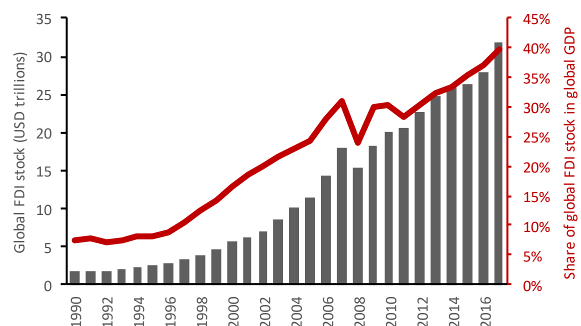
Current trends in investment policies related to national security and public order

November 2018

Over the past decades, most countries, especially advanced economies, have eliminated barriers to capital inflows. This has created vast opportunities for home and host economies as well as for businesses. With these opportunities came occasional risks, not least potential risks for the host country's national security or public order. International instruments and agreements recognise countries' rights to manage such risks, but many countries did not explicitly formulate dedicated policies in this area. Where such policies existed, they focused predominantly on military hardware and traditional defence sectors; international investment took essentially place among allies; and it had much smaller proportions than today: in 1990, the proportion of world FDI to world GDP was only 7%.

Today, many parameters are different: the proportion of world FDI to world GDP increased six-fold to reach 40% in 2017 (see insert). Privatisation of infrastructure assets that many advanced economies carried out during the 1980s and 1990s created potential for foreign investment, but also fears in some countries that malicious actors could sabotage "critical infrastructure".



Source: IMF World Economic Outlook database; IMF Balance of Payments Database; OECD Foreign Direct Investment statistics database.

Broader concern and a formal policy response to these concerns began to emerge only as of the mid-2000s, fuelled by the additional factor of consistently high oil prices, which drove an acquisition boom from oil-exporting economies that were not traditional allies of advanced economies and that often involved less-than-transparent sovereign wealth funds (SWFs). Even then, only a few countries introduced formal policies – cross-sectoral notification, review and screening mechanisms – to respond to newly identified potential threats. Subsequently, internationally agreed standards of behaviour of SWFs – the Santiago principles –, as well as OECD Guidelines for recipient country investment policies related to National Security, and the OECD Declaration on SWFs and Recipient Country Policies and changing global economic conditions with the advent of the financial and economic crisis attenuated attention to this policy area.

Ten years after the first wave of new investment policies motivated by national security concerns associated with foreign ownership, a second, much broader reconsideration of this policy area is currently underway. Ever more countries are adopting new policies or making significant adjustments to existing mechanisms, and new issues and approaches emerge:

- digitalisation has turned personal data – and companies that possess such data – into national security-relevant assets, thus broadening considerably the scope of assets that are considered sensitive;
- technological developments and interdependencies and a shift of global economic weights has created new dependencies, threats, and interests, leading to further broadening of the notion of sensitive assets; and
- traditional concerns associated with foreign ownership – sabotage and espionage – are complemented by concerns about diversity of suppliers and access to advanced technology with defense applications.

These changes have shifted some countries' perspective of what is needed to safeguard their national security: Preventing others to acquire assets in one's territory was *then* – the new concern is to prevent certain others to acquire certain assets from anyone.

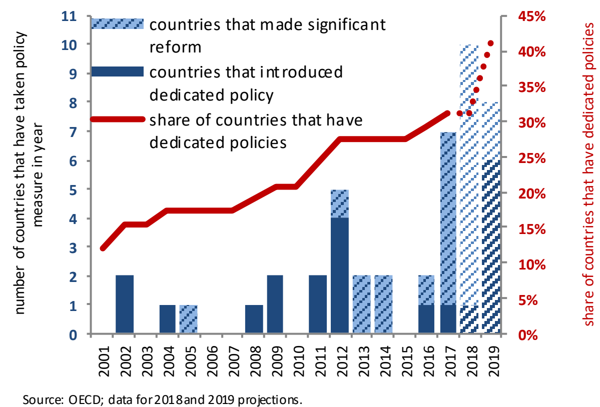
With these changes, the public debate about controversial policies and cases, and highly visible government statements about other governments' intentions, investment policies motivated by national security considerations have stepped out of their niche and leapt onto newspapers' front pages.

This note summarises current trends in this policy area. It sets out five observations and suggest three issues for policymakers to consider. The note is intentionally brief and largely omits detail and references to allow greater emphasis on trends and paradigm shifts; it also does not claim to be exhaustive on the observed changes, but rather focuses on structural trends. A more detailed report on national-security related investment policies, including in individual countries, will be available for discussions in a broader workshop scheduled for March 2019. It will expand on findings made in an earlier horizontal study that OECD and non-OECD Roundtable participants discussed in 2015 and on earlier OECD work on investment policies related to national security.

Five observations

1. Views remain split on whether dedicated policies to manage national security risks are warranted

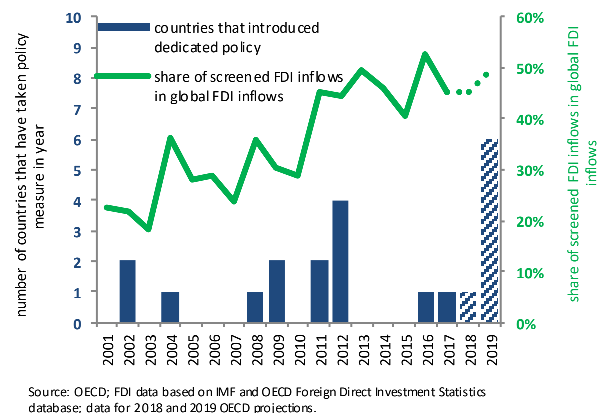
While some countries have had investment policies related to national security for many decades and some continue to experience vivid debates about their merits, scope and design, a majority of the 58 advanced and emerging economies that participate in OECD-hosted dialogue on international investment policies do not yet appear to have a dedicated policy in this area. There are however indications that additional countries will introduce explicit policies that would allow them to halt or subject to conditions planned investments that they believe may impair their national security or public order (see insert on right).



Source: OECD; data for 2018 and 2019 projections.

Many of the countries that have policies to address national security concerns continue to curate and refine them at regular intervals: The increasing frequency of reforms of existing policies, in particular in 2017 and 2018, suggests a polarisation between countries that do not consider such policies warranted at all and those that pay great attention to this policy area.

The share of inward FDI that is subject to cross-sectoral screening procedures in global inward FDI has likewise grown over time and now hovers around 50% of global inward FDI flows (see insert on right, green graph). This share is projected to continue its upward trend in the near future. Its trajectory would be even steeper if sector-specific screening mechanisms were included, as these mechanisms also tend to expand in scope; lack of sufficient sector-specific FDI data for many countries does not currently allow an inclusion in the analysis.



Source: OECD; FDI data based on IMF and OECD Foreign Direct Investment Statistics database; data for 2018 and 2019 OECD projections.

2. Policies designs vary widely

Among the countries that have introduced dedicated policies to manage national security risks associated with investment, large structural differences remain as to scope, approaches, resourcing and caseload.

Some countries are content with narrow, asset- or sector-specific restrictions, while others have designed multiple and broad cross sectoral screening and review mechanisms. A number of countries continue to rely on voluntary notifications rather than mandatory, pre-closure approval requirements.

Strong variance is also observed with regard to the resources that different countries dedicate to the process: Some countries require almost no resources to administer the policy, especially where self-executing equity caps for foreign investments are used or where narrow, sector specific authorisation requirements are rarely triggered. On the other end of the spectrum, some countries have heavily resourced institutional arrangements that involve the intelligence community, rely on international cooperation, and have multi-million USD annual budgets.

The resulting caseload also varies on a very broad spectrum: some countries review hundreds of transactions per year, while others have never used their review mechanisms, as few or no transactions have ever met their trigger conditions for the rules to apply.

There are no obvious explanatory variables that would suggest why such a stark contrast persists in policy designs. Neither size of the host economy, level of development, FDI-to-GDP ratio, nor imitation effects offer a full and stringent explanation for why countries have made such a different assessment of the merits of having investment policies related to national security and on their design, administration and resourcing. Over a decade of policy dialogue on the subject and transparency obligations would typically lead to some convergence in many areas, but this effect is felt only moderately in this area.

3. Four traditional features fade

Until recently, investment policies motivated by national security considerations almost universally featured four defining characteristics: policies were activated at the time of an *acquisition*; they concerned acquisitions by *foreigners*; concerned *controlling stakes*; and applied to *inward* investment. These features circumscribed the core of concerns and assumed sources of risks. Recent policy changes suggest that all four traditionally defining features begin to fade.

Almost all countries' policies are activated at the time of an **acquisition**. A change of ownership of an asset can entail a change of associated national security risk, but many other changes may impact the national security relevance, too. As noted in an OECD study released in 2016, cases of greenfield investment in sensitive sectors; changing business orientation of an acquired enterprise; or changing national-security relevance of an assets, for instance an acquired company or its products do not typically trigger policies, and regulatory oversight may not always capture ownership-related risks.

Australia has recently established a new policy that addresses such risks stemming from ownership of sensitive assets, outside the context of an acquisition, making it one of the first

countries to explicitly address national security risks associated with ownership; on its face, the policy applies to all owners independent of their nationality. Some other countries have sector-specific equity caps that are motivated by national security considerations; such restrictions also help manage ownership-related risks that cannot be addressed by acquisition-focused policies, but are less flexibility in their implementation.

Until recently, most investment policies related to national security only applied to acquisitions by **foreigners** – implicitly suggesting that foreigners presented a greater risk to national security than nationals. As the relevance of nationality tends to fade with greater mobility and easier and more widely available acquisition of additional nationalities by natural persons, and as nationality of legal persons for this purpose had limited plausibility for long, some countries have done away with the focus on foreigners and concentrate instead on the nature of the concerned assets. Such policy design is now observed for parts of the policies of Poland, Lithuania and Australia and planned for Norway.

The third feature that characterises traditional investment policies related to national security is their application to **controlling stakes**, especially of listed, hence typically large enterprises – a plausible approach at a time when espionage and sabotage dominated the risk scenarios. This limitation also reduced the number of reviewable transactions, and reporting requirements under securities regulations made detection of transactions easy.

Now, as countries perceive that protecting their national security interests may require withholding access to sensitive data or technology, countries like the United Kingdom, the United States or Germany have lowered or plan to lower the trigger thresholds; also, unlisted companies have been brought under the scope of policies, such as in Japan.

Concerns that access to sensitive data or technology may impair national security has shifted the focus away from **inward investment**, the fourth feature of traditional policies. Two countries, the United States and China, have now introduced policies that require certain outward flows to be assessed for their national security implications.

4. Perceptions of which assets shall not be in certain hands evolve further

Perceptions of which assets are critical change over time and depend on the specific situations of individual countries. Despite these differences, some common appreciations can be observed in specific periods, starting with defense assets several decades back, then including critical infrastructure as such assets had been privatised in many countries, before sector-specific lists gradually gave way to cross-sectoral review mechanism of enterprises in any sector at the beginning of the millennium.

New trends continue to emerge now: The latest policy changes e.g. in Germany, Italy, the United Kingdom and the United States have explicitly emphasised that advanced technology, dual-use goods, and network technology may raise concerns. Real estate in specific locations or with specific use are also becoming subject to review, e.g. in the United States, echoing decades-old restrictions on foreign investment in border areas in some countries. The inclusion of certain real estate assets also marks a step away from the focus on the acquisition of established enterprises.

Not all countries are including these areas at the same time, and in many respects, countries' policies appear to root in different decades in how they frame what bears risk – an

observation that is reminiscent of the broader disagreement on whether specific policies are needed to manage national security concerns associated with ownership or acquisitions of certain assets at all.

5. Policy practice documents an increasing complexity of consequences

As ever more countries collect experience with their policies' implementation, they encounter more complex scenarios and difficult decisions. Government authority to prohibit transactions sometimes fails to address certain ownership situations: What needs to be done when debt-to-equity swaps in an insolvency scenario bring in an unsuitable acquirer? What, if an owner wishes or needs to dispose of an asset, but all suitors are considered a national security risk?

In some recent cases, governments have acquired assets themselves through state-controlled funds to avoid their sale to suitors deemed undesirable, but some assets may be too-big-to-buy, and not all governments may wish to acquire assets that have become too sensitive to be owned by any other bidder. In a current case, a country may review the acquisition of an asset by the government of another country in which the largest part of the asset is located. This illustrates potential future complexities: the public interest of one country to buy an asset that is situated on its soil may conflict with the public interest of another country who feels its national security may be impaired by that acquisition.

As more countries introduce policies, as these policies evolve and cover greater scope, and as awareness and national security implications grow, more such situations are likely to be observed. The sole power to prohibit transactions or to order mitigating measures may not always offer sufficient flexibility to address national security concerns and economic imperatives simultaneously.

Three issues for policymakers to consider

Based on these current trends, policymakers could consider three issues:

1. Evolution in policies warrant awareness and adaption

New threat perceptions have led to an evolution of countries' investment policies related to national security beyond the traditional boundaries: no longer do all countries limit their policies to inward acquisitions of controlling stakes by foreigners. Where policies are non-discriminatory vis-à-vis foreigners and where they apply to established enterprises or other assets rather than proposed acquisitions, they become harder to distinguish from general regulatory measures that seek to safeguard national security. Also, the evolution of policies in this area may raise new challenges, for example in relation to international law obligations taken on in investment treaties.

In reality, the contours of investment policies related to national security have never been clearly defined, and some countries' policies did not feature all four traditional criteria. Conventions on the boundaries of most policy areas are likewise fluid and evolve with new insights, needs and priorities.

Policymakers and analysts should be aware of this evolution and of emerging interactions with related policy areas, in particular non-ownership transactions such as government procurement. At times, clarifications of terminology, concepts and policy guidance may be warranted. The forthcoming updated and enhanced study of this policy area will contribute to this effort.

2. International cooperation becomes more critical

With the number of countries that operate review mechanisms growing, and with supply chains and operations tending to involve more countries, transactions are likely to require national security clearance in a growing number of jurisdictions. This may increase uncertainty, delays and costs for transactions. A similar accumulation of review requirements has been observed for merger reviews by competition authorities, where it has led to efforts to cooperate internationally to lower the burden for businesses and government resources.

In the area of national security, such cooperation may be more delicate, as countries may not share their concerns and information as willingly. However, some countries have established cooperation on national security issues, and some new policies – e.g. in the United States or the European Union – call explicitly for cooperation.

So far, international cooperation on investment policies related to national security is in its infant stages and takes place informally. Governments may want to reflect on the scope of such cooperation and suitable venues and may want to take inspiration from experience in policy areas where similar situations arise, for instance based on the OECD's pioneering work in the area of cooperation among competition authorities.

3. The difficulties to assess the impact on a country's attractiveness for investment will not go away

Some countries and constituents assume that investment policies related to national security may reduce the attractiveness and openness of a country for inward investment – probably the single most important concern that slows a broader adoption of such policies. Businesses also resent the effect of such policies on enterprise value if certain bidders are not acceptable to home governments.

Several factors contribute to the difficulties to assess the collateral effect of the policies: Measurement challenges – measuring FDI flows, attributing specific policies to any changes, or comparing hypothetical scenarios with the turn of events – add to difficulties to assess invisible effects. In particular, legislated equity caps rather than discretionary decisions based on individual risk assessments do not reveal foregone investment proposals; policies that reveal in great detail the criteria that are applied for discretionary policies have similar effects; and some countries favour inducing "voluntary" withdrawals of proposals that they deem unviable, which also hampers an exact assessment of the policies' effects.

A normative factor further complicates a comprehensive appreciation of the policies' effect on inward investment: Receiving investment that impairs a country's national security is certainly not desirable, and some rejections are hence in the public interest. The sole volume

of foregone investment under a given policy does not reveal how much *desirable* investment the policy has affected.

Although increasingly detailed implementation statistics become available for some countries – others remain cautious – the economic impact of such policies remains difficult to determine. This complicates policy impact assessments and reduces transparency about the chosen policies and their implementation. Ultimately, this uncertainty also nourishes the suspicion of "hidden protectionism" that hangs over this type of government measure – a suspicion that merger reviews on competition grounds or law enforcement action against foreign companies for all sorts of regulatory breaches do not encounter as often.

Policy dialogue and efforts to increase the legitimacy of these policies, including by offering greater transparency, may help overcome these difficulties.

Further reading

Guidelines for Recipient Country Investment Policies relating to National Security (2009) – oe.cd/natsecgl2009

Investment policies related to national security (2016) – oe.cd/natsec2016

Events

Investment policies related to national security: *New policies to manage new threats?* – workshop, 13 March 2018

Forthcoming: Investment policies related to national security: New Policies to manage new threats– 12 March 2019

Contact

Frédéric Wehrlé – +33 1 4524 1787
Joachim Pohl – +33 1 4524 9582
OECD Investment Division
oe.cd/natsec

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