



FREEDOM OF INVESTMENT, NATIONAL SECURITY AND 'STRATEGIC' INDUSTRIES

Progress Report by the OECD Investment Committee

This progress report was published following the 7th Roundtable on Freedom of Investment, National Security and 'Strategic' Industries which took place in Paris on 26 March 2008.

The OECD mandate

In recent years, a number of OECD and other governments have reassessed their investment policies in response to a changing context for national security and the increasing prominence of new investors, including large investors controlled by foreign governments.

The OECD is convinced of the long term benefits of an open international investment environment, which include job creation, more efficient resource allocation, and social and environmental progress. As the custodian of international investment instruments, the Organisation has overseen progress in liberalisation for more than 40 years.

The OECD Investment Committee's project on "Freedom of Investment, National Security and 'Strategic Industries'" has, since early 2006, provided a forum for intergovernmental dialogue on how governments can reconcile the need to preserve and expand an open international investment environment with their duty to safeguard the essential security interests of their people. Discussions have taken place in a series of seven Roundtables involving the 30 OECD members, the 10 non-member adherents to the Declaration¹ and other major non-member countries².

The "Freedom of Investment" (henceforth, FOI) project carries on a tradition of OECD dialogue on investment issues that has been framed by the two OECD investment instruments: the Code of Liberalisation of Capital Movements and the Declaration on International Investment and Multinational Enterprises. These instruments and the investment principles they contain are summarised in Box 1.

The FOI discussions have confirmed the continuing relevance of the basic principles underpinning these instruments – transparency, liberalisation and non-discrimination. They have focused on clarifying, in the current security context, the one exception to open investment policies provided for in these

¹ Argentina, Brazil, Chile, Egypt, Estonia, Israel, Latvia, Lithuania, Romania, Slovenia.

² Russia attended all FOI discussions and other countries (China, India, Indonesia and South Africa) attended one or more.

instruments – that governments may take measures they “consider necessary to protect essential security interests” and to maintain “public order or the protection of public health, morals and safety.”³

The FOI discussions include peer monitoring sessions through *tours d’ horizon* of national developments, in-depth policy discussion of selected national security topics, and identification of good investment policy practices. This Progress Report covers work over the period April 2007-April 2008. The peer monitoring has shown that six OECD countries took new measures and that these measures were designed to codify or clarify existing laws.

The Investment Committee is treating the issue of recipient country policies toward Sovereign Wealth Funds (SWFs) and other government-controlled investment entities as an integral part of the FOI project. A companion Report by the Investment Committee on SWFs can be found online at www.oecd.org/daf/investment/foi.

Box 1. The OECD *Acquis* – Established Investment Policy Principles

The key OECD investment instruments are the OECD Code of Liberalisation of Capital Movements, adopted in 1961, and the OECD Declaration on International Investment and Multinational Enterprises of 1976, as revised in 2000. They have procedures for notification and multilateral surveillance under the broad oversight of the OECD's governing Council to ensure their observance. The instruments embody the following principles:

Non discrimination. Foreign investors are to be treated not less favorably than domestic investors in like situations. While the OECD instruments protect directly investors established in OECD member countries, they also commit members to using their best endeavors to extend the benefits of liberalisation to all members of the International Monetary Fund. Experience has shown that, in practice, OECD governments nearly always adopt liberalisation measures without discriminating against non-OECD countries - investors from non-member countries reap the same benefits of free market access as OECD residents. Outright discrimination against non-OECD based investors would be a major departure from OECD tradition.

Transparency. Information on restrictions on foreign investment should be comprehensive and accessible to everyone.

Progressive liberalisation. Members commit to the gradual elimination of restrictions on capital movements across their countries.

“*Standstill.*” Members commit to not introducing new restrictions.

Unilateral liberalisation. Members also commit to allowing all other members to benefit from the liberalisation measures they take and not to condition them on liberalisation measures taken by other countries. Avoidance of reciprocity is an important OECD policy tradition. The OECD instruments are based on the philosophy that liberalisation is beneficial to all, especially the country which undertakes the liberalisation.

³ Article 3 of the Codes of Liberalisation of Capital Movements and of Current Invisibles Operations.

Strong support for the principles of proportionality, transparency/predictability and accountability

The discussions to date have revealed strong support for three principles for investment policy measures addressing essential security interests: 1) transparency and predictability, 2) proportionality; and 3) accountability. During their discussions (so far, of the first two principles) participants in the FOI project have also identified more specific policy measures that underpin transparency/predictability and proportionality. These principles are defined and more specific guidance is described in Box 2. The remaining sections of this report summarise in more detail selected issues discussed at Roundtables VI and VII: 1) the role of investment policy in addressing national security concerns; 2) investment policy and the protection of critical infrastructure;

Box 2. Investment Policy Guidance from the Freedom of Investment Project

Participants have agreed on the following guidance for investment policy measures designed to safeguard national security:

Non-discrimination: Governments should be guided by the principle of non-discrimination. In general governments should rely on measures of general application which treat similarly situated investors in a similar fashion. Where such measures are deemed inadequate to protect national security, specific measures taken with respect to individual investments should be based on the specific circumstances of the individual investment which pose a risk to national security.

Transparency/predictability – while it is in investors’ and governments’ interests to maintain confidentiality of sensitive information, regulatory objectives and practices should be made as transparent as possible so as to increase the predictability of outcomes.

Codification and publication. Primary and subordinate laws should be codified and made available to the public in a convenient form (e.g. in a public register; on internet). In particular, evaluation criteria used in reviews should be made available to the public.

Prior notification. Governments should take steps to notify interested parties about plans to change investment policies.

Consultation. Governments should seek the views of interested parties when they are considering changing investment policies.

Procedural fairness and predictability. Strict time limits should be applied to review procedures for foreign investments. Commercially-sensitive information provided by the investor should be protected. Where possible, rules providing for approval of transactions if action is not taken to restrict or condition a transaction within a specified time frame should be considered.

Disclosure of investment policy actions is the first step in assuring accountability. Governments should ensure that they adequately disclose investment policy actions (e.g. through press releases, annual reports or reports to Parliament), while also protecting commercially-sensitive and classified information.

Regulatory proportionality –restrictions on investment, or conditions on transaction, should not be greater than needed to protect national security and they should be avoided when other existing measures are adequate and appropriate to address a national security concern.

Essential security concerns are self-judging. OECD investment instruments recognise that each

country has a right to determine what is necessary to protect its national security. This determination should be made using risk assessment techniques that are rigorous and that reflect the country's circumstances, institutions and resources. The relationship between investment restrictions and the national security risks identified should be clear.

Narrow focus. Investment restrictions should be narrowly focused on concerns related to national security.

Appropriate expertise. Security-related investment measures should be designed so that they benefit from adequate national security expertise as well as expertise necessary to weigh the implications of actions with respect to the benefits of open investment policies and the impact of restrictions.

Tailored responses. If used at all, restrictive investment measures should be tailored to the specific risks posed by specific investment proposals. This would include providing for policy measures (especially risk mitigation agreements) that address security concerns, but fall short of blocking investments.

Last resort. Restrictive investment measures should be used, if at all, as a last resort when other policies (e.g. sectoral licensing, competition policy, financial market regulations) cannot be used to eliminate security-related concerns.

Accountability – procedures for parliamentary oversight, judicial review, periodic regulatory impact assessments, and requirements that decisions to block an investment should be taken at high government levels should be considered to ensure accountability of the implementing authorities. Discussions of accountability under the “Freedom of Investment” project will take place in late 2008.

Most countries assign only a limited role to investment policy in addressing essential security concerns

Of the 40 countries that participate in the OECD notification procedures for investment policies, 13 report that they do not depart from national treatment on security grounds. Others have sectoral policies that restrict foreign investment in a very narrow range of activities. Restrictions on foreign investment in war munitions are typical examples. These countries implicitly adopt the view that investment policy has only a very small or non-existent role to play in the broader policy frameworks for national security. While FOI discussions focus on the role of investment policy in protecting essential national security interests, participants agreed that they should not lose sight of the fact that most countries assign only a limited role, if any, to investment policy measures in this context.

National strategies for protecting critical infrastructure protection generally assign a small or non-existent role to investment policy

Many countries have national plans or strategies for protecting critical infrastructure that involve coordination across many government bodies and private operators. The seven national strategies surveyed for the Roundtable tend to take an all-risks approach (that is, natural and human risks) and involve many policy communities in the process of identifying and mitigating risks. There was agreement that all operators, domestic or foreign, need to show their willingness and ability to participate in national efforts to protect critical infrastructure. However, the role assigned to investment policies varies. Many countries perceive the value added by investment policy measures, relative to other policies, as negligible and accordingly see no role for them. Others note that, while their critical infrastructure protection policy adopts a broad approach to risk, investment policy is used to address only a narrow range of these risks -

those related to national security - and only as a measure of last resort, i.e. only if other, less restrictive and non-discriminatory, measures cannot adequately mitigate the identified risks.

The benefits of open markets for energy security

The OECD Competition Committee contributed a report on the role of competitive markets in enhancing energy security – that is, in successfully dealing with supply disruptions caused by political turmoil, armed conflict, terrorism, piracy, natural disasters, nationalism and geopolitical rivalry. The main conclusion of the report is that competitive energy markets allow consumers to benefit from the diversity of supply, adaptability and resilience of a healthy market economy. The main role for the investment authorities is to support non-discriminatory treatment of foreign enterprises that complement the work of competition authorities in such areas as mergers and acquisitions and promoting pro-competitive practices in the regulation of price, entry and ways of doing business in the energy sector

Transparency is essential for effective investment policy, but practices vary

Transparency is the cornerstone of a well-functioning regulatory process. At one level, nearly all participating countries adopt good practices by codifying investment laws and by making them readily available to the people covered by them. However, transparency practices differ in other important respects. For example, there are diverse approaches to deciding which investments should be subject to review. Most countries adopt fairly simple rules for making this decision. These often involve sectoral lists and/or other triggers (e.g. size of investment or control thresholds). One country noted that its list is very narrow and that it contains only sectors that are obviously relevant for national security. Another approach involves case-by-case consideration of investment proposals based on well-defined criteria for assessing risks posed to national security. The time taken for completing reviews varies. The average statutory limit for first-stage reviews is a month and a half, but some have longer review periods or second stage reviews.

Participants agreed that transparency and predictability of investment review procedures are enhanced if: 1) it is clear, from a national security perspective, why particular investment proposals are subject to scrutiny; 2) clear, publicly-available guidance is provided to the review panel on how it is to assess investment proposals and this guidance is focused on essential security concerns; 3) investment review panels can call on relevant national security and sectoral expertise, as needed; and 4) decisions to block or otherwise restrict proposed investments are made public or are subject to other transparency mechanisms (e.g. reports to Parliament) while also protecting commercially sensitive or classified information.

Proportionality

Proportionality means that restrictions on investment, or conditions on transactions, should not be greater than needed to protect national security and they should be avoided when other existing measures are adequate and appropriate to address national security concerns. As noted earlier, most countries assign little or no role for investment policy in managing the national security risks. Among those countries that do use investment policy for protecting national security, risks to be addressed through investment reviews included: infiltration of the national economy by organised crime or terrorists; loss of control of key resources needed for national defence, impeding law enforcement, and loss of control of border or security-sensitive geographic locations. Among the 11 countries participating in the FOI project that have investment review panels charged with addressing national security concerns, 6 reported that their panels have a repertoire of possible responses in addressing these concerns. These include reaching agreements between the recipient government and a foreign investor on how specific security concerns raised by a particular investment are to be addressed. This allows the investment panel to take steps that fall short of completely blocking the proposed investment. One country has also provisions which require the

authorities to be satisfied that no other existing regulations deal adequately with the problem before deciding to restrict a transaction.

Next steps

Future work under the FOI project will deepen consideration of how governments can maintain their long-standing commitments to open international investment, while also protecting essential security interests.

The work programme will include further clarification of the content of and best practices regarding the implementation of the three guiding principles, especially regarding “accountability”. It will also explore the interaction of investors’ transparency and governance practices (e.g. adequate disclosure) with recipient countries’ efforts to design and implement policies that efficiently address national security concerns while preserving the open investment environment. Discussions will include a special session on government-controlled investors.

Reports summarising the discussions held under the project, which take place three times a year, will continue to be published. A final report – bringing together all of the findings of the discussions -- will be completed in mid-2009. The resulting policy guidance will take the form of a menu of best practices which are consistent with the principles of transparency and predictability, proportionality and accountability. The report’s recommendations may also contain suggestions for appropriate revisions/clarifications to existing OECD instruments.