EUROPE: FOREIGN DIRECT INVESTMENT UNDER SCRUTINY

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Responding to recent calls from France, Germany and other Member States for stricter controls on foreign takeovers, Jean-Claude Juncker, the President of the European Commission, has proposed a new EU framework for the screening of foreign direct investment. Although the proposed Regulation comes in large part in reaction to the rise in Chinese investment into the EU in recent years, its impact might be felt more broadly. Affected companies still have time to influence the instrument before its adoption, but above all have to start preparing to navigate the new investment environment.

Authors

Jan Hueckmann, Martin Zech, John Clancy, Claire Harris

Chinese Investments Raise Concerns

The sudden increase in Chinese foreign direct investment into the EU over the past two years has alarmed political leaders in European capitals and brought the issue of Chinese takeovers to the fore.

Chinese direct investment in the EU increased by 77% to EUR 35 billion last year. Investment in Germany alone reached EUR 11 billion in 2016 – more than the previous 10 years combined[1]. Meanwhile, European companies have scaled back their investments in China, wary of operating in what the EU Chamber of Commerce in China regularly describes as an increasingly difficult business environment. The resulting imbalance in FDI flows, with Chinese investment into the EU now four times as high as those from Europe to China, has bolstered demands for greater reciprocity, and for stricter controls over Chinese investment in the EU in sectors that remain closed to foreign companies in China.

The nature of some of the deals that took place in 2016 has also raised fears in Europe that much of the Chinese investment is linked to industrial policies promoted by Beijing aiming to move the country up the value chain and compete with European companies for global market share. A large number of political leaders in Europe are worried that many takeovers, including Midea's acquisition of German robotics firm Kuka, seem to fit into Beijing's *Made in China 2025* strategy, which is designed to increase the share of core components that are made in China in ten specific industries[2].

[1] https://www.merics.org/en/merics-analysis/papers-on-china/cofdi/cofdi2017/#c17640
[2] http://news.xinhuanet.com/english/2015-05/19/c_134252230.htm

> *We are open but not dumb.*
>
> Commissioner Günther H. Oettinger, reacting to the Kuka takeover

Doubts over the role of the Chinese government or state-owned enterprises regarding the takeovers of European firms have also raised national security concerns. For example, a bid by Chinese investors to acquire Aixtron, a German semiconductor equipment maker, failed in 2016 after the Obama administration stepped in on the grounds that the firm is a key supplier of technologies with potential military applications.

Ironically, the time it has taken for European political leaders to react has created a situation in which the new screening framework is being introduced at the very moment regulators in China are cracking down on outbound investment. Late last year, Beijing started introducing measures to curb “unreasonable” capital outflows to avoid a fall in foreign exchange reserves and consequent pressure on the renminbi. In the first half of 2017, China’s outbound investment fell by 46% as a result[3]. However, while the fall is mainly concentrated in industries such as hospitality and entertainment, acquisitions in more strategic sectors have been more resilient.

Conflicting Views in Europe

Within Europe, French President Emmanuel Macron has argued forcefully in favour of greater investment controls. At his first European Council on 22-23 June, Macron had called for a European mechanism to vet and potentially block unwanted takeovers from non-European companies, especially China. Macron’s first summit seemed to have had limited success, however: the final European Council conclusions only spoke of “analys[ing] investments from third countries in strategic sectors, while fully respecting Members States' competences”, not of a potential blocking of investments.[4]

This was due to heavy resistance from Nordic, Benelux and Baltic Member States, supported by Greece, Ireland and Spain. Portugal and the Czech Republic, both of which have received significant investment from China, were also said to be sceptical.

Nevertheless, France’s push has been backed by Italy and Germany, with the three countries sending a letter to the European Commission in February 2017 asking it to address state-led investments by third country investors in key technology companies.

Some Member States have also taken the matter into their own hands. Germany, for instance, has already presented an amendment to its existing foreign investment control framework (*Außenwirtschaftsverordnung*), which came into force in July 2017. The reform requires non-EU investors to notify the German government of investments in security-related technologies and critical infrastructure. The updated law also gives the federal economics ministry extended review periods and the possibility to review an investment outside the industries explicitly identified.

A total of 12 Member States now have their own screening processes. It was therefore important for the European Commission to act quickly in order to ensure a common EU approach, thus preventing individual national initiatives from creating diverging frameworks across the continent.

The Proposal: Member States Remain in Charge

The proposed Regulation[5], which still needs to receive approval from Member States and the European Parliament, establishes a framework for the screening of foreign direct investment on the grounds of security or public order, providing legal certainty to the Member States that maintain a screening mechanism, or wish to create one. Member States that do not have such a mechanism in place will not be forced to set one up.

> *Let me say once and for all:*
> *We are not naïve free traders.*
>
> Jean-Claude Juncker, State of the Union speech

[3] http://www.scmp.com/business/global-economy/article/2102700/chinas-outbound-investment-slumps-46pc-first-half-amid

[4] http://www.consilium.europa.eu/en/press/press-releases/2017/06/23-euco-conclusions/

[5] https://ec.europa.eu/transparency/regdoc/rep/1/2017/EN/COM-2017-487-F1-EN-MAIN-PART-1.PDF

Specifically, the Regulation would clarify the ability of national governments to block investments in “critical infrastructure”, “critical technologies”, “the security of supply of critical inputs” and “access to sensitive information of the ability to control sensitive information”. In deciding whether an investment is likely to impact security or public order, “Member States and the Commission may take into account whether the foreign investor is controlled by the government of a third country, including through significant funding.”

The proposal also establishes a cooperation mechanism to help the exchange of information among Member States and with the European Commission. It requires Member States to inform each other and the European Commission about any screening of foreign investment, and allows governments to request relevant information from foreign investors on a case-by-case basis. The proposal also aims to ensure that screening mechanisms meet a defined set of criteria such as non-discrimination between different third countries, transparency and the ability to challenge decisions in courts.

Interestingly, the proposed Regulation introduces the possibility for the European Commission to screen takeovers “of Union interest”, such as acquisitions of projects or programmes that have received significant EU funding. However, although the Commission would be able to make recommendations to national governments, the final decision would remain in the hands of the Member States in which the investments take place – the Commission’s role thus remains non-binding.

Finally, the proposed Regulation includes an “anti-circumvention” clause that will allow the screening of intra-EU takeovers if it is clear that they are the result of a foreign investor trying to circumvent screening processes through “artificial arrangements within the EU that do not reflect economic reality”.

Conclusions

Negotiations will now take place in Brussels over the proposal – they are likely to go on for more than a year and their outcome is hard to predict. Back in 2012 the then EU trade Commissioner teamed up with Michel Barnier in his previous role as the EU’s internal market Commissioner to push for a “reciprocity instrument” in public procurement. The proposals - then and now - are very different but the true target remains the same: China.

The 2012 proposal aimed to level the playing field between the EU and China’s procurement markets but it was quickly shot down by northern pro-trade EU Member States. The current proposal is already facing similar fault lines. The same bloc of EU member states are already vocal in their opposition with Finland even warning of a trade war.

And yet, regardless of the final version of the adopted Regulation, there is a clear trend towards more investment protection in certain European countries, and especially among its largest economies: Germany, France and Italy. Although the Commission’s intention with this proposal is to harmonize investment screening frameworks across the EU, there is a risk that its initiative might on the contrary lead to greater fragmentation by allowing the Member States that want to further restrict foreign investments to do so. Across the EU’s key markets, scrutiny over foreign direct investments is likely to increase significantly.

Jan Hueckmann
+32 (0)2 289 0425
Jan.Hueckmann@fticonsulting.com

Martin Zech
+32 (0)2 289 0423
Martin.Zech@fticonsulting.com

Claire Harris
+32 (0)2 289 0944
Claire.Harris@fticonsulting.com

John Clancy
+32 498953773
John .Clancy@fticonsulting.com

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