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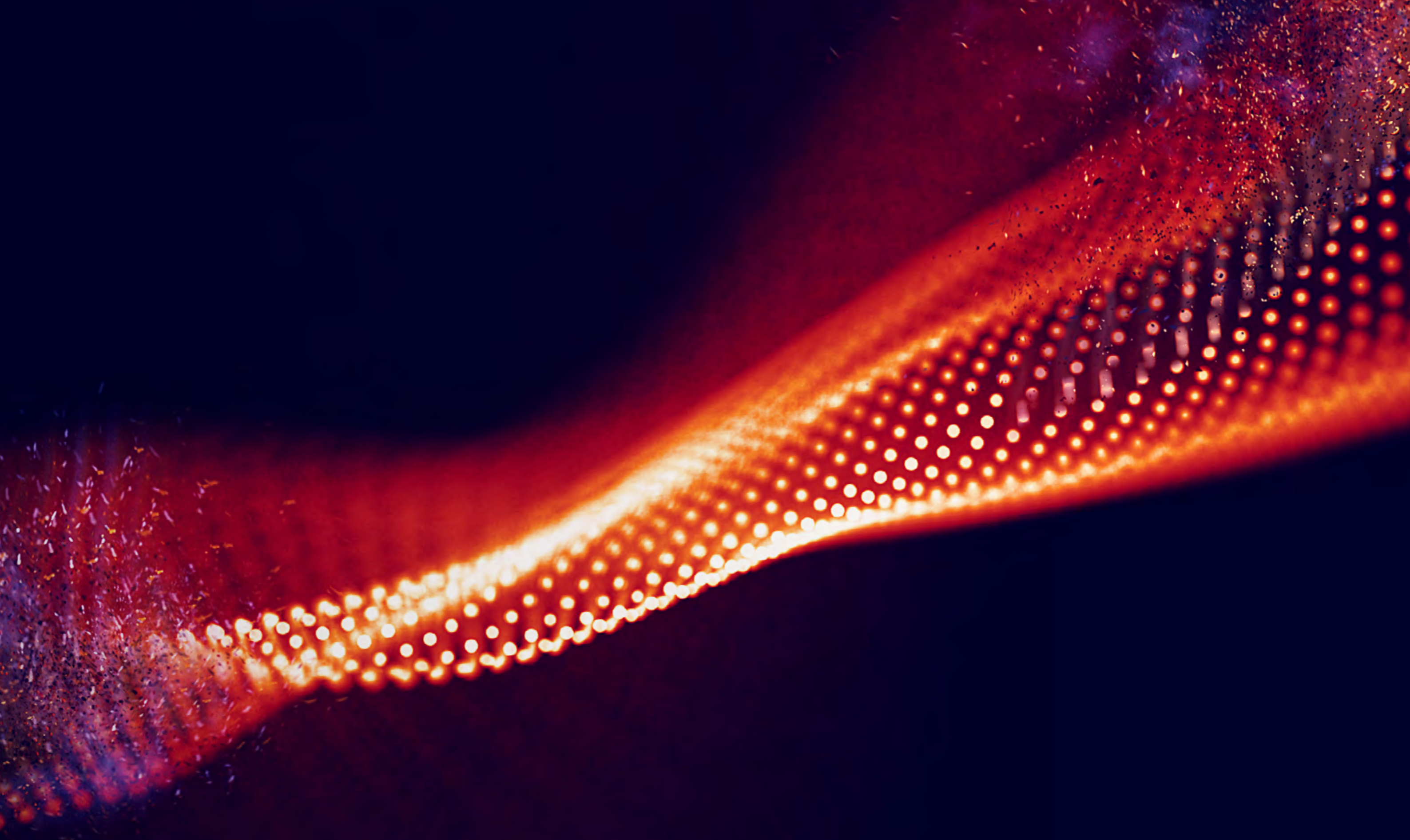
Strategies for Navigating the Global Foreign Investment Landscape:

Briefing for Sovereign Wealth Funds



Sovereigns Series: Worlds in Motion

Strategies for Navigating the Global Foreign Investment Landscape:

Briefing for Sovereign Wealth Funds

In recent years, the investment policy landscape has become more complex as nations respond to national security threats, state development strategies and geopolitical risks. Now, as major economies recover from the COVID-19 pandemic and the accompanying economic shock, foreign investment review (FIR) regimes are here to stay. Governments are focusing on protecting security of supply of inputs which are business critical to key industry sectors, ensuring national infrastructure is maintained, and defence and intelligence technologies secrets do not fall into foreign hands.

While some economies have relaxed temporary COVID-19 measures and remain eager to attract foreign investment, many jurisdictions continue to tighten their screening rules or are introducing robust new measures to protect strategically important or sensitive national assets.

Baker McKenzie has partnered with the International Forum of Sovereign Wealth Funds for its Sovereigns thought leadership series: **"Worlds in Motion"** and this briefing accompanies our webinar on the subject.

Sovereigns Resource Hub on bakermckenzie.com

FIR regimes are here to stay

Over a year on from the start of the COVID-19 pandemic, advanced economies continue to introduce and consolidate FIR regimes. Whilst some of the strictest measures introduced as a direct response to the pandemic have fallen away – and most countries continue to welcome foreign direct investment to further their economic growth and recovery – FIR regimes are here to stay.

The increasing scrutiny of foreign investment is a global phenomenon, not necessarily driven by protectionism, but a growing awareness of the risks that can arise from foreign ownership in a changing geopolitical landscape. For many economies, COVID-19 highlighted weaknesses in supply chains in critical sectors and infrastructure, causing governments to tighten foreign investment rules.

While COVID-19 and China continue to feature prominently in the headlines, the regulatory fallout is much broader. Policy changes are impacting investors from around the world, including state-owned entities from major emerging markets, buyers from sensitive regions and countries such as the Middle East and Russia, as well as purchasers from all regions focused on sensitive technologies. These developments should be viewed as indicative of shifting market sentiment. All investors, regardless of their country of origin, need to proactively manage stakeholder interests as part of their deal strategy.

As COVID-19 has wreaked havoc with the global economy, disrupting all manner of business throughout the world national governments took steps to protect companies which have become vulnerable from being taken over by foreign investors due to their struggling economies. Even as the threat of COVID-19 subsides and economies start to recover, the prevalent trend in foreign investment restrictions will unlikely reverse its course. The pandemic has highlighted the risk of foreign ownership of critical supply chains and key businesses, and governments previously focusing on national security will feel validated in their approach.

These developments reinforce the need for sovereign wealth funds to consider carefully foreign investment review risks at this highly sensitive and volatile time in respect of both deals which are currently underway and transactions being contemplated. While most transactions have a high likelihood of being approved, those in strategic sectors may encounter more scrutiny and face a prolonged approval process. Taking the time to understand the rules and identify a regulatory strategy, including appropriate messaging and communication with the relevant governmental authorities, and the consequential impact on deal documentation (such as whether any closing condition is required), early in the deal process can minimize the risk of delays, last-minute changes to the deal structure, or even failed transactions.

Which investments are reviewable?

Most foreign investment regimes capture a broad range of investments that can be subject to review.

In the **US**, both direct and indirect financial investments can trigger a CFIUS review if they give governance or information rights – this includes minority shareholdings, financings and indirect investments through fund structures. Pre-closing filings are required where a sovereign wealth fund acquires a 25% voting interest in technology, infrastructure and data businesses, and where any foreign person acquires certain governance or information rights in certain technology businesses. Beyond those mandatory requirements, CFIUS has broad authority to review investments in US businesses and certain real estate, both before and after closing. Parties hence often make voluntary CFIUS filings for deals with potential national security sensitivities to ensure that there is no after the fact questioning.

The **UK** also introduced its first standalone foreign investment regime in the past year through the National Security and Investment Act. Under the new regime, investments in 17 sensitive sectors (including defence, energy, transport, communications and a range of specialised technology industries) are subject to a mandatory notification system where a shareholding of 25% or more is acquired. Land and certain fixed assets, including IP transfers, can also be in scope. Notification is voluntary outside these sectors, but investments can be called in – for up to five years following the transaction – if the UK Government deems the transaction to give rise to a "national security" risk.

The UK Government can unwind any deal, and mandatory transactions cannot complete without clearance (with fines of up to 5% of global turnover or £10m).

Whilst the new regime has a broad scope, and the identity of the investor is one of the key considerations, the UK Government has clarified it does not regard sovereign wealth funds as inherently more likely to pose a national security risk. Funds with operational independence may raise no concerns, regardless of their nationality.

Although the Act is now law, the regime is not expected to come into force until the end of 2021. However, any deal in progress or contemplation from 12 November 2020 can be reviewed once the regime is in force.

In addition, the **EU** has introduced a foreign direct investment screening regulation, which entered into force in October 2020. This created a cooperation mechanism in relation to foreign investment into the EU but does not give the European Commission the power to block foreign investment. In response to COVID-19, the European Commission issued new guidance on foreign investment screening. The aim is to preserve EU companies and critical assets, notably in areas such as health, medical research, biotechnology and infrastructures that are essential for security and public order, without undermining the EU's general openness to foreign investment.

The message is clear: EU Member States should use whatever powers they have to protect strategic national assets and technologies from foreign takeover. In May 2021, the European Commission published a proposed Regulation aiming to address potential distortions caused by foreign subsidies in the Single Market. The proposed Regulation introduces additional regulatory obligations for companies active in the EU, under which they may need to notify any transaction financed by foreign subsidies to the Commission.

China has also recently revamped its foreign investment regime along lines of national security concerns. New laws are effective from January 2021 and apply throughout China, whereas previously Pilot Free Trade Zones were under a modified regime. Although what constitutes "national security" remains unclear, the regime covers sectors including key infrastructure and transportation, financial services, technology, energy and agriculture. Both direct and indirect investments are in scope, with acquisition of actual control being the relevant question. Greenfield investments previously excluded are also in scope.

Investments containing national-security concerns, shall be reviewed by the national security review Working Office, jointly headed by the National Development and Reform Commission and the Ministry of Commerce. After an initial jurisdictional review, the Working Office may commence a security review, and a further special review should they deem there to be national security concerns. Whistleblower provisions allow anyone to report a transaction they believe poses a national security concern.

Australia also has an established foreign investment regime under FIRB. Acquisitions by a foreign person over a specified monetary threshold must be notified, including in commercial land and leases. Whilst these thresholds were decreased to AUS$0 during the COVID-19 pandemic, they were reinstated (and in some cases, increased) from 1 January 2021. Transactions involving acquisition of shares or assets of national security business, or national security land must be notified to FIRB (generally where the target is involved in critical infrastructure, telecommunications, defence or national intelligence). Sovereign wealth funds are viewed as foreign government investors and are subject to stricter screening. In general, there is no monetary threshold and FIRB approval will typically be required for acquisition of at least 10% shareholding in an Australian company regardless of the value.

In **Japan**, both direct and indirect financial investments may trigger a pre-closing notification. Investment by sovereign wealth funds may be targeted as well. In terms of the acquisition of shares in a Japanese listed company, pre-closing notification may be required for an acquisition of 1% or more shares in a listed company engaged in the specific designated business sectors. New restrictions on acquisitions of land in proximity to "important facilities" and remote islands adjacent to borders are expected to be implemented in 2021, but will apply to both Japanese and foreign investors.

Assessing the risk

Most regulators around the world are continuing to focus on the protection of national security and preservation of critical infrastructure as the driver for foreign investment scrutiny.

Advances in technology and evolving geopolitical risks are also leading some countries to think more intently about national security and the ways in which it can be threatened.

The UK has placed the concept of national security – whilst undefined – at the core of its new FIR regime and has the power to review deals that relate to any sector of the economy that may give rise to a "national security concern". These include some parts of national infrastructure sectors (civil nuclear, energy, defence, communications and transport); some advanced technologies (including cryptographic technology, autonomous robotic systems, AI and materials); critical direct suppliers to the UK Government and emergency services sectors.

As a result, sovereign wealth funds need to be aware of foreign investment review challenges, even in sectors not typically associated with national security risk, such as healthcare (now firmly in the spotlight due to COVID-19) and agriculture.

In general, the most scrutinised sectors are critical infrastructure; defense technology and supply chains; culture and media; and critical technology.

When assessing the foreign investment risk, regulators will typically focus on the following factors:

- Does the target present any national security vulnerabilities?
- Would the sovereign wealth fund investor (or co-investor) present a national security threat?
- Could any resultant risk (vulnerability + threat = risk) be mitigated?

Investment strategy

Multi-jurisdictional foreign investment reviews are increasingly important to transaction success. We recommend the following strategies to help sovereign wealth funds to get their investments through the regulatory process:

Conduct an early risk assessment

Investors should conduct a risk assessment as early as possible to determine if national security concerns exist. Not having a clear analysis to put forward to a seller undermines an investor's negotiation position. In view of rising political and economic sensitivities, investors that are directly or indirectly government owned or controlled should consider foreign investment review regulations as a threshold issue. An early risk assessment can also help the sovereign wealth fund negotiate the assistance of the target during the review process.

Consider the risk profile of co-investors

Authorities are increasingly scrutinizing the identity of investors as part of their FIR assessment. Whilst an investor's identity as a sovereign wealth fund can be a cause for further review or greater restrictions, a number of jurisdictions focus on the degree of control. Investors concerned about their risk profile could calibrate their investment strategy to co-invest with a party or consortium the authority may view more favorably. Investor risk profile should be considered in any co-investing scenario, regardless of the drivers behind the decision.

Some jurisdictions also impose lower thresholds or fewer restrictions in certain sectors on joint ventures with national partners. Full ownership may even be prohibited in some sectors without a local partner.

Understand the process and engage early

The process and timeframe for screening investments can vary widely and may not be as predictable as statutory provisions suggest. The procedural complexities can be even greater for multi-jurisdictional deals. Sovereign wealth fund investors need global and local expertise to understand the substantive and procedural requirements in each jurisdictions as well as the likely time frame for review.

Furthermore, many FIR regimes, including Australia, Canada, Germany, Spain, the UK and the US, provide foreign investors with the opportunity formal or informal guidance from reviewing authority in advance of an official filing. Sovereign wealth funds are therefore encouraged to work with counsel to engage relevant officials proactively, even on an informal basis, to identify risks at an upfront stage.

Craft a public and government relations strategy

Foreign investment reviews can be highly political and susceptible to negative media attention, and developments on this front in one country can easily impact the perception and process in another. Since the perception of a transaction can be dictated by how it is covered by the press, sovereign wealth fund investors need to develop political and media strategies for potentially challenging transactions. These strategies should include strong messaging about issues such as how the transaction will benefit the host country workforce, economy and reputation in the global marketplace.

Be prepared to make detailed disclosures

Information requests from reviewing bodies can be detailed and seek sensitive details about the sovereign wealth fund, its investments, its owners, and key individuals (e.g., directors, key executive officers, and certain shareholders). This includes the disclosure of any ownership, control, and/or management interests or rights in the sovereign wealth fund.

Consider terms to allocate risk and responsibility

Involve regulatory counsel early in the transaction to ensure risks are effectively addressed in the transaction agreement and throughout the transaction. For example, the sovereign wealth fund should ensure that the due diligence process allows it to fully understand the relationship of the target (and its subsidiaries and affiliates) with the host country government, including whether the target:

- provides (or has provided) any products or services to any host country government agency as a contractor or subcontractor;
- has facilities or personnel with government security clearances;
- has facilities located in proximity to sensitive government facilities;
- produces or trades in any items controlled for export.

Consider mitigation measures as part of transaction strategy

As part of a regulatory strategy, particularly if risk factors are present, the parties should consider mitigation measures prior to filing a notification or application. Pre- filing consultations with the local authority can also help to identify what kind of actions might be required for approval. That can provide the time and space the parties need to work out what they may be willing to divest in a worst-case scenario, and even enable them to address the risk upfront by modifying the transaction.

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