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STRENGTHENING THE CHAIN: EUROPEAN COMMISSION PROPOSES REFORMS TO EU FOREIGN DIRECT INVESTMENT REGULATION TO ADDRESS DIVERGENCE AND BLIND SPOTS

Introduction

After months of anticipation, the European Commission ("**EC**") has now published its proposed reforms to the EU Foreign Direct Investment Regulation ("**the Regulation**").[1] These proposals, which follow a comprehensive evaluation conducted by the EC and a period of consultation, are focused on increasing the effectiveness and efficiency of the Regulation, and improving harmonisation across the national screening regimes of Member States. According to the EC, the reforms recognise that, when it comes to addressing the potential risks to security and public order associated with foreign direct investment into the EU, "*the chain is only as strong as its weakest link*".

This briefing outlines the concerns on which the EC focuses in its evaluation of the Regulation, including the absence of national screening regimes in particular Member States, the divergence between national screening regimes in relation to certain substantive and procedural requirements, and the fact that the Regulation does not extend to investments by foreign investors via an EU-based subsidiary (following the decision of the Court of Justice in *Xella*). It also considers the proposed reforms designed to address those concerns and their potential implications.

Background

In recent years, the EC has pushed for the strengthening and harmonisation of screening regimes across the EU due to concerns about certain foreign investors seeking to gain control of technologies, infrastructure or inputs that are critical to the security or public order of the EU. In 2019, the EU adopted the Regulation, offering a common template for Member States to enact their own national screening regimes in order to review foreign direct investments into their territory on the grounds of security and public order and to take action to address particular risks. The Regulation also provides for a cooperation mechanism, whereby Member States and the EC can exchange confidential information, as well as a mechanism by which the EC can recommend measures to Member States. Nonetheless, the Regulation stopped short of actively requiring Member States to institute regimes.

Since the adoption of the Regulation, there has been an increasing focus on the need for security and public order in the EU, particularly in light of significant events such as COVID-19 and the Russia/Ukraine war. This has contributed to almost all Member States deciding to adopt a national screening regime or to expand the scope of their existing regimes.

Nevertheless, there is still significant divergence in procedure across Member States, including different notification forms and informational requirements. Moreover, the information requirements under the Regulation's coordination mechanism add another form to the list of filing documents required under Member State screening regimes. Finally, the substantive approach and time taken for decisions can also differ substantially across the various national regulators.

The Evaluation Report

In 2023, the Regulation was the subject of a comprehensive evaluation by the EC, focusing on its functioning and effectiveness in the three years since its implementation.[2] This culminated in the publication of a report by the EC in late January 2024, assessing the relevance, effectiveness, efficiency, relevance and coherence of the Regulation ("**the Evaluation Report**"). The Evaluation Report follows the publication of a report on the effectiveness and efficiency of the Regulation carried out by the OECD in 2022, consultation conducted by the EC in late 2023, and the publication of a recent special report by the

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

[2] As required by Article 15 of the Regulation.

European Court of Auditors on the screening of foreign direct investment in the EU.

The Evaluation Report concludes that while the Regulation has largely been successful in protecting security and public order in the EU arising from so-called "*risky*' foreign direct investment, there are various shortcomings in the framework that could potentially undermine the ability of the EC and Member States to identify and adequately respond to transactions that would give rise to security and public order concerns.

For example, the Evaluation Report found that the success of the Regulation was impacted by the fact that not all Member States had adopted national screening regimes and by the differences in scope of existing national screening regimes. It was also critical of the fact that the Regulation's definition of foreign direct investment is too narrow (in light of the interpretation adopted in the decision of the Court of Justice in *Xella*), such that investments by non-EU investors via an entity established in the EU would not be subject to assessment, despite the fact such investments could give rise to the same security concerns as investments by non-EU investors via a non-EU entity.

The Proposed Reforms

In light of the findings in the Evaluation Report, the EC has proposed several reforms to the Regulation. The key proposals are summarised below:

- ***Requiring all Member States to adopt a national screening regime***: In response to concerns that the Regulation's effectiveness was being undermined by the absence of a national screening regime in some Member States, the EC has recommended that it be mandatory to do so - rather than voluntary, as is currently the case. If the EC's proposed reforms are enacted, Member States will have 15 months to adopt a national screening regime. This requirement is directed towards those Member States which do not have a regime, such as Croatia, Cyprus, Greece, Bulgaria, Malta and Luxembourg (though some are currently working towards adopting one).

- ***Setting minimum requirements for national screening regimes***: In order to address concerns relating to differences between the procedural and substantive operation of national screening regimes across Member States, the EC has proposed certain "*minimum requirements*" that national regimes must satisfy in order to ensure harmonisation across the EU. These include procedural requirements, such as having adequate procedures for an initial review and, if necessary, an in-depth investigation, ensuring procedural fairness and protecting confidential information, as well as substantive requirements - in particular, requiring investments into prescribed industries to be subject to an authorisation requirement. The proposed list of industries is extensive and includes dual-use items, military technology and equipment, critical technologies, critical medicines and financial infrastructure. Critical technologies are defined to include advanced semiconductors, artificial intelligence language processing, cloud computing, quantum computing, biotechnologies and virtual reality.

- ***Expanding the scope of the Regulation to capture investments from EU entities controlled by non-EU investors***: A key lacuna in the Regulation in its current form is that, in light of the decision of the Court of Justice in *Xella*, it does not extend to foreign investments made through an EU firm which is ultimately owned by a non-EU investor. This has been criticised as a "*blind spot*" for which there is no clear reason.[3] In response, the EC has proposed that the scope of the Regulation be expanded to capture investments between Member States where the investor in one Member State is controlled, directly or indirectly, by a foreign entity — regardless of whether the ultimate owner is located in the EU or elsewhere.

- ***Introducing an "own initiative" procedure***: The EC's proposals also include an "*own initiative*" procedure, whereby a Member State can open an investigation into a foreign investment in the territory of another Member State which has not been notified via the cooperation mechanism if it considers that the investment is likely to affect security or public order in the Member State. A similar procedure would be available to the EC. In either case, it would be necessary to check whether the Member State in which the investment is or will be made intends to notify via the cooperation mechanism. The implication for foreign investors is that this provides a means by which a transaction

[3] OECD Report, p 81; ECA report, p 29(b).

may be called in, even if it may not be initially notified via the cooperation mechanism.

- ***Requirements in relation to multi-jurisdictional transactions***: The EC has also proposed amendments in relation to multi-jurisdictional transactions, such as requiring such transactions to be filed in all Member States at the same time, requiring Member States to collect the same minimum level information for such transactions and imposing additional cooperation obligations on Member States. The EC has also recommended the imposition of deadlines on Member States in relation to certain milestones in the initial stages of the screening process, in order to improve the predictability of multi-jurisdictional transactions. However, the EC has not proposed any uniform obligation or deadline for Member States to issue their screening decision, such that there will remain a significant degree of unpredictability in relation to the timeline for multi-jurisdictional transactions.

Comparison with potential changes to the UK regime

The UK has developed its own new regime in parallel to the EU, under the National Security and Investment Act 2021 (**the Act**). The UK Government in turn recently issued a Call for Evidence on the Act, seeking views on the first two years of its implementation and floating possible policy changes. Interestingly, whilst the direction of travel for investment screening policy in the EU is in general towards more harmonisation, strengthening of powers and broadening of scope, the position in the UK is more mixed. On the one hand, the Call for Evidence explicitly sought to examine the ways the Act could become "*even more business friendly*", and flagged several sensible areas for review where we think the Act may be technically catching transactions where no real concerns arise. On the other hand, the Call for Evidence does show attention to capturing transactions in several key technology areas such as AI and semiconductors, much as the EC's proposals do.

Next steps

The proposed reforms to the Regulation are now subject to consideration by the European Parliament and the EU Council. It may be some time before they are enacted in light of the upcoming EU elections in June 2024. The EC has also proposed an implementation period of 15 months after the revised legislation comes into force.

The continuing change to investment screening law in Europe will be important to follow given its significance to deal processes. European screening regimes are increasingly impacting the complexity of deal execution but also, in some cases, deal certainty - and the processes and issues involved can differ from the more familiar terrain of merger control.

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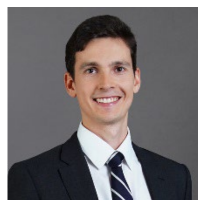

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