

Foreign investment screening: Protectionism in Corona-Times?

Why the European Commission's guidance gives cause for concern

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On 25 March 2020, the EU Commission issued guidance on the interpretation of the rules relating to the screening of foreign investments from non-EU countries and to the restrictions on the free movement of capital. The guidance comes at a time when concerns are growing that the Corona-crisis may increasingly lead to acquisitions of EU companies by foreign investors.

- ▶ Any restrictive intervention by Member States should not go beyond what is absolutely necessary to prevent serious damage to security or public order. The pandemic should not, in general, serve as an argument to restrict foreign direct and portfolio investments from third countries.
- ▶ The EU's high dependency on medical products and equipment delivered by third countries does not necessarily make capital restrictions an appropriate policy. The issue can be addressed in other ways.
- ▶ The vagueness of the FDI screening rules gives Member States too much leeway in determining the acceptability of an FDI and increases the risk of protectionism.
- ▶ While it may be legitimate for the Commission to submit its interpretation of the Treaty rules and of the CJEU's relevant case-law on capital movement restrictions, the CJEU's interpretation of EU law remains authoritative and is a narrow one in this regard.

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1 Introduction

In the EU, the Treaty on the Functioning of the EU (TFEU), i.e. primary law, sets the standard on the free movement of capital and possible restrictions to it. This is of relevance to foreign investments (FI), be they foreign direct investments (FDIs)¹ or foreign portfolio investments (FPIs)². On top of these treaty rules, the EU legislator established a secondary law framework, which deals with national procedures by Member States to screen FDIs – FPIs are not affected – emanating from third countries.³

The COVID-19 crisis and its severe consequences for the economy have raised concerns that EU companies, especially in strategic sectors such as health, may be acquired by foreign investors. Amid such concerns, some Member States have adopted measures to protect their companies.⁴

On 25 March 2020, the EU Commission issued guidance on both FDIs and FPIs (hereinafter: “FI Guidance”).⁵ It interprets (1) the TFEU rules relating to restrictions on the free movement of capital in the current COVID-19 crisis and (2) the rules on the screening of FDIs according to the FDI Regulation. The aim of the FI Guidance is “to preserve EU companies and critical assets, notably in areas such as health, medical research, biotechnology and infrastructures that are essential for our security and public order, without undermining the EU's general openness to foreign investment”.⁶

In Section 2, this cepAdhoc sets out the existing EU rules on foreign investment. In Section 3 it takes a closer look at the FI Guidance and Section 4 provides an assessment of the FI Guidance.

2 Existing EU rules on foreign investments

2.1 Primary Law

The TFEU provides for the free movement of capital both within the EU and involving non-EU-countries (“third countries”).⁷ However, the TFEU and the case-law of the Court of Justice of the EU (CJEU) allow

¹ Foreign direct investments (FDI) are investments “by a foreign investor aiming to establish or to maintain lasting and direct links between the foreign investor and the entrepreneur or undertaking” (Art. 2 (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 (hereinafter: FDI Regulation (EU) 2019/452).

² Unlike FDIs, portfolio investments “do not confer the investor effective influence over management and control of the company” [Annex p. 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), C(2020) 1981 final, 25.3.2020 (hereinafter: FI Guidance)].

³ FDI Regulation (EU) 2019/452.

⁴ Spain has introduced a new FDI screening regime in a number of sectors for acquisitions by companies outside the European Economic Area (see Foscarini et al., “European Union: COVID-19: EU Issues Guidelines Regarding Screening Foreign Investment In Connection With Industries Critical For Combating COVID-19” , <http://www.mondaq.com/unitedstates/inward-foreign-investment/913976/covid-19-eu-issues-guidelines-regarding-screening-foreign-investment-in-connection-with-industries-critical-for-combating-covid-19>). Italy has amended its “Golden Power Law” to reinforce its powers to review foreign investments in Italian assets (see Duvernoy et al., “COVID-19 - Italy expands Golden Power review of foreign investments”, <https://www.whitecase.com/publications/alert/covid-19-italy-expands-golden-power-review-foreign-investments>). The German government proposed to include companies from the health sector, e.g. vaccine and antibiotics manufacturers, in the list of particularly safety-relevant companies which are subject to investment screening (Gesetzentwurf der Bundesregierung, Erstes Gesetz zur Änderung des Außenwirtschaftsgesetzes und anderer Gesetze, 31.03.2020).

⁵ FI Guidance.

⁶ European Commission, Coronavirus: Commission issues guidelines to protect critical European assets and technology in current crisis, Press release, 25 March 2020.

⁷ Art. 63 Treaty on the Functioning of the European Union (TFEU).

Member States to restrict⁸ the free movement of capital if such restrictions are based on grounds of legitimate public policy objectives – i.e. public security or public order⁹ or overriding reasons in the general interest.¹⁰ Furthermore, any restriction must be proportionate – i.e. it must be suitable to attain its objectives and not go beyond what is necessary, in that the objectives cannot be attained by less restrictive measures.¹¹

The CJEU's interpretation is generally narrow. Legitimate public policy objectives can be invoked to justify restrictions on the free movement of capital “only if there is a genuine and sufficiently serious threat to a fundamental interest of society”.¹² Such objectives cannot be purely economic.¹³ The CJEU has recognised public health¹⁴ as well as “the minimum supply of energy resources and goods essential to the public as a whole, the continuity of public service, national defence, the protection of public policy and public security and health emergencies”¹⁵ as overriding reasons in the general interest which can justify restrictions on capital movements.

At the same time, the CJEU has emphasised that the legitimacy of restrictions on capital movements could be interpreted more broadly where they involve third countries as compared to restrictions between EU Member States.¹⁶

2.2 Secondary EU Law: The FDI Regulation

The FDI Regulation, adopted in 2019, will apply as of 11 October 2020.¹⁷ It concerns foreign direct investments only. Portfolio investments are not covered by the FDI Regulation.¹⁸

The FDI Regulation sets out a standardised framework for the screening¹⁹ of FDIs emanating from third countries. It does not entail an obligation for Member States to set up screening mechanisms.²⁰ All screening mechanisms must be transparent and must not discriminate between third countries. Member States must establish timeframes in order to give other Member States and the Commission the opportunity to comment on a disputed FDIs.²¹

As set out in the TFEU, the FDI Regulation allows Member States to prevent or mitigate FDIs “in their territory on the grounds of security or public order”. The FDI Regulation specifies that this may include the consideration of the FDI's potential effects on critical infrastructure (such as energy and health

⁸ According to the CJEU, restrictions on the free movement of capital are national measures that are “liable to prevent or limit the acquisition of shares in the undertakings concerned or to deter investors of other Member States from investing in their capital” (see e.g. CJEU, Judgement of 23 October 2007, *Commission v Germany*, C-112/05, ECLI:EU:C:2007:623, para. 19).

⁹ Art. 65 (1) (b) TFEU.

¹⁰ See CJEU, Judgement of 4 June 2002, *Commission v Belgium*, C-503/99, ECLI:EU:C:2002:328, para. 45 and CJEU, Judgement of 13 May 2003, *Commission v Spain*, C-463/00, ECLI:EU:C:2003:272, para. 68.

¹¹ *Ibid.*

¹² See CJEU, Judgement of 14 March 2000, *Eglise de Scientologie*, C-54/99, ECLI:EU:C:2000:124, para. 17.

¹³ See CJEU, Judgement of 27 February 2019, *Associação Peço a Palavra*, C-563/17, ECLI:EU:C:2019:144, para. 70.

¹⁴ CJEU, Judgement of 19 May 2009, *Commission v Italy*, C-531/06, ECLI:EU:C:2009:315, para. 51.

¹⁵ CJEU, Judgement of 26 March 2009, *Commission v Italy*, C-326/07, ECLI:EU:C:2009:193, para. 45.

¹⁶ CJEU, Judgement of 12 December 2006, *Test claimants in FII, Group litigation*, C-446/04, ECLI:EU:C:2006:774, para. 171

¹⁷ FDI Regulation (EU) 2019/452.

¹⁸ Recital 9, FDI Regulation (EU) 2019/452.

¹⁹ Screening is defined as “a procedure allowing to assess, investigate, authorise, condition, prohibit or unwind” FDIs. (Art. 2 (3) FDI Regulation (EU) 2019/452).

²⁰ See Bert Van Roosebeke and Anne-Kathrin Baran, *Framework for screening foreign direct investments*, cepPolicyBrief No. 2017-32, p. 3.

²¹ Art. 3 (2) and (3), FDI Regulation (EU) 2019/452.

infrastructure), on critical technologies (such as artificial intelligence and biotechnologies) and on the supply of critical inputs. These infrastructures, technologies and inputs have to be “essential for security or the maintenance of public order” and their disruption, failure, loss or destruction would significantly affect a Member State or the EU.²² In their assessment of whether an FDI may have an impact on security or public order, Member States may also take into account whether the foreign investor is directly or indirectly controlled by a third country’s government.²³

3 The Commission’s guidance on foreign investments from third countries (FI Guidance)

On 25 March 2020, the Commission published its FI Guidance. It takes the form of a Communication from the Commission, i.e. a soft law instrument that is not legally binding²⁴. It sets out the Commission’s interpretation of the legal possibilities for Member States to prevent or mitigate foreign investments from third countries, i.e. countries that are not EU Member States. Hence, the FI Guidance covers both FDI, for which the TFEU and the FDI Regulation is relevant, and FPI, for which only the TFEU is relevant (see table below).

Applicability of	TFEU	FDI Regulation	FDI Guidance
Foreign Direct Investments	Yes	Yes	Yes
Foreign Portfolio Investments	Yes	No	Yes

3.1 Call on Member States to introduce national FDI screening mechanisms

As of 25 March 2020, national FDI screening mechanisms as envisaged under the FDI Regulation have been put in force in 14 Member States.²⁵ The Commission calls upon those 14 Member States to make full use of their FDI screening mechanisms “to take fully into account the risks to critical health infrastructures, supply of critical inputs, and other critical sectors”.²⁶ Furthermore, it urges those 13 Member States which either do not currently have screening mechanisms or whose mechanisms do not cover all relevant transactions to “set up a full-fledged screening mechanism and in the meantime to use all other available options” to address the “risk to security or public order” posed by a foreign acquisition.²⁷

3.2 Call on Member States to make use of the cooperation mechanism of the FDI Regulation

The Commission calls on Member States to make use of the cooperation mechanism envisaged in the FDI Regulation, especially during the COVID-19 crisis. This mechanism allows Member States and the Commission to comment on FDI screenings in another Member State if the FDI could affect other

²² Art. 4 (1) and Recital 13, FDI Regulation (EU) 2019/452.

²³ Art. 4 (2), FDI Regulation (EU) 2019/452.

²⁴ National courts are however bound to take soft law – such as the Commission’s FI Guidance – into consideration “to decide disputes submitted to them, in particular where they are capable of casting light on the interpretation of other provisions of national or Community law.” (CJEU, Judgment of 13 December 1989, Grimaldi v Fonds des maladies professionnelles, C-322/88, ECLI:EU:C:1989:646, para. 19).

²⁵ A list of national screening mechanisms is available at: <http://trade.ec.europa.eu/doclib/html/157946.htm>.

²⁶ FI Guidance, p. 2.

²⁷ FI Guidance, p. 2.

Member States' security or public order.²⁸ In reaction to such comments, the Member State that is undertaking an FDI screening must "give due consideration"²⁹ to comments by other Member States and to the opinion of the Commission. The FDI Regulation is set to apply from 11 October 2020 only. However, the Commission emphasises that comments on FDIs can be made up to 15 months after completion of the FDI.³⁰ As of October, therefore, Member States and the Commission will still be able to comment on (the screening of) FDIs which is currently taking place during the pandemic, i.e. before the application date.³¹

3.3 Call on Member States to assess third country FDIs in the healthcare sector and beyond

The Commission stresses that the COVID-19 crisis shows the need for "appropriate" FDI screening mechanisms regarding "healthcare capacities (for example for the production of medical or protective equipment) or related industries such as research establishments (for instance developing vaccines)".³² FDIs should not have a "harmful impact on the EU's capacity to cover the health needs of its citizens".³³ In this regard, the Commission points out that the FDI Regulation³⁴

- allows Member States to take measures to prevent FDIs from third countries, where this would result in a "security or public order" threat, including threats linked to a "public health emergency",
- explicitly stipulates that FDI screenings can include assessing risks to critical health infrastructures and to the supply of critical inputs, and
- provides that FDI screenings may result in the prohibition of the FDI or in the adoption of mitigating measures, e.g. to guarantee the supply of medical products or devices.

The Commission's FI Guidance is not solely focussed on the health sector. The Commission also states that FDI screenings should ensure the "critical capacity of EU industry, going well beyond the healthcare sector".³⁵ "Member States should be particularly vigilant to avoid that the current health crisis does not result in a sell-off of Europe's business and industrial actors, including SMEs."³⁶

3.4 Call on Member States to use the flexibility of the Treaties for FDIs and FPIs

The Commission stresses that Member States may restrict both FDIs and FPIs, as the TFEU allows for such restrictions if they are justified on grounds of "legitimate public policy objectives", i.e. public security or public order or overriding reasons in the general interest.

The Commission underlines that "predatory buying" of strategic assets by foreign investors, aimed at limiting the supply of certain goods or services to the EU market, may allow for restrictive measures in

²⁸ Art. 8 (1), FDI Regulation (EU) 2019/452.

²⁹ Art. 6 (9) and Art. 7 (7), FDI Regulation (EU) 2019/452.

³⁰ Art. 7 (8) and (9) FDI Regulation (EU) 2019/452.

³¹ FI Guidance, p. 1.

³² FI Guidance, p. 1.

³³ Annex to the FI Guidance, p. 1.

³⁴ FI Guidance, p. 1.

³⁵ FI Guidance, p. 1.

³⁶ Annex to the FI Guidance, p. 1.

order to ensure the security of supply or the provision of essential public services as a “fundamental interest of society”.³⁷

Furthermore, the Commission points out that for companies with valuations that are deemed too low, restrictions could be considered, taking into account the “actual or potential impact” of foreign investments on the safeguarding of “public interests”. However, the Commission warns that such restrictions may have a negative impact on companies and the economy at large.³⁸

The Commission further calls on Member States to screen FPIs where the investor acquires at least a qualified shareholding (e.g. 5%), conferring on him or on connected shareholders certain rights under the national company law.³⁹

Finally, the Commission also points out the possibility for Member States to retain special rights in undertakings (“golden shares”) which may allow them to block or limit certain types of investments in the undertakings concerned.⁴⁰

4 Assessment

The EU is one of the most open world regions for foreign investments⁴¹ and the COVID-19 pandemic should not alter that as foreign investments promote growth and employment and stimulate productivity and innovation. Any restrictive intervention by Member States – even in these days – should not go beyond what is absolutely necessary to prevent serious damage to security or public order. The pandemic should not, in general, serve as an argument to restrict foreign direct and portfolio investments from third countries.

However, with the FI Guidance, the Commission is evidently advocating more restrictive measures by Member States against FDIs from third countries. This is indicated by

- the recommendation for greater use of national FDI screening mechanisms,
- the call for both the Commission and Member States to use the cooperation mechanism under the FDI Regulation and
- the demand that the flexibility in the Treaties be used to assess FDIs.

Clearly, the EU’s high dependency on medical products and equipment delivered by third countries makes the EU particularly vulnerable to a lack of supply in times of a pandemic. However, this does not necessarily make capital restrictions an appropriate policy. The issue can be addressed in many ways, e.g. by building up reserves of certain intrinsic goods, e.g. masks and drugs, at national or even at EU level, and by diversifying the supply structure, which prevents goods being provided by a very small number of suppliers from only a few countries. Also, the ambition of a third country investor to buy a European facility providing “critical goods” must not necessarily have a negative impact on the availability of those critical goods in the EU. Conditions attached to FDIs may well ensure future local access to goods and services in the EU.

³⁷ Annex to the FI Guidance, p. 3.

³⁸ Annex to the FI Guidance, p. 3-4.

³⁹ Annex to the FI Guidance, p. 2-3.

⁴⁰ Annex to the FI Guidance, p. 3.

⁴¹ See e.g. the OECD FDI Regulatory Restrictiveness Index: <https://goingdigital.oecd.org/en/indicator/74/>.

The FDI Regulation, in this respect, is double-edged. On the one hand, it provides more clarity regarding the procedures Member States may follow when assessing FDIs and thus reduces uncertainty on the part of both investors and affected companies. On the other hand, it opens the door for a more protectionist screening of FDIs. The Regulation explicitly allows for restrictions on the movement of capital because of “potential effects on critical infrastructure, technologies [...] and inputs which are essential for security or the maintenance of public order”. This vagueness gives Member States too much leeway in determining the acceptability of an FDI and increases the risk of protectionism. Some Member States are already picking up on this signal. In Germany, drafts for adapting German law to the requirements of the FDI Regulation include the replacement of the criterion of an “actual and serious risk” to public order and security by the vague criterion of a “probable adverse effect”.^{42,43} What is more, the FI Guidance is not specifically limited to the Corona pandemic. Clearly, it has been issued due to the pandemic’s considerable economic repercussions for the European economy. However, there is the risk that it will open the floodgates for more restrictive FDI screenings even after the crisis has been overcome. This should be avoided.

It is, in fact, the Treaty – and not the FDI Regulation or the FI Guidance – which lays down the scope of the legitimate restrictions on free movement of capital that Member States may introduce. While it may be legitimate for the Commission to submit its interpretation of the Treaty rules and of the CJEU’s case-law on capital movement restrictions, the CJEU’s interpretation of EU law remains authoritative.

So far, the CJEU has chosen a narrow interpretation of legitimate restrictions on capital movements: It requires “a genuine and sufficiently serious threat to a fundamental interest of society” and that the restriction be proportionate to the legitimate public policy objective which it aims to attain. These fundamental conditions should not be abandoned.

⁴² Gesetzentwurf der Bundesregierung, Erstes Gesetz zur Änderung des Außenwirtschaftsgesetzes und anderer Gesetze, 31.03.2020.

⁴³ The proposed changes in the German draft law are not a reaction to the COVID-19 pandemic. However, the pandemic is likely to lead to further proposals for amending the Foreign Trade and Payments Ordinance.