INVESTMENT SCREENING: EVOLVING POLICIES FOR A WORLD IN CHANGE

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Open economies – principally OECD countries – have for decades benefitted from foreign direct investment (FDI), and have progressively reduced restrictions on foreign investment among themselves and with third countries.

Dramatic geopolitical and geo-economic developments in recent years are now leading these open economies to revisit many policies, including their investment policies. The shift of economic weight away from a community of open and liberal countries, the assertive if not hostile stance that some countries occasionally take in economic and traditional security domains, and new vulnerabilities resulting from the diffusion of advanced technologies and sensitive information all fuel concerns about the impact of some foreign investment on essential security interests.[2]

For now, these changes in the global economic and security landscape have not led to a change in OECD Members' stance on openness to international investment in

[1] OECD Investment Division in the Directorate for Financial and Enterprise Affairs. The opinions expressed and arguments employed are those of the authors and may not represent the official views of the OECD or of its member countries.

[2] See for a broader analysis of the drivers of this trend OECD (2020), "*Acquisition- and ownership-related policies to safeguard essential security interests – current and emerging trends, observed designs, and policy practice in 62 economies*", https://oe.cd/natsec2020.

general – these countries remain committed to the benefits that such investment brings in most cases. The policy changes are concentrated on a limited subset of transactions.

Investors are concerned about swift developments in this area, about uncertainties that result from new, often broad concepts, and about the application of new rules that cannot always be anticipated.

A bird's eye perspective on policy developments in this area suggests that most of the recent developments should not be surprising. Significant parallels exist across countries, and while developments may be fast-paced, they are relatively similar across countries and follow a predictable path.

This contribution seeks to document these communalities and trends in a broad set of advanced economies; points out the drivers of the new policies; and proposes an outlook on likely future developments in this area based on current trends. This contribution is based on longstanding work by advanced economies at the OECD on this policy area and factual information generated in this context.[3]

New policies to manage new threats

For the great part of the last decades, only a small number of OECD countries had mechanisms in place that allowed their governments to review the inward investment proposals for essential security implications. Most countries did not see a need for such reviews as international investment took place essentially among allies, and most had not experienced cases in which such powers were needed. Where mechanisms existed, they were typically limited to defence production and sensitive real estate such as border areas – and were rarely used.

Awareness of vulnerabilities grew in certain countries in the early 2000s. Acquisitions of sensitive assets such as critical infrastructure by less-than-transparent investors such as Sovereign Wealth Funds, as well as the experience of international terrorism and occasional, isolated acquisition proposals by investors from non-allied countries led to the reconsideration of the potential impact of foreign acquisitions and ownership on host-countries' essential security interests. A limited number of countries began to introduce the possibility for investment reviews or strengthened existing mechanisms, but continued to use these possibilities rarely.

As a global standard-setter in international investment policy, the OECD developed guidelines for the design of investment policies related to essential security concerns in 2009. The then 30 OECD Members adopted the *OECD Guidelines for Recipient Country Investment Policies relating to National Security*[4] that contain guidance on how to reconcile openness with needs to protect essential security. The Guidelines call for policies to be transparent, predictable, proportionate and implementing governments to be accountable and recommend detailed design features that are now widely reflected in newer policies across OECD countries.

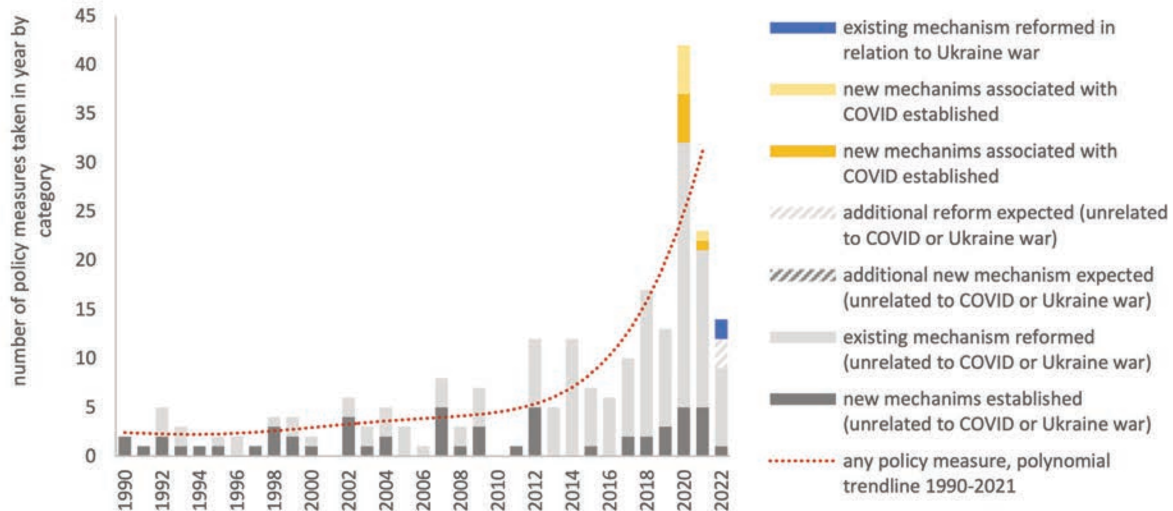
The Global Financial Crisis of 2008 temporarily disrupted international investment activity, but as of 2016, concerns about essential security in the context of international investment returned to the agenda. This time, the concerns were mainly associated with strategic, state-guided and state-subsidised investment from China, which sought to acquire companies in high-tech sectors.

These concerns were shared broadly. As a result, a large and growing number of advanced economies began to introduce mechanisms to review foreign investment projects. Repeated reforms in quick succession transformed the initial rudimentary rules into operational mechanisms, established bureaucratic infrastructure, and led to the emergence of a new administrative discipline within only a few years.

The scope of application of investment reviews evolved in line with newly identified threats. The exceptional circumstances arising from the COVID-19 pandemic and, shortly after, the Russian invasion of Ukraine, have further accelerated reforms. Figure 1 documents policy-making activity across the now 38 OECD Members between 1990 and mid-2022.

[3] OECD work on this area is documented at https://oe.cd/natsec.
[4] https://legalinstruments.oecd.org/en/instruments/OECD-LEGAL-0372

Figure 1: Introduction or reform of mechanisms to review foreign investment projects for essential security implications in OECD Members 1990-2022

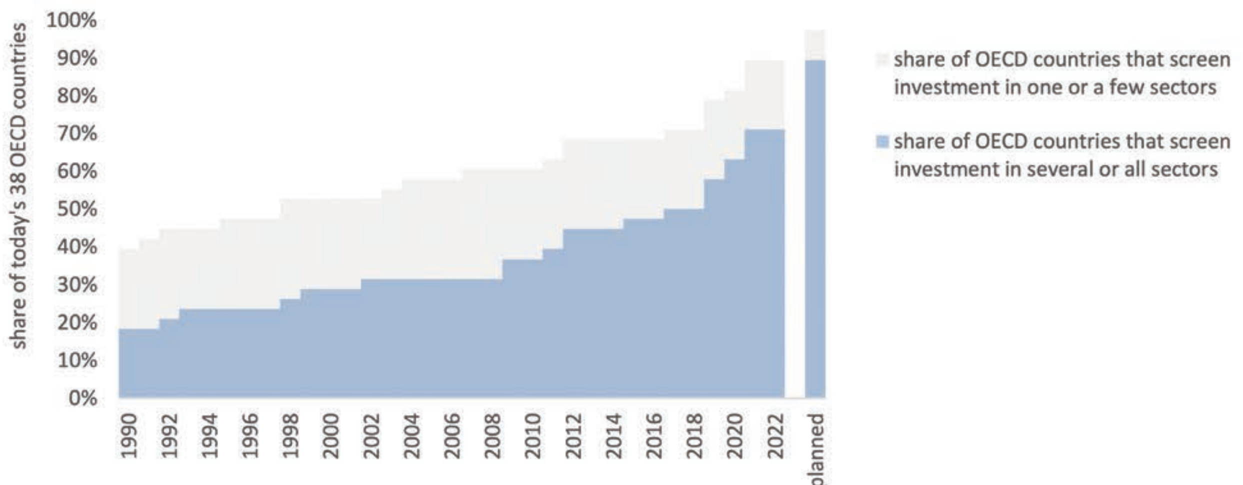


Source: OECD.

As a result of this policy-making dynamic, most OECD countries now have operational investment review mechanisms or will do in the near future.

In some countries, reviews can only be carried out for acquisitions in a narrow scope of sectors, while in others they can be carried out in multiple sectors (as in France for example) or across the entire economy. Broadly applicable investment review mechanisms have become the norm and replace or complement pre-existing sector specific mechanisms in some countries. By 2023, 34 of today's 38 OECD countries will have the possibility to intervene in foreign investment projects that threaten their essential security. Figure 2 documents how the share of OECD countries that operate such mechanisms has been growing over time.

Figure 2: Presence of narrowly or broadly applicable foreign investment review mechanisms in today's 38 OECD Members (1990-2022)



Source: OECD.

The establishment of investment review mechanisms in a growing number of countries that are important recipients of FDI and the broadening scope of mechanisms overall increases the likelihood that a given FDI transaction into an OECD country will be subject to screening. Many transactions may be subject to reviews in more than one jurisdiction if the target enterprise has subsidiaries in more than one country.

Security concerns evolve

Security concerns associated with foreign investment evolve as geopolitical and geo-economic parameters change, business practices develop, and investors adapt to new regulatory environments. All these factors have undergone rapid evolutions in the past years and investment review mechanisms are following suit.

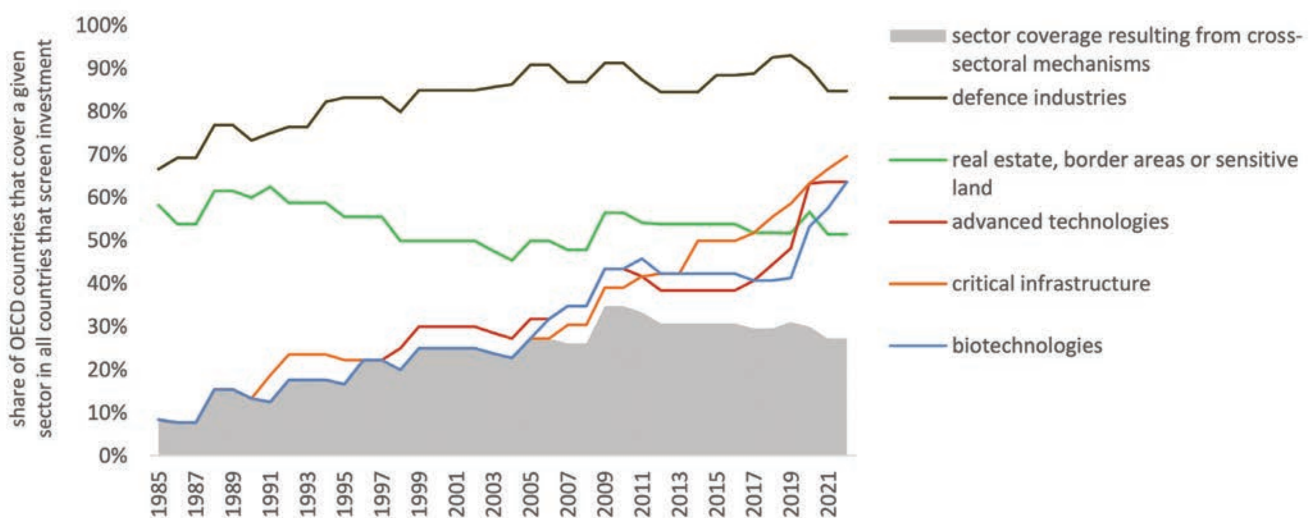
The sectoral scope of investment review mechanisms in the second half of the 20th century reflects a defence-mindset that saw espionage and sabotage as being the main concerns along with the risk that military capabilities of potential adversaries be furthered. Correspondingly, defence industries and sensitive real estate were the focus of review mechanisms and other restrictions on foreign ownership in most countries.

A number of factors have broadened the understanding of "essential security interests" significantly and are reflected in the evolving scope of investment review mechanisms: First, the privatisation of critical infrastructure such as telecommunications in the 1980s and 1990s opened these sectors to foreign capital. Second, technological developments created new vulnerabilities that malicious actors may try to exploit. Third, these technological advances also expanded the scope of industries that supply defence applications, and fourth, data on individuals now has a central role for essential functions of our societies.

Unexpected shortages of essential goods and services in the context of the COVID-19 pandemic have opened governments' eyes to vulnerabilities that they had hitherto ignored or accepted. These new insights led to the swift broadening of review mechanisms to include health-related industries and infrastructure.

Figure 3 documents these evolutions in OECD countries over time. It shows, for each year between 1980 and 2022, the share of OECD countries that applied investment screening to selected sectors from among those countries that had any investment screening mechanism in the same year. As such, it reveals the relative priorities among sectors in which foreign investment raises concerns and the growing diversification of these sectors.

Figure 3: Sector coverage of foreign investment review mechanisms in OECD Members as share of OECD Members that carry out investment screening in any sector (1985-2022)



Source: OECD.

More particularly, Figure 3 reveals that defence industries and sensitive real estate dominated concerns in the 1980s as almost the only sectors in which foreign investment was subject to security-related restrictions. Critical infrastructure and advanced technologies emerged in the scope of investment screening mechanisms in the 1990s. Biotechnologies first emerged as subject to investment screening in their own right in 2005, and their prominence rose extraordinarily swiftly in 2020 and 2021 with the spread of the COVID-19 pandemic.

Evolutions in this area are unlikely to come to a halt any time soon

The dissemination and substantive developments of investment policies related to essential security interests respond to an evolving economic and security environment. This environment will continue to evolve, and, judging from most recent events, this evolution will rather accelerate. The Russian invasion of Ukraine, the energy crisis, and the build-up of military tensions elsewhere; the climate crisis and its impact on food and water security; and the competition for increasingly scarce resources are all likely to weigh on international economic relations and on risk perceptions, and will consequently shape international investment policies and in particular investment screening policies.

Three main developments are expected in the near and medium term:

First, attempts to acquire advanced technologies, not least to boost defence capabilities, will rely on avenues other than acquisitions of mature companies. International research funding and inward and outward researcher exchange are likely developed as a means to transfer know-how across borders and to countries that are lagging behind technologically and a means to circumvent investment reviews.[5]

Second, strategic international investment in resource-rich or strategically located developing countries may be used to exclude open economies from these essential inputs and thus threaten their security. Such investment is not always intended to generate economic benefits for the investor – rather, the purpose may be to exclude other countries and their investors from use or access. This often state-directed behaviour is out of reach of traditional investment review mechanisms as it takes place in other, sovereign states.

Third, the dissemination and growing scope of investment review mechanisms could make beneficial international investment more difficult and onerous. To counter this effect, it is likely that governments will further refine their policies to minimise the impact on beneficial investment and establish transparency and predictability about policies and their implementation.

It is also likely that like-minded governments will increasingly co-ordinate their reviews, and they may ultimately even strive to co-ordinate mitigation measures. Many countries now include an explicit opening for international co-operation in their screening mechanisms, and the EU has spearheaded co-operation among EU Members based on EU Regulation 2019/452 establishing a framework for the screening of foreign direct investments into the Union. It is likely that co-ordination of investment screening will be expanded in the future.

In this complex and constantly evolving context, the OECD provides evidence and comparable data to policy makers and offers a forum for co-operation and exchange on good policy practice across borders.

[5] See for a more detailed analysis Joachim POHL and Nicolás Rosselot (2021), "*Managing access to AI advances to safeguard countries' essential security interests*", OECD publishing, https://oe.cd/il/natsecbfo21.