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The EU Commission publishes the second annual report on the screening of foreign direct investment into the Union

REGULATORY, ALL BUSINESS SECTORS, EUROPEAN UNION, REFORM, FOREIGN INVESTMENT, COMPETITION POLICY, COVID-19

European Commission, *Second Annual Report on the screening of foreign direct investments into the Union*, Report, 1 September 2022

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On 1 September 2022, the European Commission ("Commission") published the Second Annual Report on the screening of foreign direct investments ("FDI") into the European Union (available *here*), and the accompanying Commission Staff Working Document (available *here*), pursuant to the annual reporting obligation under Article 5 of Regulation (EU) 2019/452 ("FDI Regulation").

This is the second annual report on FDI screening since the FDI Regulation establishing the EU cooperation mechanism on FDI became fully operational on 11 October 2020. The first annual report, published on 23 November 2021 (available *here*) showed that Member States and the Commission are eager to review deals with an FDI element and which may have an impact on the national or the EU's security and public order.

The first annual report also showed that whilst most transactions were cleared swiftly and without an in-depth investigation, foreign investors should expect increased scrutiny in the future with more EU countries adopting national FDI screening mechanisms and tighter rules for such deals on grounds of security and public order.

This trend of increased FDI scrutiny by the Member States and at EU level is confirmed by the second annual report, which provides the following key highlights:

- While the global FDI flows have increased significantly (52%) compared to 2020, in the EU there was a decrease of FDI flows of 31% with respect to 2020 and 68% with respect to 2019. Despite these results, the total number of mergers and acquisitions and greenfield investments have increased in 2021.
- Most of the inward FDI into the EU originated in the US and the UK. China reduced its overall contribution to

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inward FDI flows into the EU and most jurisdictions reached pre-COVID-19 levels in terms of the number of M&A deals in 2021. However, the number of greenfield investments was lower in 2021 than in previous years.

- Germany, Spain and the Netherlands were the EU countries that received the most inward FDI in 2021. The most prominent sectors receiving FDI in the EU were information and communications technology (ICT) and manufacturing.
- The EU Member States received a total of 1,563 notifications for FDI clearance in 2021 (including ex-officio cases). This is slightly less than the 1,793 notifications reported in the Commission's first annual report, but the number of formally screened cases has increased slightly from 20% in 2020 to 29% in 2021.
- At the EU level, 13 Member States submitted a total of 414 notifications to the Commission, which is a significant increase compared to the 265 notifications in 2020. Most of these notifications were made by Austria, France, Germany, Italy and Spain. The five sectors with the highest number of transactions were ICT (36%), manufacturing (25%), financial activities (9.5%), wholesale and retail (8.5%) and construction (4%).
- Of the 414 cases notified in 2021, 86% (356 cases) were closed in Phase 1 (i.e., within the initial 15 calendar days), with the remaining 11% (47 cases) proceeding to Phase 2 with additional information being requested from the notifying Member State. Of those Phase 2 cases, 3% (11 cases) were still ongoing at the cut-off date of the report.
- As of 10 May 2022, 18 of the 27 Member States had FDI screening mechanisms in place. Belgium, Croatia, Estonia, Greece, Ireland and Luxembourg and Sweden are expected to adopt national FDI screening mechanisms shortly, which will increase the number of EU countries with national FDI screening mechanisms to 25.

A more detailed analysis of these key highlights is provided below. For more information on the Commission's second annual report and the EU screening mechanism more generally, please also visit the Global Competition Review (GCR) Guide to Foreign Direct Investment Regulation edited by Veronica Roberts, competition and foreign investments partner at Hebert Smith Freehills, with contributions from Kyriakos Fountoukakos, Daniel Vowden and Daniel Barrio, amongst others. The full online version of the guide is available *here*.

More FDI flows globally but a general decrease in the EU

According to the report, global FDI flows reached EUR 1.5 trillion, which constitutes an increase of 52% with respect to 2020, and an increase of 11% with respect to the pre-COVID-19 levels of 2019. A similar increase in FDI flows did not occur in the EU, which only contributed EUR 117 billion to the global recovery in 2021. This constitutes a decrease of 31% with respect to 2020 and a 68% decrease compared to 2019. These rather disappointing results were allegedly caused by a decrease of inward FDI in Ireland, Germany and Luxembourg and disinvestments in the Netherlands.

Despite this drop in aggregated FDI flows in the EU, the number of mergers and acquisitions (M&A) and greenfield investments in 2021 increased by 32% and 12% respectively, compared to 2020. However, the total number of acquisitions was still 9% below the pre-pandemic levels in 2019 and 39% for greenfield investments.

United States and the United Kingdom were the largest originators of inward FDI into the EU

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According to the report, the majority of inward FDI into the EU in 2021 originated in the US, accounting for 32.3% of all acquisitions and 39.4% of all greenfield investments, followed by the UK with 25.6% and 20.9%, respectively.

China reduced its overall contribution to inward FDI flows into the EU, with only 2.3% of all foreign acquisitions in 2021 (a reduction from 3.4% in 2020) and 6% of all greenfield investments (down from 7.1% in 2020). According to the report, this overall reduction was probably due to stricter capital controls and the concentration of investment activities in certain core industry sectors. However, despite this overall decrease, investments originating in China still accounted for EUR 9 billion 2021, compared to EUR 6.5 billion in 2020.

Most jurisdictions reached pre-COVID-19 levels in the number of M&A deals in 2021. However, the overall number of greenfield investments remained lower than in 2019. The only exception were certain "offshore countries" such as Bermuda, British Virgins Islands, Cayman Islands, Mauritius and the United Kingdom Channel Islands, which engaged in 133 projects in 2021 (compared to 106 in 2019) and Russia, with 46 projects in 2021, up from 20 in 2019.

Germany, Spain, France and the Netherlands received the most FDI

In terms of target EU countries receiving the most inward FDI in 2021, Germany was the top destination with a share of 16.4% of all acquisitions by foreign investors, which constitutes a 20% increase with respect to 2020. Spain, France and the Netherlands followed with a share of foreign transactions of 13.8%, 10.7% and 10.5%, respectively.

The most prominent sectors that drove the rebound in foreign transactions in the EU were information and communications technology (ICT) and manufacturing. ICT ranked first in M&A activity and second in greenfield investments (after retail) with 30% of new acquisitions and 15.4% of new greenfield investments in 2021, which constitutes a growth of 34% and 15% respectively compared to 2020.

Similar number of notifications at the national level but greater scrutiny by national FDI screening authorities

In 2021, a total of 1,563 notifications were made for FDI clearance with the national EU Member States' authorities (including ex-officio cases). This is slightly less than the 1,793 notifications reported in the Commission's first annual report. However, the number of formally screened cases has increased slightly from 20% in 2020 to approximately 29% in 2021. According to the report, this is probably due to a greater attention by national screening authorities to what is considered "critical" (e.g. critical infrastructure or critical technologies) and to changes in investment trends.

A large majority of the national applications in 2021 (approximately 71%) were deemed ineligible or did not require formal screening because of an evident lack of impact on security and public order. Of all cases formally screened, the majority were authorised without conditions (73% compared to 79% in 2020), which means that the transaction was approved without any additional action required from the investor. However, 23% of the decisions required an approval with conditions or the adoption of mitigating measures, which constitutes a significant increase compared to the first annual report with 12%. Only 1% of all cases were blocked by the national authorities and approximately 3% of transactions were ultimately abandoned by the parties.

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More FDI notifications by Member States at the EU level

In 2021, 13 Member States submitted a total of 414 notifications to the Commission, pursuant to Article 6 of the FDI Regulation. This is a significant increase compared to the 265 notifications made by 11 Member States in 2020. Most of these notifications (85%) were made by the following 5 Member States: Austria, France, Germany, Italy and Spain. The five sectors with the highest number of transactions were ICT (36%), manufacturing (25%), financial activities (9.5%), wholesale and retail (8.5%) and construction (4%).

Of the 414 cases notified in 2021, 86 % (356 cases) were closed in Phase 1 (i.e., within the initial 15 calendar days), with the remaining 11% (47 cases) proceeding to Phase 2 with additional information being requested from the notifying Member State. Of those Phase 2 cases, 3% (11 cases) were still ongoing at the cut-off date of the report. The main sectors subject to Phase 2 were manufacturing (76%), ICT (32%) and financial activities (10%). Manufacturing includes critical infrastructure and/or technologies such as defence, aerospace, energy, health (including pharma) and semiconductor equipment's.

For all Phase 2 cases, the average duration for Member States to provide the requested information was 22 calendar days (compared to 31 calendar days in the Commission's first annual report), with a range from 3 to 101 days (compared to 2 to 101 calendar days in the first report). Opinions have been issued in less than 3% of all cases notified, which is a similar figure as the one provided in the first annual report. In 2021, the Commission did not screen any investments on its own initiative (*ex-officio*), pursuant to Article 7 of the FDI Regulation.

More EU Member States are putting screening mechanisms in place

As of 10 May 2022, 18 of the 27 Member States had FDI screening mechanisms in place, which is the same number provided in the Commission's first annual report in November 2021.

According to the report, in 2021, seven Member States had national FDI screening mechanisms in place (Austria, Finland, Malta, Poland, Portugal, Slovenia and Spain), six Member States have amended an existing mechanism (France, Germany, Hungary, Italy, Latvia and Lithuania), two had a consultative or legislative process expected to result in updates to an existing mechanism (the Netherlands and Romania), and three Member States have adopted a new national FDI screening mechanism (Czech Republic, Denmark and Slovakia).

Belgium, Croatia, Estonia, Greece, Ireland and Luxembourg and Sweden had a consultative or legislative process expected to result in a new FDI screening mechanism, which would increase the number of EU countries with national FDI screening mechanisms to 25. There is no public information available that would suggest that there are initiatives for national FDI regimes ongoing in relation to Bulgaria and Cyprus.

In its second report, the Commission again encourages all Member States to adopt, adapt and implement national screening mechanism. Most recently, the Commission called upon Member States to set up a fully-fledged screening mechanism in the 2020 Guidance to Member States on how to use FDI screening in times of public health crisis and economic vulnerability in the EU (available *here*) and in the 2022 Guidance to Member States on FDI from Russia and Belarus (available *here*).

Despite regular cooperation in 2021 between the Commission and Member States and a number of important similarities between national screening mechanisms, Member States still continue to show significant degrees of differences in terms of what constitutes a formal screening of FDI, applicable timelines, sectoral coverage,

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notification requirements and other elements. According to the report, the Commission remains dedicated to support the alignment of national screening mechanisms and expects that all 27 Member States will soon have a national FDI screening mechanism in place.

FDI from Russia and Belarus

The report also addresses the recent Guidance issued by the Commission in relation to FDI from Russia and Belarus (see our previous note *here*).

The report explains that since the beginning of Russia's military aggression against Ukraine, the EU adopted a series of packages of financial, economic and trade measures (sanctions) against Russia aimed at significantly weakening its economic base, depriving it of critical technologies and markets and undermining its ability to finance the war. In parallel, the existing EU sanctions regime against Belarus has been expanded in response to its involvement in Russia's aggression against Ukraine.

On 6 April 2022, the Commission issued Guidance to Member States on how to screen foreign direct investment from Russia and Belarus into the EU, in light of the ongoing military conflict in Ukraine. In the Guidance, the Commission acknowledges that the screening of FDI and sanctions are two distinct legal instruments, each with a different purpose. However, in light of Russia's military aggression against Ukraine, the Commission calls for greater vigilance against Russian and Belarusian FDI into the EU.

This would apply not only to individuals or entities currently subject to sanctions in the EU but also to any investment directly or indirectly related to a person or entity associated with, controlled by or subject to influence by the Russian or Belarusian government into critical assets in the EU that may pose a threat to security or public order in a Member State.

Next steps

In terms of next steps, the report provides that the Commission launched a study in 2021 on the FDI cooperation mechanism in order to assess discrepancies and inefficiencies between the FDI screenings carried out by national authorities and the Commission and how those interactions may be improved. The study, which is expected to be concluded in the summer of 2022, will also contribute to the Commission's assessment on the potential need for a revision of the FDI Regulation in 2023.

Finally, the report indicates that despite the positive economic outlook for 2022 expected by some analysist, the sharp increase in the cost of energy and raw materials, and the economic repercussions of supply chain disruptions caused by Russia's invasion of Ukraine, will likely influence the dealmaking momentum in the EU, potentially leading to a downward revision of the initial positive outlook for 2022.

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