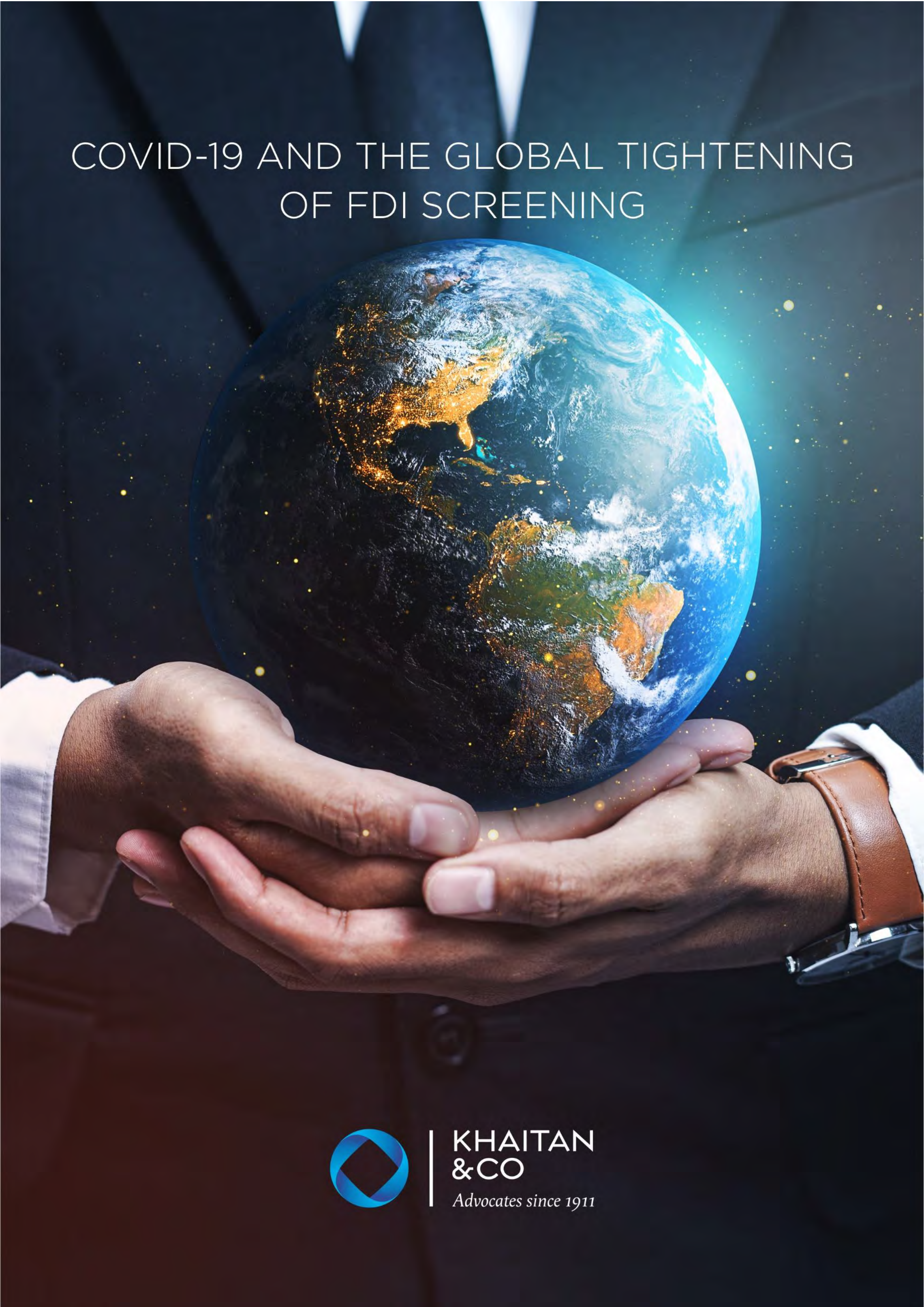
COVID-19 AND THE GLOBAL TIGHTENING OF FDI SCREENING



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On 17 April 2020, the Indian Government announced a significant change to its foreign direct investment policy (**FDI Policy**) pursuant to Press Note No. 3 (2020 Series) (**Press Note**). According to the Press Note, all investments by entities incorporated in a "*country which shares land border with India or where the beneficial owner of an investment into India is situated in or is a citizen of any such country*", will now require prior approval of the Indian Government. The countries which share a land border with India are Afghanistan, Bangladesh, Bhutan, China, Myanmar, Nepal and Pakistan.

Prior to the introduction of the Press Note, only foreign direct investment (**FDI**) from entities which were either based out of Pakistan or Bangladesh required prior government approval.

While the intention of the Indian government behind the introduction of PN 3 of 2020 was to "*curb the opportunistic takeovers/acquisitions of Indian companies due to the current pandemic*", the primary trigger seems to have been the rising geopolitical tensions between India and China at the Indo-China border. The introduction of the Press Note appears to be more of a retaliatory measure to put economic pressure on China to resolve the issues at the Indo-China border. In addition to the Press Note, the Indian Government has also banned the use and download of over 200 Chinese mobile applications[1] and restricted Chinese involvement in public procurement citing "national security" concerns.

More recently, on 16 December 2020, the Cabinet Committee on Security approved the National Security Directive on Telecommunications Sector (NSD) which mandates all telecom service providers (TSPs) to purchase telecom equipment only from "trusted sources" in a move to create a secured national network. The Government is expected to release a list of sources from whom no procurement can be done, and many believe that the Government would place restrictions on the use of Chinese telecom gear / equipment by private sectors TSPs.

Implications of the Press Note

According to the Press Note, if there is any direct/indirect investment from entities situated in China or the other border nations, prior approval of the government will be required. The Press Note interestingly does not provide any clarity on what is meant by 'beneficial ownership' and the method for computation of the same. It is noteworthy that other Indian legislations such as the Companies Act 2013 and anti-money laundering laws prescribe minimum thresholds (10% / 25%) for computation of 'beneficial ownership'. The lack of clarity on *de-minimis* thresholds in the Press Note has led to a draconian situation where minority/non-controlling stake purchases and even Indian legs of global deals (involving minimal Chinese stakes) may potentially require prior approval of the government. It is however very interesting to note that the press release restricting public procurement from China provides clarity on what constitutes beneficial ownership[2].

Since the introduction of the Press Note, over 150 applications[3] involving investments from Chinese entities have been pending for approval with the government and no approvals or clarifications have been issued till date. The Press Note has dealt a major blow to start ups by depriving them of funds from cash rich Chinese / Hong Kong based investors.

As it stands currently, all investments (whether direct or indirect) from entities which have Chinese/Taiwanese/Hong Kong/Macau (or other border nation) beneficial ownership, irrespective of the percentage or quantum of investment, will require prior government approval. Further, all applications filed pursuant to the Press Notes are required to undergo a mandatory (and stringent) security clearance by the Ministry of Home Affairs.

FDI Regulation – Global Overview

With COVID-19 crippling and hemorrhaging several sectors across the globe, governments are increasingly concerned that "critical" national companies are becoming more vulnerable than usual to foreign acquisition. Against this backdrop, there has been an increase in FDI screening mechanisms across the globe, the most notable being the regulations introduced in *Australia*, *Canada*, *China*, *The European Union* (*France*, *Germany*, *Italy* and *Spain*), *Japan*, *The United Kingdom (UK)* and *United States (US)*.

[1] Source available at: https://www.livemint.com/technology/apps/indian-govt-bans-aliexpress-42-more-chinese-apps-full-list-here-11606217588968.html

[2] Office Memorandum F. NO. 6/18/2019-PPD dated 23 July 2020, Ministry of Finance, Department of Expenditure, Public Procurement Division

[3] Source available at: https://economictimes.indiatimes.com/news/economy/policy/nods-fast-tracked-for-cos-with-minor-china-hk-investments/articleshow/78776152.cms?from=mdr.

Australia

Australia's foreign investment regime requires all private investors to seek prior approval before acquiring a substantial interest (being an interest of at least 20%) in an Australian entity valued above $275 million. The regime does provide some relaxation, by way of higher monetary screening thresholds, for acquisitions by investors from free trade agreement partner countries (including the United States, New Zealand, Japan and South Korea). In addition, investments in certain sensitive sectors (such as agribusiness and media) and in Australian land have separate, lower, thresholds. Foreign government investors (which includes sovereign wealth funds and public pension funds) also have lower thresholds.

However, as a reaction to the COVID-19 pandemic, on 29 March 2020, the Australian Government introduced a zero dollar monetary screening threshold for all investments. From 1 January 2021, the old thresholds will be reinstated, except that the zero dollar threshold will continue to apply for investments in a 'national security business' (which includes, among others, investments in critical infrastructure assets, telecommunications, critical technology and defense-manufacturing and supply companies) in a bid to bolster national security.

Canada

The Canadian government released a policy statement on 18 April 2020, stating that the government would scrutinize foreign investments in companies related to public health or companies that supply critical goods during the COVID-19 pandemic. The government will similarly pay close attention to any investments by state-owned companies or by investors with close ties to foreign governments[4].

China

While China has not introduced an COVID-19 specific screening regulations, the government had introduced sweeping changes to its foreign investment laws in January 2020 ushering in some long awaited liberalizations on foreign investment controls. All foreign investments (direct or indirect) and asset deals involving Chinese entities involved in defence security / national security areas will either be prohibited or require prior approval from the Chinese government.

The European Union

Taking a leaf from the Committee on Foreign Investment in the United States' (**CFIUS**) playbook, the EU adopted the Regulation on the screening of FDI (Regulation (EU) 2019/452) (**EU FDI Regulation**) on 19 March 2019. While the EU FDI Regulation does not specifically mandate or call for the creation of FDI screening practices; it does, however, call on all EU Member States to "maintain, amend or adopt" their existing FDI practices to screen FDI on the grounds of "security and public order". The EU FDI Regulation came into force on 11 October 2020.

As a pre-cursor to the implementation of the EU FDI Regulation, the European Commission also published a Guidance Note on 26 March 2020 (**Guidance Note**) to EU Member States on the screening of FDI, free movement of capital from third countries, and the protection of Europe's most important companies and ideas. The Guidance Note was published in the context of the COVID-19 pandemic and was aimed at ensuring that strategic European assets in the fields of health and health-related technologies, as well as strategically important companies that had been financially weakened by the pandemic, would not be sold off to foreign investors as the pandemic unfolded.

Currently, 15 EU Member States have already introduced their own national screening measures to curb opportunistic takeover of European companies carrying on businesses in critical and strategically important sectors. We have summarised below the key features of the FDI regulations introduced by *France*, *Germany*, *Italy* and *Spain*:

France

- investments in certain sensitive activities/sectors (approx. 23 activities) require prior approval from

[4] Source available at: https://www.ic.gc.ca/eic/site/ica-lic.nsf/eng/lk81224.html

the French Government. The list of activities include research, production or supply of weapons, ammunition, explosive substance or other war materials for military use, any activities related to water and energy supply, any activities related to security and information systems.

- any investment by a non-EU or non-EEA investor in an entity engaged in any of the restricted sectors will require prior approval only if the investor proposes to *acquire 25% or more of the voting rights* of the target (10% if the target is a listed company – applicable till 31 December 2020).

Germany

Under the existing FDI rules in Germany, an investment into a domestic company requires mandatory FDI filing (with closing conditionality and certain stand-still obligations), if:

- a share acquisition (direct or indirect) made by a foreign investor *reaches or exceeds 10% of the voting rights* in a target entity, which is involved in certain key-listed activities, that include defence and IT security activities (e.g. manufacturers and developers of war weapons and other key military technologies specified in export control lists; companies operating satellites with a high-grade earth remote sensing system; companies developing products with IT security functions for processing government classified information). Asset acquisitions in these sectors are similarly caught if they amount to an acquisition of a separable business unit of a domestic undertaking or the acquisition of all essential operating resources of a domestic undertaking or of a separable business unit. *For these sectors, all non-German entities are regarded foreign*.

- a share acquisition (direct or indirect) made by a foreign investor reaches or exceeds *10% of the voting rights* in a target entity, which is involved in certain key-listed activities, that include operating a critical infrastructure (e.g. companies active in the supply of energy, water, food, information or telecommunication technology, health, finance and insurance, transport or traffic); developing or modifying software for the operation of a critical infrastructure, providing cloud computing services; companies engaged in the area of telematics infrastructure; media companies (broadcasting, telemedia and print) with a wide circulation and influence on public opinion, and companies active in the healthcare sector. As regards asset acquisitions, the same applies as above. *For these sectors, all non-EU or non-EFTA entities are regarded foreign*.

Investments into all sectors that are not explicitly listed may be subject to an ex officio review by the competent authority, if they amount to an acquisition of 25% of the voting rights or a relevant share acquisition by a non-EU or non-EFTA entity.

For the purposes of calculating the voting share thresholds, all the pre-existing shareholdings of a third party, in which the foreign investor holds a respective 10% or 25% shareholding, are fully attributed to the foreign investor. It is important to note that the list of sensitive sectors that require a mandatory FDI filing is currently under review and is therefore expected to be extended in the near future to also include, amongst others, critical technologies (such as artificial intelligence, robotics, and semiconductors).

Italy

Traditionally, FDI screening mechanisms were only applied to foreign investments in:

- the defence and national security sectors (including the broadband electronic communications services based on 5G technology); and

- the energy, transport, communications and technology-intensive sectors

However, in order to deal with COVID-19, the screening mechanism was extended to investments:

- In the credit, financial, insurance, agri-food and steel sectors;

- In companies operating in certain critical sectors or engaged in critical activities such as critical technologies and dual use items (including artificial intelligence, robotics, semiconductors, cybersecurity, aerospace, defence, energy storage, quantum and nuclear technologies as well as nanotechnologies and biotechnologies), supply of critical inputs, including energy or raw materials, as well as food security, critical infrastructures (including health)

Threshold for notification: An acquisition would require prior approval if the *shareholding or voting rights* proposed to be acquired *exceeds 3%* if the target operates in the defence and national security sectors, irrespective of the nationality of the purchaser. For all the other restricted sectors, the threshold is *10% or more shareholding or voting rights* and investments are equal to or exceeding EUR 1 million for acquisitions by non-EU purchasers. In addition, the adoption by the target of any resolution, act or transaction, entailing a modification in the ownership, control, availability, use or destination, of their assets/relationships qualified as strategic would also trigger a notification obligation.

The above restrictions will be in force till 31 December 2020; however, in light of the prevailing situation around the globe, the restrictions are expected to be extended till 30 June 2021.

Spain

In Spain, prior to the COVID-19 outbreak, the FDI screening regime only applied to foreign investments in companies involved in national defence. In March 2020, the government extended the screening mechanism by requiring non-EU undertakings to notify acquisitions of *10% or more of the shareholding* in a Spanish company, or less than 10% of the shareholding in a Spanish company if it results in the effective participation in the *control or management* of the Spanish company and if the company is active in sectors relating to public order, public security or public health. These restrictions also apply to all investments (regardless of the sector in which the target company operates) in the following scenarios: (i) if the foreign investor is directly or indirectly controlled by the government, including public bodies or the armed forces, of a third country; (ii) if the foreign investor has made investments or participated in business in sectors affecting security, public order and public health in another Member State, and in particular those listed below; or (iii) there is a serious risk that the foreign investor will carry out criminal or illegal activities affecting public safety, public order or public health in Spain.

The government has generally focused its screening efforts on the following sectors: (a) critical infrastructures, both physical and virtual (energy, transport, water, healthcare, communications, media, data storage and processing, aerospace, defence, finance or sensitive installations); (b) critical technology and dual-use products; (c) essential supplies (energy, hydrocarbons, electricity, raw materials and food); (d) sectors with sensitive information such as personal data or with capacity to control such information; and (e) media.

It is noteworthy that, the Spanish government, on 19 November 2020, in an attempt to further mitigate the adverse health effects brought about by COVID-19, extended the FDI screening regime to all investments coming from other member states as well (i.e. non-Spanish entities) if the the transaction value in Spain exceeds EUR 500 million.

Japan

In Japan, prior to the COVID-19 pandemic, certain foreign investment in certain designated areas of businesses related to: (i) national security; (ii) public order; (iii) public safety; and (iv) the smooth management of Japan's economy (Designated Business Sectors) required a prior approval from the Japanese government. In principle, an acquisition of 10% or more of the shares or voting rights in a listed company and acquisition of one or more of the shares in a private company involved in a Designated Business Sector required prior approval. Some examples of Designated Business Sectors are software, telecommunications, and information processing businesses.

In May 2020, the government introduced amendments to lower the prior notification threshold for acquisition of shares or voting rights in a listed company operating within the Designated Business Sectors from 10% to 1%[5]. The amendments also identify 13 core Designated Business Sectors where foreign investments are regulated even more heavily[6]. The core Designated Business Sectors include weapons, aircrafts, dual use technologies, space, cyber security, water supply, telecommunications and pharma and medical devices. The amendments have, however, introduced an extensive set of exemptions for foreign financial institutions that acquire stocks solely for portfolio management purposes.

The United Kingdom

On 11 November 2020, the National Security and Investment Bill (slated to become law in spring 2021) (UK FDI Regulation) was introduced in the UK Parliament which will give the UK Government wide

[5] Source available at: https://www.mofo.com/resources/insights/200522-japan-restrictions-foreign-investment.html#_ftn5

[6] Refer note 5 above.

ranging powers to screen foreign investments and intervene in transactions which may give rise to a risk to national security. The UK FDI Regulation will retrospectively apply to all transactions entered into post 11 November 2020.

The UK FDI Regulation mandates compulsory notification of transactions involving acquisition of certain shares or voting rights in companies and other entities engaged in 17 specified 'sensitive sectors'[7] of the economy. Transactions subject to mandatory notification cannot be completed until clearance is granted and transactions that take place without clearance will be void.

The UK FDI Regulation only applies to transactions where there is an acquisition of 'control' or 'material influence[8] in any UK incorporated or registered entity or over land, tangible moveable property and intangible assets.

In addition to the mandatary notification requirement, the UK Government will also have broad call in powers to scrutinize transactions that do not fall within the mandatory notification regime, for national security reasons which in addition to UK companies and entities also includes acquisition of "control" or "material influence" over land, tangible moveable property and intangible assets. The term 'national security' is undefined and is a continually moving goalpost largely dependent on government policy and macroeconomic outlook. The call in powers can even be exercised retrospectively for completed transactions for a period upto 5 years from completion of the transaction. The "call-in" period is reduced to six months if the Government has become aware of the transaction.

United States

In the US, the CFIUS is charged with responsibility for reviewing foreign acquisitions of and investments in US businesses for potential national security concerns. Where CFIUS identifies a national security issue with a contemplated or completed foreign investment transaction, it is authorized to mitigate those issues by modifying, prohibiting, or even unwinding the transaction in question.

While the US government did not introduce legislation, regulation or policies specifically to address issues related to COVID-19, the Foreign Investment Risk Review Modernization Act (FIRRMA) passed in 2018 provides enough powers to the CFIUS to deal with risks and threats posed by the pandemic. For example, the FIRRMA expanded the already broad jurisdiction of the CFIUS to review foreign investments in U.S. companies that involve critical technologies, critical infrastructure, and sensitive personal data. The FIRRMA also permits the CFIUS to review non-controlling, non-passive investments in certain categories of US businesses as opposed to its previous authority to only review "control" transactions[9].

Conclusion

The FDI screening mechanisms implemented or proposed to be implemented in *Australia*, *Canada*, *The European Union*, *Japan* and *The United Kingdom* are envisaged to be used only for screening foreign investments in certain specified sensitive or critical sectors on grounds of national security and such investments (in certain circumstances) are also required to meet certain additional objective thresholds. The US also has been screening FDI in sectors such as biotechnology and critical technologies on grounds of national security for some time through the CFIUS mechanism.

In contrast, the Indian Government has gone a step further by imposing a blanket restriction on investments from Chinese entities (and other border nations) across all sectors, and not just those historically deemed "sensitive" in India (e.g. telecom, banking, insurance, pharma) and has failed to distinguish between majority / control investments or minority / passive investments. Infact, it appears that the Indian Government has, on purpose, steered clear from providing much needed clarity on some teething issues in the Press Note (e.g. definition of 'beneficial ownership', de-minimis thresholds for triggering approvals).

However, unlike the FDI regulations in *Australia*, *Canada*, *The European Union*, *Japan* and *The United*

[7] The list of sectors covered are: Advanced Materials; Advanced Robotics; Artificial Intelligence; Civil Nuclear; Communications; Computing Hardware; Critical Suppliers to Government; Critical Suppliers to the Emergency Services; Cryptographic Authentication; Data Infrastructure; Defence; Energy; Engineering Biology; Military and Dual Use Quantum Technologies; Satellite and Space Technologies; Transport.

[8] Material influence' will be interpreted in the same way as the term is used in the UK merger control regime, where any shareholding of more than 25% (giving the ability to block special resolutions) will be presumed to confer material influence and the authorities will also examine whether a share acquisition of 15% to 25% might result in the ability to exercise material influence. (source available at: https://www.simmons-simmons.com/en/publications/ckhxmwlbv14yt0936hzvwakjl/proposed-government-s-powers-to-intervene-in-m-a-transactions)

[9] Source available at: https://www.cooley.com/news/insight/2020/2020-06-15-covid-19-global-foreign-direct-investment-screening

Kingdom, the Press Note does not appear to have been introduced as a reaction to the COVID-19 pandemic and is more nationalist in nature and not a CFIUS equivalent protectionist regime. In our view, the Press Note is a retaliatory measure to put economic pressure on China and is likely to fall away or be withdrawn as soon as the border tensions between India and China are resolved. If recent news reports are to be believed[10], the Indian Government is apparently proposing to set up an inter-ministerial panel to consider and expedite approvals in cases where acquirers have minor investments from entities situated in China, Hong Kong, and entities from other border countries. Further, on 8 December 2020, the central government notified changes to the foreign investment rules clarifying that a Multilateral Bank (e.g. the Asian Development Bank) or Fund (e.g. the IMF), of which India is a member, will not be treated as an entity of any particular country nor will any country be treated as the beneficial owner of the investments of such Bank or Fund in India. It is interesting to note that the relaxation comes off the back of the Asian Development Bank (of which China is a member) recently sanctioning loans totaling over USD 1.3 billion[11] to India for undertaking certain critical infrastructure projects.

While the relaxation will only benefit a limited set investments, this is a positive development which seems to indicate a thawing in the government's rigid stance vis-à-vis Chinese investments. We could expect the Government to come out with clarifications (on thresholds for 'beneficial ownership') on the Press Note and may be even establish a fast track approval mechanism for such investments in the first half of 2021, particularly by relaxing the stringent security clearance measures.

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[10] Refer note 1 above.

[11] Sources available at: https://www.ndtv.com/india-news/asian-development-bank-approves-two-loans-of-800-million-for-india-2335945; https://www.ndtv.com/india-news/asian-development-bank-approves-two-loans-of-800-million-for-india-2335945