

PART I
Chapter 3

**Freedom of Investment, National Security
and “Strategic” Industries: An Interim Report***

* This article reproduces an interim report approved by the OECD Investment Committee at the fourth OECD Roundtable on Freedom of Investment, National Security and “Strategic” Industries on 30 March 2007.

Introduction

International investment is a key driver of growth and sustainable development. An open, non-discriminatory environment for international investment brings significant demonstrated benefits, including with respect to job creation, more efficient resource allocation, and social and environmental progress. Freedom of investment is a core value of the OECD, which has fostered progress in liberalisation in this area for more than 40 years.

In a number of OECD and other countries, concerns about international investment and, in particular, foreign takeovers of national enterprises are on the rise. Governments have reassessed their priorities in response to a changing international environment for national security. The protection of technologies considered vital to national sovereignty and competitiveness has also become an issue. Furthermore, the strong activity in cross-border mergers and acquisitions in recent years has fuelled growing concerns about jobs.

The access to energy and scarce raw materials has also gained added attention. With the price of hydrocarbons still high and the rapid industrialisation in a number of developing countries fuelling global demand for raw materials, the direct ownership of mineral-producing companies has become a political issue. Concerns may have been further heightened by apparently deliberate investment strategies in some countries to secure control over such resources.

The investment landscape is also changing with the emergence of a new group of active outward investors originating in developing and emerging economies. Where global players are not based in jurisdictions with appropriate standards of investment policy and business conduct, or where potential acquirers of national enterprises enjoy unfair advantages from foreign governments' financial support, there are legitimate concerns about a level global playing field. At the same time, discrimination on nationality grounds against newcomers might undermine the international trade and investment system. The long-standing commitment by OECD members to liberalise international trade and investment rules should be upheld.

Recent developments

Recent investment policy responses to these concerns have so far mostly focused on investment that could imperil security interests. Existing

regulatory frameworks have been used in a small number of widely publicised cases to deter investment in the infrastructure and energy sectors of OECD countries, as well as investment by enterprises controlled by foreign states.

In addition, several countries have tightened their regulation and administrative practices in recent years. France and Germany have both introduced “closed lists” of sectors and activities which restrict access for foreign investors on security grounds. In the United States, Congress is considering tightening the procedures under the Exon-Florio security legislation.

Canada currently ponders the introduction of security provisions in investment legislation. Updating foreign investment regulations related to national security is also an issue now under examination in Japan.

Outside the OECD area, Russia is in the process of establishing a framework for addressing national security concerns in investment policy. China has introduced new screening requirements on mergers and acquisitions by foreign investors in “major” industries having an impact on “national economic security”.

Anti-trust regulation, financial supervision and other regulatory approaches not formally related to investment policy have also allegedly been employed to protect “strategic” enterprises. Private sector devices to prevent takeovers and other anti-competitive practices may also have been used selectively to discourage cross-border transactions. Devices with a degree of government involvement that can be used to a similar effect include the actions of publicly owned banks and golden shares in privatised enterprises. As concerns about globalisation have moved up on the political agendas, elected officials have more frequently made statements about whether foreign takeovers of national enterprises are “welcome”. Even where legislatures have no direct responsibility for investment regulation, the prospect of having to operate amid hostility would be sufficient to deter many investors.

The need to maintain an open investment environment

Sovereign governments have a right, and an obligation, to take measures to protect the public interest – including safeguarding national security. As illustrated by recent international arbitral awards, the scope of exercising this right *vis-à-vis* foreign investors has defined limitations under customary international law¹. International investment instruments such as the OECD *Code of Liberalisation of Capital Movements*, as well as the bilateral and regional investment agreements to which most countries are party, allow governments a degree of freedom to self-judge their security needs.

It is in the interest of all participants in the international economy to limit restrictions on the freedom of investment to cases where security and other essential interests are concerned. Governments that would introduce excessive restrictions or voice hostility toward cross-border mergers and acquisitions could impose a non-trivial cost on their own economies and on others, and could also lead other countries to take similar measures.

Recent studies indicate that host countries can benefit significantly from cross-border mergers and acquisitions². The benefits are largely similar to those of greenfield investment and therefore the case for discriminating between “new” investment and takeovers of existing enterprises is weak. The positive effects on the targeted enterprise, including higher productivity and wages, are well documented. The evidence of broader, societal benefits from cross-border corporate investment is also strong, but their full realisation depends on the policies in the host country, including the degree to which national authorities make timely structural reform efforts.

Shared views of regulatory challenges

To address these challenges and help all countries reap the benefits from an increasingly interdependent global economy, OECD has embarked on a project entitled “Freedom of Investment, National Security and ‘Strategic’ Industries”. Initially, a fact-finding phase mapping existing regulatory approaches to security and other essential interests was organised with the participation of Brazil, China, the Russian Federation, South Africa and several other non-OECD governments. Private sector practitioners were invited to provide their perspectives³.

Based on the discussions so far, it is fair to conclude that while regulatory national practices vary and there is no generally accepted definition of “security”, common principles exist (for an overview, see Table 3.A1). For instance, following decades of investment liberalisation with the OECD in the driving seat, relatively few OECD countries maintain discriminatory general screening and authorisation procedures. However, a large majority of the countries participating in the project do take into account the protection of security and other essential interests in their investment policies and maintain sectoral restrictions to this effect.

Participating countries agree that sound investment policies need to be guided by the principles of regulatory proportionality; predictability; and accountability⁴. The first principle is that restrictions on investment should not be more costly or more discriminatory than needed to achieve the security objectives and they should not duplicate what is, or could be, better dealt with by other regulation. The second principle is that, while it is in the interest of both investors and national administrations to maintain confidentiality of

sensitive information, regulatory objectives and practices should be made as transparent as feasible so as to increase the predictability of outcomes and eliminate sources of misunderstanding. The third principle is that while improper political interferences in the normal exercise of regulatory power have to be avoided, procedures for parliamentary oversight or judiciary redress should ensure accountability.

A more recent challenge for regulators is the emergence of a large number of international corporate and investment vehicles⁵. As documented by work of other OECD bodies, these may complicate the identification of ultimate beneficiary ownership and control, with potential implications for security assessments. Their use moreover affects the relevance of nationality as a main criterion for such assessments. To better understand the nature of ownership and control, while avoiding unnecessary restrictions on nationality grounds, enhanced international co-operation to this effect may be helpful.

Moving ahead

The twin challenges facing decision makers are to understand the potential costs to their own economies and the global economy of unnecessarily restrictive policies to achieve security objectives and to bring all important economies into this discussion.

Building on the now-completed fact-finding phase of the project, one way of addressing both issues is to establish an enhanced mechanism for regular dialogue and review among national investment authorities. The tasks of such a mechanism could include:

- Discussions of regulatory frameworks in OECD and non-member countries and regular reporting, contributing to the highest degree of cross-country transparency around national investment regulation and practices.
- The development of shared understanding on how accepted principles of sound investment policies translate into practice, taking advantage of OECD analysis and long-standing experience with investment policy as reflected in the OECD investment instruments and the Policy Framework for Investment⁶.

Notes

1. See article in this publication, “Essential security interests under international investment law”.
2. See article in this publication, “Economic and other impacts of foreign corporate takeovers in OECD countries”.
3. Roundtable summaries are available on www.oecd.org/investment.

4. Participants discussed these principles on the basis of OECD Secretariat's document “Procedural aspects of investment regulation regarding security and other essential interests” (available for official use only).
5. Participants discussed this issue on the basis of OECD Secretariat's document “Identification of Ultimate Beneficial Ownership and Control of a Cross-Border Direct Investor” (available for official use only).
6. www.oecd.org/daf/investment/pfi.
7. The investment instruments include the *OECD Declaration on International Investment and Multinational Enterprises*, to which all OECD members and nine non-OECD countries (Argentina, Brazil, Chile, Estonia, Latvia, Lithuania, Israel, Romania and Slovenia) currently adhere, and the *OECD Code of Liberalisation of Capital Movements*.

ANNEX 3.A1

An Overview of Discriminatory Practices against Foreign Investors Motivated by Security Concerns

This annex provides a brief overview of discriminatory practices by national authorities motivated by national security and other essential interests. It is based on background material compiled and discussed by the OECD Investment Committee and other participants in the Committee’s project on Freedom of Investment, National Security and “Strategic” Industries. The material included national responses received to a questionnaire as well as information based on adhering country positions under OECD’s investment instruments⁷ in respect of public order and essential security. The main findings included the following points:

- *National security concerns play a role in most countries’ investment policies, but few of them clarify or attempt to define what they mean by “security”.* In particular, the ten adherents to OECD’s investment instruments (plus one other participant in the project: China) that rely on some form of general or security-related investment screening approach the issue largely on a case-by-case basis (Table 3.A1.1).
- *Half of the countries concerned publish “closed lists” of restricted activities.* Twenty-two countries maintain specific sectoral restrictions on investment on security grounds. About half of these are limited to the production or handling of defence materials. Others extend to the transport sectors, the ownership of land in sensitive areas and, public utilities, nuclear energy and aerospace (Table 3.A1.2).
- *Perceptions of essential interests other than national security vary widely across countries.* Countries that screen investment generally apply a national or public interest criterion that encompasses security but in many cases extend to economic benefits as well. If countries’ exceptions to National Treatment are taken as an indication, most perceptions of essential

interests other than security are of a somewhat “defensive” nature. Rather than focusing on strategic sectors and national champions, a large number of exceptions appear to be motivated by the defence of traditional livelihoods.

- *Avoiding overregulation is a priority.* Few OECD countries have legal provisions to this effect, but many investment authorities appear to defer as much as possible to specialised regulatory agencies before invoking their own powers. Some also rely on strong inter-agency procedures to avoid overlaps.
- *Few adhering countries practice statutory discrimination against enterprises controlled by foreign governments.* Conversely, relatively many investment authorities – particularly those involved in screening of investment – apply, or have the option of applying, stricter scrutiny in case of foreign public control.
- *Countries generally deny raising informal barriers to foreign corporate takeovers,* but some concede that elected officials have sometimes used their right of free expression in a way that may have discouraged would-be investors.
- *Measures are in place to safeguard the integrity of procedures.* OECD countries consider that they observe a strict confidentiality regarding company information and strive to ensure that their regulatory action is proportional to the public interest objective pursued. National practices differ with regard to transparency where countries with “negative lists” claim to be more transparent on account that they preannounce their sensitivities. Countries with a case-by-case screening approach the issue of transparency in terms of procedural clarity. Countries also differ in respect of the access to appeal. Some allow rejected investors to challenge the decision in the courts or administrative tribunals. Others allow for a procedure of consultations and revisions of proposals but do not allow investors to challenge the final award.

Table 3.A1.1. **General or trans-sectoral measures with a bearing on essential security or public order**

	Limited to certain sectors/activities?	Nature of screening	Criteria for granting/ denying authorisation	Observations
Australia	No*	General	National interest	A notification requirement and an amount threshold apply.
China	Yes	General	National economic security	Includes screening rights in case of “major industry” or the risk of transfer of “famous trademarks or traditional brands”.
France	Yes	Security	Public order, public security and the interest of national defence	A notification requirement applies. The extent of this requirement, and the definition of sectors, varies in accordance with the EU or non-EU origin of the investor.
Germany**	Yes	Security		A notification requirement applies.
Iceland	No	General	Economic effect	A notification requirement and an amount threshold apply.
Israel	No	Security	Essential public security	Government is authorised to intervene if other laws are insufficient.
Japan	Yes	Security	National security, public order and public safety,	An <i>ex ante</i> notification is required where issues of security, order or safety are likely to arise.
Korea	No	Security	Essential public interests	Government may intervene in case of “clear evidence” of a threat.
Mexico	Yes	General and Security		A notification requirement and an amount threshold apply.
New Zealand	No	General		A notification requirement and an amount threshold apply.
United States	No	Security	Credible threat to national security	The President may intervene if other laws do not provide adequate authority.
Memorandum item:				
Canada	No	General	Economic benefits	An amount threshold applies.

* However, the part of the Australian legislation that relates to the Australia-United States Free Trade Agreement does provide for differential treatment of enterprises in designated sectors perceived to be “sensitive” from a national security perspective.

** The German screening is limited to the production “war weapons” as defined by separate legislation and may, according to definition, qualify as a sectoral restriction only.

Source: OECD (2005), *National Treatment for Foreign-Controlled Enterprises* and measures reported for transparency under the National Treatment instrument, including national submissions received by the OECD Secretariat no later than March 2007.

Table 3.A1.2. **Sectoral measures motivated by essential security or public order**

	Sectors or activities	Type of restriction	Observations
Argentina	Weapons and ammunition	Investment	
Australia	Defence	Investment	Restricted access to certain documents and equipment.
	Defence technologies	Investment	Restricted access to designated technologies.
Austria	Defence material	Investment; corporate organisation	
Brazil	Real estate	Investment	Concerns border areas, coastal land and “national security areas”.
Chile	Defence and nuclear energy	Investment	
	Maritime transport	Investment	
	Real estate	Investment	Concerns border areas.
Denmark	Defence material	Investment; corporate organisation	Subject to the discretion of the Ministry of Justice.
Finland	Defence material	Investment	
France	Aerospace construction	Investment	
	Press agencies	Corporate organisation	
	Agricultural co-operatives	Corporate organisation	
Israel	Defence	Investment; government purchasing	Defence corporations are subject to nationality rules affecting procurement, ultimate control and transfer of know-how.
	Privatisation	Investment	Subject to the discretion of a ministerial committee.
	Infrastructure	Corporate organisation	Board restrictions on a wide range of utilities operators.
Japan	Telecommunications	Corporate organisation	
	Broadcasting	Investment	Other than cable television and broadcasting via telecommunication.
Korea	Air control	Investment	
	Radar and missile guidance service	Investment	
Lithuania	State security and defence	Investment	
Mexico	Finance	Corporate organisation	
Norway	Contracts involving classified information	Investment	
Poland	Real estate	Investment	Concerns border areas.
	Airports	Investment	
Portugal	Maritime transport	Investment	Concerns cabotage in, to and from the Azores.
Slovenia	Production and trading of armaments	Investment	
Spain	Production and commerce of weapons and war materials	Investment	

* This legal provision, established in 1975, has not been used to date.

Source: Measures reported for transparency under the National Treatment instrument, including national submissions received by the Secretariat no later than March 2007.

Table 3.A1.2. **Sectoral measures motivated by essential security or public order** (cont.)

	Sectors or activities	Type of restriction	Observations
Sweden	Defence material and war munitions	Investment	
Turkey	Petroleum	Investment	
	Air and maritime cabotage	Investment	
	Real estate	Investment	Concerns areas of national security concerns and real estate exceeding a certain size.
United Kingdom	Aerospace and defence	Investment; corporate organisation	
	Energy	Investment	Subject to a review by the Secretary of State for Trade and Industry and the Secretary of State for Scotland.
	Maritime transport of military freight	Investment	
	Manufacturing	Investment	The Secretary of State for Trade and Industry may block transfers of control that are "contrary to the interests of the United Kingdom or a substantial part of it".
	Defence procurement contracts	Government purchasing	Limited to cases of "overriding security reasons".
United States	Air and maritime transport	Investment; corporate organisation	A number of detailed rules apply.
	Maritime dredging and salvaging	Investment	
	Radio, broadcasting and telephone	Investment	Concerns "common carrier" licences.

* This legal provision, established in 1975, has not been used to date.

Source: Measures reported for transparency under the National Treatment instrument, including national submissions received by the Secretariat no later than March 2007.