Some Critical Observations on the EU’s Foreign Investment Screening Proposal

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The EU Foreign Investment Screening Proposal

Last September, European Commission President Juncker presented a proposal for a European foreign investment screening regulation – apparently following a request by Germany, France and Italy.

The proposal follows-up on the Commission’s “Reflection Paper on Harnessing Globalisation”, published in May 2017. The Reflection Paper notes, *inter alia*, that

> *“Openness to foreign investment remains a key principle for the EU and a major source of growth. However, concerns have recently been voiced about foreign investors, notably state-owned enterprises, taking over European companies with key technologies for strategic reasons. EU investors often do not enjoy the same rights to invest in the country from which the investment originates. These concerns need careful analysis and appropriate action.”*

In other words, this proposal aims at providing a tool for the Commission and the Member States to respond to planned foreign investments of, for example, Chinse state-owned enterprises in sectors, which are considered sensitive and critical.

Screening mechanisms are not a novel tool but are used by about half of the EU Member States, i.e. Austria, Denmark, Germany, Finland, France, Latvia, Lithuania, Italy, Poland, Portugal, Spain, and the United Kingdom, as well as many states outside the EU, most notably the American CFIUS mechanism.

Accordingly, the main argument for this European screening mechanism for foreign investments is "harmonization", by providing first and foremost legal certainty for Member States that maintain a screening mechanism or wish to adopt one. Thus, this Regulation would empower Member States to maintain their mechanisms or to create new ones in line with this Regulation.

Second, the Regulation aims at creating a "cooperation mechanism" between the Member States and the European Commission in order to inform each other about foreign direct investments that may threaten the "security" or "public order". This cooperation mechanism enables other Member States and the Commission to raise concerns against envisaged investments and requires the Member State concerned to take these concerns duly into account. In other words, this "cooperation mechanism" is an "intervention mechanism" in disguise by giving the Member States and the Commission a tool to review and intervene against planned foreign investments in other Member States.

Third, the proposal also enables the Commission itself to screen foreign investments on grounds of security and public order in case they "may affect projects or programmes of Union interest".

In short, Member States and the Commission will effectively be enabled to review any screening of any foreign investments and to intervene if they think that their interests may be affected.

However, the question arises whether this proposal will be an effective tool to review and ultimately prevent investments in sensitive sectors by foreign investors such as for example Chinese state-owned enterprises?

If one looks at the description of the screening grounds ("security" or "public order"), it immediately becomes clear that this proposal essentially can cover any foreign investment.
Article 4 titled *Factors that may be taken into consideration in the screening of the proposal* states:

In screening a foreign direct investment on the grounds of security or public order, Member States and the Commission may consider the potential effects on, inter alia:
– critical infrastructure, including energy, transport, communications, data storage, space or financial infrastructure, as well as sensitive facilities;
– critical technologies, including artificial intelligence, robotics, semiconductors, technologies with potential dual use applications, cybersecurity, space or nuclear technology;
– the security of supply of critical inputs; or
– access to sensitive information or the ability to control sensitive information.

In determining whether a foreign direct investment is likely to affect 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 first point to note is the fact that this list is only an indicative list of potential effects of planned foreign investments. This means that the Member States and the European Commission can also take other potential effects into account. Nonetheless, this indicative list illustrates the sectors which the Commission considers particularly sensitive such as energy, communications, IT and cybersecurity.

The second noteworthy point is the cooperation framework between the Member States and the Commission. This cooperation framework requires the Member States to inform each other and the Commission of planned foreign investments and allows them to review and comment on them. The Commission is able to issue its comments in the form of non-binding opinions, while the affected Member State is required to take such comments duly into account.

Consequently, in order to be effective, this Regulation essentially will require all Member States – in particular those which have not yet a screening mechanism in place – to create one, otherwise these Member States and the Commission will not be able to share the required information about planned new foreign investments and the review them.

As a result, if this proposal is approved, the screening of foreign investments will become a standard practice in all Member States.

However, the proposal fails to specify what happens if an affected Member State fails to take any concerns of other Member States and/or the Commission into account. This seems an important missing element since the views among the Member States as to whether or not a certain foreign investment by – for example a Chinese state-owned enterprise – may have dangerous effects could very well differ. Also, some Member States may value the creation of jobs as more important than a potential negative impact on for example cybersecurity.

Also, the proposal does not specify who will be financially responsible if planned foreign investments fail to materialize due to the market distorting interventions by other Member States and/or the Commission.

Moreover, if seen in the context of the EU's investment policy and FTAs, which it has already negotiated (CETA, EU-Singapore FTA, EU-Vietnam FTA) or is currently negotiating (EU-Japan FTA), the proposal raises the question to what extent this is conducive to the proclaimed aim of more openness to foreign investors and their investments. Indeed, the application of such a screening mechanism could lead to discriminatory treatment of foreign investors and hence to investment arbitration cases as result of breaches of the FTA provisions.

The same risk exists for the 1,500 bilateral investment treaties (BITs), which the Member States currently have signed with third states. After all, the aim of these investment treaties is to promote and protect foreign investments from discriminatory or unfair treatment, which could arise if the screening mechanism is applied in certain way. Interestingly, the explanatory memorandum to the proposal does not discuss this issue, neither was the EU proposal accompanied by any impact assessment.

Thus, some important issues have not been addressed and it remains to be seen whether this proposal will gain sufficient support by all Member States, and if so, to what extent it will be modified by the Council.

Convergence between the EU's screening proposal and CFIUS

In this context, it is important to note that the scope of application of the American Committee on Foreign Investment in the United States (CFIUS system) is currently more restrictive than the proposed EU screening mechanism.

First, the CFIUS system is a "voluntary" system, which means foreign investors are not required to submit their planned investments for review but can voluntarily decide to do so if they think the planned investment may fall within the jurisdiction of the CFIUS.

Second, the current scope of review of the CFIUS is limited to "mergers, acquisitions, or takeovers" of US businesses, although the CFIUS jurisdiction may extend to international transactions, which involve one or more US subsidiaries or significant US assets or operations.

Third, the current scope of the CFIUS is limited to "national security considerations".

However, in November 2017, a bipartisan group of lawmakers introduced a long-awaited Foreign Investment Risk Review Modernization Act of 2017 ("FIRRMA"), which would modernize the CFIUS review and approval process.

The proposed bill would broaden the scope of transactions subject to CFIUS review to include:

- any non-passive (even non-controlling) investment by a foreign person in any US "critical technology" or "critical infrastructure" company;
- any change in the rights that a foreign investor has with respect to a US business if that change could result in foreign control of the U.S. business or a non-passive investment in a US critical technology or critical infrastructure company;
- any contribution (other than through an ordinary customer relationship) by a US critical technology company of both intellectual property and associated support to a foreign person through any type of arrangement, such as a joint venture;
- the purchase or lease by a foreign person of real estate that is in close proximity to a US military installation or other sensitive US government facility or property; and
- any transaction or agreement designed or intended to evade or circumvent CFIUS review.

If the CFIUS review system would indeed be updated and expanded as proposed by the FIRRMA, the scope of review of the CFIUS would be rather similar to the EU's proposed screening mechanism.

In conclusion, a convergence on both sides of the Atlantic is currently taking place by expanding the available toolbox for screening planned foreign investments with the purported aim of preventing foreign – in particular Chinese – investments in sectors that are considered sensitive and critical. However, there is a risk that the screening mechanism could be abused for disguised protectionism and for gaining domestic political support.