

A Review Of The EU FDI Screening Regulation And Its Scope

By **Vassilis Akritidis and Jean-Baptiste Blancardi** (May 16, 2023, 5:05 PM BST)

On March 30, advocate general of the Court of Justice of the European Union, Tamara Capeta, published her opinion in relation to a preliminary reference submitted by the Budapest High Court.[1]

Capeta considered that the scope of the EU Foreign Direct Investment Screening Regulation is not limited to acquisitions by foreign, that is, non-EU, investors, but can also cover the acquisition of one EU undertaking by another, if the acquirer has a third-country shareholding. The advocate general's opinion may foreshadow a revision of the EU FDI Screening Regulation.

Xella Magyarország, a Hungarian company owned by a company registered in Bermuda, appearing to be a subsidiary of a U.S. private equity firm, negotiated the takeover of Janes, a Hungarian company that owns a quarry in Hungary.

Under Hungarian law, Janes is considered to be a "strategic company" because its activities cover critically important raw materials. The takeover therefore had to be reported to the minister, who decided to block the acquisition.

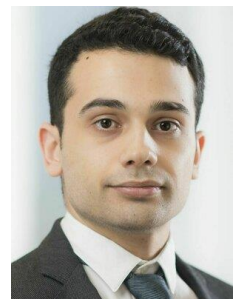
The reason for the preliminary reference was to determine whether the Hungarian law allowing the minister to veto the acquisition of a Hungarian company by an EU undertaking with a third-country shareholding is compatible both with the rules on the internal market under Article 65(1)(b) of the Treaty on the Functioning of the European Union, and with the Foreign Direct Investment Screening Regulation 2019.

This opinion, given as guidance to the CJEU before final judgment, is noteworthy for at least two reasons:

- It gives an overview of the elaborate legal framework governing foreign direct investments in the EU; and
- Capeta puts forward an interpretation of the FDI Screening Regulation that takes account of some of the geopolitical challenges faced by the EU.



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EU FDI Legal Framework Resides at a Crossroads

As evidenced by Capeta in her opinion, "direct investment" is an EU law concept that first derived from the free movement of capital within the internal market, an area of shared competence between the EU and member states. This free movement of capital also applies to foreign direct investment.

For many years, member states with FDI screening legislation had to comply with the rules on the free movement of foreign direct investments and could only take measures on grounds of public policy or public security, as per Article 65(1)(b) of the TFEU.

However, since the Treaty of Lisbon, which entered into force in 2009, FDI has been enshrined as a concept in primary EU law under the common commercial policy.

The common commercial policy is an area in which the EU has exclusive competence, and Capeta therefore found there to be an overlap, with FDI being covered by two different EU competences, one shared and one exclusive: the internal market — free movement of capital — and the common commercial policy.

FDI Screening Regulation: An Attempt to Bridge the Gap

In 2019, based on the common commercial policy, the EU adopted the FDI Screening Regulation, which authorizes but does not oblige member states to legislate on FDI screening.

According to Capeta, this regulation decentralized FDI screening in an attempt to respect traditional internal market rules, while maintaining a uniform and comprehensive approach to the common commercial policy.

The issue is that the regulation still explicitly mentions that it applies without prejudice to the measures taken by the member states on the basis of Article 65(1)(b), meaning that the two mechanisms coexist and that one does not replace the other.

The FDI Screening Regulation can be seen as an instrument designed to allow member states to screen FDI without violating international economic commitments.[2]

To this end, the language used in the regulation deviates from Article 65(1)(b), using "security or public order" instead of "public policy or public security," but is World Trade Organization-consistent in the context of the EU's compliance with its international obligations.[3]

Thus, a clarification from the court on the articulation of these two legal bases is welcomed, especially in a scenario in which an EU undertaking is acquired by another EU undertaking that has a third-country shareholding.

For this reason, the Hungarian court asked the CJEU for guidance regarding how exactly it should apply the FDI Screening Regulation and the internal market rules in this case.

Capeta's Interpretation of the FDI Screening Regulation

Scope of FDI Screening Regulation Includes Indirect FDI

The FDI Screening Regulation defines FDI as an investment "of any kind" by a foreign investor aiming to establish, inter alia, lasting and direct links between the foreign investor and the European undertaking.

The European Commission has taken this provision to apply only to foreign investors. Thus, it does not consider EU-based undertakings, i.e., undertakings having their corporate seat within the EU-27, like the two parties of the transaction at hand, to be within the scope of the regulation.

However, in her opinion, Capeta found that the phrase "investments of any kind" encompasses any type of investment through which the foreign investor gains effective participation in, or control over, an EU undertaking and that it imposes no limitation as to the structure or the investment process itself.

Hence, what is important when considering whether to apply the FDI Screening Regulation, is who ultimately acquires control over the EU undertaking in question. Therefore, according to Capeta, the FDI Screening Regulation also applies to transactions between EU-based undertakings in cases where the acquiring undertaking has a third-party shareholder. This is also known as "indirect FDI."

To further strengthen her argument, Capeta referred to Article 4 of the regulation, which specifically mentions that member states should take into account indirect control by a third country, including through ownership structure or significant funding, as a factor when determining whether an FDI is likely to affect security or public order.

FDI Screening Measures Must Still Comply

If it is established that the Hungarian screening mechanism is applicable to intra-EU transactions, the measures must still comply with the principle of free movement of capital. In fact, according to Capeta, any transaction covered by a screening mechanism must benefit from a complete proportionality review.

Capeta indicated that this review should consider:

- Whether the measures' aim is legitimate; and
- Whether the measures are proportionate. In other words, the measures must both target a genuine and sufficiently serious threat to the security or public order and be appropriate and necessary to accomplish this legitimate aim.

Moreover, when considering the legitimate aim, preventing speculative acquisitions in sectors considered strategic for the Hungarian economy is probably not a ground that can be invoked as a matter of public policy or of public security.

Exclusively economic reasons are indeed not capable of justifying an obstacle to one of the fundamental freedoms in abstracto, pursuant to CJEU case law. Furthermore, no circumstances identified by the court could justify the reliance on purely economic reasons to restrict speculative indirect FDI.

On the contrary, Capeta believes that Hungary's security of supply of sand, gravel and clay constitutes a ground that can be invoked as a matter of public policy or of public security even though the commission has not placed these aggregates on the list of critical raw materials.

Opinion Foreshadowing Future Revision

Interestingly, Capeta prefaced her opinion by pleading for a mindset change within the EU to overcome an outdated fear of perceived protectionism within the EU, and to be more conscious of national security threats, which are at the heart of the open strategic autonomy EU trade policy.

Furthermore, she references the European Commission's 2023 Work Program. This document hints at a possible upcoming revision of the FDI Screening Regulation to strengthen economic security in times of high economic uncertainty.[4]

Capeta has put forward a broad interpretation of the regulation that she evidently believes is aligned with the EU's current geopolitical ambitions.

In doing so, she has presented the CJEU with a dilemma: Should it follow her forward-looking opinion or render a judgment that risks appearing anachronistic in light of her understanding of what EU FDI screening legislation should look like in the future?

Asserting the EU's Strategic Autonomy

In parallel, member states have embraced FDI screening legislation since the COVID-19 pandemic. Some countries are adopting FDI laws for the first time, e.g., Belgium,[5] while those who already have this kind of legislation in place have enlarged temporarily their scope to englobe smaller capital participations in strategic undertakings, e.g., France.[6]

For the time being, this reinforcement of the EU FDI Screening Regulation takes the form of broadening the scope of the investments screened. However, the rules have not changed as to what makes an undertaking strategic and therefore subject to FDI screening.

The commission, which is pushing for all member states to adopt FDI screening laws and is a major driving force in this evolution, has been adamant on the issue thus far: The current legal framework based on "public policy or public security" under Article 65, TFEU is "the most relevant" to prevent "predatory acquisitions of strategic assets by foreign investors." [7]

This case illustrates this trend. Member states must demonstrate that an activity is strategic, and its assessment is eventually carried out in concreto under EU rules, as interpreted by the CJEU.

In this case, the Hungarian government considered that an undertaking owning and extracting a sand, gravel and clay quarry was strategic but, in Capeta's view, failed to demonstrate that its acquisition was a threat to Hungary's fundamental interests.

Time will tell if strengthening the FDI legal framework means extending the scope of what affects the member states' security or public order. In line with Capeta's call for understanding FDI legislation in the context of EU's strategic autonomy, the FDI Screening Regulation could expand in a future revision the list of factors that may be taken into consideration by member states or the commission in determining whether a foreign direct investment is likely to affect security or public order.[8]

During the last amendment process, lawmakers discussed using a broader language and mentioning not only critical infrastructures and technologies but also "strategic" infrastructures and technologies, as well as mentioning explicitly threats to the "strategic autonomy of the Union." [9]

This was not finally adopted, and it would certainly address the concerns of multiple member states that have called for improving the level playing field with regard to third countries' FDI screening practices. The lack of reciprocity between the EU and its member states and third countries has been a concern for some years.[10]

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[1] (Case C-106/22).

[2] Jens Velten, "Screening Foreign Direct Investment in the EU – Political Rationale, Legal Limitations, Legislative Options", European Yearbook of International Economic Law, Studies in European and International Economic Law, Volume 26, 2022, p. 60.

[3] Articles XIV(a) and XIV bis of the GATS mention respectively "public order" and "essential security."

[4] Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions, "Commission work programme 2023 - A Union standing firm and united", COM(2022) 548 final, 18 October 2022, p. 7.

[5] Belgium, Cooperation agreement of November 30, 2022 between the Federal State and the federated entities of Belgium aiming at establishing a screening mechanism foreign direct investment screening mechanism.

[6] Article R151-2 Monetary and Financial Code

[7] European Commission, "Guidance to the Member States concerning foreign direct investment and free movement of capital from third countries, and the protection of Europe's strategic assets, ahead of the application of Regulation (EU) 2019/452 (FDI Screening Regulation)", 2020/C 99 I/01, 26 March 2020.

[8] Article 4 of the FDI Screening Regulation lists

[9] European Parliament, Plenary Sitting (A8-0198/2018), Amendments 39 to 41, 4 June 2018.

[10] Paris, Rome and Berlin "Proposals for ensuring an improved level playing field in trade and investment", February 2017.