NAVIGATING CHOPPY WATERS

The post-COVID political-regulatory environment for FDI

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CONTENT

GLOBAL FDI SNAPSHOT:

THE POST-COVID POLITICAL-REGULATORY ENVIRONMENT FOR FDI

NAVIGATING CHOPPY WATERS

After a year dominated by COVID-related disruption and uncertainty, global vaccination measures are finally raising the prospect for societies and businesses to look ahead and plan for what looks to be a strong recovery, driven by pent-up demand, continuing monetary and fiscal support, and an acceleration of technology-led transformation. But while the recovery is priced in, the prospects for cross-border investments and trade are much less clear given geopolitical tensions, a policy shift across the world towards strategic autonomy, and a major leadership transition that began with the election of Joe Biden last November and will continue with the succession of Chancellor Merkel this year and presidential elections in France in Spring 2022.

Even before the pandemic, foreign direct investment (FDI) had already been under increasing scrutiny across the globe, given growing concerns over the national security and strategic economic implications of cross-border acquisitions, as well as a renaissance of active industrial policies. COVID-19 has further heightened awareness about strategic vulnerabilities in critical areas and triggered concerns about a sell-off of economic silverware in times of financial distress. Governments reacted by further beefing up their FDI screening regimes, increasing their remit to prohibit the acquisition of assets in an ever-wider array of strategic industries. Even though the main cause for the drop in cross-border transactions in 2020 was COVID-related, growing political-regulatory restrictions and uncertainties have also played an important role.

While the general focus on strategic autonomy is certainly here to stay, policy makers must balance this against the priority to support the post-COVID recovery and the need to maintain an environment that allows businesses to benefit from international growth opportunities and strategic partnerships. This is of particular importance as businesses look to M&A opportunities as a key element of their growth and transformation agendas. This raises the stakes for governments and regulators to wield their powers carefully.

GLOBAL NET CROSS-BORDER M&As

2019 - 2020

	VALUE Billions of dollars		GROWTH RATE	NUMBER of deals		GROWTH RATE
	2019	2020	%	2019	2020	%
TOTAL	507	475	-6	7118	6201	-13

Source: UNCTAD, cross-border M&A database

FROM AFTERTHOUGHT TO DEAL BREAKER

The once niche role of FDI scrutiny has by now been elevated to being a key pillar of M&A strategy, on a level with antitrust and sectoral regulatory approval regimes.

Successfully navigating FDI-related cross-currents has become a key success factor and must be factored in deal planning processes from the outset. Due diligence is required, and a strategic approach should be adopted to articulating a compelling narrative that demonstrates how a transaction will create value and contribute to political and regulatory agendas. Fine-tuning this narrative must be one of the key priorities in a deal roadmap.

As this report brings together the key political and regulatory trends on the global FDI landscape, 5 points stand out:

1. The scope of industries and technologies under scrutiny continues to be widened, reflecting an expansive interpretation of what constitutes national security and strategic interests.

2. Given the growing trend towards active industrial policies and fiscal support, FDI reviews are increasingly politicised in nature and must be approached correspondingly.

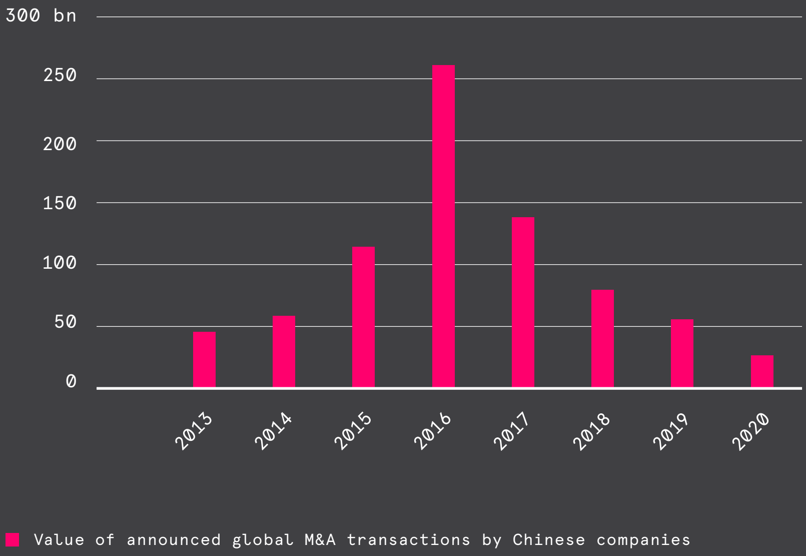
3. While investors from China certainly remain a key focus behind Western concerns, strategic autonomy considerations also extend to non-Chinese acquirers, as two recent prohibition decisions in France involving US and Canadian buyers illustrate.

4. The political environment for businesses is increasingly complex. Deals that would not appear to cause national security implications can suddenly get subject to lengthy and complicated reviews. On the other hand, even deals involving truly critical technology can still get approval, if carefully navigated. Managing this complexity requires a full understanding of the local perceptions and decision drivers and a clear gameplan.

5. Public perception plays an increasing role in the decision processes of governments, given the more public debate around FDI and industrial policy. Deal teams that bring across narratives that not only address the substantive concerns of policy makers but are also designed to provide strong arguments in a potential public debate can help to bring deals across the line.

OFFICIAL CHINESE OUTBOUND FDI DATA

(USD BILLION), 2013-2020



Source : Rhodium Group, 2021

REGULATORY DEVELOPMENTS & TRENDS BY COUNTRY

1. CHINA

MACRO ENVIRONMENT

In light of the growing geopolitical tensions between East and West and concerns about a decoupling, it is easy to lose sight of the fact that in terms of FDI, the picture looks a lot brighter than one would think. China's investment links to the world are in fact increasing. In 2020, China overtook the US as the world's largest destination for FDI, driven by a combination of China's early recovery, the continued importance and growth potential of China's vast market, and steps towards a further liberalization of cross-border investment conditions.

This is not to say that the political crosscurrents aren't a concern for investors and international businesses. The Chinese government's economic strategy ("Dual Circulation") seeks to allocate more economic resources on the internal market development to unlock the potential of domestic consumption and gain greater self-reliance in critical areas such as semiconductors.

We also hear complaints about the politicization of business in China, lack of specific plans to implement the opening steps announced and administrative hurdles for foreign companies, especially from their dealing with the local governments, and the harming aspects of China's economic governance (e.g. market access issues in various industrial and service sectors, the licensing issues in financial service sectors, subsidies and protective environment to hatch its own companies, vertical concentration of capital through SOE reform, etc.).

These are all real and formidable concerns. However, the bigger picture, as supported by the numbers as well as Chinese policy-makers' prominent mentioning of FDI at important international forums, is one of a slow move to a more open economy, providing opportunities for businesses and investors.

REGULATORY CHANGES

The regulatory changes come in bit by bit.

China has taken several major steps since January 2020: implementing the Foreign Investment Law, issuing updated "negative lists" by China's

Ministry of Commerce and the economic super agency National Development and Reform Commission on foreign investment and Free Trade Zone Special Administrative Measures, and easing foreign access to the financial market, to further expand opening-up, vigorously promote foreign investment, and standardize the foreign investment management.

China further released rules for foreign investment security reviews, which came into effect in January 2021, to review holding majority stake in sectors which concern the national security, including vital agricultural products, energy and resources, military industry, China positioned it, however, as a normal international practice and more as the necessary safeguard of the opening up and said that the necessary reviews won't impact the normal foreign investors.

One of the latest movements was the establishment of The Free Trade Zone Alliance of the Yangtze River Delta Region by FTZs in Shanghai, Zhejiang, Jiangsu and Anhui (three neighbouring provinces of Shanghai) on May 10, to facilitate high-quality and integrated development of the region and to further facilitate trade and investment, financial innovation, and cross-border research and development.

This follows reform measures to improve the overall business environment to ensure the stability in key areas (including financial and service sectors, foreign investment and foreign trade) to maintain China's economic recovery from COVID-19 by allowing foreign investment firms to set up wholly owned asset management business to conduct onshore investments for their Chinese clients and expanding the opening-up of the service industry in Hainan province, Tianjin, Shanghai and Chongqing municipalities.

IMPLICATIONS FOR INVESTORS AND OUTLOOK

For now, when talking about the China market potential, what is prominent in investors' mind is still the market's scale, not the environment. Aggregated data – first-quarter FDI inflows jumped 43.8 percent year-on-year to $44.86 billion – confirms that the investor perspective is an entrepreneurial one, focussing on the vastness of the market and its growth dynamic. In the first quarter alone, 10,263 new foreign-funded enterprises were established in China, up 47.8 percent year-on-year. This is all the more remarkable, given that China's strict zero-COVID-case strategy and the resulting tight travel controls for foreign nationals not only hinder the free exchange of talents, but also prevent potential new investors from conducting actual site visits, which is particularly important for greenfield investments.

However, it might prove increasingly difficult to deal with a more self-assertive China, which wants to have a firm grip of power in all domains, and which is increasingly a political rival and economically and technologically fierce competitive environment. Now with everything closely tied to politics, how can the existing and potential investors successfully manage their business in China, carefully navigate through the sensitive topics, ensure positive perceptions at their home country, abide by the values and principles defined by the key stakeholders, while showcasing their China commitment? Foreign investors need to be aware that foreign capital will only be supported in areas which China government will need strategic input, in China government's own term – high quality development. Key events to watch for next year which might pose a great impact on FDI to China include the 2022 Winter Olympics. The fear is that at some point investors might be forced to take a stance either supporting this sports event or joining the boycott camp, especially the EU companies.

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1. CHINA

2. EUROPE

The European Commission is engaged in the tenuous endeavour of safeguarding a global level playing field while ensuring a smooth and continuous flow of productive investments into the continent. In the wake of the COVID-19 pandemic, foreign direct investment in Europe fell by 13%. The surge of the virus led to unprecedented public support to the economy and fuelled Europe's already ongoing turn toward a greater geopolitical appraisal of investments.

Europe witnessed the launching of massive recovery plans. EU's first-time stimulus package "Next Generation EU" alone reached EUR 750 billion. Public support to home champions and reshoring of value chains arose as key discussion points which resulted in the establishment of extraordinary measures tightening foreign investment scrutiny in nearly all European countries, while EU's FDI regulation started to be applied in October 2020.

Leaning on both its industrial strategy and the broader review of its trade policy, the Commission proposed to adopt a new legal tool allowing its services to identify and tackle foreign subsidies unfairly distorting competition in Europe. Cultivating the EU's growing geopolitical involvement, the Commission is determined to demonstrate to European citizens and businesses its effectiveness in protecting their interests. Between 30 and 50 transactions are expected to fall in the scope of the proposed Regulation every year. Reflecting the importance of this unprecedented mechanism, Commissioner Vestager called European legislators to "feel our urgency" and to fast-track parliamentary procedure.

The introduction of this new framework for the control of foreign subsidies, together with the application of the FDI screening regulation and the activism at the Member State level, underlines the growing appetite of European decision makers for the control over foreign investments and the protection of strategic sectors. A notable example is when CNH Industrial ended talks to sell its IVECO truck and bus business to China's

FAW Group following a coordinated effort by the Italian and French economy ministers opposing the transaction.

At the same time, Europe is engaged in a quest for economic rebound and the Commission acknowledges that it will notably be driven by private foreign investment. Foreign investors active in Europe must therefore mindfully navigate a complexified environment to seize the oncoming business opportunities.

EU FDI SCREENING MECHANISM

How can Europe remain open for investments whilst being able to defend its strategic autonomy and economic sovereignty at the same time? The EU's FDI screening mechanism tries to balance just that. First and foremost an industrial policy tool and an additional bargaining chip in the EU's foreign policy tool-kit, converging opinions amongst Member States on how often to use said mechanism have already begun. Some Member States are much more active in commenting than others – France has already established itself as a clear front runner, unsurprisingly looking at its long history and broad scope of national investment screening.

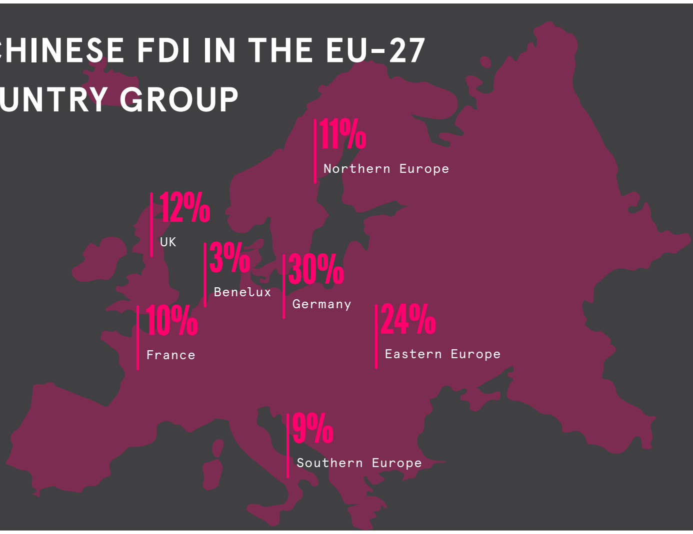
The EU framework for screening FDI has become fully operational as of 11 October 2020. While it is not a full equivalent to a national screening mechanism, it helps identify and raise awareness through a mechanism that exchanges information on cases where FDI may affect security or public order between the Member States and the European Commission. Member States notify and inform the Commission and other Member States of any FDI undergoing screening in their respective country, and if a Member State considers FDI to affect security or public order it provides comments to the Member State undertaking the screening. The same goes for the Commission, which in that case can issue an opinion. However, the Commission does not have the ability to block FDI, and the final decision whether to accept or reject an investment lies with the affected Member State.

From a deal perspective the EU screening mechanism has so far foremost led to extended deal timelines. The cooperation and coordination between the national authorities and the Commission takes time. Additionally, the lack of transparency – on why the authorities notify a case under the EU screening mechanism as a potential risk to security or public order – adds another risk factor to a transaction and makes it much harder to build up experience to develop successful narratives and strategies for planned deals. Overall, the mechanism is still in its early stages and needs to prove itself as an effective tool rather than just another bureaucratic hurdle.

Moreover, from a political perspective the absence of a "level playing field" or more precisely the lack of uniform regulations raises concerns. In Germany for instance, the threshold for screenings is lower than in many other Member States. This means there is a higher likelihood that transactions in Germany are flagged and commented on than transactions from other Member States. The question remains if over time this will also lead to a higher declining rate of deals in low threshold-members states.

COMPLETED CHINESE FDI IN THE EU-27 AND UK BY COUNTRY GROUP

2020



Source : Rhodium Group, 2021

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2.1. FRANCE

MACRO ENVIRONMENT

France was a pioneer in foreign investments scrutiny, adopting legislation already in 1945, while constantly and increasingly ranking among the first destinations for foreign investments. Successive governments have praised France's attractiveness for investors while nevertheless adding more layers to the country's scrutiny tools and safeguarding the scope of the State's intervention on the markets. This tenuous balance between much needed openness to capital flows and tightened scrutiny makes both the design and the enforcement on the control of foreign investment highly permeable to the influence of the country's top political priorities.

Losses of industrial capacities and fears of offshoring mainly in the manufacturing sector underpinned the reinforcement of the FDI scrutiny framework in the first decades of the 2000s. Still, over the past years France saw a shift in priorities toward putting a greater emphasis on the protection of "strategic assets". Echoing the emergence of the debate around "France and Europe's sovereignty" with President Emmanuel Macron urging not to miss the "historical momentum for industrial, economic, strategic, environmental and military sovereignty brought by history". This shift of priorities is driven by the fear of seeing France and Europe lagging in the global race for control over the sectors dominating the future of the economy and notably the next generation of digital and low carbon technologies. The downstream consequences of the COVID-19 crisis further fuelled this dynamic by revealing gaps in the country's productive base.

Not to be omitted is the steadily growing wariness of parts the population over globalization, giving way to protectionist considerations escalating higher on the policy agenda ahead of crucial electoral battles in 2022. The French government is hence engaged in a bet of modernizing its productive base while keeping control over national assets. This wager already profoundly shook the outlook of the French FDI regime and increasingly confronts investors with a more difficult landscape to navigate.

REGULATORY CHANGES

In 2014, in a move to defend "economic patriotism" then-Minister for the "productive recovery" Arnaud Montebourg signed a decree widening the list of sectors in which foreign investments were subject to scrutiny. The question remained quiet until 2018, where three major steps helped materialize the turn toward increased protection over strategic assets.

Firstly, the Decree n°2018-1057 on foreign investments subject to prior authorization, published on December 1, 2018 and applicable since January 2019 widens the list of sectors subject to scrutiny, adding companies in the aerospace and civil protection sectors, or that conduct research and development activities in cybersecurity, artificial intelligence, robotics, additive manufacturing, semiconductors, as well as hosts of certain sensitive data to the scope of control.

Secondly, the omnibus PACTE law, of May 2019 and its application decree together brought the tightening of the scrutiny to a higher level. The list of sectors subject to scrutiny was further widened to include print and digital media, food safety, critical technologies, energy storage and quantum technologies, and the participation threshold for scrutinizing investments was lowered from 33% to 25%. The political character of the scrutiny process was further strengthened by granting new policing and sanctioning powers to the Economy Minister. Additionally, companies targeted by an investment now themselves benefit from the right to directly request a prior authorization. The public disclosure of foreign investors has also been strengthened by the PACTE law, with the introduction of a yearly report, communicated to the Parliament and encompassing of the number of files processed by the DG Treasury, the origin of investors and the sector targeted.

Thirdly, the outbreak of the COVID-19 pandemic added a new layer to this trend. An emergency and temporary framework – extended until December 2021 – adds biotechnologies to the list of sectors subject to control, and the threshold triggering the scrutiny over investments for listed companies has been lowered from 25% to 10%. This last amendment was announced by the French Minister for Economic Affairs, Bruno Le Maire, on the occasion of the Franco-German Parliamentary Assembly summit of June 2020, demonstrating his quest for stronger cooperation with France's neighbour and main economic partner, few months before the European FDI Screening Regulation became fully operational.

IMPLICATIONS FOR INVESTORS AND OUTLOOK

This renewed framework for FDI control had immediate implications for investors, and two landmark cases provided insights into how the French government will likely treat future deals.

In mid-December 2019, the government blocked US-based industrial conglomerate Teledyne's attempted acquisition of the Photonis Group – active in the field of optronics for defence – marking the first time the government banned an investment by an American – or even allied country – company. It is also notable that this veto came nearly one year after the government launched the process of investigating the financial credibility of the buyer. Besides demonstrating the scope of the recent reforms, the decision further showcases that foreign buyers must consider the political-institutional hazard, which may lead in some cases to rejection – even in the home stretch. For the government the veto signals its intent to uphold its commitment to reinforcing European sovereignty, leading to an extended burden for non-EU bidders who will undoubtedly need to take this into account.

In early 2021, the French economy Minister opposed the takeover of Carrefour by Canadian incumbent Couche Tard on the ground that the operation would end up threatening French "food sovereignty". The intervention of the Ministry showcased the extent to which the concept of sovereignty can be stretched as a basis for FDI scrutiny. Above all, the Minister publicly deplored the lack of engagement of the parties with its services, pointing out that effective stakeholder engagement is a rising pre-condition for the success of any deal in France and in Europe.

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2.2. GERMANY

MACRO ENVIRONMENT

Ever since the takeover of German industrial robot icon Kuka by the Chinese consumer giant Midea in 2016, FDI control has continuously gained traction on the political agenda. The Corona crisis and the discussion around strategic autonomy has only further fuelled concerns over the sell-off of German intellectual property and the need to protect Germany's industrial basis. The topic even made it on the agenda of Germany's #1 tabloid BILD, with its editor-in-chief publicly demanding the German chancellor to promise "that no Chinese company [will] be able to acquire any company in Germany in the next 10 years. At a bargain price. On the grabbing table of the crisis."[1]

While such populism luckily doesn't translate directly in government actions, the underlying concerns have had an impact. Over the past 12 months, the German *Außenwirtschaftsverordnung* (Foreign Trade and Payments Ordinance) saw no fewer than three amendments (+ one amendment of the *Außenwirtschaftsgesetz*, or the Foreign Trade and Payments Act), partly in reaction to COVID, partly to reflect the changing European framework. And while the majority of investments reviewed continues to be approved, last December saw the second prohibition decision (state-owned Chinese Addsino Co. Ltd takeover of IMST GmbH), while Zhejiang Shuanghuan pulled out of acquiring a majority share in gearbox and auto component manufacturer Schmiedetechnik Plettenberg after failing to reach an agreement with the Ministry of Economic Affairs and Energy on some FDI-related provisions.

In addition, the number of transactions subject to FDI review, as well as the number of those deals requiring remedies has increased, and the intensifying political interest in FDI reviews are having an impact on the government's approach to and handling of cases.

That being said, it is important to emphasize that German political leaders and the public remain deeply convinced of the importance of open trade, driven by a keen sense of Germany's interests as an export-oriented economy, but also by a deeper belief that open trade and invest-

[1] Chief Editor of BILD Julian Reichelt on the occasion of a television speech by German Chancellor Angela Merkel on 18 March 2020.

ments are key for global stability and prosperity. Consequently, Germany remains a leading destination for FDI (#5 worldwide, 36 billion USD in 2020[2]) as well as FDI investor abroad.

REGULATORY CHANGES

THE MOST SIGNIFICANT SUBSTANTIVE CHANGES ARE:

- Expansion of the sectors covered to include the health sector with a notification obligation and screening starting from 10% acquisition of shares as a reaction to the ongoing COVID-19 pandemic (15th amendment, June 2020).

- Implementation of the European legal framework along the lines of the European Screening Mechanism: from the requirement of a "serious genuine danger" the threshold was lowered to cases with "expected negative impact" on public order or security as well as projects and programmes of Union interest to become relevant for assessment (16th amendment and amendment of the AWG, October 2020).

- Extension of the sectors covered based on the requirements of the EU Screening Regulation: artificial intelligence, robotics, semiconductors, cyber security, aerospace, industry-specific software as well as quantum and nuclear technology (in total 16 newly added sectors) with a notification obligation and review starting from 20% share acquisition (17th amendment, April 2021).

- Regulating atypical acquisitions of control and additional acquisitions of shares beyond the acquisition of control (17th amendment, April 2021).

IMPLICATIONS FOR INVESTORS AND OUTLOOK

The legislative changes will lead to a significant increase in cases subject to review. Even though the unit responsible will see a moderate a staff increase, it is still to be determined whether this will be commensurate

[2] OCED FDI Figures, April 2020.

with the increase of workload, which will likely further increase by the coming into force of the FDI screening mechanism and the fact that UK investments now also fall under the FDI review.

Politically, 2021 is a "super" election year in Germany and will mark the end of the "Merkel era". Given the whirlwind of legislative activities in recent months, we do not expect any major legislative activities by a new government nor any fundamental shift in the way cases are being handled. However, depending on which party takes over the Ministry for Economic Affairs (as well as the other key ministries usually involved in reviews) there might be changes in style and certain arguments gaining or losing favour. More than ever, investors should critically examine whether their plans are in line with the industrial policy goals of the German government. Without political-regulatory due diligence and, if necessary, pre-clearance, the risks are unpredictable, especially for the timing of an investment project. However, it is also clear that German industrial policy promotes and needs foreign investment.

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2.3. ITALY

MACRO ENVIRONMENT

Two major – seemingly conflicting - political trends underpin Italy's approach to FDI screening: the strategic interest to protect critical industries and infrastructures from foreign (perceived) opportunistic takeovers and the need to promote the internationalisation of Italian businesses and attract foreign investments.

While stricter FDI screening responds to the national need to protect key local industries, it has also been fuelled by a closer alignment to the EU's revised industrial policy – strongly affected by the COVID-19 pandemic - and Italy's belonging to the "transatlantic alliance". As a result, the government's golden power to veto a transaction or impose special conditions on its completion, including corporate governance and organisation measures has constantly grown over the past years - together with an extension of the sectors in scope.

On the other hand, Italy's economic recovery strategy entails a strong political push to promote the internalisation of national businesses, support export and attract FDIs towards innovative R&D and positive social impact on the real economy. While these goals have long guided Italy's approach to foreign investors and international transactions, the newly appointed administration led by the former President of the European Central Bank Mario Draghi has revamped the political effort. The government – whose near-term task is to kickstart Italy's economic recovery and allocate more than €200 billion to six key missions under the EU's Recovery and Resilience Plan – created a layered network of organisations that connects foreign governmental representations to regional actors in a joint effort to assess investment opportunities and foster their realisation and improve the attractiveness of Italy as a destination for FDI.

REGULATORY CHANGES

Several legislative measures have underpinned Italy's strategic political goals since the transition from a "golden share" to a "golden power" regime in 2012. Between 2012 and 2019 the focus had mainly been on defining the government's powers of intervention and identifying the key sectors subject to public scrutiny. These included transactions in energy, transport, and telecommunication sectors, but only insofar potential risks to national security and public order could be detected. Italian lawmakers considered this condition to be automatically fulfilled only in the case of 5G infrastructure technologies, added to the list in 2019. In addition, an inter-ministerial committee was set up in 2014, bringing together the Ministries for Foreign Affairs, Economy and Finance, Economic Development and Public Administration to assess FDIs considered of highest strategic relevance and sensibility. .

ITALY HAS STRENGTHENED ITS FDI SCREENING REGULATIONS IN APRIL 2020 IN THE MIDST OF THE COVID-19 PANDEMIC AND OFF THE BACK OF THE EU'S FDI SCREENING GUIDELINES, THE NEW RULES INCLUDE:

- Enhanced political discretion in reviewing transactions, applicable to all acquisitions by EU entities in the sectors covered by the law, and to non-EU transactions with an interest representing at least 10% of corporate capital or entitling to at least 10% of the voting rights of the target if the investment value exceeds € 1 million.
- Empowering the government to start a review process ex officio if the involved parties fail to abide by the filing rules, with heavy monetary sanctions for the breaching investors.
- Expanded scope of affected sectors, from healthcare to food supply, water, defence, financial services, raw materials, and emerging digital technologies.
- Closer coordination with EU governments and institutions.

IMPLICATIONS FOR INVESTORS AND OUTLOOK

From a political perspective, the Draghi administration is notably relaunching Italy's relations with other EU Member States, the new US administration and China. The realignment has a strong pro-European and Atlanticist profile and is in lockstep with the EU's goals to strengthen its industrial competitiveness. The U-turn from the past administration's wink to China – with whom a Memorandum of Understanding was signed in 2019 to join the flagship Belt and Road Initiative (BRI) – is best illustrated by the government vetoing the acquisition of LPE SPA, a small producer of components for power electronics applications, by the Chinese Shenzen Investment Holdings. The decision was a watershed; marking not just a decisive shift away from China and all but ending Italy's participation in the BRI, but also demonstrating how the government is ready to wield the enhanced golden power to attain its political goals.

At national level, the inclusion of regional authorities and public-private partnerships in the decision-making process will expand foreign investors' accountability to Italian society and local interests. This evolution will require a further effort to showcase the value of investments and the positive impact on the real economy.

Finally, investors should factor in the risks related to extended golden power review periods and potential intervention of third EU Member States or institutions – non-binding per se – on the national decisions.

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2.4. SPAIN

MACRO ENVIRONMENT

In March 2020, the Spanish government approved measures to protect Spanish listed companies from possible incursions of foreign corporations in their share capital. This came following the steep discount at which many of them traded last year which made "bargain" acquisitions relatively easy. The situation was particularly alarming for firms in strategic sectors, such as energy and finance, which were confronted with the risk of hostile acquisitions by foreign investors.

At the same time, the government's fear of uncontrolled takeover bids and of strategic Spanish companies falling in the hands of foreign capital is coming face to face with the priority of kickstarting economic recovery. While FDI inflows in 2020 were slightly down compared to 2019, they did grow significantly in the last quarter of 2020, notably in key sectors such as financial services, telecommunications and construction.

REGULATORY CHANGES

- Decree Law 8/2020 of 17 March on urgent measures to address the economic impact of COVID-19. It amends Law 19/2003 of 4 July 2003 on the legal regime governing capital movements and cross-border economic transactions. The law established mandatory prior express authorisation from the Government for companies from countries outside the EU and EFTA that wish to invest directly in Spanish companies in certain sectors. The definition of these sectors was sufficiently broad and vague to cover practically all target companies.

- This was extended to companies from EU and EFTA countries by Decree Law 34/2020, of 17 November, and established that all transactions of above €500 million or acquisitions exceeding 10% of a company's capital in the above-mentioned sectors or those of national importance would be subject to the new rules. In effect, the changes significantly broaden the transactions requiring ministerial authorisation and increase government's veto powers.

IMPLICATIONS FOR INVESTORS AND OUTLOOK

The government has so far virtually approved all foreign acquisitions submitted for approval, despite the protections.

Since March 2020 the Ministry of Industry has received 520 enquiries and requests for authorisation from foreign investors wishing to carry out operations in Spain. Of these, 26 have been submitted to the Council of Ministers, and all have been authorised – just one (which has been kept anonymous) received conditional approval. Transactions have been authorised in key sectors such as biotechnology (Kerry's takeover bid for Biosearch) and telecommunications (American Tower's acquisition of Telxius towers), and over the law's fifteen-month lifetime foreign groups have launched acquisitions worth more than €42 billion.

Despite the seemingly defensive nature of the regulations, the government is considering ways to attract capital, and it seems unlikely at this time that sweeping new rules will be introduced to most transactions given the government's ongoing deliberations on whether to renew for another six months Decree Law 34/2020 of 17 November.

It is said that the interventionist and more pragmatic wings of the government are deliberating over the decision. In this regard, commentators believe that the outcome of the authorisation process for the partial takeover bid presented by the Australian fund IFM to acquire 22.76% of Naturgy may provide clues as to the next steps that might be taken, with an unconditional approval decision being seen as a positive signal to international investors, especially in light of the conflicting messages from different governmental bodies about the transaction.

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2.4. SPAIN

2.5. UNITED KINGDOM

MACRO ENVIRONMENT

With the passing in April 2021 of the National Security and Investment Act, the UK has constructed a dedicated, stand-alone regime for assessing national security risk on transactions, some 45 years after President Ford established the Committee on Foreign Investment in the United States (CFIUS). While the UK has been very late to the game, the resulting regime is arguably more intrusive than CFIUS.

It is nearly five years since then Prime Minister Theresa May announced a review of the national security provisions in the Enterprise Act 2002, following her unenthusiastic approval of Chinese investment in the Hinkley Point C nuclear power station. During the slow path towards the new Act, the message throughout has remained consistent – the breadth and depth of national security risks to the UK have increased beyond the ability of the creaking regime in the Enterprise Act to manage effectively.

Despite the burden of both the COVID-19 pandemic and uncertainty over the terms of the UK relationship with the EU weighing heavily on the shoulders of dealmakers, the UK M&A market saw a strong finish to 2020. A surge of deals in H2 of 2020 delivered the strongest second half of the year since 2016. Relief over the final UK/EU agreement being reached, UK success in rolling out the COVID-19 vaccination programme and Sterling still seen as being undervalued, has driven an extremely strong start to 2021, with US and Japanese investors especially active.

REGULATORY CHANGES

The National Security and Investment Act 2021 passed into law in April 2021, although a commencement date is still waited for the regime to have effect, expected to be in Q4 of 2021. The structure of the new regime is though both clear and comprehensive:

- Will cover both acquisition of entities and assets.
- Mandatory notification in 17 specific sectors of the economy judged to be of the highest sensitivity, ranging AI and Artificial Intelligence, through to Quantum Technologies and Energy.
- Voluntary notification route for the rest of the economy, permitting merging parties to assess their own exposure and secure clearance so removing any retroactive risk.
- Sole decision-maker to be the Secretary of State for Business, Energy, and Industrial Strategy, to be informed by Investment Security Unit within their department.
- Ability to unwind any transaction completed without clearance whether mandatory or voluntary, for up to six months if government aware of transaction, or five years if not.
- Two phase process – initial 'review period' of 30 days to either clear or 'call-in' for an in-depth 'assessment period' of between 30-75 days, with extensions possible beyond the 75 day period.
- Criminal sanctions for non-compliance with the regime, including threat of imprisonment.
- Extra-territorial reach with ability to assess transactions taking place outside the UK but with exposure to the UK, and will capture UK-UK transactions.

IMPLICATIONS FOR INVESTORS AND OUTLOOK

The new legislation itself has created a situation where despite welcome late changes to raise the bar in terms of the minimum level of shareholding at which scrutiny will usually take place, it remains the case that certainly hundreds, potentially even thousands, of transactions will be notified annually, with the ability for the more sensitive transactions to be subject to political, media and public pressure.

Immediately after entry into force, we will see great uncertainty at the administrative level and therefore expect transactions to quickly become the subject of political consideration. This will have an impact not exclusively, but also on the timeline of transactions.

For deal makers then, the challenge when the new regime goes live later this year will be to ensure as much as possible that as well as quantifying and mitigating security risk any associated political risk must be fully addressed across the litany of contentious areas that might help drag the transaction into the corridor of uncertainty, such as jobs, investment, pension liabilities, HQ and tax jurisdiction. Investors need to ensure that these issues are communicated consistently and effectively when the deal is announced and throughout the completion process (and beyond closure).

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3.
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MACRO ENVIRONMENT

While expected to resolve intense political campaigns that had raged prior to and through the coronavirus lockdown, the U.S. elections in November 2020 ushered in a new period of turmoil and tumult for the American public. President Trump's refusal to acknowledge his loss to former Vice-President Joe Biden made what had traditionally been a peaceful transfer of power anything but that. While contesting results in several states, President Trump also resisted common transition protocols that would have facilitated a quick start to the Biden Administration on January 20, 2021.

As a result, President Biden assumed office having announced some key appointments and issuing a flurry of orders undoing Trump-era policies, but without a full team in place or a clear policy blueprint to guide them. Rattled by recent challenges to the democratic process, many Americans waited anxiously as the new leadership in the White House and a new Democratic majorly in the Senate settled in. Meanwhile, foreign investors and other observers remained uncertain regarding the direction the new president would take.

The pre- and post-election period took place – and continues to evolve – against the backdrop of increasing tensions in U.S.-China relations and concerns about America's competitiveness in the world. Trump's "America First" unilateral approach to diplomacy and trade left a web of tariffs, export controls, sanctions and national security restrictions that deterred Chinese investors and others considering transactions involving sensitive technologies.

REGULATORY CHANGES

To date, President Biden has done little to alter key elements of the Trump approach. This has been driven in part by politics, with many Republicans looking to accuse the new president at every instance of being weak toward China. It has also been caused by the slow pace at which Biden's senior appointments to key agencies have taken place. For example, at the Treasury Department only 2 of 28 senior officials have been approved by the Senate. That being said, some of the White House’s initial determinations and actions already indicate the direction the new administration is going. Most importantly, these include:

- A “Made-in-America” initiative announced within days of Biden taking office that is intended to benefit U.S. businesses and their employees, particularly in the manufacturing, infrastructure and technology sectors. The anticipated regulations will increase the domestic content threshold for a product to qualify as a U.S.-made item, which gives it preferential consideration when bidding for U.S. Government contracting opportunities.

- A comprehensive review of U.S. policies toward China, with multiple agencies evaluating the intent and effectiveness of current approaches and making recommendations for possible modifications. The results of this review will have a significant impact on the direction and key areas of focus for the remainder of President Biden’s tenure. In the meantime, both policy and regulatory officials continue to operate under Trump-era guidelines, which at an organization like the Committee on Foreign Investment in the U.S. (CFIUS) has resulted in some transaction parties finding it advantageous to withdraw and refile their submissions in the hope that Biden officials will take a more balanced approach than their predecessors. And the prospects for cooperation with China on environmental issues suggests a possible desire to compartmentalize issues so progress can be achieved in some areas.

- Measures to address U.S. tariffs on European imports as a step toward rebuilding America’s traditional alliances. In early March the U.S., United Kingdom and European Union agreed to temporarily suspend the wide-ranging tariffs Trump and his EU counterparts imposed as a result of a longstanding dispute over government support to their respective aviation sectors. The parties have also pledged to address other wide-ranging tariffs, and in particular those imposed by the U.S. on European and others’ steel and aluminium exports, as well as retaliatory actions by Europe.

IMPLICATIONS FOR INVESTORS AND OUTLOOK

For investors, navigating the U.S. policy landscape currently and in the coming period is bound to be difficult. The strong rhetoric and initiatives President Biden has initially put forward could be discouraging to foreign investors, but may be followed by regulations that are less onerous or open partnership opportunities with U.S. companies that were not previously contemplated.

For those considering investments in companies that contract with the U.S. Government, special attention should be given to the impact the investment will have on the company's eligibility for domestic content preferences. For others, possible changes in tariffs on a target company's products – or on key components in its supply chain – should be assessed carefully. Finally, understanding and, if possible, anticipating evolutions in U.S.-China relations will likely be of benefit to any prospective investor given the likely market reverberations of policy changes by either side that may lie ahead.

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