The meaning of screening: Germany, the EU and Chinese technology transfer

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Summary

Earlier this month, the German cabinet adopted a directive expanding the scope of the German state's ability to investigate foreign acquisitions in a wide range of critical infrastructure and the IT services that support it. In parallel, Berlin has led an advocacy campaign at the EU level over the last six months for the creation of a new EU level screening regime for FDI in sensitive sectors where state-backed acquisitions might raise political concerns. This is a material shift from Berlin, and one which has the scope to produce material change in the way the EU approaches inward investment from China and Russia in particular. So is this a pre-election gesture from Berlin, or a sign of a more serious shift in the EU approach to inward investment?

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Time, locus, leverage

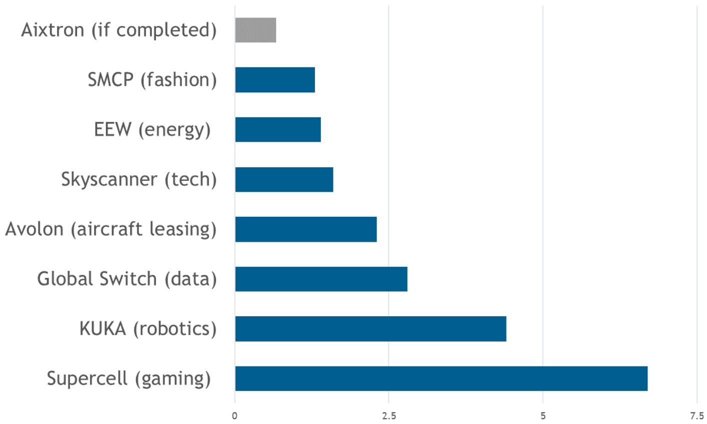
Like many EU states, Germany already has a review system for foreign acquisitions under its Foreign Trade and Payments Act. This is a process overseen by the Economic Ministry that tests foreign acquisitions against the public security criteria in the EU merger regulation, and formalises the German state's powers to prevent mergers. So rarely does this process produce a decision to block an acquisition that it is routinely requested by foreign acquirers as a hedge against political or public criticism. This is the framework the new directive evolves. The new rules double the previous time available to the German authorities to investigate acquisitions (to four months) and expands the scope of previous rules into both new areas (a wide range of software providers to critical physical infrastructure and defence -related technologies) and into indirect acquisitions – the establishment of vehicles in the EU for subsequent mergers in these areas. The new system can be expected to capture only a tiny handful of additional acquisitions annually, but it is an important signal nonetheless.

The focus of the change is China, and the new directive reflects a two year period in which the German position on Chinese acquisition has shifted in a much more defensive direction. 2016 saw more Chinese money spent acquiring German firms than the previous ten years combined, and increasingly aggressive criticism from the German-dominated EU Chamber of Commerce in China on the 'brute force state intervention' in Chinese industrial policy. Berlin tried and failed to find an alternative EU buyer for German robotics firm Kuka in May 2016 when it was sold to Chinese appliance maker Midea. In October 2016, at US urging, the German Federal Economic Ministry withdrew its previous approval under this process for the proposed takeover of chip equipment maker Aixtron by Fujian Grand Chip Investment Fund, citing public security concerns. The acquisition subsequently collapsed.

It is these two transactions above all that have shaped the way the German regime will evolve. They have encouraged German policymakers to seek what their counterparts in Paris have long seen as critical in such acquisitions: locus, time, and leverage. The 'Montebourg Decree' in 2014 established a new French authorisation process for foreign acquisitions affecting the "integrity, security, and continuity of supply" in the energy, water, and defence industries and in transportation and electronic communication networks. The decree forces buyers to engage with the French authorities on the merger and its implications to seek formal approval.

Such approaches have to tread carefully around EU law, which limits the grounds on which member states can block transactions to public security, financial stability and media plurality. Other public interest rationales for intervention are permitted in principle, subject to EU pre-approval. The French system avoids breaching EU competition law by simply requiring that an acquirer seek authorisation from the French state, and does not, in itself, repudiate the obligation to clear any intervention that might flow from such an authorisation process with the European Commission first. The process is intended, above all, to exercise the power of the pause button. The aim is to slow down acquisitions, to provide time to mobilise the media and to create a locus for the French state in the process that forces both parties to engage with the government, including on possible flanking commitments to 'sweeten' deals politically. The changes to the German system are designed to do the same.

Major Chinese acquisitions in the EU in 2016 (€bn)



Source: Rhodium Group, Aixtron Data FT

CIFIEU? EUFIRB?

Berlin is not only acting at the national level to provide new political tools for inward investment screening, but openly advocating that the EU itself do the same. German-led advocacy for a new EU screening process produced a formal joint Franco-German-Italian proposal in February 2017, via a letter to the EU Trade Commissioner Cecilia Malmström, who oversees the EU's broad collective commitments on inward investment, and is sympathetic.

The French/German/Italian proposal calls for an EU regime to allow screening of, and intervention in, takeovers leading to control by non-EU investors, where three broad criteria are met. First, the acquired company holds "key technological competences" that are being "acquired for strategic reasons". Second, foreign ownership rights in the firm's home state are limited or constrained by joint venture requirements. Third, the bid is backed by a sovereign or state-controlled entity, or facilitated by state subsidy. This is, of course, a description of Kuka and Aixtron, and China.

The idea of an investment screening process for foreign buyers at the EU level is not new. Policymakers in Brussels and national capitals have at times looked wistfully at the toolkit developed in the US (in the CFIUS system), Australia (the Foreign Investment Review Board) and elsewhere. As with the last serious push for such policy change in 2011 (backed on that occasion by Rome and Paris without Berlin's support), this one is driven by China. However, alongside the crucial shift in the German position, two key things are notably different in the EU political economy this time around.

First, there is a rising sensitivity in Europe to the perceived fragility of the EU's technological lead in digital, biotechnological and other automation technologies. This has helped make large scale Chinese purchase of European IP in these areas politically a lot more sensitive. The recent mid-term review of the EU's Digital Single Market agenda flagged the need for greater scrutiny of acquisitions in these sectors for this reason.

Second, two combative and key sources of opposition to previous attempts to check Chinese acquisitions in the EU through the mergers regime are muted, or openly supportive, this time around. The leadership of the Competition Directorate under Margrethe Vestager has swung behind the idea of oversight, in contrast to her predecessor Joaquin Almunia, who opposed it in 2011. The UK's voice – which would still be a sceptical one if anyone was listening - is now marginal in shaping an EU position, and will become negligible.

The meaning of screening

It is not certain that this new mood will ultimately produce a new European instrument, but it is probably more likely than not. France (like Italy) has long supported a tougher line on 'reciprocity' in inward investment screening at the EU level, especially with China. Berlin's choice of timing (after the G20 and the EU-China Summit but before the September German election) is not coincidental, but a post-election German government is likely to remain interested in EU action. With Berlin now supportive of a European scrutiny mechanism, Paris has a much stronger hand and can be expected to play it: Emmanuel Macron campaigned on the establishment at the EU level of a CFIUS style mechanism for the EU, based on the French authorisation system. This is precisely the kind of 'smarter openness' that he will be looking to deliver as part of his centrist platform. The European Commission's mid-2000s reluctance to start fights with Beijing has worn away sufficiently to mute real opposition. The European Parliament called for such a process in 2015 and would support one now.

The Franco-German-Italian proposal as it stands nevertheless leaves a lot open to debate and design. It is not clear for example, whether the approach could be to widen the scope for national intervention by amending EU competition law, or to create an entirely EU level process. Member states may be drawn to the idea of using an EU process as an institutional shield in their bilateral diplomacy with Beijing – as they do in areas like trade defence now. Any proposal would probably require EU legislation – either creating a new EU regime, or amending EU competition law to allow sensitive cases to be reviewed and potentially blocked at national level. The former would be simpler. However, it would not capture comparatively small acquisitions like Kuka which are handled at the national level, unless there is a mechanism for referring such deals to Brussels in a new way.

What this actually means for acquisitions will depend on the detail of any formal proposal. Most advocates of an EU process argue that the various 'delay and probe' mechanisms at the national level in the EU are a feasible model at the EU level. Key questions would revolve around what powers to block were attached to such as process and what criteria were ultimately agreed for such interventions, given the clear intent to widen oversight into industrial policy concerns around the 'loss' of key IP. The long list of sensitive sectors annexed to the Montebourg system established in France in 2014 is probably a good guide to where EU states might go, although even this focuses on 'critical infrastructure' rather than perceived industrial strengths and IP.

Four weathermakers

Germany	The key to a new European screening regime, Berlin has materially changed its position over the last two years in the face of a series of sensitive acquisitions.
France	Paris defined the current playbook with the Montebourg system in 2014, which is designed to give the French state more time and locus to chill or shape acquisitions without breaking EU law.
Poland	The shift in Polish policy under the current PiS administration is worth noting as the clearest EU takeovers policy approach targeted at Russia. The Act on the Control of Certain Investments adopted in 2015 after the PiS won both the presidency and control of parliament is targeted chiefly at Russia and was prompted by a series of acquisition attempts of Polish companies by Russian interests, notably the takeover attempt of Grupa Azoty, a strategic Polish chemicals manufacturer, by Acron. The Act is broadly modelled on the French system and provides for the screening of acquisitions in energy generation and distribution and a range of other designated critical sectors
UK	The UK has conventionally occupied the far-liberal wing in EU policymaking on inward investment and foreign ownership, but even here the debate on foreign acquisitions has evolved over the last decade, often targeted more at a concern about 'short-termism' in takeovers than foreign acquisition per se. However, the current government fought an election on a pledge to create a new authorisation mechanism to delay bids while the government engages with both parties on impacts on the UK. Needless to say, the UK voice in the EU debate is now immaterial. However, the UK's own domestic framework is in flux: while the UK post-Brexit will want to defend inward investment, public opinion on foreign acquisition and its implications is volatile.

The system would have to be non-discriminatory, so large US (and other) acquirers could expect to be captured by it in some form, even if ultimately only as a formality. This will have implications for the atmospherics around large bids, will focus media and political stakeholders on the ‘value leakage’ dimension of takeovers (even with ‘friendly’ counterparties like the US) and could affect transaction momentum. At the very least, it will require bidders to have developed a clear public strategy for dealing with industrial policy concerns. As business advocacy groups like the German BDI have implied in their criticisms of the new German approach, it can also be expected to prompt a hardening of approach in markets against which it is used – above all China, and potentially Russia. Although in both cases acquisition is already heavily constrained and politicised.

The screening proposal is part of a wider deterioration of the EU-China relationship on trade and investment. The pressures in the EU system for greater political oversight of Chinese acquisitions has been building for at least a decade – being as long as material flows of Chinese capital have been seeking out IP and technology transfers in the EU. Successful early attempts to check any such defensiveness are increasingly giving way to a more openly sceptical mood. This reflects the domestic politics of the EU, which have developed a strong thread of wariness about globalisation. It reflects an increasingly settled view inside the EU policy machinery that Chinese state capitalism is the elephant in the room in the EU’s second largest trading relationship and one that needs a tougher approach - as demonstrated by the EU’s refusal to give up the scope to continue treating China as a ‘non-market’ economy in aspects of its trade defence policy. But it also reflects the growing tempo and scale of Chinese acquisitions, and a rising sensitivity about the shift from Chinese interest in capital goods (before Kuka, the emblematic Chinese acquisition in Germany was concrete pump maker Putzmeister in 2012) into highly sensitive technologies on which European policymakers are betting the continent’s economic future. For this reason, it is safe to assume that the odds on Europe toughening its approach to screening inward investment are as short as they have ever been.

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