LOOKING A GIFT HORSE IN THE MOUTH: HEIGHTENED SCRUTINY OF FOREIGN DIRECT INVESTMENT

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I. INTRODUCTION

Although the global level of foreign direct investment fell in 2017, it remains very strong.[2] At the same time, protectionism appears to be on the rise. One of the ways in which this new wave of protectionism is manifesting itself is in an increase in the scrutiny of foreign investments, including screening measures or review mechanisms introduced or planned by many of the governments of the world's largest economies.

The enhanced scrutiny of foreign investments will inevitably be a factor for investors when making investment decisions, and risks deterring investments that would otherwise be made. Depending on the jurisdiction, many types of investment may be caught, including greenfield investments, asset or stock purchases, mergers and joint ventures. Investors planning cross-border transactions or investments, particularly those in certain sectors (including the defense and dual-use sectors), may now find that they need to navigate multiple foreign investment, as well as merger control, regimes. That can be complex and challenging, and preparation and early engagement with government stakeholders is essential.

That is not the only challenge created by the trend towards increased scrutiny of cross-border investments. Governments have challenges, as well as investors. Governments will have to navigate a course between scrutinizing foreign investment where that is considered necessary, and making sure that the nature and level of scrutiny does not create an overly hostile environment for inward investment. For those jurisdictions introducing, or enhancing, mechanisms to review foreign investments, the design of the regime will therefore be critical. It is in the interests of both governments and investors that those regimes work efficiently and effectively.

II. INCREASED SCRUTINY

There has been a clear trend towards governments strengthening national regimes for scrutinizing inward foreign direct investment. The scrutiny that foreign direct investments face will inevitably become increasingly prominent in investment decisions as new regimes are introduced, or existing regimes strengthened, across key jurisdictions.

A comprehensive survey of those changes across jurisdictions is beyond the scope of this article, but to illustrate the trend:

- All G7 countries have recently introduced, or plan to introduce, tighter rules designed to increase the scrutiny of foreign investments. These changes include, in the UK, the lowering of merger control thresholds in certain sectors to increase the scope for political intervention on public interest ground (effective from June 11, 2018),[3] and proposals to introduce a mandatory screening regime for foreign investment in specific industries. In France, there are proposals to expand rules on national security screening of foreign investments to cover additional sectors, including artificial intelligence and companies in the digital industry, and in Japan new rules include mandatory reviews of share transfers between foreign investors relating to unlisted Japanese companies, and tougher civil and criminal sanctions for non-compliance. Germany has also recently introduced changes that have tightened control over acquisitions of domestic companies by foreign investors. Most recently, in the U.S. on June 18, 2018 the Senate approved legislation expanding the jurisdiction of the Committee on Foreign Investment in the United States ("CFIUS"), including by allowing CFIUS to review (i) any non-passive foreign investment in a critical technology or critical infrastructure company; and (ii) certain changes to a foreign investor's rights in a U.S. company.

  To put this in context, in 2017, the G7 countries accounted for almost 60 percent of outward foreign direct investment, and over 30 percent of inward foreign direct investment. Changes to the review regimes in those jurisdictions will therefore impact a significant number of potential investments

- The European Commission has recently proposed a regulation establishing a framework for the review of foreign direct investment into the EU,[4] triggered by calls from France's President Macron and others. The proposals do not set out an EU-wide screening mechanism (except in relation to certain projects or programs with a "Union interest"), but rather provide for an enabling framework for the European

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2 OECD, *FDI in Figures,* April 2018.

3 Hogan Lovells, *New UK foreign investment screening rules come into force,* June 18, 2018.

4 Proposal for a Regulation of the European Parliament and of the Council establishing a framework for screening of foreign direct investments into the European Union.

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Commission and Member States to review and coordinate non-EU foreign investments on grounds of security and public order.[5]

Again, to put this in context, in 2017 the current 28 Member States of the European Union accounted for over 30 percent of outward foreign direct investment, and over 20 percent of inward foreign direct investment.

It is difficult to predict what proportion of global foreign direct investment will be reviewable under the new or expanded review or screening regimes in the future, as that will depend on a broad range of factors, including the identity of the jurisdictions, sectors and investors. It will also depend on the nature of the screening or review regimes in place – for example, in some jurisdictions the scrutiny of foreign investments will be automatic, whereas in others it will be a discretionary political decision.

However, even just taking the changes and proposed changes highlighted above, a significant and growing proportion of all foreign direct investment will either be subject to automatic scrutiny, or at risk of being subject to a discretionary political review. Will this have an impact on the level of foreign direct investment?

III. DOES INCREASED SCRUTINY HAVE AN IMPACT ON LEVELS OF FOREIGN DIRECT INVESTMENT?

The OECD recently reported that foreign direct investment fell by 18 percent in 2017 compared to 2016.[6] Even with that fall, flows of foreign direct investment in 2017 were still strong, according to the OECD, representing 1.8 percent of global GDP.

In today's complex global economy, it is not usually safe to draw a direct link between one trend and another. There are often many factors at play. It should also be recognized that foreign direct investment reviews have existed for decades in many key jurisdictions. It is nevertheless tempting to observe that the current fall in foreign direct investment flows comes at a time when protectionism in many forms, including the expanded scrutiny of foreign direct investment, appears to be on the rise. Also, importantly, those developments have sometimes been accompanied by strong rhetoric, including around foreign direct investment, which is likely to have created a chilling effect beyond that caused by any changes to the review rules themselves.

Again, the OECD figures allow for some interesting commentary on the impact that perception and uncertainty can have on inward foreign direct investment:

- For example, in the U.S. where some would argue that the rhetoric has been the strongest, and CFIUS is perceived as becoming increasingly interventionist, the OECD figures suggest that there has been a 39 percent fall in the level of inward investment flows.

- In the UK, the position appears to be even more pronounced. The OECD figures suggest that there was a 92 percent fall in inward investment flows between 2016 and 2017. There are probably many and complex reasons for this, including uncertainty caused by the result of the Brexit referendum. But it is likely that reports of behind-the-scenes government interventions in the context of some recent high profile transactions have created further uncertainty and mixed messages about the UK's openness for business, and contributed to this fall in inward investment.[7]

Although it is impossible to demonstrate definitively the impact of the trend towards stronger scrutiny on the level of foreign direct investment, it is something that, in our experience, investors factor into their decision making. Even where it is relatively easy to navigate a screening or review regime, and in reality only the most contentious and sensitive investments are likely to face detailed scrutiny, the existence of a review or screening regime can, of itself, send a message about whether, or the extent to which, foreign investment is welcome.

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5 The supranational requirements of EU law may continue, however, to limit the ability of EU governments to intervene in such cases – see Brandenburger & Jones, *Protectionism or Legitimate National Interest? A European Perspective on the Review of Corporate Acquisitions by Foreign Purchasers,* CPI Antitrust Chronicle, 2014, vol. 10.

6 OECD, *FDI in Figures,* April 2018.

7 Reader, (2018) *Extending 'National Security' in Merger Control and Investment: A Good Deal for the UK? Competition Law International,* 14 (1).

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IV. BE PREPARED

How should potential investors react to this increase in scrutiny? The short answer is: be prepared and, in particular, be prepared to engage.

To be prepared, investors need to be forewarned. From the outset, investors need to work with their advisers to establish whether, and where, a transaction or investment could trigger foreign investment screening or review. As with merger control notification requirements, foreign investment reviews can have a significant influence on the timing, structure and scope of a transaction – especially in those cases where reviews in multiple jurisdictions may be required. It is therefore important for investors to map out the risks and requirements, to avoid surprises, take views on risk, and develop engagement strategies to navigate multiple (and possibly conflicting) political sensitivities.

The latter point is particularly important. Early engagement is essential, not just as part of that risk-mapping exercise, but also to navigate the reviewing process (to the extent possible). In many cases, the need to engage (and who that engagement should be with) is clear. For example, proposed investments or transactions involving targets operating in sensitive industries, or as government contractors, are likely to be key candidates for in-depth review. Even where it is less clear who investors should speak to, initial engagement with government is advisable to avoid entering into a screening or review process completely cold. Proactive discussions with the relevant government departments and agencies may be advisable to identify whether substantive concerns will be raised, whether those concerns could put the investment in jeopardy or cause unacceptable delay, whether steps can be taken to address concerns without the need for an intensive review, and whether those steps are commercially acceptable.

Being prepared to navigate the process is not, however, enough. Screening or review requirements, and the uncertainty they can give rise to, may need to be addressed in any contractual arrangements as the parties negotiate to apportion the risks between them. This will likely include introducing additional conditions, precedent and commitments by the purchaser on obtaining approvals. This may require consensus between the parties as to which approvals are required before closing (which may be particularly contentious if notifications are not mandatory).

In summary, in order for investors to negotiate effectively, they need to be aware of the potential risks and possible outcomes from the outset.

V. WHAT SHOULD A SCREENING OR REVIEW REGIME LOOK LIKE?

Enhanced screening or review of foreign direct investment may also raise issues for governments. In establishing or strengthening regimes for the scrutiny of foreign direct investment, governments face a conundrum. This was neatly expressed by the UK government in its recent consultation on possible changes to the UK regime:

> Foreign direct investment brings considerable benefits to the UK economy: the injection of foreign capital, new jobs, ideas, talent and leadership…
>
> However Britain's rightly-praised openness to foreign investment also needs to be accompanied by appropriate scrutiny of the potential national security impacts of deals... The vast majority of investment into the UK's economy raises no national security concerns. However, we need to be alert to the risk that having ownership or control of critical businesses or infrastructure could provide opportunities to undertake espionage, sabotage or exert inappropriate leverage.[8]

Similar sentiments were expressed by the European Commission when it announced proposals to establish a framework for the screening of foreign direct investment.[9] In short, governments need to balance the desire to scrutinise foreign investment where that is considered necessary to protect national interests, against the need to encourage inward investment (or at least not discourage such investment by creating a perception of hostility to inward investment).

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8 UK Department for Business, Energy and Industrial Strategy, *National Security and Infrastructure Investment Review,* October 2017.

9 Communication from the Commission to the European Parliament, the European Council, the Council, the European Economic and Social Committee and the Committee of the Regions: *Welcoming Foreign Direct Investment while Protecting Essential Interests,* September 13, 2017.

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How this balance can be achieved will depend on the jurisdiction, the investments caught by the regime and, most significantly, what a particular jurisdiction considers to be "national interests" that need to be protected.

However, there are some features of foreign direct investment review regimes that, we consider, are important to ensure that a hostile environment is not created, or seen to be created. In this regard, Article 6 of the European Commission's proposed regulation makes a valuable contribution, by identifying a number of key principles that provide a framework for any review mechanisms to be adopted by Members States, as do the G20 Guiding Principles for Global Investment Policymaking.[10]

A. Procedural Certainty

It would be naive to assume that the absence of a formal regime means that foreign direct investment is never the subject of government attention. Governments may be watching and willing to intervene if they consider that a specific inward investment could be damaging to the national interest (or the political interests of the government), even if there is no formal review regime. If governments routinely intervene even in the absence of a formal regime (or outside of an existing regime), the unpredictability and apparent arbitrariness of the intervention inevitably risks deterring potential future investors.

Starting from the basis that government attention to foreign direct investment is probably a fact of life – at least currently – there are therefore advantages to having an appropriate formal screening or review regime. The need for procedural certainty is reflected in the EU's proposed regulation, which states that:

> Member States' screening mechanisms shall be transparent... In particular, Member States shall set out the circumstances triggering the screening, the grounds for screening and the applicable detailed procedural rules (Article 6(1)).
>
> Member States shall establish timeframes for issuing screening decisions (article 6(2)).

Procedural certainty, especially certainty as to when a screening or review will be triggered, means that investors know what to expect, and within what timeframe. As highlighted above, if investors know what to expect, the uncertainty that could act as a barrier to investment is reduced. Even if the eventual outcome is uncertain, procedural certainty means that investors at least have a broad road-map to follow.

B. Accountability

Given the nature of the assessment, particularly in cases involving national security, most review regimes contain a degree of discretion or political input that means outcomes can never be fully predicted. It is therefore important that mechanisms are built in to review regimes to ensure that outcomes are not arbitrary.

This includes ensuring that such regimes should operate (and be seen to operate) in a non-discriminatory and non-arbitrary way in terms of both procedures and outcomes. To a certain extent, this flows from the points highlighted above. However, it goes further and requires ensuring that parties have the right to be kept informed, to make representations throughout the process, and for those representations to be heard by the final decision maker.

It also includes holding decision makers accountable. Again, the EU proposals acknowledge this, stating that "Foreign investors and undertakings concerned shall have the possibility to seek judicial redress against screening decisions of the national authorities" (Article 6(4)). As the G20 Guiding Principles for Global Investment Policymaking make clear, this is part of a wider imperative of ensuring legal certainty: "Investment policies should provide legal certainty and strong protection to investors and investments... Dispute settlement procedures should be fair, open and transparent, with appropriate safeguards to prevent abuse." The ability to challenge a final decision is necessary to assure potential investors that they will get a fair hearing. That reassurance comes where the avenues for challenge are truly independent, and the decision-making subject to full scrutiny – the ability to appeal to an independent body is therefore also important in this respect.

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10 G20 Trade Ministers Meeting Statement, Annex III: G20 Guiding Principles for Global Investment Policymaking - July 9-10, 2016.

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C. Focused Intervention

To avoid review regimes being used as a means to obtain commitments from, or information about, investors that are unconnected to the proposed investment, appropriate measures need to be put in place to ensure that any information provided by an investor is treated in an appropriate way. Briefly put, such regimes should be focused on the screening or review of foreign direct investment and should not be used for other collateral purposes.

Again, the European Commission's proposals acknowledge this in part by providing that: "Confidential information, including commercially-sensitive information, made available by foreign investors and undertaking concerned shall be protected" (Article 6(3)). What is meant by the term "protected" in this context is unclear, but we would suggest that it should mean that information disclosed as part of the review process should not be disclosed to any other parties (including government or other state agencies), or used by the relevant agency for any purpose other than the review itself.

However, the point goes further than the use or misuse of confidential information. Screening or review regimes should not expose investors to wider political scrutiny or challenge. It is also important that foreign direct investment review regimes should not facilitate the exercise of political influence in areas outside of the proposed investment.

VI. CONCLUSION

Foreign direct investment remains important to the global economy. Equally, it is inevitable that governments will be concerned to ensure that inbound investment does not harm their national interests. It is also inevitable that investors will be concerned by increased scrutiny, and the uncertainty that brings. But it is in the interests of both governments and investors to seek to ensure that investment flows continue.

It is therefore incumbent on those governments or supranational authorities designing changes to existing screening or review regimes, or creating new ones, to seek to make sure that those regimes do not create an overly hostile environment for investment, and to ensure as much certainty, transparency and even-handedness as possible within the regime.

Foreign direct investment is not a new phenomenon, and neither is its scrutiny. The fact that the scrutiny of foreign direct investment is becoming more prevalent need not cause undue anxiety, as long as the scrutiny is predictable, transparent and non-discriminatory, and as long as investors are well prepared to assess and navigate the screening and review regimes.

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