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EU FDI Screening – Legal Considerations

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Summary

Concerns regarding foreign direct investment in the European Union ("EU") are on the rise. Earlier this year, three EU Member States asked the European Commission to draft legislation to screen foreign direct investment ("FDI screening").[1] Subsequently, the European Parliament also made a similar request.[2]

This report focuses on legal aspects of a possible EU-level foreign direct investment ("FDI") screening mechanism. The first section puts FDI screening in the context of existing mechanisms in selected countries, international trade law provisions (WTO[3] and OECD[4]), and EU law aspects (Union and Member State competence). The report then examines security-related laws at EU-level, which arguably

1 French, German and Italian minister's letter to Cecilia Malmström, the European Parliament call for a proposal, *available at* http://www.bmwi.de/Redaktion/DE/Downloads/E/eckpunktepapier-proposals-for-ensuring-an-improved-level-playing-field-in-trade-and-investment.pdf?__blob=publicationFile&v=4.
2 Proposal for a Union Act, 20.3.2017, B[8-0000/2017] submitted by Members of the European of Parliament, Weber, Caspary, Saïfi, I. Winkler, Cicu, Proust, Quisthoudt-Rowohl, Reding, Schwab, Szejnfeld.
3 World Trade Organization ("WTO").
4 Organisation for Economic Co-operation and Development ("OECD").

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MANNHEIMER SWARTLING

should be considered, and concludes with a section on proposed considerations for a possible EU-level mechanism. This report does not deal with the legal aspects of bilateral investment treaties.

In sum, our main observations are:
- Many EU Member States and other countries around the world already have FDI screening in place;
- International trade law rules as well as primary EU law give way to FDI screenings when justified for national security reasons;
- An EU-level FDI screening mechanism would likely not risk breaching WTO trade laws or commitments undertaken in the OECD context;
- The Union has exclusive competence to regulate foreign direct investments under the EU's common commercial policy. There would be no shift in power and EU Member States would retain the right to adopt or act for national security reasons even outside an FDI screening mechanism;
- Several existing EU laws have been adopted to achieve EU-level security measures. An EU FDI screening mechanism would align with such measures; and,
- An FDI screening mechanism could be implemented by allowing Member States to designate national competent authorities, which would be empowered to review and if necessary restrict FDI.

Based on our analysis, the following main elements should be considered when drafting an FDI screening mechanism.

PROPOSED MAIN ELEMENTS OF AN EU FDI MECHANISM

Elements	Purpose/rationale
Define targeted transactions as foreign direct investment only, based on criteria from EU case law (e.g. control and active participation).	Using the FDI definition from EU case law sets a scope and ensures that the legislation would be under Union exclusive competence.
Define a minimum scope of sectors, industries or services, for which FDI screening should be undertaken by Member States.	The scope should align to cover the scope of existing EU laws, in particular the combined coverage of the NIS and ECI Directives (critical infrastructure and essential services).
Consider mandatory notification requirements.	Uniform criteria for when a foreign acquirer has to notify a transaction for review to a Member State (e.g. before a transaction is completed, certain thresholds of proposed ownership) and effects of non-compliance (e.g. investment may become null and void).
Define common factors to assess in a review.	Common mandatory factors (e.g. foreign state ownership or control, state-backed funding, defence industry-related, human rights aspects) are important for a consistent EU-level effect.
Define powers of Member State competent authorities to review and to block or restrict an investment, as well as common procedural rules for completing a review.	It is important to ensure competent authorities' autonomy and ability to make independent decisions, however uniform procedural rules should apply for reasons of predictability. Sanctions for non-compliance would likely fall under Member State competence.
Define responsibility of Member States to report and cooperate with the European Commission and other Member States.	Information exchange regarding assessments is important to avoid diverging interpretations and ensuring a similar EU-level of security. A reporting mechanism to the European Commission would ensure EU-level monitoring of what FDI measures are applied.

FDI Screening Mechanisms

The following section puts FDI screening mechanisms into context and examines existing screening mechanisms in France, Germany and the US, the WTO and OECD provisions, and the EU's legal competence to adopt legislation in this field.

FDI screening as one of several FDI measures

Global capital flows allow for cross-border acquisitions. However, politically, welcoming FDI may sometimes weigh against a country's national interests. Some countries choose to restrict FDI, through e.g. equity caps in sensitive sectors, screening of management, nationality requirements for key personnel and restrictions on buying land or real estate.

FDI screening is relatively common, and entails a review by a governmental authority, which may block or impose conditions on the foreign investment.[5] Such screenings are usually motivated by national security interest, but could also entail economic rationale.

Many EU Member States perform FDI screenings, but in varying ways (Germany, France, Denmark, Spain, Italy, Latvia, Lithuania, the Netherlands, Austria, Poland, Portugal, Romania, Slovakia, Finland and the UK).[6] Also, the US has a well-developed review mechanism referred to as CFIUS.[7]

There is however no EU-wide FDI screening legislation in place. FDI may therefore be treated differently among the Member States. An investment in one country may therefore be blocked for national security reasons, but allowed in another due to the lack of legislation. Establishing common EU principles and definitions, scope and minimum requirements may thus be in the Union's interest.

The following section describes FDI screening in France and Germany, and thereafter, the US CFIUS mechanism in more detail.

5 For a representative overview of countries and the screening mechanisms they apply, please see: Wehrlé, F. and J. Pohl (2016), "Investment Policies Related to National Security: A Survey of Country Practices", OECD Working Papers on International Investment, 2016/02, OECD Publishing, Paris. *Available at* http://dx.doi.org/10.1787/5jlwrrf038nx-en.

6 May 2017 briefing from the European Parliamentary Research Service ("EPRS"), Briefing May 2017 [PE 603.941] (the "EPRS Report") p. 7.

7 Committee on Foreign Investment in the United States ("CFIUS").

Existing FDI Screening mechanism in related jurisdictions

FRANCE[8]

In France, the French Monetary and Financial Code (*Code monétaire et financier*) mandates that FDI in certain sectors be subject to review. The stated reasons for such reviews are public order, public security or interests of national defence.

Factors determining the scope of the review are the nationality of the investor, the degree of control the investor acquires through its investment and the sector or activity in which the investment is made. The review distinguishes between EU/EFTA investors[9] and other foreign investors ("non-EU investors"). The list of sectors and activities which trigger a review is broader for non-EU investors, including prior approval for any investment of more than 33.33% of the capital in companies in certain sectors.

All foreign investors have to apply for an authorisation prior to investing in an entity or line of business within certain sectors. If a decision has not been taken within two months, the authorisation is deemed granted. Consequences of non-compliance include criminal penalties and nullification of the transaction in question.

8 This section is based on: Wehrlé, F. and J. Pohl (2016), "Investment Policies Related to National Security: A Survey of Country Practices", OECD Working Papers on International Investment, 2016/02, OECD Publishing, Paris, pp. 54–55.

9 *Id*. p. 54, EU/EFTA investors are: EU/EFTA national, French non-resident in the EU/EFTA or legal person whose seat is in the EU/EFTA.

The review mechanism and authorisation procedure target various sectors, including the national defence sector, dual-use goods and technologies, monitoring activities, management of information technology security (e.g. encryption), and gambling (excl. casinos), water, electricity, energy and gas, transport, communications network and services, critical infrastructure and public health.

GERMANY[10]

The German Foreign Trade and Payments Act (Außenwirtschaftsgesetz)[11] and the German Foreign Trade and Payments Ordinance (Außenwirtschaftsverordnung) allow the federal government to review and block foreign investments if the acquisition would endanger public order or security. These laws set out two mechanisms, one sector-specific notification mechanism and one cross-sectoral review mechanism, which follow different procedural rules.

The sector-specific notification mechanism is triggered if any foreign investor, including EU/EFTA nationals, acquires voting rights of 25% (directly or indirectly through an intermediary) of companies involved in production of war weapons, tank engines and cryptographic technology. The mechanism involves a notification requirement and gives the Ministry for Economic Affairs and Energy the right to, within one month, prohibit the transaction if it threatens significant national security interests.

The cross-sectoral review mechanism allows the authorities to block a transaction if a foreign investor from outside the EU/EFTA (also by an EU/EFTA investor if used as circumvention of the rules) acquires voting rights of 25% (directly or indirectly through an intermediary) of a company, and the transaction threatens the public order or security in Germany. The authorities may initiate a review within three months counting from the date the acquisition is completed.

There are no criminal penalties for failing to declare an acquisition. However, in order to ensure legal certainty, companies should, as regards the sector-specific mechanism, declare the acquisition and as regards the cross-sectoral mechanism, apply for a certification of non-objection.

THE US CFIUS SCREENING MECHANISM

The Committee on Foreign Investment in the United States ("CFIUS") has powers to review, investigate, and impose conditions on foreign investments or acquisitions of US companies if needed to protect US national security interests.

Since its creation in 1975, CFUIS' powers have been enhanced on several occasions. In 1988, the President was empowered to block transactions that "impair the national security of the United States."[12] In 2007, in the aftermath of the failed Dubai Ports World acquisition of several US ports, Congress adopted the Foreign Investment and National Security Act ("FINSA"), which strengthened CFIUS' mandate to negotiate, modify, monitor and enforce settlement agreements, including by imposing monetary penalties.[13]

10 This section is based on: Wehrlé, F. and J. Pohl (2016), "Investment Policies Related to National Security: A Survey of Country Practices", OECD Working Papers on International Investment, 2016/02, OECD Publishing, Paris, pp. 56–57.
11 See English translation of the act *available at* http://www.bafa.de/SharedDocs/Downloads/EN/Foreign_Trade/afk_foreign_trade_and_payments_act.pdf?__blob=publicationFile&v=2.

12 Section 721 of the Defense Production Act of 1950, 50 U.S.C. App. 2170.
13 P.L. 110-49 (Jul. 26, 2007).

Under the US Constitution, matters of foreign affairs and national security are largely considered to be exclusively the competence of the federal government. Ultimately, CFIUS derives its authority from the President's executive authority and legislation passed by the US Congress.

Scope and test of foreign control
CFIUS's scope of review is not limited to particular sectors or industries. The mere proximity of a target company to a national security asset has been sufficient grounds for CFIUS to take action. In 2013, a Chinese company was forced to divest a wind farm in Oregon, because the wind farm was located near a US-military weapons training facility.[14]

CFIUS' scope of review covers "any merger, acquisition, or takeover . . . by or with any foreign person which could result in *foreign control* [emphasis added] of any person engaged in interstate commerce in the United States."[15] Passive investments of 10% or less of the outstanding voting interest in a company are outside the scope of the CFIUS process.[16] Start-up or "greenfield" investments are also excluded. In light of recent concerns regarding foreign involvement in the US technology sector, however, consideration is reportedly being given to expanding CFIUS' scope of review to cover joint ventures and minority ownership stakes.[17]

14 James K. Jackson, The Committee on Foreign Investment in the United States (CFIUS), CRS (Apr. 6, 2017), p. 23.
15 Section 721(b)(1) of the Defense Production Act of 1950, 50 U.S.C. App. 2170.
16 31 C.F.R. § 800.302.
17 See Phil Stewart, U.S. Weighs Restricting Chinese Investment in Artificial Intelligence, Reuters (Jun. 14, 2017), *available at* http://uk.reuters.com/article/us-usa-china-artificialintelligence-idUKKBN1942OX.

The test used by CFIUS to determine "control" is expansive and focuses on the ability of a party to "determine, direct, or decide important matters", whether by virtue of ownership, board representation, contractual arrangements or other formal or informal means.[18] Rather than taking a formalistic approach, CFIUS evaluates all relevant facts and circumstances in assessing the substantive relationship between the acquirer and the target company.[19]

Notice, review and investigation
A review can be initiated either voluntarily by the acquirer or on CFIUS' own initiative. Acquirers are not obligated to notify CFIUS in advance of closing a transaction. If there is a potential national security concern, however, acquirers often do so. CFIUS has the power to initiate reviews at any time and recommend to the President that a transaction be unwound after closing. Voluntary notice allows the acquirer to take advantage of a "safe harbour" if, after reviewing the transaction, the Committee decides not to take action.[20]

Formally, CFIUS has 30 days to conduct its review from the time a transaction is officially notified. If CFIUS determines that the acquisition could impair US national security and conducts a more in-depth investigation, that investigation must then be completed in 45 days. Such an investigation is mandatory if the acquisition would result in the US company being controlled by a "foreign government", either directly, or indirectly through any company that is in turn controlled by a foreign government.

18 31 C.F.R. § 800.204.
19 73 Fed. Reg. 70706–70707.
20 See 31 C.F.R. § 800.601.

National security review

In conducting its assessment, CFIUS first considers whether the acquirer itself presents a threat to national security interests. CFIUS then examines the US target company and whether the acquisition would create a vulnerability in US national security.[21]

CFIUS will then evaluate all relevant facts and circumstances and may consider ten specific factors that Congress has determined poses national security risks.[22] The list includes factors relating to the spread of military goods, equipment or technology, the effects on US "critical technologies", the preservation of US technological leadership and the control of a US business.[23]

A significant portion of CFIUS reviews relate to foreign companies acquiring US companies that: deal in items subject to US export controls, hold US government contracts, or operate in sensitive sectors, such as energy, transportation, or telecommunications.[24] CFIUS also considers network and data security issues, along with cyber security matters, including whether an acquisition would create an opportunity for foreign espionage.[25]

21 73 Fed. Reg. 74,569 (Dec. 8, 2008).
22 Listed in Section 721 of the Defense Production Act of 1950.
23 Section 721(b)(1) of the Defense Production Act of 1950, 50 U.S.C. App. 2170.
24 73 Fed. Reg. 74,569 (Dec. 8, 2008).
25 CFIUS Annual Report to Congress (CY 2014).

Presidential determinations and risk mitigation

CFIUS may recommend that the President block a transaction, or if already completed, that the transaction be unwound. This rarely happens in practice.[26] CFIUS is empowered by law to "negotiate, enter into or impose, and enforce" any agreement needed to mitigate national security threats. In recent years, roughly 8% of reviews resulted in such mitigating measures.[27] Risk mitigation measures are used frequently with respect to the software, network services, and technology industries. Examples include: restricting access to sensitive technology to certain individuals, establishing special internal committees or appointing US-government approved security officers or board members, and retaining veto rights over certain business decisions.[28]

WTO and OECD rules on security measures and foreign investments

FDI screenings may have trade restrictive effects, but if undertaken for national security reasons, they would normally not violate WTO rules or OECD commitments.

WTO AGREEMENTS

Numerous WTO member states – including Canada, China, France, Germany, Italy, Japan, the Republic of Korea, the Russian Federation, and the United States – conduct FDI screenings.[29]

The General Agreement on Tariffs and Trade ("GATT") 1947 contains a national security exception in Article XXI, which has also been replicated in Article XIVbis of the General Agreement on Trade and Services ("GATS").[30]
In principle, Article XXI allows a WTO member to take "any action which it considers necessary for the protection of its essential security interests" relating to traffic in arms or similar goods or measures taken "in time of war or other emergency in international relations". [31]

Notably, Article XXI's security exception is not limited in the same manner as the general exceptions in Article XX of

26 In practice, there is rarely a need for the President to act. Instead, the threat of such action either prompts the acquirer to accept certain mitigating measures to alleviate the national security concerns, or causes the acquirer to abandon the transaction altogether.
27 See CFIUS Annual Report to Congress (CY 2014), p. 23; CFIUS Annual Report to Congress (CY 2013), p. 21; CFIUS Annual Report to Congress (CY 2012), p. 20; CFIUS Annual Report to Congress (CY 2011), p. 18.
28 CFIUS Annual Report to Congress (CY 2014), p. 23.
29 UNCTAD, World Investment Report 2016, p. 96.
30 The Agreement on Trade-Related Investment Measures incorporates by reference all GATT exceptions, including the Article XXI national security exception.
31 Article XXI, General Agreement on Tariffs and Trade (1994).

GATT.[32] Thus, the use of Article XXI, is not conditioned upon refraining from "arbitrary or unjustifiable discrimination" wher "like conditions prevail".

Although debated, there is a general view that if invoked, a WTO panel is precluded from reviewing an Article XXI exemption.[33] Since its inception, there has never been a binding GATT or WTO panel decision on the security exception. This is despite the widespread existence of export controls in relation to national security, and frequent invocations of import controls and trade embargoes.[34] Interestingly, the European Community, with support of the United States, has argued that the right to invoke Article XXI is "inherent" and that neither "notification, [nor] justification, nor approval" are required.[35] The European Community has also argued that it is "left to each contracting party the task of judging what [is] necessary to protect its essential security interests."[36]

THE OECD CODE OF LIBERALISATION OF CAPITAL MOVEMENTS

The OECD Code of Liberalisation of Capital Movements (the "Code") was adopted in 1961 with the aim of opening markets to foreign direct investment. All 35 OECD countries, including Germany, France, Italy, the United Kingdom, the United States, and Japan, have adopted the legally binding Code.

Article 3 of the Code includes a broad national security exception that allows a signatory to take actions that "it considers necessary" to protect its "essential security interests" and to fulfil "its obligations relating to international peace and security". Like GATT, the language of the exception suggests that it is self-judging.

In 2009, the OECD Investment Committee commented on CFIUS as part of a larger report on international investment liberalisation issues and found that the CFIUS process "do[es] not create formal difficulties with respect to the United States position under the Code" – a finding that was not changed by the passage of FINSA in 2007.

As a general matter, the Investment Committee urges signatories to refrain from invoking Article 3 as a "general escape clause" to impose disguised barriers to trade. Signatories have also been encouraged to include in their reservations under the Code any discriminatory national security investment restrictions they have in place.

EU competence to draft an EU FDI Screening Mechanism

A key question for drafting an EU FDI screening mechanism would be to establish where the competence lies, i.e. if exclusive EU competence, if shared with the Member States or if with the Member States alone. In a recent opinion (the "Opinion"), the European Court of Justice (the "ECJ") clarified that the power to regulate foreign investments, depends on whether the investment qualifies as a foreign "direct" investment ("FDI investment") or a "portfolio" investment. [37]

FOREIGN DIRECT INVESTMENT – EXCLUSIVE COMPETENCE OF THE EU

EU case law has defined FDI as an investment which establishes "lasting and direct links" with the target in order to "carry out an economic activity". Shareholder acquisitions are considered to be direct investments only if the shareholder is able to "participate effectively in the management of that company or in its control". [38]

In short, the Opinion explains that FDI belongs to the EU's common commercial policy, which is within the exclusive legislative competence of the EU.[39] Therefore, the EU only may legislate within this area, and Member States are able

32 Article XX, General Agreement on Tariffs and Trade (1994).

33 See Roger P. Alford, The Self Judging WTO Security Exception (2011), p. 699. For a summary of notable WTO challenges of Article XXI invocations, see Article XXI Security Exceptions, GATT Analytical Index, *available at* https://www.wto.org/english/res_e/booksp_e/gatt_ai_e/gatt_ai_e.htm.

34 Trade-related disputes have arisen in response to the European Economic Community's trade embargo against Argentina during the Falklands War, US sanctions against Nicaragua during the anti-Communist revolution, and the European Community's sanctions targeting Serbia and Montenegro during the war in Yugoslavia, but in none of these cases did a panel conduct a substantive review of a state's invocation of the security exception. See further, Roger P. Alford, The Self Judging WTO Security Exception (2011), pp. 710 – 718. The GATT panel established to review Nicaragua's claim against the United States noted the risk of member states invoking the security exception for purposes other than security interests. Tellingly, however, that panel suggested those concerns be considered by member states in a "formal interpretation of Article XXI", in effect conceding that the current framework did not provide sufficient support for a GATT panel to second-guess an invocation of Article XXI. See *id.*, pp. 716.

35 *Id.* p. 711. In 1982, the GATT contracting parties adopted a procedure requiring Article XXI invocations (other than Article XXI:a) to be informed "to the fullest extent possible". Article XXI Security Exceptions, GATT Analytical Index, pp. 605–606, *available at* https://www.wto.org/english/res_e/booksp_e/gatt_ai_e/gatt_ai_e.htm.

36 *Id.* p. 714. This, however, did not prevent the European Community from challenging the US secondary boycott targeting Cuba in the mid-1990's (although the challenge was ultimately abandoned). See *id.*, pp. 719–721.

37 See the ECJ's opinion (16 May 2017), recital 80 referring to case law judgments of 12 December 2006, Test Claimants in the FII Group Litigation, C-446/04, EU:C:2006:774, paragraphs 181 and 182; of 26 March 2009, *Commission v Italy*, C-326/07, EU:C:2009:193, paragraph 35; and of 24 November 2016, SECIL, C-464/14, EU:C:2016:896, paragraphs 75 and 76).

38 *Id.*

39 Articles 207 and 3(1)(e) of the Treaty on the Functioning of the European Union ("TFEU").

to do so only if empowered by the EU.[40] The EU therefore has the right to conclude international agreements and adopt autonomous measures with regard to FDI.[41]

According to the ECJ's reasoning, EU legislative acts, which regulate investments by foreign persons in the management of an EU target company, "have direct and immediate effects on trade between that third countries and the European Union". However, if there is no such participation, there is consequentially no specific link with trade between the EU and third countries.[42]

Further, the ECJ clarified that this exclusive competence – for the purpose of trade agreements – is not affected by the power of each Member State to assess its requirements of public security or public order. Such provisions allow for discrimination between foreign investors and national investors provided that such discrimination does not constitute a "disguised restriction" and that such a discriminatory measure is "necessary" to protect public security or public order.[43]

PORTFOLIO INVESTMENTS – SHARED COMPETENCE BETWEEN THE EU AND THE MEMBER STATES

The Opinion further explained that investments that do not qualify as FDI, i.e. non-direct or "portfolio" investments, include for instance acquisitions of "company securities with the intention of making a financial investment without any intention to influence management and control of the undertaking". These types of investments constitute movement of capital on the internal market for the purpose of Article 63 of the Treaty of the Functioning of the EU ("TFEU"), and they therefore fall under the shared competence between the EU and the Member States.[44]

In other words, the Opinion appears to have established a clear border between direct foreign investment falling under the common commercial policy, which the EU alone

would be competent to regulate, and non-direct foreign investments, e.g. trading in shares, which would be shared competence.

EU REGULATING FOREIGN DIRECT INVESTMENT – NOT CONTENT OF PUBLIC SECURITY

As noted in the Opinion, even though the EU has exclusive competence, the Member States have a right – under certain conditions – to impose their own restrictions to protect public order and public security.[45]

The Opinion does however not provide definitive guidance in the context where the EU would want to require Member States to actively conduct an FDI screening for the purpose of public or national security reasons. In other words, whereas it is clear that the Member States have a right to do so, the question is still somewhat open, if the EU, in its exclusive competence to regulate FDI would also have the right to oblige the Member States to perform such an FDI screening for national or public security reasons. However, as further examined in the section below, EU legislation exists in several areas with the purpose to contribute to a common EU security level whereby the EU legislation requires Member States to take certain measures and ensure a minimum level of protection. However, the substantive assessment remains at Member State level with the competent

40 Article 207(2) TFEU calls for the ordinary legislative procedure in accordance with Article 289 TFEU where the European Parliament and the Council jointly shall adopt measures on a proposal from the Commission. This means that the Member States, indirectly via the Council, take part in the legislative procedure.

41 Article 207 TFEU.

42 Opinion paragraph 84.

43 Opinion paragraphs 101–104. The question in the Opinion related to the conclusion of a comprehensive free trade agreement. The ECJ explained that when an international trade agreement containing these type of provisions (i.e. exceptions for public order or public security), this simply reflects the delineation between the EU's international trade agreements and the Member State's exclusive competence to take measures to protect public security or public order. However, when exercising the right to impose such measures, the Member States are obliged to do so in a manner that does not render the EU's trade commitments redundant.

44 Opinion paragraph 227 citing, inter alia, judgments of 28 September 2006, *Commission v Netherlands*, C-282/04 and C-283/04, EU:C:2006:208, p. 19; of 21 October 2010, *Idryma Typou*, C-81/09, EU:C:2010:622, p. 48; and of 10 November 2011, *Commission v Portugal*, C-212/09, EU:C:2011:717, p. 47.

45 See Opinion paragraphs 101–103, and Article 65(1)(b) TFEU allowing Member States to restrict the free movement of capital. EU case law has established narrow conditions for such national legislation to be accepted, including that it be suitable for securing the objective and be proportional, see for instance Case C-463/00, Judgment of the Court of 13 May 2003, *Commission v Kingdom of Spain*, ECR [2003] I-04581, paragraph 68.

authorities. A similar approach could be taken for an FDI screening mechanism.

In sum, there is arguably both legal basis and established methods which could be relied on to introduce EU-wide legislation requiring FDI screening by EU Member States.

A FUTURE EU FDI MECHANISM THOUGH A REGULATION

Based on the Opinion, if an EU FDI mechanism would cover FDI only, and not portfolio investments, the EU should in principle have exclusive competence to adopt legislation.

The European Parliament and the Council implement the common commercial policy by means of regulations adopted through the "ordinary legislative procedure". This normally means that the European Commission would prepare a proposal, which the European Parliament and Council would have to adopt.[46]

Introducing an FDI screening mechanism would therefore not shift any existing power from the EU Member States to the EU. A regulation would be directly applicable in all Member States and not require any implementation measures. This should also lead to a consistent approach among Member State competent authorities and reduce the risk that one Member State applies a more lenient approach and thereby undermines another Member State's standard of review.

46 Articles 207 and 294 TFEU.

Security-Related EU legislation

When considering an EU FDI screening mechanism, existing EU legislation may be considered to ensure a consistent approach both in terms of scope, e.g. what to protect and method, e.g. how to set up the mechanism in the Member States. The following section examines the EU's dual use rules, rules relating to market access, sectors which have been considered in need of EU-level protection and specific aspects concerning FDI backed by state funding.

EU export control under the dual use rules

PURPOSE AND SCOPE OF THE DUAL USE REGULATION

The EU Dual Use Regulation 428/2009 ("Dual Use Regulation") is one of the EU's main export control laws and is adopted based on the common commercial policy.[47]

The Dual Use Regulation restricts exports of specific dual use items to third countries. For certain items, deemed particularly sensitive, restrictions apply also within the EU.[48] The Dual Use Regulation gives the national competent authorities the discretion to decide whether or not to grant an

47 Article 133 of the Treaty of the European Community, current Article 207 TFEU.
48 The Council Regulation (EC) No 428/2009 of 5 May 2009 setting up a Community regime for the control of exports, transfer, brokering and transit of dual-use items, O.J. L 134, 29.5.2009.

export authorisation depending on the destination country and in many cases the end user. Furthermore, Member State competent authorities are also empowered to take "catch all" decisions, whereby items, other than those identified in the Dual Use Regulation, are made subject to an authorisation because of the items possible military end use or use in making chemical, nuclear or biological weapons. In other words, the restriction is associated with who may obtain the item and what it will be used for.

Thus, the Dual Use Regulation requires Member States to restrict trade in certain products, depending on the country and use or user of the items to be exported. By comparison, a similar methodology is often applied in FDI mechanisms, i.e. the legislation identifies specific sectors as sensitive and the assessment is made in relation to the identity of the foreign investor.

Further, as to the more detailed scope of an FDI mechanism, it may be relevant to provide a cross-reference to the Dual Use Regulation as a factor to consider in a review.

To note is that in the ongoing legislative review of the current Dual Use Regulation, the European Commission has proposed to extend the catch all provisions to address the risk of terrorism, human rights violations and to cyber surveillance technology which could be used for human rights violations.[49]

The current Dual Use Regulation already allows Member States to decide to restrict exports due to potential human rights violations.[50] Further to the on-going recast of the Dual Use Regulation, it is possible that in the future, Member States will not just have a right to but also be obliged to review and make a determination as to whether a particular item could be used for human rights violations. Thus, it would be conceivable that an EU FDI screening mechanism also would include the risk of human right violations as a possible factor to consider.

CONSIDERATIONS FOR AN EU FDI SCREENING MECHANISM

There is, arguably, a certain logic to ensuring that an EU FDI review mechanism is aligned to the content of the EU Dual Use Regulation.

For example, an EU company (Company A) producing certain dual use software may be prohibited from exporting to a certain customers (Company B) in a specific country. However, due to the lack of FDI screenings, the customer, Company B, may actually be allowed to acquire Company A which would allow access not only to the dual use item but also full access to the technology used to produce the dual use item. That scenario would be further aggravated, for instance, if Company B is established in a country without any comparable export control regime. In extension, this could lead to an unintended proliferation of controlled dual use technology and undermine the EU's dual use regime.

49 European Commission, 2016/0295 (COD), Proposal for a regulation of the European parliament and of the council setting up a Union regime for the control of exports, transfer, brokering, technical assistance and transit of dual-use items (recast), 2016-09-28.

50 See article 8 of the EU Dual Use Regulation. Any such restrictions shall immediately be notified to the European Commission. Several Member State already apply a human rights assessment in their dual use determinations. In addition, as regards exports of military or defence goods, Member States are obliged under Article 2 of Common Position 2008/944/CFSP (O.J. 13.12.2008, L 335, p. 99) to consider the receiving country's respect for human rights before granting an export authorisation.

Further, there is also a rationale to introducing a minimum EU standard of review of targets in the dual use sector. For example, all companies in the EU which are involved in the production, sale or supply of export control-regulated items, are subject to the same EU rules restricting export to illegitimate purposes or users. However, at present, whereas the acquisition of a company in one Member State may be subject to FDI screening and blocked for security concerns, the acquisition in another Member State, lacking such FDI screening laws, would allow the same foreign investor to acquire a company producing a similar product, and thus acquiring the underlying technology. Arguably, the lack of FDI screening in one Member State would undermine the laws and application of other Member States that do have such laws in place.

Market access and import restrictions/public procurement

RIGHT TO IMPOSE RESTRICTIONS AGAINST TRADE WITH THIRD COUNTRIES

The EU is based on a customs union covering all trade in goods. Member States are prohibited from applying any restrictions, tariffs or other measures, against each other and have to follow the common customs tariff in relation to trade with third countries. Both the customs union and the common commercial policy is the exclusive competence of the Union.[51] Case law has established that the common commercial policy's scope should be interpreted generously ("non-restrictive manner"), to avoid disturbances in intra-EU trade because Member States apply different measures against non-EU countries.[52] In other words, a uniform approach towards non-EU countries is needed to avoid disturbances on the internal market.

Nonetheless, Member States are permitted to impose restrictions for specifically justified reasons, such as "public morality, public policy or public security" as well as "protection of industrial and commercial property".[53] However, Member States cannot impose restrictions when there is harmonised Union legislation, but many times such harmonising legislation will allow Member States to deviate from the Union laws.[54] Further, any such measures have to be proportional and be undertaken in good faith.

Case law has established that the concept of public security covers both a Member State's internal security and its external security. Specific consideration has been given to the fact that "it is becoming increasingly less possible to look at the security of a State in isolation, since it is closely linked to the security of the international community at large, and of its various components". A Member States is therefore allowed to deviate from the common commercial policy and impose its own national restrictions on strategic goods (including dual-use goods) for public security reasons ("to prevent the risk of serious disturbance to its foreign relations").[55]

As set out above, there is likely no contradiction in the above mentioned right for Member States to apply public security restrictions, and future EU legislation which requires Member States to perform an FDI review to ensure a common EU-level of security. Presumably, even if an EU FDI review mechanism were put in place, Member States would still be allowed to apply additional measures for public or national security reasons.

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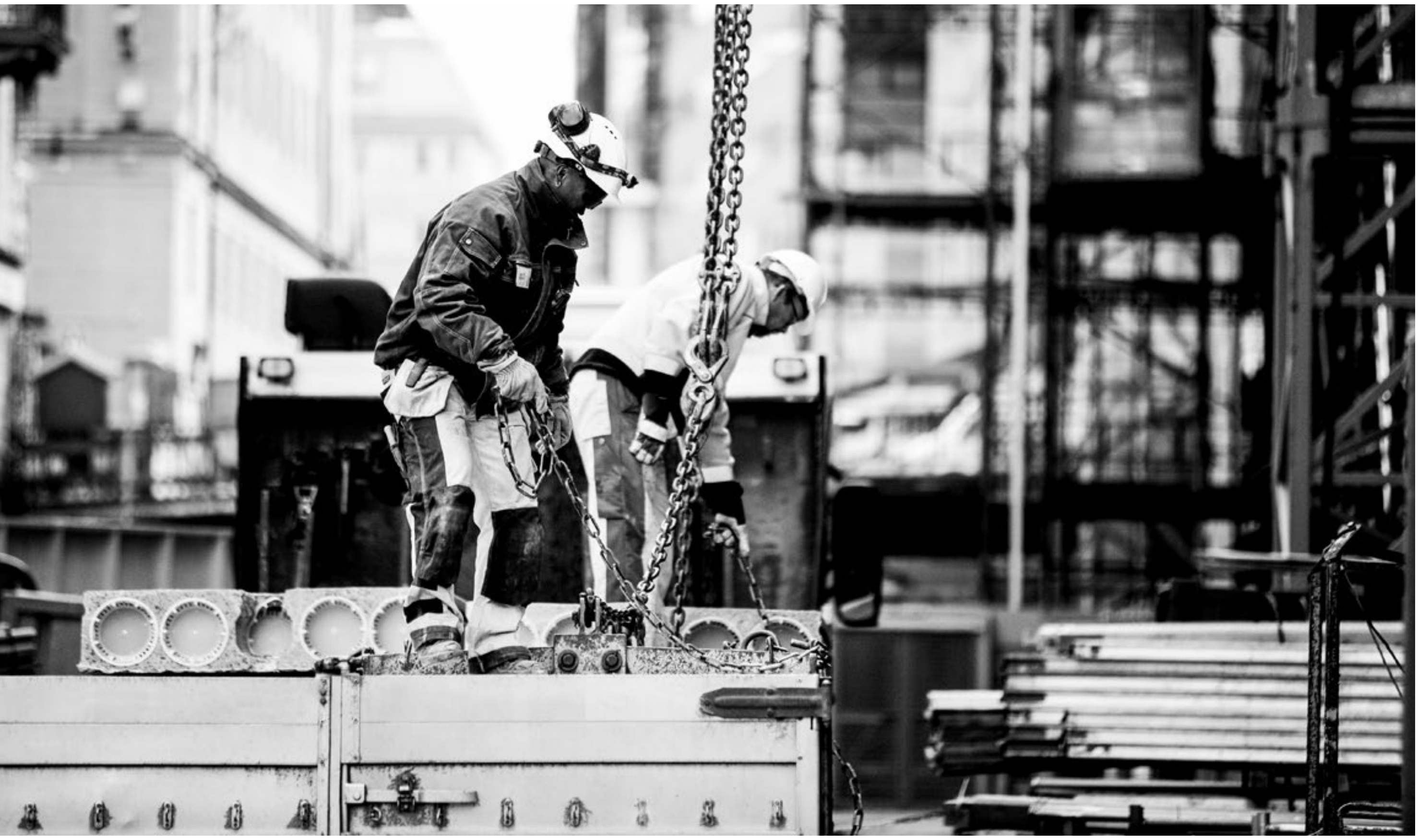
51 Article 3.1(a) and (e) TFEU.

52 Case C-70/94, Judgment of the Court of 17 October 1995, *Fritz Werner Industrie-Ausrüstungen GmbH v Federal Republic of Germany*, Reference for a preliminary ruling, ECR 1995 p. I-03189, recital 9. Case C-83/94, Judgment of the Court of 17 October 1995, *Leifer and others*, ECR 1995 p. I-03231, recitals 8–10.

53 Article 36 TFEU.

54 Case C-473/98 *Toolex* [2000] ECR I-5681; Case 5/77 *Tedeschi v Denkavit* [1977] ECR 1555.

55 Case C-367/89, Judgment of the Court of 4 October 1991, *Aimé Richardt and Les Accessoires Scientifiques SNC*, Reference for a preliminary ruling, ECR 1991 p. I-0462, recital 22, Case C-70/94, Judgment of the Court of 17 October 1995, *Fritz Werner Industrie-Ausrüstungen GmbH v Federal Republic of Germany*, Reference for a preliminary ruling, ECR 1995 p. I-03189, recital 29. Case C-83/94, Judgment of the Court of 17 October 1995, *Leifer and others*, ECR 1995 p. I-03231, recital 30.



PUBLIC PROCUREMENT

Also in the field of public procurement, special EU rules apply to the procurement of arms, munitions and war material. Article 346 of the TFEU provides that the provisions of the treaty shall not preclude a Member State's right to take such measures as it considers necessary for the protection of the essential interests of its security which are connected with the production of or trade in arms, munitions and war material. In essence, this means that a Member State in certain cases can derogate from its responsibility to publicly procure certain products, if it is needed for e.g. protecting national production of war material.

The application of the provision is limited to a certain set of products included on a list that the Council (of the European Union) has adopted.[56] Common for all the products on the list, such as bombs, artillery, ammunition, war machines, are that they are intended for military use.

Further, the EU has enacted Directive 2008/81/EC covering the procurement of certain contracts in the fields of defence and security.[57] Also this directive allows for Member States to derogate from the obligations to publicly procure if it is needed e.g. for ensuring security of supply or protecting classified information.

CONSIDERATIONS FOR AN EU FDI SCREENING MECHANISM

EU Member States are permitted to deviate from the common commercial policy and to impose restrictions on foreign imports and to refrain from the EU rules on public procurement for security reasons. A foreign supplier, which is thus prevented from supplying to that Member State, may instead consider FDI in a company in another Member State that does not apply such security restrictions, which in turn could possibly lead to a backdoor for supplying to that Member State through an acquired EU company.

An EU FDI mechanism could therefore also serve, through a cooperation mechanism between competent authorities, to prevent such types of perceived circumvention.

56 See Council Decision 255/58 of 15 April 1958, 14538/4/08 REV 4.

57 Directive 2008/81/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of procedures for the award of certain works contracts, supply contracts and service contracts by contracting authorities or entities in the fields of defence and security, and amending Directives 2004/1/EC and 2004/18/EC.

NIS Directive on essential services and ECI Directive on critical infrastructure

The EU Parliament, in its call to the European Commission to draft EU legislation on FDI screening, suggests that an FDI screening mechanism is applied to strategic sectors, such as the energy, transport, telecommunications and health and water sectors.[58]

INTERNATIONAL COMPARISON

In a 2016 report on foreign investment, UNCTAD concludes that whereas the scope of FDI screening for national security reasons in some countries is more narrow, the concept of national security and therefore also the scope of the screening, is applied in different ways and in many countries extends to investment in critical infrastructure and strategic industries. Most of the examined countries have review mechanisms which reportedly cover sectors such as electricity, water and gas distribution, health and education services, transportation and communication. However, only a few countries apply reviews in strategic economic sectors, e.g. natural resources. The report also observes that FDI screening mechanisms are on the rise, both in terms of countries enacting and introducing FDI screening, but also other countries which revise and extent the scope of FDI screening mechanisms, to extend to new sectors.[59]

As there is no common definition of what sectors could be deemed sensitive from a national security perspective, the EU could include various types of companies, operators or sectors under an FDI mechanism.

Also, the EU maintains two directives which aim at ensuring certain levels of protection at EU-level for certain important sectors. The ECI Directive identifies critical infrastructure and the NIS Directive identifies essential service providers in specific sectors for the purpose of ensuring an EU-level protection. The two directives operate in parallel.[60]

58 Proposal for a Union Act, 20.3.2017, B[8-0000/2017] submitted by Members of the European of Parliament, Weber, Caspary, Saifi, I. Winkler, Cicu, Proust, Quisthoudt-Rowohl, Reding, Schwab, Szejnfeld.
59 UNCTAD, World Investment Report 2016, Section A. National Investment Policies, Subsection 2, Foreign investment and national security-related policies, p. 94.
60 See Article 1.4 of the NIS Directive, which states that its application shall be without prejudice to the application of the ECI Directive.

THE ECI DIRECTIVE – CRITICAL INFRASTRUCTURE

The ECI Directive was adopted in 2008, to identify and protect critical infrastructure against threats, primarily terrorist attacks.[61]

The ECI Directive obliges Member States to identify critical infrastructure that meet two criteria, a sectoral criteria and a cross-cutting criteria. The sectoral criteria defines critical infrastructure as “an asset, system or part thereof located in Member States which is essential for the maintenance of vital societal functions, health, safety, security, economic or social well-being of people, and the disruption or destruction of which would have a significant impact in a Member State as a result of the failure to maintain those functions”. The cross-cutting criteria targets critical infrastructure located in one Member State, the disruption or destruction of which would have a significant impact on at least two Member States. Critical infrastructure that meet the two criteria is defined as European critical infrastructures (“ECI”).

Once identified, the ECI Directive obliges the Member States to inform each other and engage in bilateral or multilateral discussions with other Member States that may be affected by a disruption. The information on what infrastructure has been identified as ECI is classified. The Member State is also obliged to assess whether the operators of ECI have appropriate operator security plans in place. Minimum content of such plans are set out in the ECI Directive.

61 Directive 2008/114/EC on the identification and designation of European critical infrastructures and the assessment of the need to improve their protection, O.J. L 345, 23.12.2008.

At the time of its adoption, the ECI Directive's scope was limited to the transport and energy sectors but with an expressed possibility to extend to other sectors as needed, notably the information and communication technology sector.[62]

THE NIS DIRECTIVE – ESSENTIAL SERVICES PROVIDERS IN SPECIFIC SECTORS

The NIS Directive aims at establishing a high common level of security of networks and information systems in the EU.[63] The directive was adopted in response to Member States having very different levels of preparedness, which "undermines the overall level of security…within the Union" and which make it impossible to set up "global and effective mechanisms at Union level".[64]

Under the NIS Directive, Member States shall, amongst other things, identify essential service providers in specific sectors, defined as providers of services which are essential for the "maintenances or critical societal [or] economic activities", which depend on network and information systems, and for which an incident would have "significant disruptive effects on the service". The sectors in which the Member States need to identify essential service providers are energy, transport, banking, financial market infrastructure, health sectors, drinking water and distribution, and digital infrastructure.

62 Article 3.3 ECI Directive.
63 Directive (EU) 2016/1148 concerning measures for high common level of security and information systems across the Union, O.J. L 194, 19.7.2016.
64 Preamble 5 of the NIS Directive.

The Member States shall submit the list of identified essential service providers to the European Commission every two years, in order for the European Commission to assess the implementation of the NIS Directive.

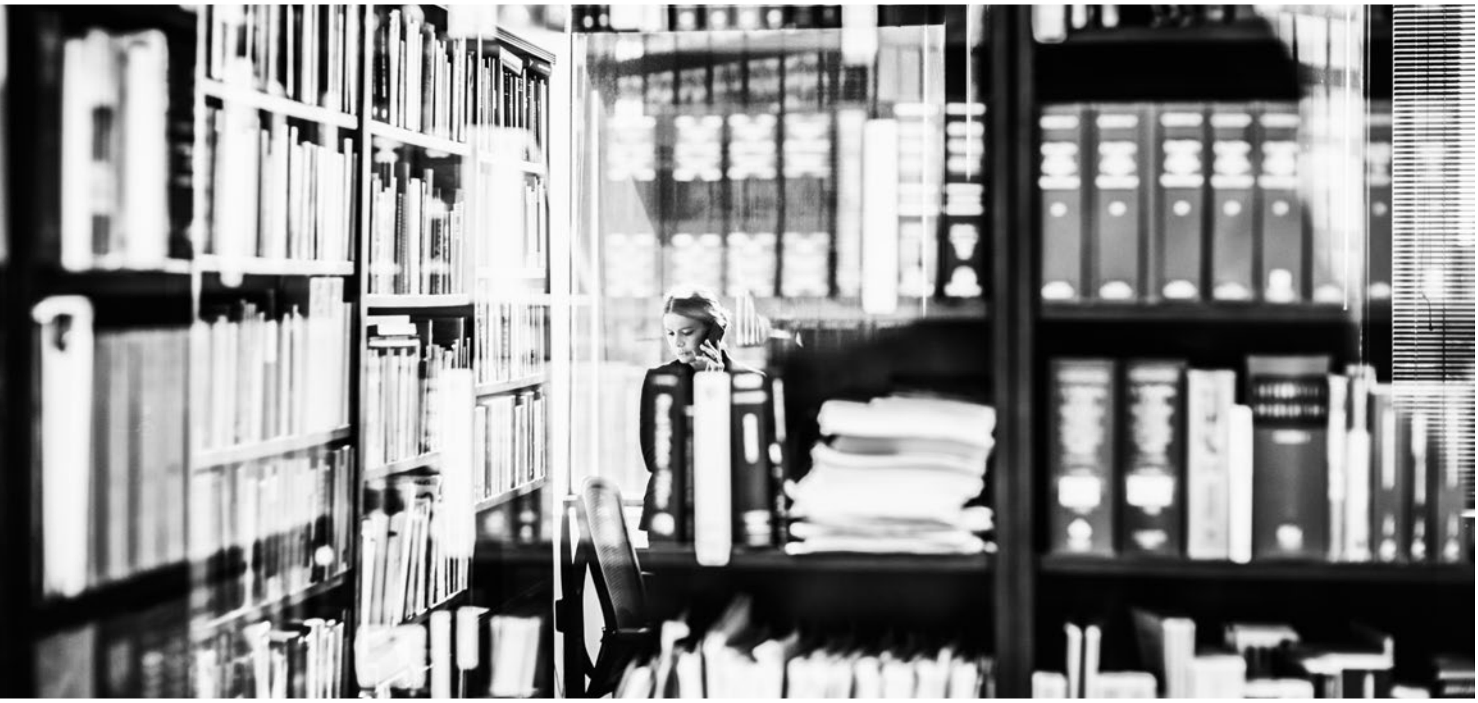
For the service providers identified by the respective Member State, the NIS Directive obliges the Member State to ensure that they have appropriate and proportional technical and organisational measures to manage risk and to prevent and minimise the impact of an incident. The NIS Directive itself does not set the actual standards, but refers to guidance by ENISA and the possibility to draft such standards through another procedure.[65] Enforcement is left to the Member States' competent authorities.

CONSIDERATIONS FOR AN EU FDI MECHANISM

Arguably, based on an international comparison, and the underlying rationale for both the ECI and NIS Directive, there is a logic for an EU FDI screening mechanism to cover, at least partially, the sectors identified in the ECI and NIS Directives, as these are defined as sensitive.

Further, both the ECI and NIS Directive are based on a rationale of providing Union-level protection; the ECI Directive is based on a cross-cutting criteria and the NIS Directive points to the risk of "undermining overall level of security" if there is no common Union security level in the defined sectors.

65 Preamble (66) of the NIS Directive with reference to Regulation (EU) No 1025/2012 of the European Parliament and of the Council.



Policy and measures to counteract perceived market distortion or subsidisation

Both Member States and the European Parliament have called for the European Commission to consider legislative action.[66] These initiatives appear to encompass not only a narrow definition of national security, but also potential market distortion caused by FDI backed by foreign-state funding.

The WTO agreement on Subsidies and Countervailing Measures ("ASCM") allows WTO members to depart from their bound tariff rates and impose anti-subsidy duties on imported goods.[67] The imposition has to be preceded by an investigation, whereby the investigating authority makes a positive determination that the imported product is subsidised by the foreign government, based on detailed calculations establishing the level of subsidisation and that the subsidy is causing injury to the domestic industry.[68]

The EU has implemented the ASCM into EU law (the "EU Regulation")[69], and regularly imposes anti-subsidy duties on foreign imports. Although the ASCM and the EU Regulation apply with respect to trade in goods only and not to services, movement of capital or investments, they do acknowledge that governmental subsidies may distort international trade, and that such distortion may justify measures to counteract the distorting effects. Both the ASCM and the EU Regulation place special focus on export subsidies, which are subsidies granted based on a company's export performance, the actual or anticipated exportation or export earnings.[70] In the same vein, FDI backed by state funds or capital, could be motivated by various reasons, including acquiring industries or sectors to strengthen the domestic industry's position globally.

In CFIUS reviews, one of the specific factors to be considered is if the proposed investor is a state-owned company (directly or indirectly). Some US Congressional leaders have recently also called on CFIUS to consider whether foreign state-owned companies have access to subsidised capital or other subsidies, when they participate in bidding on US targets.[71] The US-China Commission on Economic Security has recommended that CFIUS be authorized to reject all Chinese state-owned entities' acquisitions of US firms.[72]

66 French, German and Italian minister's letter to Cecilia Malmström, the European Parliament call for a proposal, *available at* http://www.bmwi.de/Redaktion/DE/Downloads/E/eckpunktepapier-proposals-for-ensuring-an-improved-level-playing-field-in-trade-and-investment.pdf?__blob=publicationFile&v=4. A May 2017 briefing from the European Parliamentary Research Service ("EPRS"), Briefing May 2017 [PE 603.941] (the "EPRS Report").

67 *Available at* https://www.wto.org/english/tratop_e/scm_e/subs_e.htm.

68 See ASCM, Part V Countervailing Measures.

69 Regulation (EU) 2016/1037 of the European Parliament and of the Council of 8 June 2016 on protection against subsidised imports from countries not members of the European Union, O.J. 30.6.2016, L 176/55.

70 See article 4.4 of the EU Regulation and 3.3.1 of the ASCM.

71 *CFIUS and National Security: Challenges for the United States, Opportunities for the European Union*, Theodor H. Moran, February 19, 2017 draft, p. 13, Peterson Institute of International Economics.

72 *Id.*

Similarly, the EU Parliament, in its call to the European Commission to draft laws on an FDI screening mechanism, stated that an EU mechanism should be used when the "envisaged direct investment by the third country does not comply with market rules or is facilitated by state subsidies resulting in a likely market disturbance".[73] Also the French, German and Italian Member State call for legislation contends that "intervention is particularly justified" in cases where the investment does not comply with market rules (e.g. through investment instructions) or when facilitated by subsidies which cause market disturbance.[74]

Arguably, justifying a restriction on FDI for national security is different from restricting FDI for fears of potential market distortion. Whereas the WTO exception and OECD Code cover essential security concerns, the question is whether this concept could extend to the risk of market distortion as a primarily economic justification. In other words, an FDI screening mechanism that restricts investments simply because the FDI is subsidised, faces the risk of being seen as a disguised protectionist measure.

73 Proposal for a Union Act, 20.3.2017, B[8-0000/2017] submitted by Members of the European of Parliament, Weber, Caspary, Saifi, I. Winkler, Cicu, Proust, Quisthoudt-Rowohl, Reding, Schwab, Szejnfeld.

74 French, German and Italian minister's letter to Cecilia Malmström, the European Parliament call for a proposal, *available at* http://www.bmwi.de/Redaktion/DE/Downloads/E/eckpunktepapier-proposals-for-ensuring-an-improved-level-playing-field-in-trade-and-investment.pdf?__blob=publicationFile&v=4.

That being said, the fact that FDI is subsidised by a government, should have some bearing in an FDI review. The fact that the FDI is made feasible with subsidies, for instance, by undercutting competitive bids by other market-based investors, may be part of a more strategic investment plan by the subsidising government. Thus, if the foreign investor is directly or indirectly controlled by a government, and also receives subsidised funds or capital for the investments, there is arguably a stronger justification for an FDI screening as the FDI could then be considered part of a strategic or national industrial goals of a foreign state (e.g. targeting acquisitions in certain sectors).[75] If the sectors targeted by the foreign government are classified as essential services or critical infrastructure by the receiving country, such factors should arguably allow the receiving country to block or restrict the FDI.

One suggested method to address these concerns could be that state funding or subsidisation become a trigger for mandatory FDI review. Further, if such subsidisation is confirmed and the FDI target operates in certain sectors (defined at EU-level), then the FDI would have to be subject to certain restrictions (e.g. no foreign-state control).

75 See p. 4 of the EPRS report.

Conclusion – proposed main elements of an EU FDI screening mechanism

FDI screening is already relatively common in many EU Member States. And, as such, FDI screening mechanisms do not risk breaching WTO trade laws or commitments undertaken in the OECD context. An EU FDI screening mechanism would therefore not necessarily be seen as a protectionist measure.

Further, as with many other types of EU legislation in the field of the common commercial policy, an EU FDI screening could function by requiring the Member States to appoint competent authorities and instructing such authorities to conduct reviews of a proposed transaction when certain conditions or thresholds are met (compare e.g. EU Dual Use Regulation, NIS Directive as discussed above). The assessment of what is a national security concern would remain with the Member States, but subject to a form of cooperation.

Based on the ECJ Opinion, and by comparison, the US CFIUS review, a key element in such a regulation would likely be the need to qualify FDI as an investment with the aim of obtaining "control" of an EU target in line with EU case law, and spell out a definition of such control.

Further, a regulation would also likely need to provide a justification for requiring Member States to review envisaged transactions. Whereas outside of the EU, FDI mechanisms normally are justified based on *national* security reasons in a particular country, an EU mechanism would, supposedly, have to be based on obtaining a *common EU* security.

Also, any proposed EU legislation would necessarily have to establish a minimum common scope, for example particular sectors for which a screening is mandatory. As discussed above, there are several areas in which the EU has already identified critical sectors or infrastructure, in which EU Member States are required to take particular action to secure a minimum EU-level protection. Arguably, an EU FDI screening mechanism should preferably be aligned with such other legislation such as the ECI and NIS Directives for reasons of predictability.

Also, an EU mechanism should, as is common in most EU legislation, set up some form of reporting mechanism between the Member States and the European Commission, and a cooperation mechanism between the Member State competent authorities, in order to ensure consistency and a high level of protection.

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