DECEMBER 2019 SPECIAL ISSUE

INVESTMENT POLICY MONITOR

UNITED NATIONS UNCTAD

NATIONAL SECURITY-RELATED SCREENING MECHANISMS FOR FOREIGN INVESTMENT

AN ANALYSIS OF RECENT POLICY DEVELOPMENTS

HIGHLIGHTS

- As part of their sovereign right to regulate the entry of foreign investment, countries may block it for national security reasons or subject its admission to certain conditions. Cases where foreign investment was rejected by governments or where it did otherwise not materialize for national security reasons have gained prominence in recent years. UNCTAD identified at least twenty instances of planned foreign takeovers with a value exceeding $50 million that were blocked or withdrawn for national security reasons in the period from 2016 to September 2019. The aggregated value of these transactions amounts to more than $162,5 billion. For example, in 2018 the value stood at $150,6 billion – which represents 11.6 percent of global FDI flows in that year. These figures only reflect those cases and transactions for which information is publicly available.
- Apart from their general regulatory framework for the entry of foreign investment, numerous countries have introduced new or reinforced existing mechanisms and procedures specifically dedicated to national security-related investment screening, reflecting rising political concerns in this area. From January 2011 to September 2019, at least 13 countries introduced new regulatory frameworks. In addition, at least 45 significant amendments to existing screening systems were recorded in 15 jurisdictions in this period.
- Legislative changes concerning these distinct investment screening mechanisms mainly focus on widening the screening scope, expanding the disclosure obligations of foreign investors during screening procedures or extending the statutory timelines for the length of screening procedures.
- Significant country-specific differences in these systems remain. They relate to the type of investment screening mechanisms, the screening criteria and thresholds, the institutional set-up, the treatment of SOEs in screening procedures and the type of investment authorizations after screening.
- Intergovernmental dialogue could address concerns that tighter investment screening for national security reasons might create new investment barriers. It could also aim at identifying international good practices, thus strengthening the transparency and predictability of existing screening mechanisms.

Acknowledgements

This special issue of the Investment Policy Monitor was prepared by the National Policy Section under the supervision of Joachim Karl, Chief of the Section, Division on Investment and Enterprise (DIAE). Overall guidance was provided by James Zhan, Director, and Joerg Weber, Head, DIAE. The report was drafted by Oktawian Kuc, Associate Legal Officer.

1. Introduction

Host countries have various policy instruments at their disposal to exercise their sovereign right to regulate the entry and establishment of foreign investment on their territory. They include business registration and approval requirements, as well as the full or partial prohibition of foreign investment in certain sectors of the economy. These restrictions may, *inter alia*, reflect national security concerns of host countries.

In recent years, yet another regulatory tool has gained prominence –distinct screening mechanisms for individual foreign investment that may pose a risk for national security or other public concerns.[1] Originally perceived as an instrument to control inward investment in the military and defence sectors, its use has evolved significantly over the years, resulting in a progressive extension of the scope and content of this type of investment screening procedures.

Thereafter, screening was extended to foreign investment in domestic strategic industries and critical infrastructure, such as energy production and supply, water supply, transport, telecommunication, mineral resources or media. Nowadays, investment screening increasingly extends to the acquisition by foreigners of domestic technology and knowhow, such as artificial intelligence, robotics, semiconductors, cloud computing, 5G, quantum technology, computing hardware, nanotechnologies, biotechnologies or satellites and aerospace. Most recently, security-related screening procedures have also been applied or are under consideration to control the access of foreign investors to sensitive data of domestic citizens.

Several reasons may explain these developments: First, cutting edge technologies and know-how have become a key factor for the international competitiveness of countries. States in possession of such assets may therefore have a strong interest in ensuring that they remain in domestic hands. Second, many countries may find it necessary or desirable that other companies of strategic importance and critical infrastructure are not foreign controlled. Third, governments may consider FDI screening as a necessary counterweight to earlier privatizations of State-owned companies and infrastructure facilities. Fourth, extending the scope of screening is in part also a reaction to the increasing investment activities of foreign State-owned or -controlled enterprises and sovereign wealth funds. There are concerns that these activities might result in foreign state control over key companies or critical infrastructure.

The remainder of this note documents and analyses in more detail recent developments concerning national security-related screening of foreign investment. In the first section, it presents cases from recent years in which individual investment projects have been blocked or were withdrawn for these reasons. The subsequent section reports on recent legislative changes relating to distinct investment screening mechanisms to safeguard national security. Thereafter, the note examines the remaining main differences in these systems. The concluding part makes some suggestions on how to address foreign investment screening concerning national security at the international level.

2. Cases where FDI is blocked for national security reasons gain prominence

In recent years, there have been numerous cases where foreign investment has been rejected by targeted host countries for national security reasons and related public concerns. UNCTAD identified at least 20 instances of planned foreign takeovers with a value exceeding $50 million that were blocked or withdrawn for national security reasons in the period from 2016 to September 2019, with 12 of them dating from 2018. They are listed in Annex I. The aggregated value of these deals amounts to more than $162,5 billion. For example, in 2018 the value stood at $150,6 billion – which represents 11.6 percent of global FDI flows in that year. These figures only reflect those cases and transactions for which information is publicly available.

Furthermore, in some cases, host-country governments have found other means apart from a formal interdiction to prevent a foreign takeover or have allowed it only under the condition that the foreign ownership share be reduced. For example, in 2017, Shanghai Fosun Pharmaceutical Group decided to scale down its acquisition of Hyderabad-based Gland Pharma to only a 74 per cent stake as India's Cabinet Committee on Economic Affairs raised national security concerns. In a similar vein, the Government of Germany succeeded, in 2018, in preventing the acquisition of a 20 per cent minority share of "50Hertz" – a German grid operator with 18 million connected users – by the State-

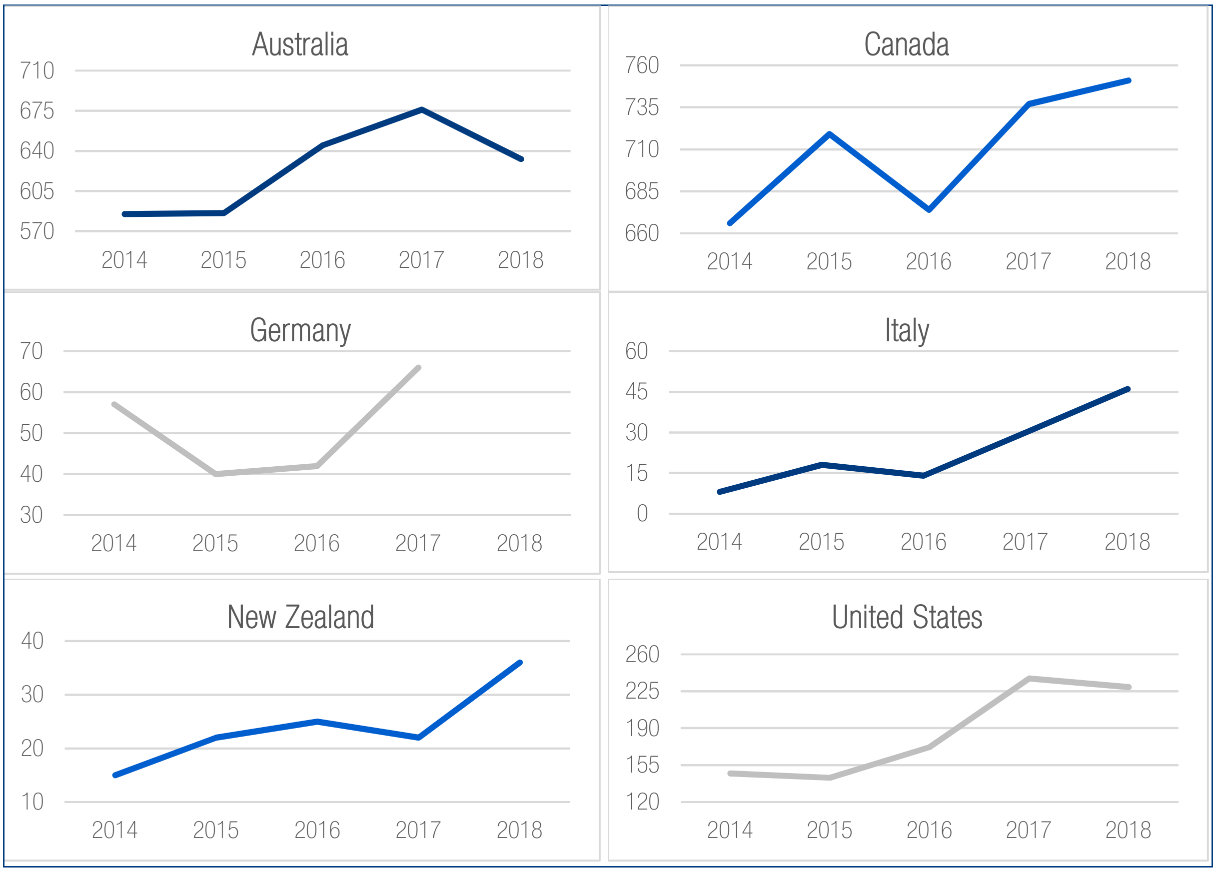
[1] The main characteristics of these dedicated FDI screening mechanisms are: i) they target only foreign investment; ii) they are instruments of general application introduced mostly by complex statutory acts; and iii) these mechanisms focus on national security, public order, national interest or related standards of evaluation.

owned State Grid Corporation of China, although the planned transaction did not meet the screening threshold. It initiated a purchase of the stake by the State-owned "Kreditanstalt für Wiederaufbau".

Available data also indicate that the number of cases, where foreign investments were being screened for national security and public interest reasons is rising. In Italy, for example, the number of such proceedings in 2018 was 255% higher in comparison to 2015; in the United States, the number of cases screened in 2018 was 160% higher than in 2015 (see Figure 1; Annex II). Notwithstanding these developments, the total number of transactions blocked or withdrawn represent only a minority compared with the total number of FDI screening proceedings; however, considerable country-specific differences exist. (see Annex II).

Figure 1: FDI screening cases concerning national security, selected countries

(Number of cases per year[2])



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3. Numerous developed countries and emerging economies have introduced distinct FDI screening mechanisms concerning national security or reinforced them

Distinct FDI screening procedures for national security reasons are predominantly used in advanced countries and emerging economies. UNCTAD has identified 28 jurisdictions that have such a mechanism. These countries are: Australia, Austria, Belgium, Canada, China, Denmark, Finland, France, Germany, Hungary, Iceland, India, Italy, Japan, Latvia, Lithuania, Mexico, New Zealand, Norway, Poland, Portugal, the Republic of Korea, Romania, the Russian Federation, Spain, South Africa, the United Kingdom and the United States. In addition to these 28 countries, an FDI screening cooperation mechanism was also established by the European Union.

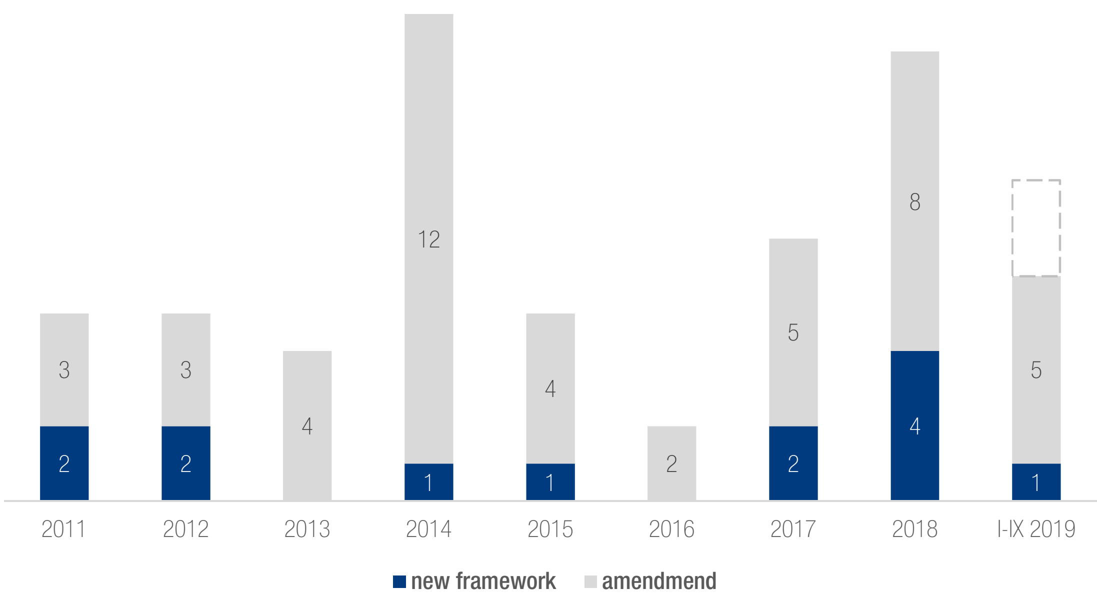
[2] For Australia and Canada, reference is made to the fiscal year. Please refer to Annex II for detailed information.

Countries that have not established dedicated FDI screening mechanism for national security reasons may control inward investment through other means. Some countries impose restrictions on foreign land ownership, particularly in border areas. Others set sectoral restrictions for foreign investors through negative lists or stipulate additional conditions to be met in licencing procedures. Furthermore, numerous countries provide in their investment laws for general safeguard clauses relating to national security and public order. According to UNCTAD Investment Law Navigator, there are at least 27 of such jurisdictions[3]. This regulatory approach is not part of this IPM.

The concentration of distinct FDI screening mechanisms in advanced countries and emerging economies may be explained by the fact that they are the main global destinations for foreign investment, making them therefore more exposed to foreign takeovers in sensitive sectors and activities. In addition, many of these economies show a relatively high degree of openness towards foreign investment, including in key economic sectors and infrastructure. FDI screening for national security reasons may thus serve as a safety valve for regulating the entry of foreign investment in critical cases.

From January 2011 to September 2019, at least 13 countries introduced new regulatory frameworks for dedicated national security-related screening mechanisms for foreign investment. They are Austria, Belgium (the Flanders region), China, Hungary, Italy, Latvia, Norway, Poland, Portugal, the Republic of Korea, Romania, the Russian Federation and South Africa. In addition, at least 45 significant amendments to existing screening systems were recorded in 15 jurisdictions in this period. Most of them occurred in 2014 and 2018 (Figure 2). Data for the first nine months of 2019 suggest that the trend from 2018 continues. Most regulatory changes resulted in a tightening of screening procedures - only 9 measures (in five economies) temporarily eased existing rules.

Figure 2: Distinct FDI screening mechanisms related to national security, legislative changes by type of enactment, 2011- September 2019



Source: ©UNCTAD.

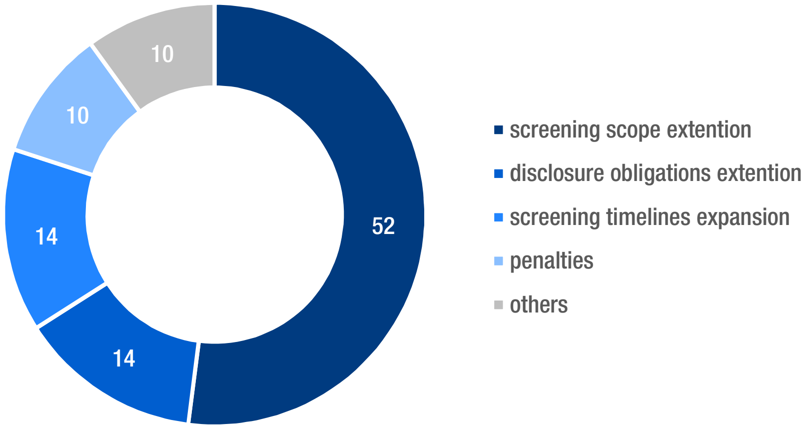
Legislative changes focus on four main aspects of FDI screening procedures concerning national security. Firstly, they widen the screening scope by adding new sectors or activities subject to review, lowering the thresholds that trigger investment screening, or broadening the definitions of foreign investment subject to screening. Secondly, some new policies expand the disclosure obligations of foreign investors during screening procedures. Thirdly, statutory timelines are being extended in order to provide screening authorities with more time for considering complex, cross-border foreign mergers and acquisitions. Finally, new civil, criminal or administrative penalties for not fulfilling or

[3] The UNCTAD Investment Laws Navigator is available online at the Investment Policy Hub: https://investmentpolicy.unctad.org/.

circumventing notification and screening obligations have been introduced (Figure 3 and Box 1). Additional regulatory changes, such as adding or clarifying screening criteria or other procedural matters, are categorized as "Others".

Figure 3: Main aspects of national security-related FDI screening systems in new legislation, by category, 2011- September 2019

(per cent)



Source: ©UNCTAD.

Box. 1	Changes to FDI screening legislation related to national security (Policy examples)

Adding new sectors and activities:

- In the Republic of Korea, an amendment in 2011 provided for FDI screening when targeted companies are in possession of national core technologies defined as having high technological and economic value in the Korean and overseas markets or bringing high growth potential to their related industries.
- In 2014, France extended its list of sectors in which foreign takeovers require screening to include water, electricity, gas, oil and energy supply, transport network operation, electronic communication, public health, and the operation of critical plants and facilities.
- In 2018, Germany broadened the definition of critical infrastructure in its screening process to include news and media companies critical for the formation of public opinion.
- At the end of 2018, the United States launched the Critical Technologies Pilot Program, aimed at extending and clarifying the scope of foreign investment screening in relation to mergers and acquisitions of companies engaged in emerging and foundational technologies.
- The US Foreign Investment Risk Review Modernization Act of 2018 requires screening of any investment, not only those that acquire a controlling stake, in any American entity maintaining or collecting sensitive personal data of citizens that may be exploited.
- An EU Regulation that entered into force in April 2019 recommends Member States to consider effects of a foreign investor's access to sensitive information, including personal data, or the ability to control such information during their FDI screening process.
- In May 2019, the Government of Japan extended the list of sectors covered by the FDI screening mechanism to include: manufacturing of integrated circuits, computers, wireless communication equipment and mobile phones; software development; telecommunications and information processing services.

Lowering screening thresholds:

- In 2012, Finland adopted a new law on foreign corporate acquisitions, lowering the threshold for control over entities subject to review from 33 per cent to 10 per cent.
- In 2018, the United Kingdom lowered the thresholds that trigger investment screening from £70 million to £1 million in high-tech industries, specifically computing hardware design and production, and quantum technology development and production.

• At the end of 2018, the German government amended the Foreign Trade and Payments Ordinance to lower the foreign ownership threshold from 25% to 10% in the following sectors: military equipment, crypto-technology and IT security, critical infrastructure and software operating the latter.
Broadening the definition of investment or control that triggers FDI screening:
• Starting in 2017, Japan began reviewing foreign acquisitions of shares and equity in all corporations in selected sectors, not only listed ones. • In the United States, the Foreign Investment Risk Review Modernization Act of 2018 adds new types of transactions covered by FDI screening, such as those that result in affording a foreign person: a) access to any material non-public technical information , b) membership or observer rights on the board of directors or equivalent governing body or the right to nominate an individual to a position on the board of directors or equivalent governing body; or c) any involvement, other than through voting of shares, in substantive decision-making in regard to critical infrastructure and technologies as well as sensitive personal data of United States citizens.
Expansion of screening timelines:
• In 2015, Canada extended certain deadlines provided in the National Security Review of Investments Regulations to enable the Government to take a more flexible approach. For example, the relevant minister is entitled to prolong the examination of a foreign takeover for an additional 45 days upon sending a notification. • In 2017, Germany prolonged the maximum time frame for screening procedures from two to four months. • In 2019, Italy extended the maximum period for its investment screening procedures from 15 to 45 days.
Extension of disclosure obligations:
• In 2011, China specified the documents to be disclosed in the screening procedure in its "Provisions for the Implementation of the Security Review System". The documents include a list of board members, general managers, partners and other senior managerial personnel to be appointed in the post-merger enterprise. • In 2014, Italy specified the information to be disclosed in the FDI screening process (e.g. a financial plan, a general description of a takeover project and its effects, detailed information on the purchaser and on its scope of operation).
Penalties related to FDI screening:
• In 2015, Australia introduced third-party liability for assisting in contravening FDI screening requirements. • Starting in 2017, any foreign investor in the Russian Federation acquiring 5 per cent or more of share capital in a company without having gone through a required screening has had its voting rights in the company suspended. • By Decree-Law No. 64 of 11 July 2019, Italy introduced administrative sanctions for circumventing the FDI screening process up to the double value of a transaction. Its provisions lapsed on 10 September 2019.

Source: ©UNCTAD.

In addition, legislative initiatives are currently under way in several countries. For example, in July 2018, the Government of the United Kingdom published a white paper on national security and investment that presented plans for legislative reform of the FDI screening mechanism. This was later elaborated in background briefing notes to the Queen's Speech 2019.[4] They aim at introducing a comprehensive national security review process that will cover approximately 200 transactions a year. The Austrian Parliament is considering an amendment to the Foreign Trade Act of 2011 (*Außenwirtschaftsgesetz 2011*) submitted by the government that, once adopted, would lower the thresholds triggering FDI screening from 25% to 10% of share capital in media and technology sectors.[5] In Japan, the Cabinet approved in October 2019 a draft bill strengthening the FDI screening regime and presented it to the Diet for consideration. Its main goal is to lower certain thresholds triggering the review.[6] Recently, the German Federal Ministry for Economy and Energy presented a proposal to expand the scope of the existing FDI screening regime by including

[4] https://www.gov.uk/government/consultations/national-security-and-investment-proposed-reforms, https://www.gov.uk/government/publications/queens-speech-2019-background-briefing-notes.
[5] https://www.parlament.gv.at/PAKT/VHG/XXVI/ME/ME_00149/index.shtml#tab-Uebersicht.
[6] https://www.mof.go.jp/english/international_policy/fdi/20191021.html.

additional areas (artificial intelligence, robots, semiconductors, biotechnology, quantum technologies) and to allow the blocking of an investment already if public order or security is likely to be endangered.[7]

Finally, tighter control of foreign mergers and acquisitions due to national security and public interest concerns is also becoming a regional concern. On 10 April 2019, the regulation establishing a framework for the screening of FDI into the EU entered into force, after being approved by the Council of the EU and the EU Parliament. This regulation introduces the first statutory definition of FDI screening,[8] and aims at setting common FDI screening standards between Members States and establishing a mechanism for cooperation between different national authorities. It also provides for the inclusion of the European Commission in the process when a foreign investment is likely to "affect projects or programmes of Union interest on grounds of security or public order". These projects of EU interest include the European GNSS programmes (Galileo & EGNOS), Copernicus, Horizon 2020, Trans-European Networks for Transport, Trans-European Networks for Energy, Trans-European Networks for Telecommunications, European Defence Industrial Development Programme and Permanent structured cooperation.[9]

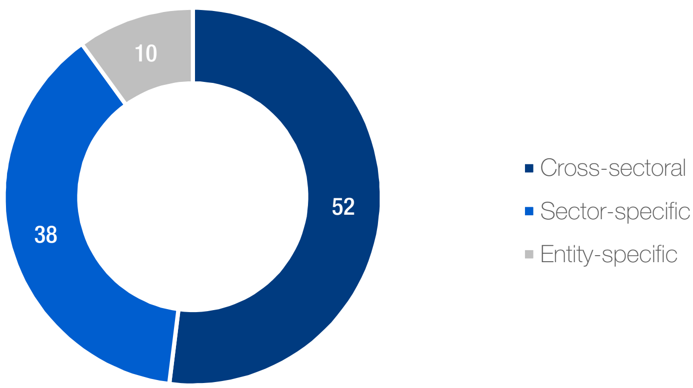
4. Significant country-specific differences in national-security related FDI screening mechanisms remain

Changes in dedicated foreign investment screening legislation concerning national security have not resulted in a harmonization of national procedures. Considerable country-specific differences continue to exist and impact on the degree to which foreign investment is subject to screening for national security reasons.

A. Different types of FDI screening mechanisms for national security

Foreign investment screening mechanisms related to national security can be categorized in three main groups, depending on their depth and scope (Figure 4).

Figure 4: FDI screening mechanisms by category (Per cent)

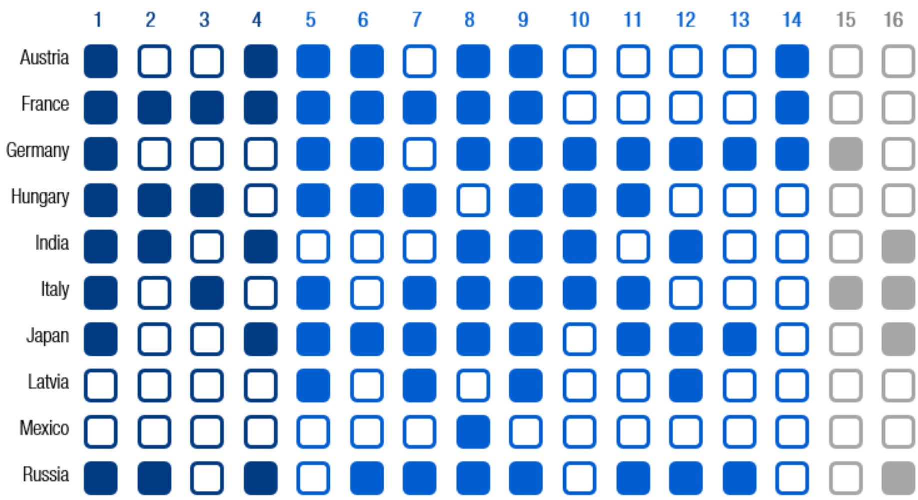


Source: ©UNCTAD.

First, a significant number of countries apply sector-specific investment screening. National legislation enumerates sectors or activities that are considered sensitive to national interests, thus requiring screening of inward investment. The examples of these sectors are available in Figure 5. This approach provides more predictability for foreign investors, as an engagement in a sector not listed in the legislation will not be subject to a review.

[7] https://www.reuters.com/article/deutschland-schl-sseltechnologien-idDEKBN1Y21BY
[8] Art. 2(4): 'screening mechanism' means an instrument of general application, such as a law or regulation, and accompanying administrative requirements, implementing rules or guidelines, setting out the terms, conditions and procedures to assess, investigate, authorise, condition, prohibit or unwind foreign direct investments on grounds of security or public order.
[9] The list may be amended by the European Commission.

Figure 5: Sector-specific FDI screening related to national security (country examples)



Selected sectors

defence industries

1 defense and military manufacturing and technology

2 intelligence cryptology, and cryptology services

3 dual use products and technologies

4 security services

strategic industries and critical infrastructure

5 energy production and distribution

6 water supply

7 gas or petroleum production, storage and distribution

8 transport and aviation

9 telecommunication and electronic communication

10 financial services and infrastructure

11 governmental or infrastructure IT systems and software development/management

12 media: broadcasting, cable, print

13 agriculture, food supply, livestock, fishery

14 health services

technological competitiveness

15 foundational or high technologies*

16 space activities, satellites, aerospace

* e.g.: AI, robotics, semiconductors, cloud computing, 5G, quantum, or computing

Source: ©UNCTAD.

Other countries have implemented cross-sectoral screening with broadly defined review criteria that focus on specific risks rather than industries. These criteria differ significantly between countries (see sub-section B below). Nevertheless, even in jurisdictions with typical all-embracing cross-sectoral reviews, certain sectors or activities may