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Global Counsel

**FOREIGN
INVESTMENT:
RISING TIDES
OF POLITICS
IN REGULATION**

Foreign investment scrutiny in today's world

Recent years have seen important global shifts in both the policy frameworks for screening inward foreign investment and the way in which they are applied. As a result, foreign direct investment (“FDI”) regulation has featured increasingly on the radar for cross-border M&A, against a backdrop of amplified protectionist rhetoric. Even before the Covid-19 pandemic, a number of countries traditionally seen as being open to foreign investment were moving towards stricter public interest and FDI scrutiny of transactions (such as the UK, USA and Australia). Following the outbreak of the pandemic, this trend has only increased. In particular, governments have sought to move quickly to protect businesses affected by the economic fall-out from opportunistic acquisition by foreign buyers. The focus continues to stretch well beyond acquisitions by certain Chinese companies, and the concept of “national security” continues to be extended, to include critical infrastructure, communications assets, advanced technology and data, and – influenced by the pandemic – healthcare. These trends reflect some big shifts in the global economy, as well as the political mood. Whilst some of the amendments directly related to the pandemic may ultimately prove to be temporary, the overall picture is likely to be one of structural change, rather than cyclical, with the pandemic helping to accelerate already existing trends. At the same time, the historical “level playing field” frustration when it comes to FDI restrictions has been turning. Asian countries, in particular China and India, have progressively opened parts of their economies to FDI and have streamlined their screening processes. It remains to be seen whether this trend will also continue as these jurisdictions emerge from the pandemic.

The new landscape in countries traditionally open to investment has been exemplified in recent years by the US: the volume and intensity of CFIUS reviews has significantly increased under the Trump administration and reforms which came into effect in February 2020 have formally expanded the jurisdiction of CFIUS even further. This has been part of a wider shift to a more protectionist approach: in Europe, we have seen increased intervention in France and Germany, a new standalone FDI regime on the legislative agenda in the UK, and an EU Regulation on FDI screening mechanisms. In Australia, over 70 per cent of recent policy amendments have been either regulatory or restrictive of FDI, and a number of high-profile deals have been blocked.

The unprecedented global impact of the pandemic has clearly accelerated this trend. On 18 March 2020, Spain became the first EU Member State to significantly tighten its rules on FDI due to the impact of the pandemic on the value of domestic companies. This has been followed by similar tightening of FDI regimes in France, Italy and Germany, as well as a number of non-European jurisdictions, such as Australia, Canada, and – in a marked contrast to its previous direction of travel towards relaxation of FDI rules – India.

A key initial driver for the change in approach – pre-Covid-19 – was the growing weight of China as an exporter of capital, and a broadening of the sectors targeted by Chinese investment. However, whilst national security concerns surrounding Chinese investment clearly remain a key consideration, it is notable that the stricter approach to FDI scrutiny has increasingly also been linked to wider political concerns about how FDI by multinational companies – regardless of where they are based – is changing global value chains, with high-value activities being up-rooted from one location to another as company ownership changes.

These considerations are now overlaid with growing concerns surrounding the economic impact of the pandemic, in particular a concern that businesses in jurisdictions which are still subject to more stringent restrictions may be at risk of opportunistic takeovers by foreign investors, perhaps especially by Chinese buyers (with the wider Asian region emerging sooner from Covid-19 restrictions). The rhetoric surrounding the introduction of the EU-level guidelines on FDI screening during the pandemic is telling in this regard: on 25 March 2020 the European Commission urged EU Member States to be “particularly vigilant to avoid that the current health crisis does not result in a sell-off of Europe’s business and industrial actors”.

Enhanced scrutiny is manifesting itself in two distinct ways, which are important for foreign investors to understand. Politicians are adopting new political strategies for injecting informal government locus into deals, often deliberately creating ambiguity about the state's power of discretion to force acquirers to court their approval more assertively. This typically means taking greater advantage of the room for discretion that is invariably available within existing legislative frameworks. In some cases, however, they are going further and seeking new policy tools that allow for a more thorough vetting of foreign investments, often requiring new legislation, as illustrated by many of the recent Covid-19-related amendments.

The contrasting approach taken in many Asian countries wishing to encourage inward FDI is exemplified by China, India and Vietnam, whose recent policy-making activities – at least prior to the pandemic – have been heavily weighted towards measures intended to liberalise their respective FDI regimes. This strategy is well illustrated by the new Foreign Investment Law which came into effect in China on 1 January 2020, which overhauls the previous regime and opens up more sectors to foreign investment whilst also streamlining the process for approval.¹ These efforts are reflected in the numbers, with record levels of inward investment being recorded in these countries in recent years.

However, it remains to be seen to what extent this trend may be derailed by the impact of the pandemic. For example, on 17 April 2020 the Indian government announced a tightening of FDI restrictions to curb *"opportunistic takeovers/acquisitions of Indian companies due to the current Covid-19 pandemic"*. This amendment came in the context of the People's Bank of China acquiring a 1% stake in HDFC (India's largest mortgage bank) in early April 2020.

The result is a fluid and uncertain environment for foreign investment in which FDI filings are an increasingly important piece of the regulatory jigsaw for cross-border M&A. The approval process is often far from transparent, but behind the scenes FDI authorities are increasingly sharing information and liaising with each other during the course of reviewing transactions. This makes it more important than ever for foreign investors to understand both the legal framework and political and policy contexts they are operating in, and to co-ordinate a consistent global approach to any FDI filings required.

In this report, Global Counsel and Herbert Smith Freehills' Foreign Investment Regulation Group (made up of experts from our Competition, Regulation & Trade, Mergers & Acquisitions and Dispute Resolution practices) consider the current landscape and how to navigate this through effective deal planning and execution.

Alongside this report, Herbert Smith Freehills is publishing an interactive map and country-by-country guide summarising the FDI/public interest control processes and trends in key jurisdictions, an essential tool when considering potential deal hotspots.

Email FDIPublications@hsf.com to access your copy.

¹ For further information about the new Foreign Investment Law in China and the practical implications for investors, please see the Herbert Smith Freehills briefings available here: <https://sites-herbertsmithfreehills.vutvurevx.com/95/21568/compose-email/china-set-to-implement-the-new-foreign-investment-law.asp>, and here: <https://sites-herbertsmithfreehills.vutvurevx.com/95/21761/february-2020/national-security-review-regime-under-the-new-foreign-investment-law.asp>

Four trends and a shifting mood

Four trends stand out as being particularly significant in terms of predicting sensitivity for acquisitions: the impact of the Covid-19 pandemic; a widening focus beyond China; an evolving view of national security; and a value chain dilemma. These trends are inter-related and changing the way inward FDI is viewed by many host governments. There is no reason to believe the overall direction of travel will be reversed any time soon, even if some of the restrictions directly related to the pandemic ultimately prove to be temporary.

Client perception

In April 2020, participants in a webinar hosted by Herbert Smith Freehills and Global Counsel on navigating foreign investment and merger control regimes during the Covid-19 pandemic were asked what they thought the impact of recent changes in FDI regulation would be:

FDI regulation will deter foreign investment significantly?

35.7%

More likely to see foreign acquirers agreeing to remedies to get their deal through?

64.3%



The impact of the Covid-19 pandemic

The unprecedented global impact of the pandemic has accelerated a pre-existing trend towards protectionism, as governments have sought to move quickly to protect businesses affected by the economic fall-out from opportunistic acquisition by foreign buyers. Whilst there is still a degree of uncertainty and volatility in global markets, it is clear that there is scope for such acquisitions, particularly as some regions (notably Asia) emerge sooner from Covid-19 related restrictions than others.

A number of jurisdictions have responded by making specific legislative amendments to tighten their FDI regimes. The effects of this are two-fold: (i) generally lowered thresholds across a wide range of sectors in many regimes (as illustrated by, for example, Spain and Italy) increase the risk of regulatory review, particularly in respect of certain sensitive purchasers (such as state-owned enterprises and non-EU investors); and (ii) within this general lowering of thresholds, the specific classification of medical assets as sensitive or critical in some regimes (as illustrated by, for example, Germany) will increase the risk of regulatory review in the health sector. The global landscape is currently changing on an almost daily basis, and keeping up to date with amendments to the rules will be critical in terms of transaction planning and risk allocation in the challenging Covid-19 cross-border M&A environment.

By way of illustration of this trend, one of the first jurisdictions to act was Spain, which significantly tightened its FDI rules in response to the pandemic on 18 March 2020. Acquirers based outside the EU (or where the ultimate owner is outside the EU) must now obtain prior approval for an acquisition of a shareholding of 10% or more, or a management right, in a Spanish company in a very broad range of sectors. Where the foreign investor is directly or indirectly controlled by a foreign government, the stricter FDI regime applies for investments across all sectors.² This focus on non-EU or state-owned enterprise acquirers chimes with rhetoric from some across Europe regarding the possibility of opportunistic takeovers by government-controlled acquirers from China.³

Similar tightening of FDI regimes has also been seen in France, Germany and Italy (which has notably also extended tighter rules to EU-controlled investors until the end of 2020), against the backdrop of new EU-level guidelines which strongly encourage EU Member States to strenuously enforce their national FDI screening mechanisms, where these exist, to protect sensitive assets from foreign takeovers during the pandemic.

² These include critical infrastructure and technology, healthcare, communications, energy and transport, and also the supply of key inputs such as energy, raw materials and food security.

³ See for example "Vestager urges stakebuilding to block Chinese takeovers" at <https://www.ft.com/content/e14f24c7-e47a-4c22-8cf3-f629da62b0a7>

These types of changes have not been limited to Europe, with Australia, Canada, and – in a marked contrast to its previous direction of travel towards relaxation of FDI rules – India, all also imposing stricter restrictions on FDI to protect domestic targets from opportunistic takeovers during the pandemic. Further detail on the steps taken in particular jurisdictions is set out in the section headed “Spotlight on new restrictions taking effect during 2020”, and in the HSF country-by-country guide published alongside this report.

It seems inevitable that increased regulatory hurdles will have a dampening effect on FDI, particularly when combined with the economic consequences of the pandemic in terms of disruption to supply, demand contractions and ongoing uncertainty and volatility in global markets. Indeed, an OECD report published in May 2020 estimated that FDI flows are expected to fall by more than 30% in 2020 even under the most optimistic scenario for the success of the public health and economic support policy measures taken by governments to address the pandemic and the resulting recession.⁴

However, that same report also recognised that FDI could play an important role in supporting economies (particularly emerging and developing economies) both during and after the crisis, through financial support to affiliates, assisting governments in addressing the pandemic, and through linkages with local firms. Where investment opportunities arise, it will be critical to establish early in the transaction planning process whether the transaction is likely to give rise to investment screening, and if so, to anticipate potential issues and identify ways of addressing them.

A widening focus beyond China

China has become well-established as the second most important destination for FDI, after the US, with the stock of inward foreign investment standing at US\$2,928 billion in 2019.⁵ This reflects the progressive opening of more parts of the Chinese economy to FDI and streamlining of the Chinese FDI screening process. However, over the last 10 years China has also become an increasingly prominent source of outward investment, with the total outward FDI stock standing at US\$2,095 billion in 2019.⁶ This reflects an average annual growth rate of 23.9% between 2009-2019,

compared to just 5.0% for OECD countries over the same period. Whilst China still lags behind countries such as the US and the Netherlands in terms of total outward FDI stock, it overtook the UK in 2017 and has since maintained that position.⁷

Much of this Chinese investment was initially directed towards natural resources, including energy, metals and foods. However, the last few years have seen a significant shift towards a much broader range of sectors, with an increasing emphasis on critical infrastructure, communications assets, and advanced technology and data.

This dual-pronged “Chinese pivot” has resulted in an increased focus on the perceived risks of such investment to national security (ever-more broadly defined, as discussed below) in countries such as the US, UK and Australia (amongst others), which have traditionally been seen as open to, and indeed encouraging of, FDI. Against a backdrop of concerns that existing powers of intervention are insufficient to effectively address the concerns arising from such investments, existing FDI regimes are being significantly tightened and, in the UK, a new standalone regime is on the legislative agenda for 2020.

To date, the focus has remained heavily on Chinese investment in particular, or investment perceived to be influenced by China. For example, all three deals recently blocked by CFIUS under the Trump administration have involved Chinese acquirers. In the UK, the government recently intervened on national security grounds (under the public interest provisions of the merger control regime) in two acquisitions involving Chinese investment: the proposed acquisition of Impcross Limited – a UK manufacturer of parts for military aircraft – by Gardner Aerospace Holdings Limited (which is ultimately controlled by a Chinese listed entity)⁸ and the proposed acquisition of Mettis Aerospace by Aerostar (a fund established in China).⁹ Similarly, much of the recent focus in Australia has been on acquisitions by Hong Kong-based companies (such as the takeover offer by Cheung Kong Infrastructure for APA Group which was blocked in November 2018), in large part due to concerns about China’s influence over Hong Kong.

⁴ “Foreign investment flows in the time of Covid-19”, OECD, 4 May 2020, available at: https://read.oecd-ilibrary.org/view/?ref=132_132646-g8as4msdp9&title=Foreign-direct-investment-flows-in-the-time-of-COVID-19

⁵ Source: <https://www.oecd.org/investment/investment-policy/FDI-in-Figures-April-2020.xlsx>

⁶ Source: <https://www.oecd.org/investment/investment-policy/FDI-in-Figures-April-2020.xlsx>

⁷ Source: <https://www.oecd.org/investment/investment-policy/FDI-in-Figures-April-2020.xlsx>

⁸ On 17 June 2020, the Secretary of State announced a consultation on undertakings offered by Gardner Aerospace Holdings Limited regarding the abandonment of this transaction.

⁹ This transaction was abandoned by the parties in February 2020.

However, what is even more important to appreciate looking ahead in 2020 and beyond is that the focus of this stricter scrutiny is beginning to stretch beyond acquisitions by Chinese companies. For example, the UK government intervened last year in both the proposed acquisition of British satellite operator Inmarsat by a private-equity led consortium including equity funds based in Canada, and the proposed acquisition of defence and aerospace manufacturer Cobham by US private equity group Advent International. In both cases it ultimately proved possible to deal with the concerns by agreeing undertakings relating to maintenance of strategic capabilities and protection of sensitive information. However, dealmakers should not assume this will necessarily be the case, nor underestimate the impact of the review and approval process. It is notable in this regard that the French government recently prohibited the acquisition of the French company Photonis (which develops applications with military uses) by the US group Teledyne (the first publicly announced refusal of FDI authorisation in France).

This widening focus also ties in with a decrease in outward Chinese investment when viewed on an annual basis (rather than total FDI stock levels): recent figures indicate that Chinese FDI in the EU has declined over 50% from the 2016 peak of €37 billion.¹⁰ This can be explained in part by continued capital controls and tightening of liquidity in China, but there is no doubt that growing regulatory scrutiny – particularly in France, Germany and UK, which have traditionally been the biggest EU recipients of Chinese capital – has also been a key factor.

From ores to ports and energy networks: enhanced security in Chinese FDI in Australia

Australia has long seen Chinese investment in the extractives sector. However, as the scale of Chinese investment has increased, and the nature of it has expanded to target investment in the country's critical infrastructure, the controversy surrounding such investment has grown considerably. Despite reforms introduced in July 2017 to raise the threshold for screening under the Foreign Investment Review Board (FIRB) regime and widen the scope of exemptions, political sensitivity with respect to Chinese investment in critical infrastructure remains high.

A high-profile illustration of this is the November 2018 decision by the Federal Treasurer to block the proposed takeover of APA Group by Hong Kong-based Cheung Kong Infrastructure.¹¹ The deal was cleared by the Australian competition regulator (ACCC), but would have resulted in a single foreign company group having sole ownership and control over Australia's most significant gas transmission business. A number of vocal opponents also raised concerns about perceived national security risks arising from China's influence over Hong Kong, although the Treasurer's decision did not expressly refer to these issues and focussed instead on concerns about market concentration.¹² This prohibition followed on from a 2016 bid by the same proposed acquirer for a A\$25 billion stake in Ausgrid, the largest energy grid in Australia. That deal was also expressly blocked on the basis of national security, in light of the 'critical' power and communications services provided by Ausgrid to the federal government (despite the deal enjoying the backing of the state government in New South Wales).

However, FIRB approval for Chinese investment has been granted in a number of other recent cases. In 2017 Cheung Kong Infrastructure obtained FIRB approval for its takeover of DUET Group, another Australian pipeline and electricity network owner. The previous year, a smaller investment (just A\$0.5 billion) in Darwin Port by Chinese company Landbridge was also approved despite security concerns expressed by the US government, which has a military base in Darwin. Key factors in that approval decision appear to have been that the economic need for the investment was so great and the local authorities in Darwin were unwavering in their support.

¹⁰ Source: Rhodium Group and the Mercator Institute for Chinese Studies (MERICS) – Chinese FDI in Europe: 2018 Trends and Impact of New Screening Policies (March 2019).

¹¹ The Treasurer's announcement noted that his decision was reached in close consultation with both FIRB (which was not able to come to a unanimous recommendation) and the Critical Infrastructure Centre, an organisation established in January 2017 to safeguard Australia's critical infrastructure. This highlights the Treasurer's ultimate discretion in relation to foreign investment applications.

¹² The "national interest" factors considered by FIRB in advising the Treasurer include the impact on competition in Australia. This case highlights that the competition aspects considered by FIRB are potentially broader than competition aspects considered by the ACCC under the Competition and Consumer Act.

An evolving view of national security

National security is well established as the pre-eminent public interest justification for state intervention in foreign investment (as demonstrated by the focus on this in the recent EU Regulation on FDI screening and the proposed new standalone FDI regime in the UK, discussed below).

It is an obvious but important point that involving national security as a basis for investment restrictions necessarily requires that policymakers are willing to label acquirers, and the countries that stand behind them, security threats. US policymakers overseeing the CFIUS process have historically displayed a much higher level of comfort for such open confrontation than their European and other OECD counterparts, particularly with respect to China.

However, this appears to be changing. In 2016 Germany openly characterised China as a potential strategic threat for the purposes of foreign investment when it withdrew its approval – at US urging – of the acquisition of Aixtron by the Fujian Grand Chip Investment Fund. Since then it has significantly tightened its FDI regime, resulting in the prohibition of the acquisition of Leifeld Metal Spinning AG by Yantai Taihai Corporation (a French/Chinese consortium) in 2018.¹³ Political influence was also used to prevent State Grid Corporation of China from acquiring a 20 percent minority stake in 50Hertz, one of Germany's four providers of high-voltage transmission systems. A similarly changing stance can be seen in the UK (as illustrated by the government intervention in the acquisition of Sepura by Chinese company Hytera in 2017)¹⁴ and France (where the Minister of the Economy indicated during a 2018 visit to China that he had rejected "many" contemplated acquisitions by Chinese investors, without giving further details).¹⁵ What is also evolving – and which is also of wider application for acquisitions by non-Chinese companies – is the scope of the sectors and technologies considered by policymakers to fall within the concept of national security in this context. Alongside the conventional forms of defence material manufacturing is a growing list of critical infrastructure (including energy networks and ports), communications assets and advanced technologies, potentially extending still further to other businesses that are crucial to keeping public life running smoothly, from airports to hospitals.

For example, in September 2017, Chinese mapping company Navinfo abandoned plans to buy a 10% stake in HERE Technologies, a German mapping company

providing digital maps for the automotive industry, following opposition from CFIUS. More recently, in May 2019 CFIUS required Beijing Kunlun Tech Co. Ltd to divest Grindr LLC, a dating app, due to concerns about foreign access to US citizens' personal information (a rare and high-profile example of CFIUS requiring a completed acquisition to be unravelled).¹⁶

These expanding definitions of national security concerns inevitably blur into more general political conceptions of national competitive interests and technological strengths. This is well illustrated by many of the recent amendments to FDI regimes in response to concerns surrounding the potential impact of the pandemic: the political desire to restrict foreign ownership of businesses considered critical to the domestic response to the pandemic has resulted in significant expansion of the list of sectors subject to review.

In this regard it is notable that the EU-level guidelines published by the European Commission on 25 March 2020 on FDI screening during the pandemic specifically identify healthcare – including medical research and biotechnology – as a sector considered to be particularly vulnerable to increased exposure to FDI (and deserving of protection) in light of the pandemic. Specific amendments to FDI regimes implemented in response to the pandemic in Spain, Italy, Germany and Canada have included expressly adding healthcare to the list of sectors to which the regime applies. In France, where existing FDI rules already covered activities essential to protecting public health, the scope of strategic sectors covered by the regime has recently been extended to include biotechnology-related R&D.

More generally, even if policymakers adopt a relatively narrow conception of the security threats posed by, for example, technology transfer, politicians will often take a much wider view of economic competition and the strengths and assets that represent the national interest. Navigating this evolving definition of national security will be one of the key challenges over the coming years for both acquirers and sellers.

¹³ The deal was abandoned prior to being formally prohibited, but the government had announced that it would be blocked if the parties attempted to proceed with the transaction.

¹⁴ Sepura is a UK company which manufactures radio devices used by emergency services. The government intervened in the acquisition and required legally binding undertakings from the parties to resolve national security concerns.

¹⁵ Decisions of the French Ministry of Economy regarding approvals of FDI are not generally made public.

¹⁶ Beijing Kunlun Tech Co. Ltd had acquired control of Grindr LLC through two separate deals between 2016 and 2018, without submitting the acquisition for CFIUS review. In May 2019 CFIUS ordered it to divest Grindr LLC by June 2020.

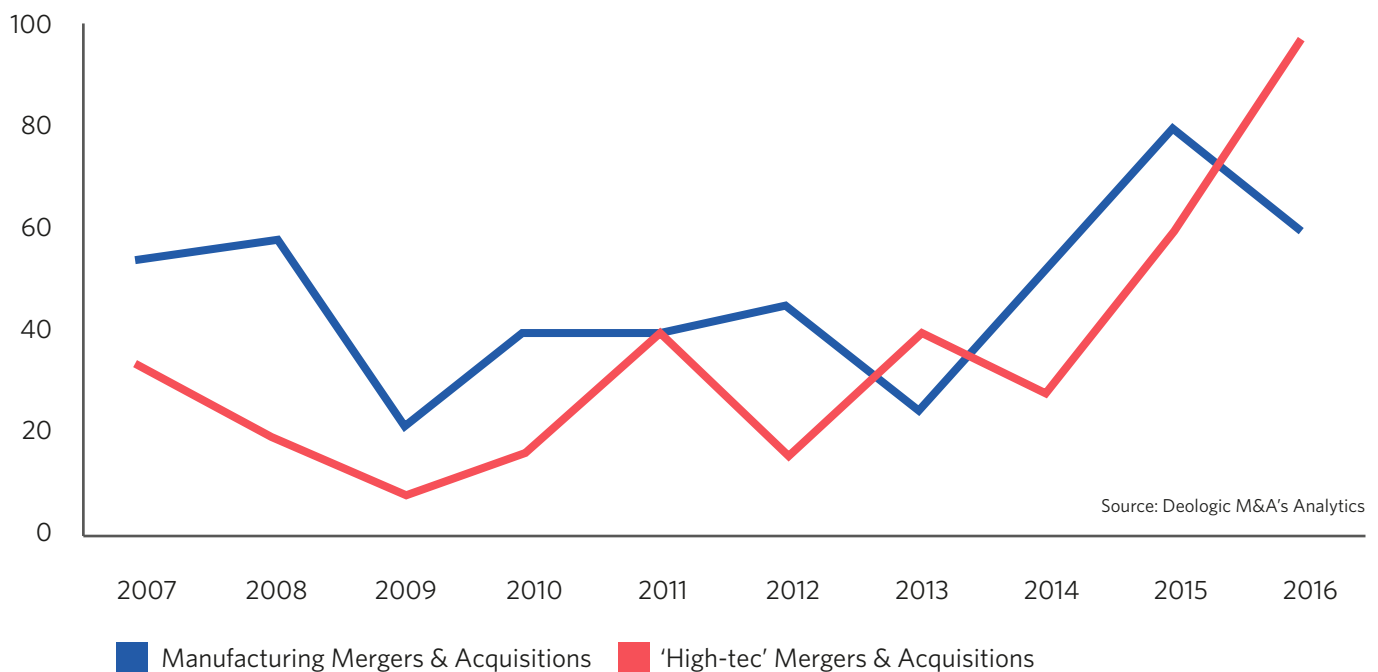
A value chain dilemma

This links directly to a fourth important trend in investment scrutiny. Against a rising public sense of unfairness with globalisation and economic inequalities, and a backdrop of increased protectionism on a global scale, politicians are increasingly under pressure to consider the impact of acquisitions on

politically-favoured employment in the advanced manufacturing, research intensive and technology sectors. This can be compounded by a perception, in the EU and the US in particular, that the opportunities which open investment frameworks have created in OECD countries, especially in respect of Chinese capital, have not been reciprocated.

Non-EU FDI in high technology sectors and manufacturing

EUR (billions)



The result is a growing political focus on the impact of acquisitions, where these are motivated by a desire to consolidate international value chains in a way that is perceived to work against the interests of countries which have nurtured the targeted industries. This is likely to become even more pronounced against the backdrop of the pandemic, with potential long term impact on investment in global value chains. Notwithstanding anxieties about China, the real concern here is often not the nationality of the acquirer or the implications for national security (at least as traditionally defined), but rather the intentions of acquirers with rationalisation and relocation of value-adding activities in mind. Governments are likely to consider the commercial logic of the deal, the economic circumstances facing the company that is being acquired, and the type and nature of any assurances that are given by the acquirer. The corporate character, or reputation, of the acquiring company may also prove to be important.

In some cases it may be possible to offer up remedies to address such concerns outside the formal FDI or public interest merger control approval regime. Particularly where no significant national security issues also arise, or where those concerns can be side-stepped, it may be possible to simply offer voluntary undertakings or make non-binding pledges with respect to issues such as maintaining domestic investment or employment. For example, when China-backed private equity group Canyon Bridge acquired UK chip designers Imagination in 2017, the UK government focussed on the implications for jobs, research and development and the headquarters of the company, but did not require any legally binding commitments in this regard.

Alternatively, it may be possible to carefully structure the transaction in a way which alleviates concerns, combined with pro-active engagement with the process of securing political support. When Chinese firm Cosco acquired Piraeus Port in Greece in 2016 it was limited to a 51% stake, with an increase to 67% in 2021 conditional on the company completing its local investment programme. When Italian ship maker Fincantieri was allowed to take a 51% controlling stake in French naval ship-builder STX in 2017, it was with 1% of equity 'borrowed' from the French government. The government retained the option of taking back that stake, and control of the company, should the Italian company fail to meet its pre-acquisition commitments, which included the protection of jobs.

Where more formal commitments are required, it may still be possible to agree these without a formal FDI or public interest intervention, as illustrated in the UK by the use of post-offer undertakings pursuant to the

Takeover Code (introduced following the failed bid by Pfizer for UK drug-maker AstraZeneca in 2014, where Pfizer faced significant political pressure to commit to maintaining its research and development capacity in the UK, before ultimately abandoning its bid). For example, when UK mobile technology company Arm was acquired by Japanese firm SoftBank in 2016, a government keen to present a post-Brexit referendum openness to FDI nevertheless sought and received post-offer undertakings to keep Arm's headquarters in the UK and to double the UK workforce.

A similar approach was taken in the 2018 hostile bid by London-listed Melrose plc for UK-based aerospace and automotive parts manufacturer GKN, where binding post-offer undertakings were accepted with respect to the future business of GKN in the UK, including commitments to maintain UK headquarters and a London Stock Exchange listing and maintaining a previously agreed level of R&D expenditure. Melrose also gave additional undertakings directly to the government to address national security concerns. Following acceptance of the undertakings, the Secretary of State confirmed that he would not formally intervene on public interest grounds.

However, avoiding formal intervention in this manner will not always be possible, and certainly in the UK there are indications that a stricter approach is being adopted ahead of the introduction of a new standalone FDI regime. In the context of the proposed acquisition of British satellite operator Inmarsat plc by Connect BidCo (a private-equity led consortium including equity funds based in Canada), the UK government formally intervened using its public interest merger control powers in July 2019 to secure notably more detailed and onerous undertakings than those which had been voluntarily offered by the parties at the outset (and accepted by the UK government). These included strict restrictions on the transfer or disclosure of sensitive information, and a commitment to continue to offer to supply certain specified services to the Ministry of Defence. Commitments regarding the use of sensitive information are also frequently a feature of undertakings agreed to resolve national security concerns under the French regime, alongside commitments relating to the ongoing provision of information to the French government.

Looking ahead, the process of agreeing commitments to address these sorts of concerns can be expected to remain a recurrent feature of sensitive acquisitions and the process of securing political support for them. The importance of well-timed, effective and sensitive communication with stakeholders to explore potential options should not be underestimated.

The evolving toolbox for investment scrutiny

Until recently, most OECD states allowed only a narrow scope for government intervention in acquisitions based on a set of well-established national security and public order prerogatives set out in international agreements. However, recent practice has demonstrated an increased willingness by many governments to seek to work inside the confines of the existing legal toolkit in new ways, as well as seeking new policy tools that allow for a more thorough vetting of foreign investments, often requiring new legislation (as illustrated by many of the recent Covid-19-related amendments). The combined effect is markedly increased levels of scrutiny, with FDI regulation now an increasingly important part of the regulatory jigsaw for cross-border M&A.

Alongside these developments, we are seeing greater reliance on the informal influence which politicians can and do have on the progress of takeovers through the media and the government's informal networks. This is crucial to understanding many systems, in which government ministers can operate in the grey areas of what might otherwise appear to be heavily constraining frameworks. The SoftBank/Arm example in the UK is a good illustration of this in practice: even though there was no basis for the government to formally intervene in the acquisition under the public interest merger control provisions of the Enterprise Act 2002, post-offer undertakings (on which the government was consulted) were secured under the new Takeover Code regime (see previous section).

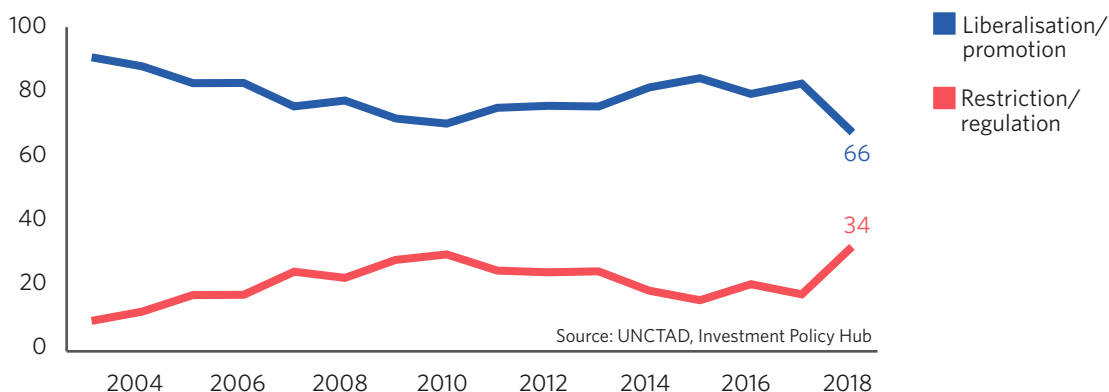
The French system also exemplifies this approach in many ways. Boxed in by the constraints of EU law on blocking takeovers (in particular the limitation on Member States' powers of intervention where the transaction falls within the scope of the EU Merger Regulation), the French state has nevertheless sought to institutionalise ambiguity about the discretionary powers of the state and ramp up pressure on dealmakers nervous about maintaining transaction momentum.

Since 2014, the 'Montebourg decree' has obliged acquirers in a wide range of sectors impacting on the 'integrity, security, and continuity of supply' in the energy, water, defence, transport and communications sectors to consult the government on their intentions and receive formal government blessing. This list of sectors and national security technologies was significantly extended in 2019, and again in 2020. It now also includes space operations, cyber security, artificial intelligence, robotics, additive manufacturing, semi-conductors quantum technologies, energy storage and biotechnologies. Under the 2019 "Pacte law", new administrative sanctions are now applicable in the event of non-compliance with the approval procedure. These include both monetary fines and – subject to further implementing regulations – injunctions, suspension of an investor's voting rights, and appointment of a government representative within the target.

This gives French authorities clear locus and a formidable platform to push acquirers to compromise on a deal. It also provides them with a "pause" button to delay them, while more politically-acceptable counterbidders are flushed out. The French system seeks to avoid breaching EU law by simply requiring that an acquirer engage and seek authorisation from the French state on the basis of protecting its legitimate interests. This has allowed the French authorities to exert great influence over takeovers and corporate restructurings, such as those involving the industrial group Alstom.

A similar approach has also been adopted by both the Spanish and German governments. When the bid by Italian group Atlantia for Spanish infrastructure manager Abertis provoked political concerns, Spanish ministers sought to slow and complicate the process of obtaining the necessary regulatory approvals, in order to allow a German subsidiary (Hochtief) of a Spanish conglomerate (ACS) to put in an alternative offer. The competing bidders subsequently agreed to invest jointly in Abertis,

Changes in national investment policies 2003-2018 (Per cent)



partly with the intention of easing the Spanish government's concerns. In Germany, the government succeeded in preventing State Grid Corporation of China from acquiring a 20 percent minority stake in 50Hertz in 2018, despite the investment falling below the 25% threshold which applied at that time, by exerting political influence to encourage the majority shareholder (Elia) to exercise its pre-emption right and immediately sell the stake on to the State-owned bank KfW.

In addition, many jurisdictions have implemented, or are in the process of implementing, new or expanded powers to scrutinise foreign investment. This was already the case before the pandemic, but the economic fall-out is undoubtedly accelerating this trend.

For example, in August 2017 the German government introduced significant additional obligations for foreign investors and extended rights of control, following political controversy over the acquisition of German robotics company Kuka by Chinese firm Midea, (which was cleared by officials despite political objections and US security concerns).

Amendments to the German regime included doubling the time available to the authorities to investigate acquisitions (four months), and broadening the scope of the rules to cover new areas, spanning software providers, critical infrastructure and defence-related technologies. Officials were also empowered, for the first time, to investigate indirect acquisitions involving EU-based vehicles established for the purpose of a foreign acquisition.¹⁷ The amended regime was used in August 2018 to prohibit Chinese investor Yantai Taihai Corp from acquiring Leifeld Metal Spinning AG, a manufacturer of high-strength materials for the aerospace industry that are also usable in the nuclear sector. Additional reforms requiring non-EU/non-EFTA investors to notify transactions and obtain clearance for acquisitions of 10% or more of the voting rights in German companies (lowered from 25%) were subsequently implemented in December 2018, and further significant changes are taking effect in 2020 (as detailed in the following section). Although the general plans for these reforms pre-date the pandemic, the impact of Covid-19 may have provided a catalyst for the publication in April 2020 of a draft legislative

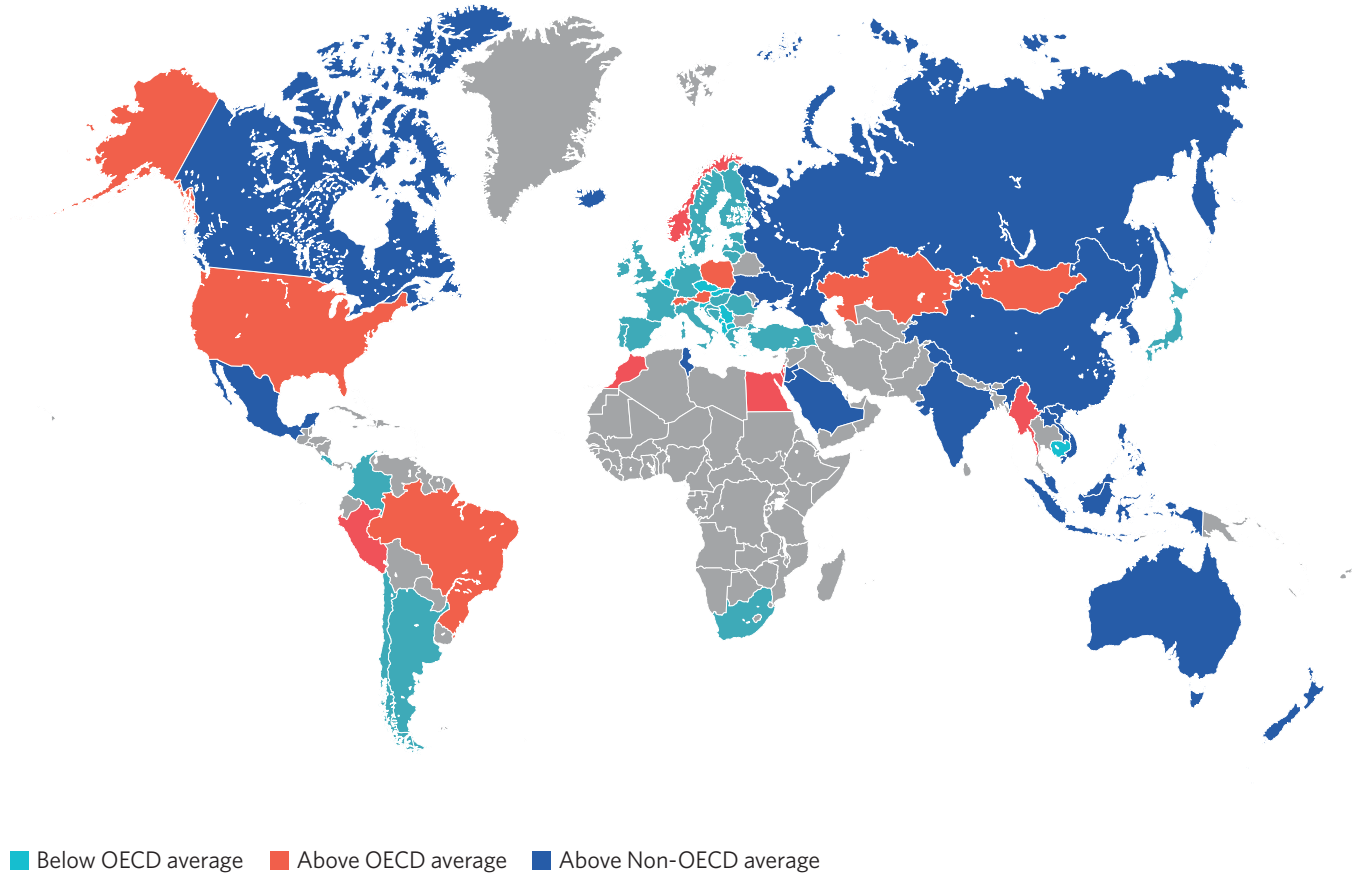
amendment which would lower the intervention threshold for non-EU investments, and a further amendment in May 2020 extending the business activities triggering a mandatory FDI filing from any investor (both EU and non-EU) acquiring 10% or more of the voting rights in German companies.

A further raft of reforms is due to come into effect by the end of 2020, many of which pre-date the pandemic, which will tighten the FDI regimes in a significant number of key jurisdictions worldwide (considered in more detail in the following section). The new EU Regulation on FDI screening mechanisms is also likely to encourage those EU Member States that do not currently have their own regime (just under half of them) to introduce one.

The combined effect of these various reforms will inevitably be to ramp up the level of FDI scrutiny faced by dealmakers involved in cross-border M&A, particularly against the backdrop of the pandemic and political concerns regarding opportunistic takeovers by foreign acquirers. It will be more important than ever to consider early in the transaction planning process whether the transaction is likely to give rise to investment screening issues, and the extent to which these may threaten the viability of the deal if acceptable remedies cannot be agreed.

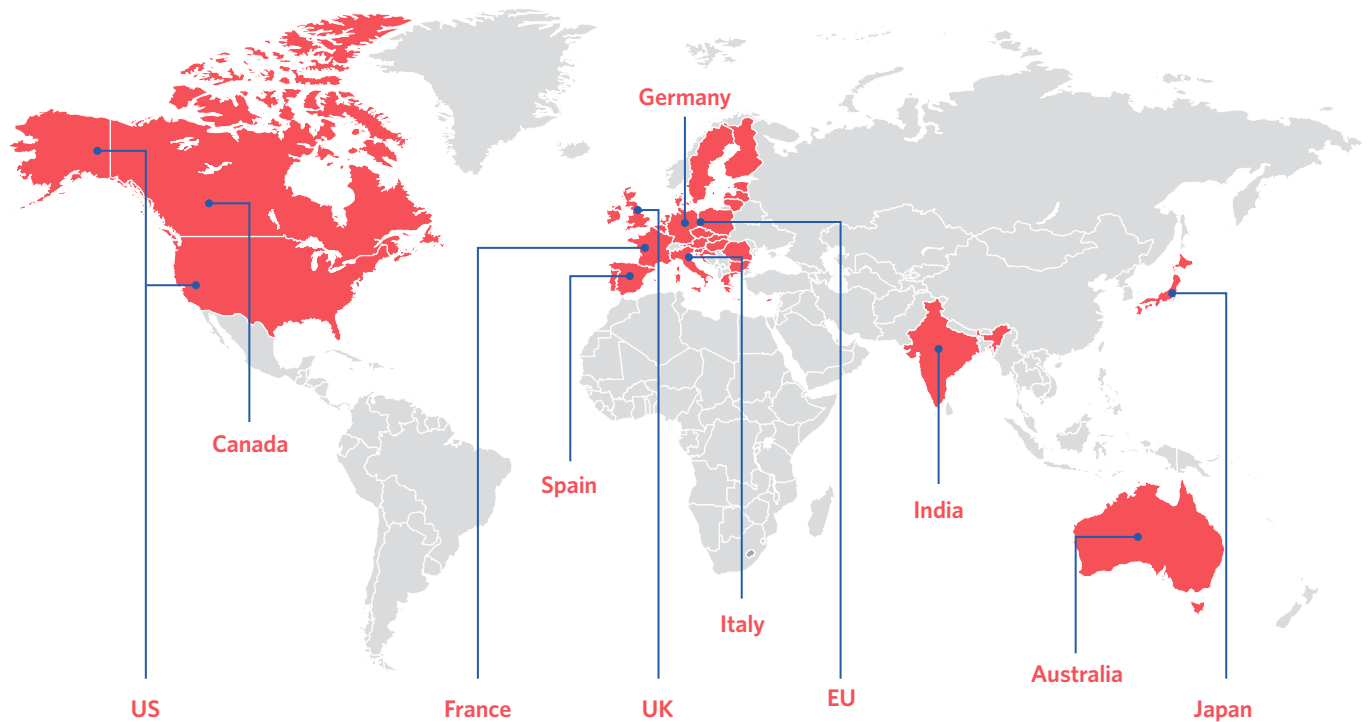
¹⁷ Source: Herbert Smith Freehills – Germany implements extended foreign investment control mechanisms: "<http://www.herbertsmithfreehills.com/news/germany-implements-extended-foreign-investment-control-mechanisms>"

Discrimination against foreign investors



Source: OECD FDI Regulatory Restrictiveness Index database (2018)
<https://data.oecd.org/fdi/fdi-restrictiveness.htm>

Spotlight on new restrictions taking effect during 2020



UK

In December 2019 the UK government confirmed that it plans to introduce a new distinct regime and standalone powers enabling it to investigate and intervene in transactions on the grounds of national security interests. It is anticipated that draft legislation in the form of a National Security and Investment Bill will be forthcoming in summer 2020.

Detailed proposals for the new regime were first set out in a July 2018 White Paper. On the basis of the framework set out therein, it is anticipated that the new regime will involve a voluntary notification regime allowing companies to flag transactions potentially raising national security concerns, alongside a “call-in” power to enable the government to review non-notified transactions. The framework set out in the White Paper had no target turnover or market share threshold, and was intended to be applicable across all sectors, subject to certain “core areas” being identified as being particularly likely to give rise to concerns (including parts of national infrastructure and certain advanced technologies). A “quick and efficient” screening process was expected to rule out national security risks in most cases, but it was envisaged that the government would have powers to impose conditions or – as a “last resort” – block transactions on national security grounds.¹⁸

Pending the introduction of the new standalone regime, in June 2018 the UK government enhanced its powers of intervention on national security grounds in transactions involving targets active in certain specified sectors (military and dual-use goods, computer processing units, and quantum technology) by temporarily lowering the applicable jurisdictional thresholds.¹⁹ On 21 June 2020 the government announced its intention to lower jurisdictional thresholds in three additional sectors: artificial intelligence, cryptographic authentication technology and advanced materials. Legislation to achieve this was tabled in Parliament on 22 June 2020, but will be debated before entering into force. At the same time, against the

¹⁸ Source: Herbert Smith Freehills e-Bulletin: www.herbertsmithfreehills.com/latest-thinking/uk-government-consults-on-increased-powers-to-scrutinise-foreign-investment-in-the.

¹⁹ Source: Herbert Smith Freehills e-Bulletin: <https://sites-herbertsmithfreehills.vulturex.com/37/16576/compose-email/outlook.asp>

backdrop of the pandemic, the government added “to combat and mitigate the effects of a public health emergency” as a criterion for intervention in a transaction by the government on public interest grounds (under the existing public interest merger regime), with effect from 23 June 2020. This is intended to allow intervention in transactions involving companies which mitigate the effects of a pandemic (such as internet service providers) as well as those directly involved in the public health response (such as vaccine and PPE manufacturers).²⁰

In a related development, on 8 April 2020 the Foreign Affairs Committee launched an inquiry into the Foreign & Commonwealth Office's (“FCO's”) role in blocking foreign asset stripping of UK companies, especially where there may be national security risks. This ongoing inquiry is examining how the FCO assesses whether a potentially hostile party is seeking to secure significant influence or control over a UK company and in what circumstances the FCO should intervene. The Foreign Affairs Committee has also stated that it will consider what safeguards are required in the forthcoming National Security and Investment Bill to ensure that the FCO has a full role in the decision-making process in relation to interventions.



On 10 April 2019 the new EU Regulation on foreign investment screening entered into force, with the new framework to be fully applicable from 11 October 2020. This is based on a proposal tabled by the European Commission in September 2017, in response to increased FDI into European technology and infrastructure assets.

The Regulation does not oblige EU Member States to adopt an FDI screening mechanism or to fully harmonise national regimes. However, it does require existing (and any new) regimes to comply with a minimum set of requirements, and is expected to encourage those EU Member States which do not currently have an FDI regime to adopt one.²¹

In particular, the framework sets out a non-exhaustive list of factors that Member States may consider when assessing FDI. This includes potential effects on a wide range of sectors, including critical technologies, energy, transport, water supply, health, and media. The new rules also call for heightened scrutiny of investments by directly or indirectly state-controlled entities (including through significant state-backed funding, rather than ownership), and encourage Member States to review investments that form part of “state-led outward projects or programs.” It has been suggested that 82 percent of Chinese M&A transactions in Europe in 2018 would have potentially been caught by the new framework.²²

The Regulation also provides a mechanism under which the European Commission can intervene when foreign investment in a Member State is likely to affect EU projects and programmes on grounds of security and public order (eg Galileo and Horizon 2020). In such cases, the European Commission will be able to issue an opinion which the reviewing Member State must “take utmost account of” (albeit not legally binding).

Alongside this there will also be a co-operation mechanism where foreign investment is likely to affect security or public order in one or more Member States. The ultimate decision on investment will remain with the reviewing Member State, but from a practical perspective review processes are likely to become longer, given the obligation to give the opinion of the European Commission and other Member States' comments due consideration.

Ahead of the Regulation becoming fully applicable from 11 October 2020, the European Commission published guidelines on the screening of FDI on 25 March 2020 in the context of the pandemic. Its stated intention was to ensure “that the current health crisis does not result in a sell-off of Europe's business and industrial actors”. These guidelines do not create new law. They do, however, provide guidance to EU Member States on how to apply their national rules on FDI screening in line with but ahead of the Regulation becoming fully applicable. They also strongly encourage those Member States that do not currently have their own FDI regimes, to consider introducing their own mechanism.²³

²⁰ Source: Herbert Smith Freehills e-Bulletin: <https://sites-herbertsmithfreehills.vutorex.com/46/22880/compose-email/significant-amendments-to-uk-merger-control-regime-targeting-foreign-investment.asp>

²¹ The European Commission's list of screening mechanisms notified by EU Member States indicates that as of July 2019 15 Member States had some form of screening in place. Source: <http://trade.ec.europa.eu/doclib/html/157946.htm>

²² Rhodium Group and the Mercator Institute for Chinese Studies (MERICS) – Chinese FDI in Europe: 2018 Trends and Impact of New Screening Policies (March 2019)

²³ Source: Herbert Smith Freehills Competition Notes Blog: <https://hsfnotes.com/crt/2020/03/27/commission-urges-member-states-to-screen-foreign-direct-investment-into-strategic-industries-under-strain-from-covid-19/>



France

Wide-ranging reforms have recently established a new foundation for FDI in France applicable to all investment applications.²⁴ The new regime has been developed in three stages, the last of which entered into force on 1 April 2020: (i) a decree of 29 November 2018 (applicable since 1st January 2019) expanding the list of strategic sectors to which the FDI regime applies, to include in particular space operations and R&D activities linked to sensitive technologies and activities (cybersecurity, artificial intelligence; robotics; additive manufacturing; semiconductors); (ii) provisions of the May 2019 "Pacte law", significantly strengthening sanctions for non-compliance with the authorisation procedure or the conditions which may be attached to an authorisation; and (iii) new FDI rules set out in a decree and order dated 31 December 2019 (in force since 1 April 2020), which establish a broader definition of control when analysing foreign investors, and also lower the triggering threshold to 25% of voting rights for investment by non-EU investors in a French company active in a sensitive sector (lowered from 33.3% per cent of share capital or voting rights).

Major changes have also been made to the authorisation procedure, extending in practice the duration of the procedure to three and a half months (increased from two months). Finally, new items have been added to the strategic sectors, to include production, transformation and distribution of certain agricultural products, in cases where certain food safety objectives apply to the products in question; publishing, printing and distribution of media including online media services and R&D activities linked to sensitive technologies and activities, such as quantum technologies and energy storage.

Two further steps have also recently been taken by the French government in response to the Covid-19 pandemic. On 27 April 2020, an order was made which permanently adds the biotechnology sector to the list of R&D activities linked to sensitive technologies and activities falling within the scope of the FDI regime. Although activities relating to health safety had been covered by the regime since the Montebourg decree of 2014, the French government wanted to protect this sector more specifically, as it affects both research on living organisms and fields as varied as agriculture, health, industry and the environment. On 28 April 2020 a second measure was announced, which will temporarily lower the triggering threshold for the FDI authorisation procedure to 10% of voting rights (as opposed to 25% in normal times) for investment by non-European investors in listed French companies active in a sensitive sector. The review of such transactions by the Ministry of the Economy (MINEFI) will be exercised according to a special accelerated procedure: the investor crossing the 10% threshold will have to notify the MINEFI, which will then have 10 days to decide whether the transaction should be subject to an in-depth investigation, on the basis of a full authorisation request. Such an investigation may result in the investor not being allowed to hold more than 10% of the voting rights. These provisions will be implemented by a new decree (not yet published) which is due to take effect on 1 July 2020 and expire on 31 December 2020.



Italy

On 8 April 2020, against the backdrop of the pandemic, the Italian government significantly extended its powers to review FDI, both to new sectors and within the sectors already subject to the Italian FDI regime.²⁵

Prior approval is now required for acquisitions of 10% or more by non-EU-controlled investors in new sectors – finance, insurance, food and health – if the acquisition value exceeds €1 million. The inclusion of health (and possibly insurance) as a strategic sector appears to be a direct response to the pandemic. A further Ministerial Decree is expected to be issued shortly, which will identify in greater detail the specific assets and activities subject to the FDI regime within the newly included sectors.

It is notable that these tighter rules have also been extended until the end of the year to acquisitions by EU-controlled investors of controlling interests in companies operating in strategic sectors. This represents a divergence in approach from countries such as Spain and France, where the focus of restrictions has been on non-EU investors, and is a potentially worrying precedent.

²⁴ Source: Herbert Smith Freehills e-Bulletin: <https://sites-herbertsmithfreehills.vaturevx.com/125/21724/compose-email/e-bulletin-l-foreign-investment-controls-in-france-l-january-2020.asp>.

²⁵ Source: Herbert Smith Freehills e-Bulletin: <https://www.herbertsmithfreehills.com/latest-thinking/covid-19-pressure-points-fdi-regime-during-the-crisis-important-novelties-under-the>



Germany

The German FDI regime has been and will be subject to significant changes in 2020, in part in response to implementing the EU Regulation on foreign investment screening and reacting to the pandemic. By way of first steps, both the Foreign Trade and Payments Act (AWG) and the Foreign Trade Ordinance (AWV) have recently been amended. This has resulted in a significant lowering of the threshold for official orders to be made in respect of FDI in Germany.

Previously, the intervention threshold for non-EU investments required an *actual threat* to public safety or order (which already afforded the government significant flexibility). However, pursuant to amendments made to the AWG, it is now sufficient if the foreign investment is *likely to affect* security or public order. A standstill obligation has also been introduced for all transactions where a filing obligation exists. This includes so-called cross-sectoral examinations (covering the acquisition of critical infrastructure et al by non EU/EFTA buyers) as well as sector-specific cases, covering the acquisition of defence and related industries by non-German buyers. A breach of this standstill obligation is a criminal offence, punishable with imprisonment for up to 5 years or a fine for the individuals responsible.²⁶

In addition, the recent AWV amendment passed on 20 May 2020 has extended the business activities triggering a mandatory filing for FDI from non-EU investors above a 10% voting right threshold. The amendment increases the list to include, inter alia, personal protective equipment, various medicinal products, and in-vitro diagnostics.²⁷ These changes come in the context of (unsubstantiated) media reports that President Donald Trump attempted to acquire German pharmaceutical company CureVac to secure exclusive Covid-19 vaccine production for the USA.

Further measures tightening the German regime are expected during 2020, including in relation to the extension of notification obligations and a further expansion of critical infrastructure sectors subject to filing requirements.



Spain

Prior to the pandemic the FDI regime in Spain was liberalised. Foreign investors were only required to report investments for administrative, statistical and economic purposes, with certain exceptions pertaining to specific sectors and transactions for which prior authorisation was required. However, on 17 March 2020, Spain became the first EU Member State to significantly tighten its rules on FDI, primarily due to the impact of the pandemic on the value of domestic companies.

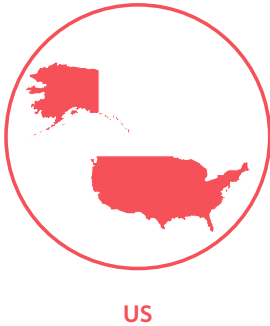
Acquirers based outside of the EU and the EFTA (or where the ultimate owner is outside the EU and the EFTA), must now obtain prior approval for an acquisition of a shareholding of 10% or more, or a management right, in a Spanish company in a very broad range of sectors. These include critical infrastructure and technology, healthcare, communications, energy and transport, media and also the supply of key inputs such as energy, raw materials and food security, as well as any other sector with access to sensitive information (in particular personal data).

Where the foreign investor is directly or indirectly controlled by a foreign government, the stricter FDI regime now applies for investments across all sectors. The same applies when the investor has made investments in sectors that affect public safety, public policy or public health in another Member State, or when a court or administrative action has been brought against the investor on grounds of having engaged in criminal or unlawful conduct in any other state.

Foreign investment for an amount lower than €1 million is exempted and does not require prior authorisation.

²⁶ Source: Herbert Smith Freehills e-Bulletin: <https://www.herbertsmithfreehills.com/latest-thinking/planned-new-regulation-in-germany-states-standstill-obligation-and-lower-threshold>

²⁷ Source: Herbert Smith Freehills e-Bulletin: <https://www.herbertsmithfreehills.com/latest-thinking/covid-19-pressure-points-new-german-fdi-rules-germany>



On 13 February 2020 final regulations took effect which implement changes – made by the Foreign Investment Risk Review Modernization Act ('FIRRMA') – that significantly expand CFIUS jurisdiction (following a consultation on proposed regulations published in September 2019).²⁸

The regulations empower CFIUS to review certain non-controlling "covered investments" by foreign persons in US businesses that deal in critical technology, critical infrastructure, or sensitive personal data. However, in a development not foreshadowed in the draft regulations, certain investors from Australia, Canada and the UK – newly designated as "excepted foreign states" – are exempted from the filing requirements relating to such non-controlling covered investments (though they remain subject to CFIUS jurisdiction when making controlling acquisitions). Consistent with FIRRMA, the regulations also exempt from these provisions any passive, indirect investments by foreign persons in such businesses via investment funds, where the foreign investors receive memberships (as limited partners) on the fund advisory board.

In a departure from prior CFIUS practice, the regulations impose mandatory filing requirements for certain investments in US critical technology businesses, and also permit the filing of a short-form declaration for mandatory and voluntary filings.

CFIUS also gained increased authority under the regulations to review real estate transactions for potential national security implications, marking an important change to the long-standing rule that pure greenfield real estate transactions are not formally subject to CFIUS authority.

Pursuant to interim regulations that took effect from 1 May 2020, filing fees are now required for CFIUS notices filed in connection with both control transactions and certain non-controlling investments, and certain US real estate acquisitions. The regulations assess filing fees based on the value of the transaction, with fees ranging from no fee for deals under \$500,000, to a maximum fee of \$300,000 for transactions valued at \$750 million or above. The value of a transaction generally will be calculated based on the entire value of the deal, even if the US business being acquired is only one part of a larger cross-border transaction.²⁹

In addition, on 21 May 2020 CFIUS published proposed regulations that would elevate the importance of export control regulations in the CFIUS review process, by changing the mandatory filing requirements in certain "critical technology" transactions to focus on whether a US export control authorization would be required to transfer the underlying technology to a non-US acquirer (thereby eliminating the current reliance on certain industry sector codes (the "NAICS" codes) to determine whether a filing is required in some transactions). This proposed change had previously been indicated in the FIRRMA implementing regulations.³⁰

This reflects not only CFIUS's continued scrutiny of investments that would confer non-US control over or access to US critical technologies, but also the increasing importance of the US export control regime to the CFIUS review process and in particular the national security assessments undertaken by CFIUS. The proposed regulations are subject to a public consultation process ending on 22 June 2020, and final version is not expected to be issued until August 2020 at the earliest.

²⁸ Source: Herbert Smith Freehills e-Bulletin: <https://sites-herbertsmithfreehills.vaturevx.com/254/22488/may-2020/e-bulletin-alert--filing-fees-now-required-for-certain-cfius-filings.asp?sid=8212e53e-a998-4c76-9beb-0e98b5356a29>

²⁹ Source: Herbert Smith Freehills e-Bulletin: <https://sites-herbertsmithfreehills.vaturevx.com/254/22488/may-2020/e-bulletin-alert--filing-fees-now-required-for-certain-cfius-filings.asp?sid=8212e53e-a998-4c76-9beb-0e98b5356a29>

³⁰ Source: Herbert Smith Freehills e-Bulletin: <https://sites-herbertsmithfreehills.vaturevx.com/254/22687/may-2020/e-bulletin-alert--proposed-regulations-would-modify-cfius-mandatory-filing-requirements-to-focus-on-us-export-control-licensing.asp>



Canada

Canada has generally seen a relaxation in monetary thresholds for the review of FDI in recent years, although the number of transactions being reviewed under national security provisions has increased (consistent with the trend seen in Europe and the USA). However, on 18 April 2020, the Canadian government issued a Covid-19 policy statement explaining that *"many Canadian businesses have recently seen their valuations decline as a result of the pandemic...[which]...could lead to opportunistic investment behaviour"*.

The policy statement explains that, until Canada has recovered from the pandemic, the Canadian government will scrutinise with particular attention FDI of any value, controlling or non-controlling, in Canadian businesses that are related to public health or involved in the supply of critical goods and services to Canadians or to the government.

All foreign investments by state-owned enterprises regardless of their value, or private investors assessed as being closely tied to or subject to direction from foreign governments, will be subject to enhanced scrutiny.



India

India has undergone a significant relaxation of its FDI laws over the past few years, in particular since 2017, and continues to further streamline its FDI laws as part of the economic measures to aid post-pandemic recovery (eg removing or increasing approval caps in defence and insurance sectors).

However, on 17 April 2020 the Indian government announced a tightening of FDI restrictions to curb *"opportunistic takeovers/acquisitions of Indian companies due to the current Covid-19 pandemic"*, following the acquisition of a 1% stake in HDFC (India's largest mortgage bank) by the People's Bank of China.

Any foreign investment by a non-resident based in a country which shares a land border with India will now require the prior approval of the government, irrespective of the sector into which the investment is being made (as an exception to the sector-by-sector process). The new law does not expressly specify the relevant countries, but it seems clear that prior approval will now be required for investment from China, Nepal, Myanmar, Bhutan and Afghanistan, in addition to restrictions on investment from Pakistan and Bangladesh which already existed prior to 17 April 2020. The requirement for approval also applies to subsequent changes in beneficial ownership of any existing or future FDI which would fall within the scope of the new restriction. This amendment is expected to have a material impact on the ease of investment from or connected with China in particular.



Japan

On 8 May 2020 amendments to the Foreign Exchange and Foreign Trade Act ("FEFTA") approved by the Japanese Diet in November 2019 came into effect, lowering the threshold for notification and pre-transaction approval from 10 percent to 1 percent in relation to foreign direct investment in Japanese listed companies active in a wide range of regulated sectors deemed relevant to national security (expanded earlier in 2019 to include information processing equipment and software and a wider range of telecommunications and IT services). The new rules were fully implemented on 7 June 2020 (following expiry of a 30-day transition period).

Notification will be required both for share acquisitions that take the foreign investor's shareholding above the 1 percent threshold, as well as for actions such as appointment of directors to a company's board of directors by existing foreign investor shareholders. Portfolio investments by certain financial firms are generally exempted, provided the investor does not exercise material influence over the management of the target or have access to non-public information on technology relevant to national security. However, this exemption is not available for investments in highly sensitive industries (such as weapons production, nuclear power, electrical power and communication), or for investors subject to the influence of foreign governments, such as state-owned companies.

In conjunction with these reforms, the Ministry of Finance published a list designating all listed companies in Japan as falling into one of three categories: (i) companies conducting business activities only in non-Restricted Businesses into which investment by foreign investors is exempted from pre-transaction approval and subject to post-transaction notification for acquisitions above 10 percent only; (ii) companies conducting business activities in Non-Core Restricted Businesses, into which investment by foreign investors above 1 percent is subject to pre-transaction approval, but for which portfolio investments are exempted; and (iii) companies conducting business activities in Core Restricted Businesses, into which investment by foreign investors will be subject to the most onerous filing requirements, and for which no exemption is available for asset managers. The list is available on the Ministry of Finance website,³¹ and will be periodically updated. On 15 June 2020, the Ministry of Finance added manufacturers of pharmaceutical and medical products to the category of Core Restricted Businesses in response to concerns over security of supply following Covid-19. These changes will take effect from 15 July 2020.

A notice summarising the 12 factors which will be applied by the authorities during the screening process has also been published. These include the identity and nature of the foreign investor, and the impact the investment would have on national security, maintenance of public order or protection of public security.



Australia

On 29 March 2020, a number of temporary but significant amendments to the Australian FDI regime were announced. The Australian government described these measures as "*necessary to safeguard the national interest as the coronavirus outbreak puts intense pressure on the Australian economy and businesses*", and, in doing so, implicitly recognised the possibility of takeovers of distressed Australian assets.

These changes effectively make all FDI reviewable for the duration of the pandemic by lowering the financial threshold for review in terms of a target's valuation to AUS\$0. This represents a significant tightening of the regime, especially when combined with the already relatively low shareholding threshold for review (20% or lower in some cases). Furthermore this is a particularly significant change for investors from countries which have free trade agreements with Australia (such as the USA) – such investors could previously benefit from a threshold of approx. AUS\$1.2bn for investments in certain (non-sensitive) sectors. These amendments therefore have a wide application to all foreign investors (to the potential benefit of domestic investors) and are in contrast to the more targeted approach adopted in Spain, France and India.

More permanent and significant reforms were subsequently announced on 5 June 2020, with a renewed focus on sensitive national security-related businesses.³² This new framework will create new and potentially broad categories of investment that may require FIRB approval, and shift the focus of the foreign investment framework in Australia towards a qualitative assessment of the nature of the investors and their investments. The new regime is scheduled to take effect from 1 January 2021, with the temporary changes in response to the pandemic outlined above remaining in place until then.

Key changes include the extension of the AUS\$0 financial threshold and direct interest tests currently applicable to foreign government investors to all foreign private entities that invest in sensitive national security businesses, and the removal of the moneylending exemption for such investments (ordinarily available to foreign financiers taking security over Australian assets for the purposes of their financing activities). In addition, FIRB will be given a new power to 'call in' an investment (before or after it occurs) to review whether it raises national security concerns and passes the 'national security test', alongside a new 'last resort' power to reassess approved foreign investments where national security risks later emerge.³³ A positive development for private equity and pension funds will be the relaxation of the 40% aggregation rule that currently requires stricter review of investments by certain funds with multiple smaller stakes held by 'foreign government investors'.

³¹ Source: https://www.mof.go.jp/international_policy/gaitame_kawase/fdi/list.xlsx

³² The definition of such businesses is not yet settled: the government has advised that it will not be as broad as the definition of 'sensitive businesses' under the existing regulatory framework, but it is anticipated that businesses in sectors as far reaching as energy, telecommunications, data, water and ports will still be caught.

³³ Source: Herbert Smith Freehills e-Bulletin: <https://www.herbertsmithfreehills.com/latest-thinking/pressure-points-proposed-changes-to-australias-foreign-investment-regime>

Navigating foreign investment controls in practice

FDI filings are an increasingly important piece of the regulatory jigsaw for cross-border M&A, and co-ordinating a global approach is key to minimising deal risk. Deal parties must consider early in the transaction planning process whether the transaction is likely to give rise to investment screening issues, and whether these threaten the viability of the deal.

Anticipate your critics

In some cases the political sensitivity of a transaction will be obvious; for example, transactions involving military or dual use products, or – against the backdrop of Covid-19 – transactions involving healthcare providers or other businesses critical to the response to the pandemic. But parties need to think well beyond the established legal parameters for investment blocking in considering why an acquisition might be politically contested. State backing, directly or indirectly, or acquiring key infrastructure or technologies, will always be "red flags", even if carefully managed. Extensive rationalisation or consolidation plans, which incentivise a deal for investors on paper, can also look like corporate social irresponsibility to political stakeholders. In the current mood, anticipating this kind of objection is essential.

Move carefully and prepare the ground

The simplest maxim for investors is always that the capacity to buy does not equal the licence to buy. The great majority of acquisitions will always pass without political comment. But a growing category of transactions are taking in targets that politicians and policymakers regard as political assets, as much as commercial ones. The licence to acquire such assets has to be earned through careful and sensitive engagement, compromise and, increasingly, binding commitments. A global approach is especially important, as can be seen from the examples of national authorities liaising with each other behind the scenes.

Get comfortable with institutionalised ambiguity about state discretion

The single most important trend in current investment screening behaviour is the desire to carve out new scope for governments to force acquirers to engage with authorities and give authorities time to dull the momentum of transactions or seek to redirect them through mechanisms other than blocking. Political

disapproval can have a powerful chilling effect on acquirers and can spook wavering sellers and empower reluctant ones.

Factor FDI risks into deal planning

You should consider whether the transaction will trigger mandatory filing/approval requirements or whether voluntary filings (for example to CFIUS) should be made. You should consider whether completion must be suspended pending a screening decision, and, if not, which party will take the regulatory risk and what the timing implications will be. Timing of any merger control filings that are required will also need to be factored in, although usually merger control timelines are more transparent and predictable. You should also consider whether there are likely to be active complainants and whether reverse break-fees reflecting regulatory risk are warranted.

Consider possible mitigants up-front

These could be behavioural, such as restrictions on access to data, or structural, such as divestments. In some jurisdictions, it will be possible to seek confidential guidance as to the likelihood of issues at an early stage. In others, it will involve taking into account previous interventions, regulatory trends and the political context. This could impact on transaction structure, for example where successful mitigation may be achieved through the inclusion of domestic co-acquirers or a reduction in the level of control acquired, or where carve out or "hold separate" arrangements may allow a transaction to be completed globally, while investment screening issues for a particular jurisdiction or business unit are assessed.

How we can help

Global Counsel

Contact one of the Global Counsel contacts, experts in political and policy due diligence, to assist in planning and executing a coordinated strategy to deal with foreign investment risks.

Global Counsel is an advisory firm that works with clients navigating the critical area between business, politics and policymaking. We help companies and investors across a range of sectors to anticipate the ways by which politics, regulation and public policy-making create both risk and opportunity, and to develop and implement strategies to meet these challenges.

Global Counsel can provide support in specific markets or policy areas, or build teams to work alongside strategic decision makers for projects or transactions. Our work is backed up by high quality analytical content and collateral that is politically and economically informed, and which builds quickly into executable strategy. Our team incorporates an international network and is led by former public policymakers and political advisors with experience at the highest level of government and policymaking.

Further insights on foreign investment and other political risk issues can be accessed on the Global Counsel blog.³⁴

Herbert Smith Freehills

For assistance with transaction planning, contact one of the Herbert Smith Freehills Foreign Investment Regulation Group, who have extensive expertise in formulating and implementing regulatory strategies to secure global clearances and successful completion.

Herbert Smith Freehills is one of the world's leading professional services businesses, bringing together the best people to meet clients' legal services needs globally. Accessing our deep global sectoral expertise, as well as our local market understanding, we help organisations realise opportunities while managing risk to help them achieve their commercial objectives.

Operating as one global team, we use innovative systems and processes to ensure client work is delivered intelligently, efficiently and reliably. When working with Herbert Smith Freehills, clients are assured world class, full-service legal advice and the best results.

In order to assist clients in identifying potential foreign investment and public interest hotspots, Herbert Smith Freehills has published an interactive map and country-by-country client guide summarising the main elements of FDI control processes and current trends in key jurisdictions.

Email FDIPublications@hsf.com to access your copy.

Further insights from Herbert Smith Freehills can also be accessed on our [Future of Global Trade and Investment hub](#),³⁵ which contains updates on the latest developments in this rapidly evolving area.

³⁴ See: www.global-counsel.co.uk/blog

³⁵ See: www.hsf.com/fgti

Case studies

Beijing Kunlun/Grindr (US)

The acquisition of a dating app might at first sight appear unlikely to trigger national security concerns, at least under the more traditional notions of that concept. However, as Chinese conglomerate Beijing Kunlun Tech recently discovered, the range of sectors in which foreign investment may attract scrutiny is becoming much broader, particularly where the US review body CFIUS is concerned. The company acquired control of Grindr (an LGBTQ dating app) through two separate deals between 2016 and 2018, without submitting the acquisition for CFIUS review, but CFIUS subsequently intervened on its own initiative. In May 2019 it ordered Beijing Kunlun Tech to divest Grindr by June 2020, due to concerns about foreign access to US citizens' personal information (data collected by the app includes location information, messages, and even HIV status if users choose to provide this). This is a rare and high-profile example of CFIUS requiring a completed acquisition to be unravelled.

Ant/MoneyGram (US)

In January 2018 the proposed US\$1.2 billion acquisition of money transfer company MoneyGram by Ant Financial Services Group (part of Chinese conglomerate Alibaba) was abandoned following the parties' failure to secure CFIUS approval for the deal. MoneyGram had reportedly committed to operate separate information technology networks to Ant and bar Ant's investors from accessing MoneyGram's customer data, but such proposals were not sufficient to assuage the national security concerns of CFIUS.

Midea and Kuka (Germany, US)

The acquisition of German robotics manufacturer Kuka in 2016 by Chinese home appliances company Midea led to a reassessment by the Berlin government of its FDI policy framework. The €4.5 billion deal was the largest ever in Germany by a Chinese company, but it was the motivation – accessing Kuka's advanced technology – that caused upset among German politicians and policymakers. While many could see the commercial logic for the deal, in that it would make it easier for Kuka to serve the rapidly growing Chinese market, German politicians nevertheless sought answers as to why the Chinese authorities were making this difficult under German ownership. The deal was eased by winning the support of the Kuka board and by Midea providing assurances on jobs and keeping an independent HQ in Germany. It required the divestment of Kuka's US aviation subsidiary, which is active in the defence sector, as a result of US CFIUS considerations. What German policymakers found is that they were unable to block the deal under the previous rules.

Broadcom/Qualcomm (US)

On 13 March 2018, President Trump blocked Broadcom's US\$142 billion offer for Qualcomm on "national security" grounds. In defending the hostile bid – which would have been the largest ever tech deal – Qualcomm sought the intervention of CFIUS, which recommended that President Trump block the transaction. The major concerns raised by CFIUS related to cuts that Broadcom envisaged making to R&D spending at Qualcomm. It was feared that such a reduction in spending would grant Qualcomm's Chinese rival, Huawei, the opportunity to gain an advantage in 5G technology. The transaction was the second transaction blocked by President Trump in 2018 and provides a further example of the matters that have traditionally been competition/antitrust issues that are now influencing foreign investment reviews.

Fujian Grand Chip Investment Fund and Aixtron (Germany, US)

A €670 million takeover of the German chip maker Aixtron by the Fujian Grand Chip Investment Fund was blocked late in 2016 by the US authorities, due to security concerns. Aixtron's technology is used in the manufacture of LED chips and is not designed for military purposes, however the US was concerned that it could be applied in a military context. The unusual factor in this process was that the deal had already won the approval of the German authorities when US intelligence officials drew attention to the potential security risk, leading to withdrawal of the initial approval. While it was the US that pulled the plug on the deal, a review by the German authorities may have led to the same conclusion. It came as a blow for the Aixtron management team, which was an enthusiastic backer of the deal, arguing that it was necessary to remain competitive in a sector where Chinese companies are increasingly active.

Canyon Bridge and Imagination/Canyon Bridge and Lattice Semiconductor (US, UK)

The critical role played by national political attitudes to investment was illustrated at the end of 2017 by the contrasting fortunes of bids by California-based private equity group, Canyon Bridge for chip designers, Imagination in the UK and Lattice Semiconductor Corporation in the US. The potential sensitivity was created by the involvement of China Reform Holdings as a limited partner in the Canyon Bridge consortium. The US blocked the Lattice takeover on the grounds that it posed a threat to national security, given China Reform Holdings' links to the Chinese state. The UK authorities raised no concerns about the national security implications of the Imagination acquisition and were reported to have encouraged the transaction. The government's focus was on the implications for jobs, R&D and the headquarters of the company, which is the last major chip designer based in the UK. The company's share price had slumped earlier in the year when Apple said it would stop using its technology in its iPhones. However, concerns have recently surfaced in some parts in the UK regarding alleged attempts by China Reform Holdings to take control of the Imagination board and transfer key technologies out of the UK. This is now being investigated by the UK Foreign Affairs Committee as part of its ongoing inquiry into the Foreign and Commonwealth Office's role in blocking foreign asset stripping of UK companies.

Fincantieri and STX (France)

Fincantieri's takeover of French naval shipbuilder STX provided a reminder of how politics can still readily interfere in transactions within the EU. It also demonstrated how careful structuring of a transaction and high-level political deal-making can overcome obstacles. French concerns about the original offer were largely about jobs, but officials also questioned whether Fincantieri, which also builds ships in China, could be trusted with French naval technology. The government in Paris threatened the 'temporary' nationalisation of STX, unless its concerns were addressed. Under the deal that was eventually concluded in September 2017, the state-backed Italian industrial company took a 51% stake in STX, and control over the French company, but subjected itself to a 12-year period of reviews, which give the French government the opportunity to seize back control if it deems Fincantieri is not complying with its commitments. The deal was finally brokered by Italian Prime Minister Paolo Gentiloni and French President Emmanuel Macron.

Connect BidCo/Inmarsat (UK)

When Connect BidCo (a private-equity led consortium including equity funds based in Canada) sought to acquire British satellite operator Inmarsat, it initially sought to address potentially national security concerns by voluntarily agreeing legally-binding undertakings with the UK government. However, this proved to be insufficient to avoid a formal public interest intervention by the Secretary of State using her powers under the Enterprise Act 2002. In October 2019 the Secretary of State decided to accept undertakings in lieu of a reference for a more in-depth "Phase 2" investigation. Unsurprisingly, these were intended to provide assurances that sensitive information would be suitably protected post-merger, and that enhanced security controls are in place to ensure the continued supply of key services used by the Ministry of Defence. However, the undertakings were significantly more onerous and detailed than the undertakings first offered by the parties. This deal is also a notable example of government intervention on national security grounds in an acquisition involving a non-Chinese acquirer.

SoftBank and Arm (UK)

The 2016 £24 billion takeover by Japan's SoftBank of British smartphone chip designer, Arm, was the largest ever acquisition of a European tech firm and, as such, was always going to attract political attention. SoftBank provided the UK government with assurances that it would maintain its HQ in the UK and double its UK-based workforce. The latter commitment was a "post-offer undertaking" under the UK's Takeover Code for public bids and therefore legally binding. This was enough to win the support of the British government, which also welcomed the deal as an endorsement of the UK's economic prospects, coming soon after the Brexit referendum. The willingness of the UK government to be assertive in this case, in contrast with the Imagination takeover the following year, partly reflects the political circumstances, as the government had only recently announced its intention to place foreign takeovers under greater scrutiny. It also reflects economic circumstances, with Arm being acquired in a position of strength, contrasting with the weaker position of Imagination. As for SoftBank, its decision to engage the government early, and make commitments that ministers could claim as 'concessions', undoubtedly helped.

State Grid Corporation and Ausgrid (Australia)

In August 2016, the Australian government blocked (in line with recommendations from FIRB) a A\$25.1 billion bid for Ausgrid by the Chinese State Grid company, citing unspecified national security concerns. Ausgrid, which operates Australia's largest energy grid, was put up for sale by the state government in New South Wales. The Australian government claimed its decision was based on the nature of the asset and was not 'country specific', noting that Ausgrid provides 'critical power and communications services' for business and government. The government added that the process was unable to identify 'suitable mitigants' to allow the sale to go ahead. The decision has led to accusations of protectionism, particularly as State Grid already owns extensive gas and power networks in several Australian states. The proposed deal also enjoyed the backing of the New South Wales government. In October, the stake in Ausgrid was eventually sold to local investors for A\$20.8 billion, a discount of A\$4.3 billion.

Yantai Taihai Corp/Leifeld Metal Spinning (Germany)

In August 2018 a consortium of France's Manoir Group and China's Yantai Taihai Group abandoned its planned acquisition of Leifeld Metal Spinning, a German machine tool manufacturer, following objections from the German government on national security grounds. Leifeld is a technology leader for machine tools that can process high-strength materials to manufacture components for the aerospace industry and can also be used in the nuclear sector. If the deal had not been abandoned, the German government had made clear that it would be blocked under revised German foreign investment review rules, which had been tightened following controversy surrounding the acquisition of Kuka by Chinese firm Midea in 2016 (see separate box).

Cheung Kong Infrastructure/APA Group (Australia)

Hong Kong-based Cheung Kong Infrastructure may well have felt quietly confident about its proposed takeover of Australian gas transmission business APA Group in 2018, following the clearance of its acquisition of Australian pipelines and electricity network owner DUET Group the previous year. However, following FIRB recommendations the APA deal was blocked by the Australian federal government on national security grounds. Had it been permitted to proceed, it would have resulted in a single foreign company group having sole ownership and control over Australia's most significant gas transmission business, at a time of growing concerns about potential national security risks arising from China's influence over Hong Kong.

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