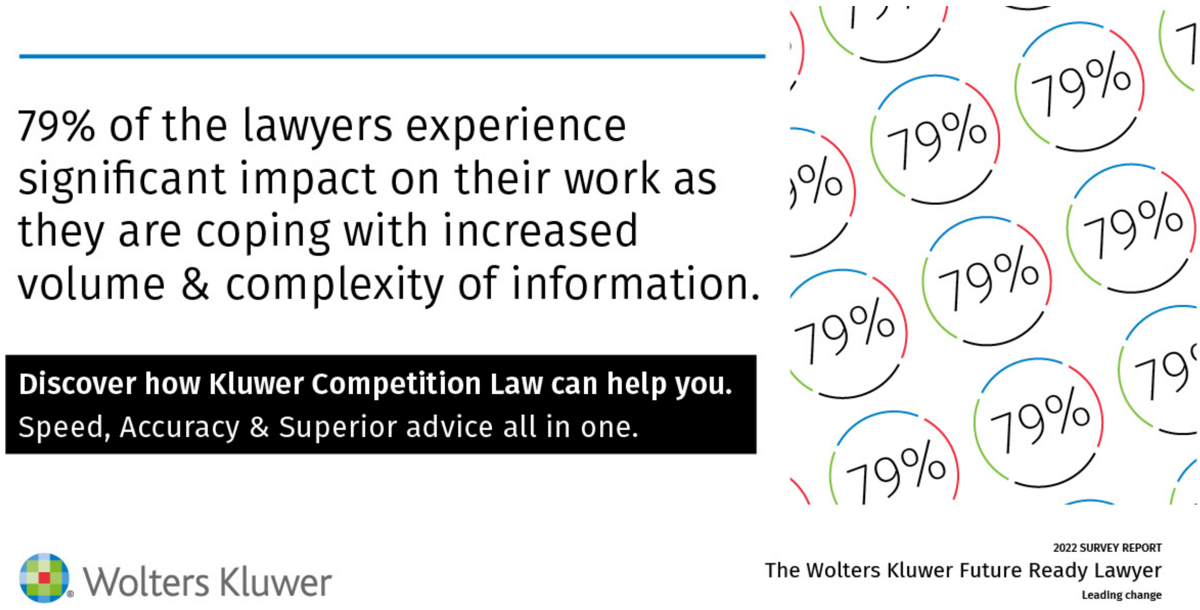

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