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Foreign Direct Investment screening for "national security" or sustainable development: A blessing in disguise?

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Research
Paper

30 July 2024

Foreign Direct Investment Screening for 'National Security' or Sustainable Development: a blessing in disguise?

Daniel Uribe Teran



 **SOUTH
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RESEARCH PAPER

205

FOREIGN DIRECT INVESTMENT SCREENING FOR 'NATIONAL SECURITY' OR SUSTAINABLE DEVELOPMENT: A BLESSING IN DISGUISE?

Daniel Uribe Teran*

SOUTH CENTRE

30 JULY 2024

* Daniel Uribe Teran is Lead Programme Officer of the Sustainable Development and Climate Change Programme (SDCC) of the South Centre. The author would like to thank Prof. Carlos Correa for his valuable commentaries and suggestions on this paper. His insightful feedback significantly enhanced the quality and depth of this Research Paper.

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ABSTRACT

Over the past decade, the global adoption of Foreign Direct Investment (FDI) screening mechanisms (ISMs) has surged, reflecting developed countries' policies aiming at restricting FDI on the grounds of broadly defined 'security' or 'national' interests. Recent geopolitical and economic crises have further fuelled this trend, leading to increasingly stringent ISMs. This paper explores the definition, evolution, and current practices of ISMs, highlighting their resurgence and differing motivations globally. It examines how, if properly used, ISMs could also be used to promote sustainable development and resilience, and advance climate action agendas. The paper also provides policymakers with insights into maximizing the impact of ISMs to achieve sustainable development and economic resilience in an interconnected world.

Au cours de la dernière décennie, la mise en place à l'échelle mondiale de mécanismes de filtrage des investissements directs étrangers a connu un essor sans précédent, dans la lignée des politiques adoptées dans les pays développés qui visent à restreindre les investissements directs étrangers pour des raisons de « sécurité » ou « d'intérêts nationaux » au sens large. Les récentes crises géopolitiques et économiques ont encore alimenté cette tendance, conduisant à la mise en place de mécanismes de plus en plus stricts. Le présent document explore la définition, l'évolution et les pratiques actuelles en matière de mécanismes de filtrage des investissements directs étrangers, en mettant en avant les raisons à l'origine du regain d'intérêt qu'ils suscitent et des différentes motivations des pays qui ont choisi de les mettre en œuvre. Il examine comment, s'ils sont correctement utilisés, ces mécanismes pourraient également contribuer à promouvoir le développement durable et la résilience, et à faire avancer les programmes d'action sur le climat. Il fournit également aux décideurs politiques des indications sur la manière de maximiser leur impact en vue d'atteindre les objectifs de développement durable et de favoriser la résilience économique dans un monde interconnecté.

En la última década, ha aumentado considerablemente la adopción mundial de mecanismos de control de la Inversión Extranjera Directa (IED), lo que refleja las políticas de los países desarrollados destinadas a restringir la IED por motivos de "seguridad" o intereses "nacionales" ampliamente definidos. Las recientes crisis geopolíticas y económicas han impulsado aún más esta tendencia, dando lugar a mecanismos de control cada vez más estrictos. Este documento analiza la definición, la evolución y las prácticas actuales de los mecanismos de control de la IED, destacando su resurgimiento y las diferentes motivaciones a nivel mundial. Examina cómo, si se utilizan adecuadamente, estos mecanismos también podrían servir para promover el desarrollo sostenible y la resiliencia, y avanzar en las agendas de acción climática. El documento también brinda a los responsables políticos perspectivas para maximizar el impacto de los mecanismos de control de la IED con el fin de lograr el desarrollo sostenible y la resiliencia económica en un mundo interconectado.

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INTRODUCTION

Over the past decade, the global landscape of Foreign Direct Investment (FDI) has witnessed a notable surge in adopting FDI screening mechanisms (ISMs) by countries across various developmental stages, but notably by developed countries¹. Recent geopolitical developments have led to a resurgence in ISMs aimed at protecting vaguely defined 'national security' and 'national interests', including authorisation procedures, divestment orders, and ownership limitations. This research paper first highlights the definition and evolution, current practices, and differing motivations behind the implementation and expansion of ISMs globally. It then considers how, if properly used, these screening mechanisms could potentially serve as tools for promoting sustainable development and resilience. Finally, this research paper provides insights for policymakers into maximising the impact of FDI screening mechanisms, as tools for aligning FDI with broader sustainable development objectives and fostering economic resilience in an interconnected world economy.

¹ Vicente Guazzini, Anastasia Leskova and Massimo Meloni, "The Evolution of FDI Screening Mechanisms", UNCTAD Investment Policy Monitor, Issue 25 (February 2023), p. 5. Available from https://unctad.org/system/files/official-document/diaepcbinf2023d2_en.pdf (accessed 20.03.2024).

1. DEFINING INVESTMENT SCREENING MECHANISMS

Investment screening refers to the means and procedures used by different governments for assessing, conditioning, or prohibiting FDI based on different grounds or objectives. Governments have commonly aligned these procedures towards addressing national security or public order concerns. Nonetheless, such grounds have been defined vaguely, allowing States to take actions not limited to national security or public order concerns².

In the 1970s and 1980s many developing countries implemented ISMs to align FDI to their development needs.³ They included an obligation to register any foreign direct investment after an assessment of its potential impact on job creation, imports, establishment of manufacturing capacity, etc.⁴ Those mechanisms, however, were dismantled in the context of the liberalization promoted by the Washington Consensus⁵. Overall, the view of FDI screening as an obstacle to investment led many developing countries to open their markets to FDI. Moreover, many of them shifted from regulations to *control* FDI to mechanisms to *promote* it, in the light of the declining flows of FDI. Thus, FDI flows only showed a marginal increase of 3% globally and fell 9% to developing countries in 2023, with declining or stagnating flows in most regions (see Figure 1). The participation of a large number of developing countries at the World Trade Organization in the negotiation of an Investment Facilitation Agreement largely reflects this new approach.

However, the number of countries introducing ISMs has expanded after the 2008 financial crisis, further boosted by the COVID-19 crisis (see Figure 2). There are two different drivers for this increase, as further discussed below. On the one hand, ISMs were introduced by developed countries on 'national security' grounds, focusing on rules to identify the origin of the investment, including the nationality of the investor, as well as public or private ownership of the foreign entity. They also defined specific sectors where FDI requires further screening. The outcome of these measures includes the screening for authorising the investment, divestment measures, prohibiting investments, or limited ownership of the investment⁶. Such ISMs have been based on a vague concept of 'national security' as their main objective has actually been to prevent foreign companies (mainly from China) from getting access to critical assets such as advanced technology for semiconductors production⁷.

² See: Lorenzo Bencivelli, Violaine Faubert, Florian Le Gallo and Pauline Négrin, "Who's Afraid of Foreign Investment Screening?", Banque de France, Working Paper 927 (2023), p. 4.

³ See: Carlos Correa, "Características y tendencias de la regulación de las inversiones extranjeras en América Latina", *Integración Latinoamericana*, No. 97 (Buenos Aires, December 1984); Carlos Correa and Nagesh Kumar, *International Rules for Foreign Investment. Trade-Related Investment Measures (TRIMS) and Developing Countries* (London & New Delhi, ZED Books /Academic Foundation, 2003).

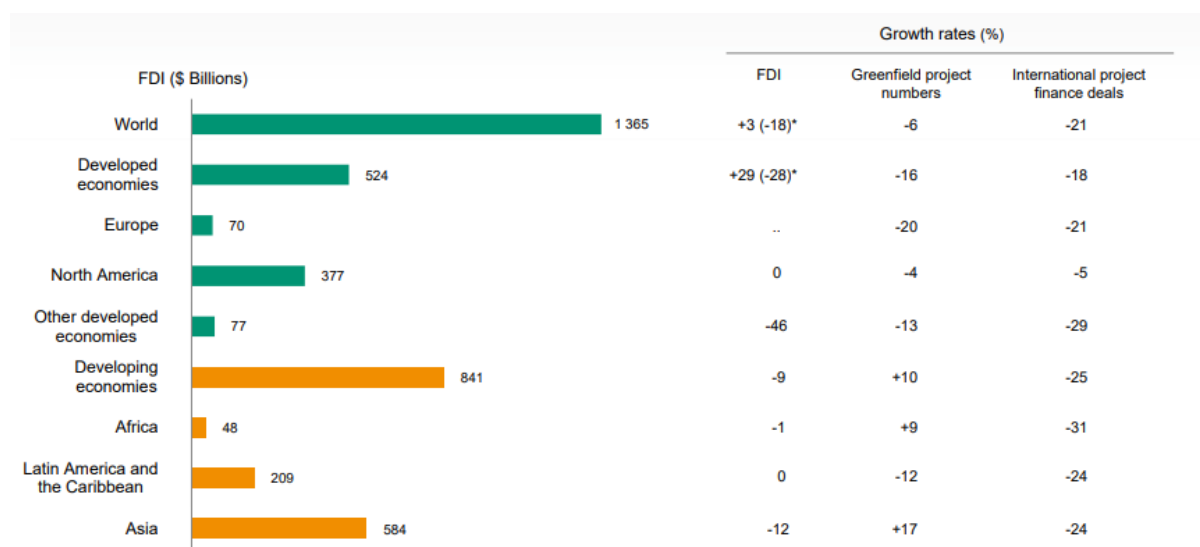
⁴ See: Robert Thomas Kudrle, "Canada's Foreign Investment Review Agency and United States direct investment in Canada", *Transnational Corporations*, Volume 4, No. 2, UNCTAD/ITE/IIT (1995), p. 58.

⁵ See: Nicolas Perrone, *Investment Treaties and the Legal Imagination: How Foreign Investors Play by Their Own Rules* (First edition, Oxford University Press, 2021), p. 102.

⁶ UNCTAD's Investment Policy Monitor (2023), *op. cit.*, p. 14.

⁷ See: Ana Swanson, "U.S. Cracks Down on Chinese Companies for Security Concerns", *New York Times*, 15 December 2022. Available from <https://www.nytimes.com/2022/12/15/business/economy/us-china-biden-security.html>.

Figure 1. Investment Trends by Region, 2023 vs 2022



Source: UNCTAD, 2024

On the other hand, a number of other countries have implemented ISMs to promote economic and social development by advancing diversification and production upgrading, as well as reshoring manufacturing to domestic companies⁸. These measures have focused on improving infrastructure, education, technology, and innovation and reducing the global footprint of multinational firms⁹. The grounds for implementing ISMs have expanded to include transactions relating to critical infrastructure, improving labour and logistics trade-offs, reducing geopolitical and global value chain (GVC) risks, and increasing domestic investment into research and development practices¹⁰. These measures have, therefore, become cross-sectoral, including reviewing investments in advanced technologies, pharmaceuticals, and data management (see Figure 3). Despite their legitimate objectives, these ISMs have been characterised as protectionists and as creating restrictions and obstacles to FDI¹¹. For example, the Organisation of Economic Co-operation and Development (OECD) has included 'screening or approval mechanisms' as regulatory restrictions in its FDI Regulatory Restrictiveness Index¹².

⁸ See: PwC, "Reshoring and Foreign Inbounding: A Goldilocks Moment for US Manufacturing in?" (2023). Available from <https://www.pwc.com/us/en/industries/industrial-products/library/reshoring-manufacturing-foreign-inbounding-us.html> (accessed 20.03.2024).

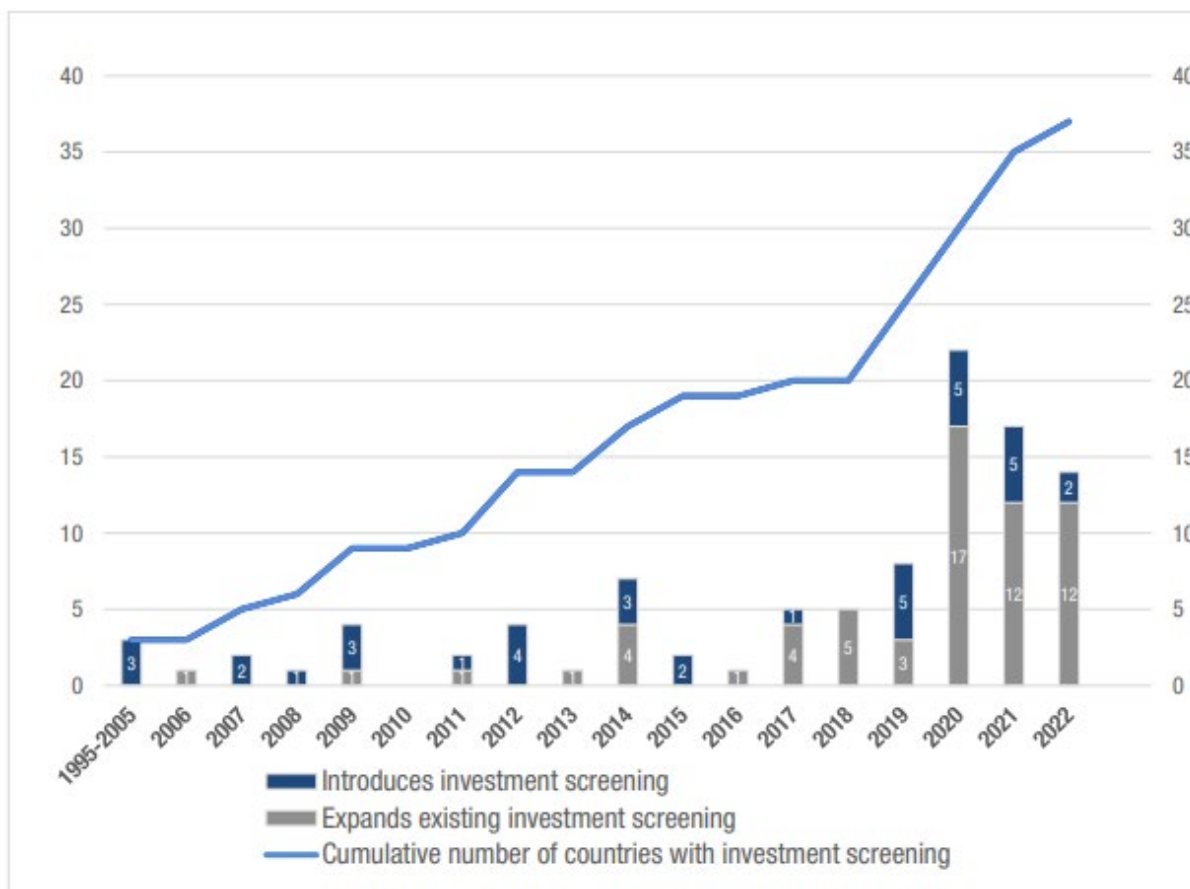
⁹ Reda Cherif, Faud Hasanov and Nikola Spatafora, "Industrial Policy for Growth and Diversification: A Conceptual Framework", International Monetary Fund, Departmental Paper DP/2022/17, September 2022. Available from <https://www.imf.org/-/media/Files/Publications/DP/2022/English/IPGDCFEA.ashx#:~:text=Such%20diversification%20is%20driven%20by.before%20the%20COVID%2D19%20pandemic> (accessed 20.03.2024).

¹⁰ Bencivelli *et al.*, *op. cit.* and PwC, *op. cit.*

¹¹ Organisation for Economic Co-operation and Development (OECD), *Framework for Screening Foreign Direct Investment into the EU: Assessing Effectiveness and Efficiency* (Paris, 2022) p. 16. Available from https://www.oecd.org/en/publications/2022/01/framework-for-screening-foreign-direct-investment-into-the-eu_d966075e.html.

¹² See: OECD, FDI Regulatory Restrictiveness Index (accessed 20.03.2024).

Figure 2. Number of Countries Introducing or Expanding Security-related Investment Screening (1995 – 2022)



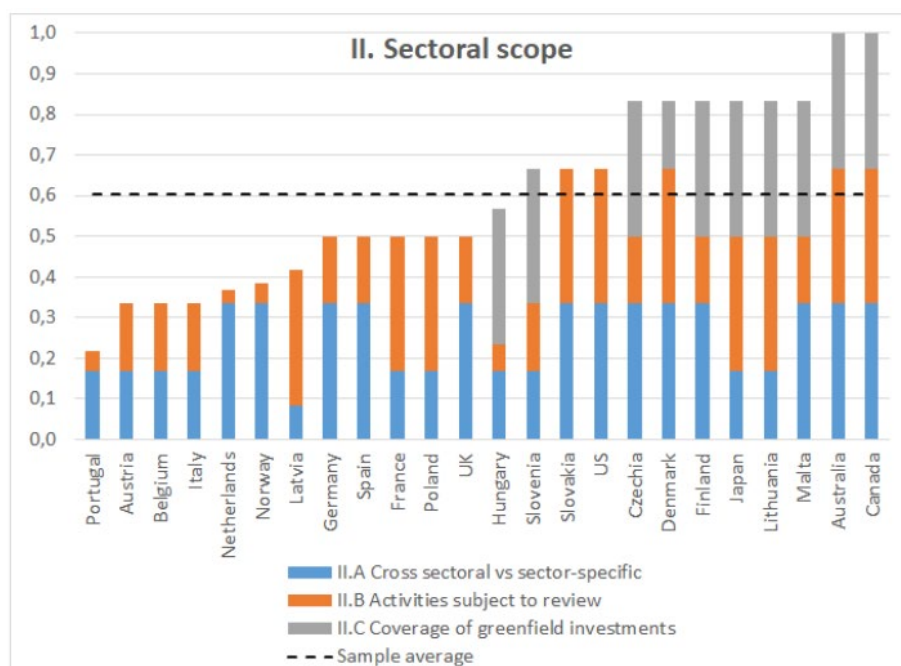
Source: UNCTAD's Investment Policy Monitor (2023)

2. CURRENT PRACTICES ON FOREIGN DIRECT INVESTMENT SCREENING MECHANISMS

As mentioned, ISMs are not new, as several States have used them to regulate foreign investments entering their territories since the 1970s. The United States, for example, established the Committee on Foreign Investment (CFIUS) in 1975 and mandated it to “review investments in the United States which, in the judgment of the Committee, might have major implications for United States national interests (...)”¹³. This Committee has been considered as the ‘golden standard’ of ISMs and as a policy tool to control and regulate investments in the United States in line with their national interests.¹⁴ Likewise, it has been highlighted that:

States have long regulated which foreign investments are allowed on their territory. Tools of investment control have included substantial state ownership in sensitive assets and sectors, ‘golden share’ arrangements conferring outsized voting rights to the state in strategic companies, and foreign equity restrictions limiting foreign ownership of domestic firms or banning foreigners outright from sensitive sectors.¹⁵

Figure 3. Sectoral Scope of ISMs



Source: Lorenzo Bencivelli and others (2023).

Nonetheless, the use of ISMs declined during the 1980s and 1990s. The FDI liberalisation narrative aimed to discourage States from taking ‘investment restrictive measures’ and promote an investment-friendly regulatory framework for foreign firms and investors,¹⁶ on the argument that FDI liberalisation was vital for accelerating growth and economic transformation

¹³ United States, Executive Order 11858, Foreign Investment in the United States (1975). Available from <https://www.presidency.ucsb.edu/documents/executive-order-11858-foreign-investment-the-united-states>.

¹⁴ Sarah Bauerle Danzman and Sophie Meunier, “Mapping the Characteristics of Foreign Investment Screening Mechanisms: The New PRISM Dataset”, *International Studies Quarterly* 67, Issue 2 (2023).

¹⁵ *Ibid.*

¹⁶ See: Najib Zamani, “A Legal Comparative Approach Towards the Screening of Outbound FDI: What Can the EU and Its Member States Learn from the US National Critical Capabilities and Defense Act Proposal?”, *Erasmus Law Review* Issue 4 (2022), p. 300.

and an “important source of private external finance for developing countries”¹⁷. ISMs were considered a restriction to FDI and an obstacle to globalisation. Nonetheless, since 2017, governments have increased their attention to FDI-related measures needed to safeguard their policy objectives and protect them from ‘unfair competition’¹⁸ and as a response to the poly-crisis, including the effects of the COVID-19 pandemic, geopolitical tensions, and climate change¹⁹.

This section will consider several States’ current practices on ISMs and the factors or circumstances that have triggered such policy changes. It will also identify some of these measures’ common characteristics and objectives across different regions.

2.1. Measures Adopted by the European Union

In 2017, the European Union (EU) started a process to re-position the EU as an economic and political power globally by strengthening the union among its Member States. One of the reasons behind this approach was the “rapidly rising influence of emerging economies”²⁰, requiring the European Union to “speak with one voice and to act with the collective weight of its individual parts”²¹. The White Paper on the Future of Europe highlighted the need to “focus on jobs, growth and investment by strengthening the single market and investing in digital, transport and energy infrastructure”²². The paper also put in place a process to assist the EU Member States in the years ahead through the preparation of ‘reflection papers’ by the EU Commission on the role of Europe in 2025.

A Reflection Paper on Harnessing Globalisation was subsequently published, which considered the role of the EU in facing the challenges and opportunities deriving from changing globalisation²³. The paper emphasises the need to develop a balanced, rules-based and progressive trade and investment agenda, including safeguarding Member State’s policy space necessary to protect their citizens and safeguard EU industries from unfair competition. The paper highlighted that:

Openness to foreign investment remains a key principle for the EU and a major source of growth. However, concerns have recently been voiced **about foreign investors, notably state-owned enterprises, taking over European companies with key technologies for strategic reasons**. EU investors often do not enjoy the same rights to invest in the country from which the investment originates. **These concerns need careful analysis and appropriate action** (emphasis added)²⁴.

After the publication of this reflection paper, the European Council concluded on the need to “analyse investments from third countries in strategic sectors”²⁵. This conclusion was followed by the European Parliament resolution on building an ambitious EU industrial strategy as

¹⁷ *Ibid.*

¹⁸ Baurle and Meunier, *op. cit.*

¹⁹ See: Simon J. Evenett, “What Caused the Resurgence in FDI Screening”, SUERF Policy Note, Issue No. 240 (20 May 2021), p. 12.

²⁰ See: European Commission, White Paper on the Future of Europe: Reflections and Scenarios for the EU27 by 2025 (2017), p. 8. Available from https://commission.europa.eu/document/download/b2e60d06-37c6-4943-820f-d82ec197d966_en?filename=white_paper_on_the_future_of_europe_en.pdf (accessed 24.03.2024).

²¹ *Ibid.*, p. 8

²² *Ibid.*, p. 16

²³ See: European Commission, Reflection Paper on Harnessing Globalisation (2017), p. 14. Available from https://commission.europa.eu/document/download/0b1f30b3-2b65-4a96-8edb-6df62d7f229e_en?filename=reflection-paper-globalisation_en.pdf (accessed 24.03.2024).

²⁴ *Ibid.*, p. 15.

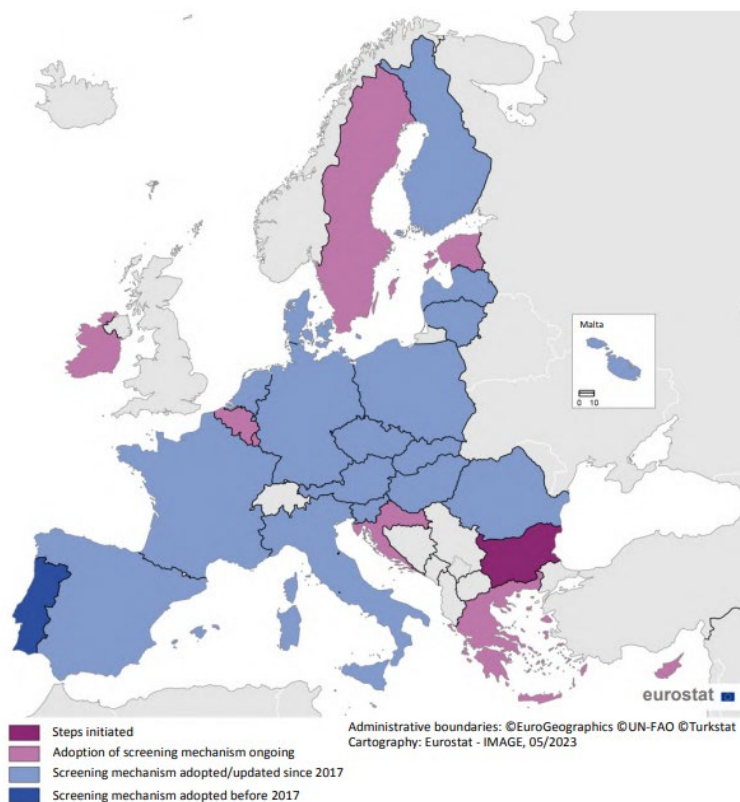
²⁵ *Ibid.*, p. 17.

a strategic priority for growth, employment, and innovation in Europe,²⁶ which called on the European Commission to:

(...) **screen third country FDI in the EU** in strategic industries, infrastructure and key future technologies, or other assets that are important in the interests of security and protection of access to them while bearing in mind that Europe depends to a large extent on FDI (emphasis added)²⁷.

Following this call, the European Commission submitted a communication 'Welcoming Foreign Direct Investment while Protecting Essential Interests'²⁸. The communication invoked the risks associated with foreign investors' undertakings that might have repercussions on critical technologies, infrastructure, inputs or sensitive information, particularly when "foreign investors are state-owned or controlled, including through financing or other means of direction"²⁹, given that "such acquisitions may allow the States in question to use these assets to the detriment not only of the EU's technological edge but also its security and public order"³⁰. Quite obviously, the main objective of the Commission was to prevent FDI from China. Currently, two-thirds of EU Member States have established ISMs (see Figure 4).

Figure 4. EU Member States with Screening Mechanisms



Source: European Union (2023)

²⁶ See: European Parliament, Resolution on building an ambitious EU industrial strategy as a strategic priority for growth, employment and innovation in Europe, Doc. 2017/2732(RSP) (2017). Available from <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A52017IP0305> (accessed 24.03.2024).

²⁷ *Ibid.*, para. 20.

²⁸ See: European Commission, Welcoming Foreign Direct Investment while Protecting Essential Interests, Communication from the Commission to the European Parliament, the European Council, The Council, the European Economic and Social Committee and the Committee of the Regions, Doc COM(2017) 494 (2017). Available from <https://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2017:0494:FIN:EN:PDF> (accessed 24.03.2024).

²⁹ *Ibid.*, p. 5.

³⁰ *Ibid.*

Moreover, in 2019, the European Parliament and the Council adopted Regulation 2019/452, establishing a framework for the screening of FDI in Europe³¹. The regulation defines screening as a “procedure allowing to assess, investigate, authorise, condition, prohibit or unwind foreign direct investment”. It also refers to the screening mechanism as “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 screen investments.

Article 3 of the above-mentioned regulation allows Member States of the EU to maintain, amend or adopt mechanisms to screen FDI and requires such mechanisms to include relevant timeframes, be transparent and not discriminatory, and offer a recourse against any decision resulting from the screening processes. Article 4 enumerates the factors that may be taken into consideration by Member States and the Commission to conduct the screening of FDI that may have potential effects on critical infrastructure and technologies (see Box 1), supply of critical inputs, access to sensitive information and freedom of the media.

Box 1.- Definition of Critical Technologies and Critical Infrastructure

Regulation 2019/452 defines **critical technologies** as those including artificial intelligence, robotics, semiconductors, cybersecurity, aerospace, defence, energy storage, quantum, and nuclear technologies as well as nanotechnologies and biotechnologies. Likewise, it considers **critical infrastructure** to be either physical or virtual infrastructure related to energy, transport, water, health, communications, media, data processing or storage, aerospace, defence, electoral or financial infrastructure, and sensitive facilities, as well as land and real estate crucial for the use of such infrastructure.

The EU’s regulation also includes a mechanism for cooperation among Member States and the Commission (see Figure 5). This cooperation mechanism requires Member States utilizing screening mechanisms to provide information to the Commission and other Member States for commentaries on such screening.

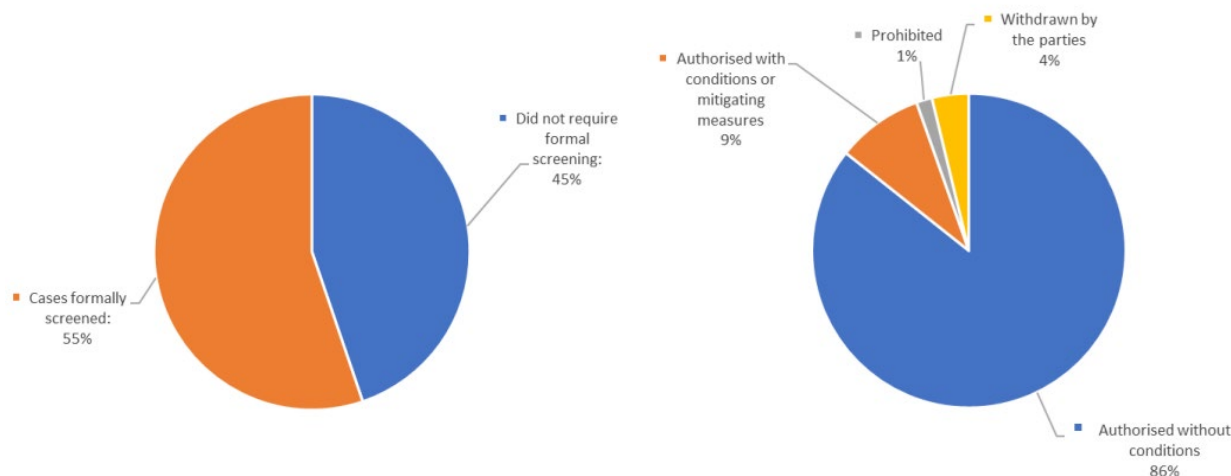
This information includes the ownership structure of the foreign investor and of the undertaking in which the foreign direct investment is planned, the approximate value of the FDI, the products, services and business operations of the foreign investor and of the undertaking in which the foreign direct investment is planned, the Member States in which the foreign investor conduct relevant business operations, the funding of the investment and its source, based on the best information available to the Member State the date when the FDI is planned to be completed or has been completed. This cooperation mechanism aims at improving information sharing among EU Member States and the Commission on FDI entering the EU with the objective of authorising, conditioning, or prohibiting the investment.

The EU Commission has also established a group of experts on the screening of FDI into the EU. This group of experts is mandated by Article 12 to provide advice and expertise to the Commission, discuss issues related to the screening of FDI, share best practices and lessons learned, and exchange views on trends and issues of common concern relating to FDI.

³¹ European Parliament and European Council, Regulation establishing a framework for the screening of foreign direct investments into the Union, (EU) 2019/452 (2019). Available from <https://eur-lex.europa.eu/eli/reg/2019/452/oj> (accessed 24.03.2024).

According to the European Commission³², almost 55% of requested authorisations of acquisition by foreign investors were subject to screening mechanisms, 86% of these requests were authorised without condition, 1 % were blocked, and 4% of transactions were withdrawn by the investors (see Figure 5).

Figure 5. Result of Cases Formally Screened in the European Union



Source: European Commission (2023)

2.2. Measures Adopted by the United States

As noted, the United States established the Committee on Foreign Investment (CFIUS) in 1975 with a mandate to review investments in the United States in the light of their possible 'major implications' for US 'national interests'³³. The Committee was created pursuant to the Defense Production Act of 1950. The Executive Order 11858 directed the CFIUS to analyse the trends and developments of FDI in the United States, provide guidance on investments made by foreign governments, review investments that might have implications for US interests and consider proposals for legislation to regulations related to foreign investment.

It is possible to identify different stages in the development of the CFIUS mandate. The first one was after the adoption of Executive Order in 1975, when the Committee considered the political and economic aspects of its mandate. During this stage, the CFIUS reviewed transactions involving the foreign acquisition of firms that produced materials used by the U.S. military, and any merger, acquisition or takeover by foreigners that threatened national security³⁴. In 1988, an amendment to the Defense Production Act was adopted by Congress (Exxon-Florio amendment), which allowed the Executive to block any foreign business transactions that could impair national security if (1) other US laws are inadequate to protect

³² European Commission, Third Annual Report on the screening of foreign direct investments into the Union, Document COM(2023) 590 (2023). Available from <https://data.consilium.europa.eu/doc/document/ST-14427-2023-INIT/en/pdf> (accessed 24.03.2024).

³³ United States, Executive Order 11858, Foreign Investment in the United States (1975). Available from <https://www.presidency.ucsb.edu/documents/executive-order-11858-foreign-investment-the-united-states>.

³⁴ Jason Jacobs, "Tiptoeing the Line Between National Security and Protectionism: A Comparative Approach to Foreign Direct Investment Screening in the United States and European Union", *International Journal of Legal Information*, Volume 47, Issue 2 (2019), pp. 109-110. Available from https://web.archive.org/web/20200505214704id_/https://www.cambridge.org/core/services/aop-cambridge-core/content/view/ACF5607BD017010E037D55925985C5E6/S0731126519000180a.pdf/div-class-title-tiptoeing-the-line-between-national-security-and-protectionism-a-comparative-approach-to-foreign-direct-investment-screening-in-the-united-states-and-european-union-div.pdf (accessed 24.03.2024).

national security and (2) there was 'credible evidence' that the transaction will risk national security³⁵.

One of the elements that gained major attention was the definition of 'control' to assess the role of the foreign investor in the business transaction. According to the Treasury Department regulations, the term 'control' was not defined by a "numeral benchmark", but it focused on the level of functional influence of the foreign investor in the firm, for example, its capability to affect how certain decisions are made (see Box 2)³⁶.

Box 2. Definition of 'control' according to the US Treasury Department

The term control means the power, direct or indirect, whether or not exercised, and whether or not exercised or exercisable through the ownership of a majority or a dominant minority of the total outstanding voting securities of an issuer, or by proxy voting, contractual arrangements or other means, to determine, direct or decide matters affecting an entity; in particular, but without limitation, to determine, direct, take, reach or cause decisions regarding:

1. The sale, lease, mortgage, pledge or other transfer of any or all of the principal assets of the entity, whether or not in the ordinary course of business;
2. The reorganisation, merger, or dissolution of the entity;
3. The closing, relocation, or substantial alteration of the production, operational, or research and development facilities of the entity;
4. Major expenditures or investments, issuances of equity or debt, or dividend payments by this entity, or approval of the operating budget of the entity;
5. The selection of new business lines or ventures that the entity will pursue;
6. The entry into termination or non-fulfilment by the entity of significant contracts;
7. The policies or procedures of the entity governing the treatment of non-public technical, financial, or other proprietary information of the entity;
8. The appointment or dismissal of officers or senior managers;
9. The appointment or dismissal of employees with access to sensitive technology or classified U.S. Government information or
10. The amendment of the Articles of Incorporation, constituent agreement, or other organisational documents of the entity with respect to the matters described at paragraph (a) (1) through (9) of this section.

Source: US Code of Federal Regulation, Title 31, Part 800.208

In addition, neither the Treasury Department nor CFIUS have adopted a definition of 'national security'. It has been generally recognised that the concept includes critical infrastructure and technologies. 'Critical infrastructure' is considered to exist in respect of any "systems and assets, whether physical or virtual, so vital to the United States that the incapacity or destruction of such systems or assets would have a debilitating impact on national security"³⁷. For critical technologies, the definition expands to include munitions and arms, agents and toxins, nuclear equipment and material, emerging and foundational technologies, among others³⁸.

In 1992, the Congress amended the Exxon-Florio statute through Section 837 of the National Defence Authorization Act for Fiscal Year 1993, which required CFIUS to conduct a 45-day

³⁵ James K. Jackson, *The Exxon-Florio National Security Test for Foreign Investment*, Congressional Research Service (2013), p. 4. Available from <https://sgp.fas.org/crs/natsec/RL33312.pdf> (accessed 24.03.2024).

³⁶ *Ibid.*, p. 6.

³⁷ 31 CFR 800.214

³⁸ 31 CFR 800.215

investigation of any merger, acquisition, or takeover by a State-owned or controlled entity³⁹. Although it seemed that the amendment included a mandatory screening of foreign investments owned or controlled by foreign States, the Committee considered that such screening was discretionary and that two requirements were needed to conduct a full 45-day investigation:

- 1) that the firm is owned or controlled by a foreign government, and
- 2) that the investment could affect national security⁴⁰.

Further, in 2007, the US Congress adopted the Foreign Investment and National Security Act (FINSA), implemented by Executive Order 13456, in accordance with which other US agencies may be appointed to lead investigations and the Director of National Intelligence is required to evaluate the security implications of transactions⁴¹. FINSA continues to cover transactions conducted by firms or entities controlled by foreign governments and redefines 'critical technologies' as critical components or critical technology items essential to national defence⁴².

In 2018, Congress passed the Foreign Investment Risk Review Modernisation Act (FIRRMA), which expands the purview mandate of CFIUS by including any purchase, lease, or concession by or to a foreign person of real estate that is in close proximity to government facilities⁴³. It also identifies sensitive transactions involving countries of 'special concerns' as those transactions involving firms unaffiliated to the United States by foreign persons, that is:

- i. a national or a government of, or a foreign entity organised under the laws of, a country of particular concern; or
- ii. a foreign entity controlled by a national or a government of, or by a foreign entity of a country of special concern; or
- iii. a foreign entity in which the government of a country of special concern has a substantial interest.

Likewise, it considers 'sensitive' transactions that could lead to access to sensitive personal data that can threaten national security or that provide substantive decision-making, other than through voting of shares, of the firm in the United States and may be used for the development, acquisition, or release of sensitive personal data of United States' citizens, critical technologies, or critical infrastructure⁴⁴. In 2022, the Executive Order 14083 was issued recognising the role of CFIUS and expanding on the existing list of factors and sectors considered for screening investments, including microelectronics, artificial intelligence, biotechnology, advanced clean energy, cyber security and critical materials. In doing this, the Executive Order also considers three additional factors for screening investments⁴⁵:

- i. Aggregate control of foreign investors in a sector or technology through a series of transactions;
- ii. National security risks posed by cyber-enabled activities; and,
- iii. The use of sensitive data that can be used for surveillance, tracing, tracking, and targeting of individuals or groups of individuals.

Pursuant to the CFIUS procedure, a party may be obliged to submit a declaration to the Committee when a foreign person acquires control over a US business involved in critical

³⁹ H.R.5006 - National Defense Authorization Act for Fiscal Year 1993, Sec. 837

⁴⁰ See: Jackson, *op. cit.*, p. 8.

⁴¹ See: Jacobs, *op. cit.*, p. 111.

⁴² Pub. L. No. 110-49, 121 Stat. 246 (2007), and Exec. Order 13456.

⁴³ See: H.R.5841 - Foreign Investment Risk Review Modernization Act of 2018, Sec. 201.

⁴⁴ See: H.R.5841 - Foreign Investment Risk Review Modernization Act of 2018, Sec. 201.

⁴⁵ Executive Order 14083 of September 15, 2022

technology or any substantial interest for the national security of the United States, including critical infrastructure or sensitive personal data. This will require the investor to consider if the transaction will allot control to the foreign investor of businesses involving non-public information on critical technologies or substantial interest, including decision-making rights on the use or disposition of such technologies, or if the transaction will target products or services that are controlled for export under certain sections of the export control laws.

After the reception of the declaration, a notice will be submitted by CFIUS that will cover almost 100 days (a 45-day review period, a 45-day investigation period and a 15-day Presidential review). Although certain transactions require mandatory declarations, most processes start with voluntary procedures that allow the parties to a transaction to submit a declaration to obtain a 'safe harbour' letter against future requested filings. After the review and investigation period, CFIUS can decide to impose conditions on the transaction to mitigate such risks or may refer the case to the President for decision, including not accepting the transaction. From 2018 to 2022, CFIUS covered 558 transactions (see Table 1). More research will be needed to establish whether this low rate is explained by a flexible application of the screening criteria and rules or rather by the deterrent effect that the US regulations may have, leading potential foreign investors just to look for other more welcoming destinations for investment.

Table 1. Covered Transactions under CFIUS

Covered Transaction Declarations and Withdrawals, 2018-2022		
Year	Number of Declarations	Declarations Withdrawn
2018	20	1
2019	94	1
2020	126	1
2021	164	0
2022	154	0
Total	558	3

Source: CFIUS – ANNUAL REPORT TO CONGRESS (2022).

2.3. Measures Adopted by Other Countries

In recent years, other developed countries have taken steps towards adopting new policies for screening FDI or strengthening their existing procedures. From 2020 to 2022, the adoption of ISMs reached its peak in the context of the COVID-19 pandemic and geopolitical tensions. This section provides an overview of the screening mechanisms adopted by a number of developed countries.

i) Canada

FDI in Canada is regulated by the Investment Canada Act (ICA) adopted in 1985⁴⁶. The regulation aims at protecting national security and providing the review of 'significant' investments in Canada by non-Canadians. This review process has the objectives of encouraging investments that promote economic growth and employment in Canada, as well as to impede those that could be detrimental to national security⁴⁷. The ICA requires that every transaction that implies acquiring control of a Canadian company or establishing a new

⁴⁶ See: R.S.C., 1985, c. 28 (1st Supp.)

⁴⁷ *Ibid.*, Section 2.

Canadian business by a non-Canadian be notified to the Investment Review Division (IRD) of the Federal government's Department of Innovation, Science and Economic Development or the Cultural Sector Investment Review Division (CSIRD).

The ICA only applies to non-Canadians; it provides for two grounds of review: 1) 'net benefit' ground and 2) national security review. In the first case, the review under 'net benefit' refers to whether the transaction to be reviewed falls under a financial threshold⁴⁸ for direct or indirect acquisition of control of Canadian entities⁴⁹. In this case, the definition of 'control' includes the acquisition of more than 50% of the voting shares of a corporation or more than 50% interest in the profits or assets of the firm. There are exceptions to these rules if the non-Canadian investor is a State-owned company and if the transaction raises national security concerns. In the second case, the national security review applies to minority investments or acquisitions of non-Canadian businesses that could be detrimental to national security. Although the government has significant discretion in assessing the impact of every investment, the number of government actions under this ground is limited.

In addition, Canada adopted a new Policy Statement for reviewing FDI in the interactive digital media sector, aimed at screening investment in this sector that could propagate disinformation or manipulate information in a manner that is injurious to Canada's national security. It also adopted a policy regarding FDI from State-owned enterprises (SOEs) in Critical Minerals which regulates the FDI from SOEs and private investors that could be tied, or subject to influence from foreign governments, "particularly non-likeminded governments"⁵⁰. Likewise, it has the objective of developing "Canada's industrial capacity and access to vital Critical Minerals, and attract major investments to develop our strategic assets from mines to manufacturing"⁵¹.

The Annual Report of implementing the Investment Canada Act⁵² shows an increase in reviews based on national security, particularly in sectors related to technology, scientific research, mining and pharmaceuticals. Nonetheless, less than 3% of reviews have a final decision to divest (see Table 2). Like in the case of the US screening, it is unclear the extent to which the low rate of negative decisions can be explained by the deterrent nature of Canadian provisions.

⁴⁸ See: Jason Gudofsky, Debbie Salzberg and Michael Cadecott, "Canada: Foreign Direct Investment Regulations", GCR, 6 December 2022. Available from <https://globalcompetitionreview.com/guide/foreign-direct-investment-regulation-guide/second-edition/article/canada> (accessed 23.03.2024).

⁴⁹ See: R.S.C., 1985, c. 28 (1st Supp.), Section 28.

⁵⁰ See: Government of Canada, Policy Regarding Foreign Investments from State-Owned Enterprises in Critical Minerals under the Investment Canada Act (October 28, 2022 – Ottawa, Ontario). Available from <https://ised-isde.canada.ca/site/investment-canada-act/en/policy-regarding-foreign-investments-state-owned-enterprises-critical-minerals-under-investment> (accessed 24.03.2024).

⁵¹ *Ibid.*

⁵² See: Ministry of Industry, *Annual Report: Investment Canada Act (2022 – 2023)*. Available from <https://ised-isde.canada.ca/site/investment-canada-act/en/home/annual-report-2022-2023#2022-23-numbers> (accessed 24.03.2024).

Table 2. Actions under National Security Review

	Review continued pursuant to s.25.2	No further action following s.25.2 notice	Investor withdrew investment following s.25.2 notice	Review extended pursuant to s.25.3 order	No further action following s.25.3 order	Investor withdrew investment following s.25.3 order	Final decision under s.25.4
2022-23	32	10	0	22	10	8	3 Divest (one review ongoing)
2021-22	24	9	3	12	7	4	None (one review ongoing)
2020-21	23	12	1	11	4	4	2 Divest 1 Block

Source: Innovation, Science and Economic Development Canada (2023)

ii) United Kingdom

The National Security and Investment Act (NSIA) of the United Kingdom entered into force in February 2022⁵³. The NSIA delegates authority to the government to scrutinise and intervene in business transactions involving foreign investors that could impact national security and block purchases of investments in firms in strategic sectors.

The review is triggered by the acquisition of more than 25% of rights or interests of an entity or assets located in, or that has a connection to, the UK, which includes land, tangible moveable property, or ideas, information, or techniques of industrial, commercial or economic value. It is also triggered if the transaction allows the investor to pass or block resolutions governing the entity's affairs or provides material influence in policy-making. If the investment is carried out in one of the 17 defined sensitive economic sectors (see Table 3), the parties to the transaction must notify the government.

⁵³ United Kingdom Cabinet Office, National Security and Investment Act 2021 (2020). Available from <https://www.gov.uk/government/collections/national-security-and-investment-act> (accessed 20.03.2024).

Table 3. Sensitive Economic Sectors under the NSIA

<ul style="list-style-type: none"> • Advanced Materials • Advanced Robotics • Artificial Intelligence • Civil Nuclear • Communications • Computing Hardware 	<ul style="list-style-type: none"> • Critical Suppliers to Government • Cryptographic Authentication • Data Infrastructure • Defence • Energy 	<ul style="list-style-type: none"> • Military and Dual-Use • Quantum Technologies • Satellite and Space Technologies • Suppliers to the Emergency Services • Synthetic Biology • Transport
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Source: UK Cabinet Office (2024)

iii) Australia

Australia's FDI screening framework is governed by the Foreign Acquisitions and Takeovers Act (FATA), adopted in 1975 and amended in 2023. The Foreign Investment Review Board (FIRB) examines the proposed investments in Australia in line with FATA. In general terms, all persons or firms interested in investing in Australia should submit information to the FIRB to allow the screening of every investment.

Besides the information required about the business plan for future investments, foreign investors must include motivations explaining why their investments will not have an impact on Australia's national security. Other investments that involve acquiring an interest in national security land, exploration tenements over national security land, in a national security business or an entity that carries on a national security business or starts a national security business must notify the FIRB before initiating any investment transaction.

Several situations impose certain conditions or require divesting any investment where national security risks emerge. This 'last resort' power is subject to several safeguards, including direct investments or interests in critical infrastructure, telecommunications, provision of security and intelligence services, media businesses and access to land.

The main purpose of Australia's foreign investment review framework is to identify the advantages of foreign investments in the face of national interests. Under this process, the FIRB can decide to block the high-risk investments that do not achieve the country's security and national interest. Nevertheless, Australia's FDI screening establishes a presumption in favour of investment from abroad, considering its contribution to the Australian national economy.

There are two particular tests applicable to FDI screening: the 'national interest test' and the 'national security test'⁵⁴. In the first case, the **national interest test** mandates the FIDR to determine whether a particular investment aligns with the national interest objectives of the State. Various factors are considered in this assessment, particularly the effects on the competition with other firms in a particular sector of the economy, the impact on tax revenues, and the background and practices of the investor, among others. This test underscores the importance of fair access to the market and reinforces the alignment of investments with national interests within this context.

⁵⁴ See: Australian Government, The Treasury, Australia's Foreign Investment Policy. Available from https://foreigninvestment.gov.au/sites/foreigninvestment.gov.au/files/2023-06/AUSTRALIAS_FOREIGN_INVESTMENT_POLICY.pdf (accessed 24.03.2024).

In the second case, the **national security test** focuses on the effects or impact of FDI on the State's national security. Under this test, the FIRB can prohibit investments contrary to national security or impose conditions to mitigate risks. As in other regimes, there is no clear definition of 'national security', which allows the FIRB to decide this process on a case-by-case basis. All investments can be screened under the national security screening if the FIRB deems it necessary within a 10-year timeframe.

iv) Japan

Japan has a long tradition in screening FDI. The Japan FDI screening mechanism was developed under the Foreign Exchange and Foreign Trade Act (FEFTA) in 1949. According to FEFTA, the Ministry of Foreign Affairs and the ministries of specific industry sectors are responsible for screening investments⁵⁵. Under FEFTA, foreign investors must notify and submit reports to government authorities when making certain investments in Japanese companies. The FDI screening process aims at identifying any possible risks to national security, public order, public health and safety, or the functioning of the market.

The FEFTA requires foreign investors to notify the Bank of Japan (BOJ) about any FDI arriving in Japan at least six months before the planned transaction date. This notification is forwarded to relevant government ministries, such as the Ministry of Finance and the Ministry of Economy, Trade and Industry (METI), for review. After a waiting period of 30 days, the investment can proceed, although this period can be extended up to five months if national security concerns arise.

During the review process, authorities assess various factors, including the impact on national security, the foreign investor's objectives regarding management and access to technology, the investor's attributes, and compliance with FEFTA and similar legislation in other jurisdictions. If the investment poses a risk to national security or other key interests, authorities may recommend changes or even order the cancellation of the transaction. Additionally, specific business sectors such as telecommunications, broadcasting, and transportation have additional restrictions on foreign investment and the appointment of foreign directors. Likewise, Japan included new "Specially Designated Critical Commodities" for securing stable supply under the Economic Security Promotion Act, designating new economic sectors as 'core business sectors'⁵⁶ (see Table 4).

Table 4. Core Business Sectors of the FEFTA (2023)

Fertilizers (potassium chloride, etc.) Importing	Permanent Magnets Manufacturing / Material Manufacturing
Machine Tools/Industrial Robots Manufacturing, etc.	Semiconductors Manufacturing of Manufacturing Equipment, etc.
Storage Batteries Manufacturing / Material Manufacturing	Natural Gas Wholesaling
Metals and Mineral Products Refining	Marine Equipment Engine Manufacturing, etc.
Metal 3D Printers Manufacturing / Metal Powder Manufacturing	

Source: Ministry of Foreign Affairs of Japan

⁵⁵ Foreign Exchange and Foreign Trade Act, Act. No. 228 (December 1949). Available from <https://www.japaneselawtranslation.go.jp/en/laws/view/4412> (accessed 24.03.2024).

⁵⁶ See: Ministry of Foreign Affairs, Foreign Exchange and Foreign Trade Act. Available from https://www.mof.go.jp/english/policy/international_policy/fdi/relateddocument_20230424.pdf (accessed 24.03.2024).

2.4. Common Characteristics of Foreign Direct Investment Screening Mechanism

The review in the previous sections permits to identify common characteristics and differences of the ISMs implemented in the EU, the United States, Canada, the United Kingdom, Australia and Japan, including a growing trend to protect broadly defined 'national security' due to concerns related to foreign influence and access to advanced technology by foreign firms.

The United States has strengthened its FDI screening mechanism established in 1975. Over time, the Committee's mandate evolved, with amendments to the Defense Production Act and the adoption of regulations defining the screening process's application to critical technologies and essential sectors. Countries like Canada, the UK, and Australia also implemented FDI screening mechanisms to safeguard national interests. These mechanisms allow government authorities to scrutinise and intervene in business transactions involving foreign investors that could impact national security. While not formally discriminatory, the intent to prevent countries, such as China, that challenge the technological supremacy of some of those countries, from getting access to advanced technology through FDI, seems to be an evident objective of the mechanisms put in place.

The ISMs established by these regulations are based on broad and ill-defined concepts of 'national security', 'national interest' or 'sensitive' sectors, thereby giving the implementing authorities a wide discretionary power to approve or not an investment proposal. Such concepts are very far from providing *objective and transparent* criteria as requested in the draft Agreement on Investment Facilitation (article 14(a)) developed by a large group of members of the World Trade Organization.

These mechanisms highlight the increasing importance placed on FDI screening to isolate selected sectors from foreign participation and deter competitors from obtaining key assets and technologies. Some common characteristics of these mechanisms include:

Common Characteristics of FDI screening

Across these countries, there is a common objective of balancing openness to FDI with safeguarding 'national security' or 'national interests', particularly in critical sectors.

Definitions of control, critical infrastructure, and national security or national interests are broad and vary but generally encompass strategic industries and technologies. Communication technologies, mining and manufacturing are the sectors most screened.

FDI screening mechanisms aim to assess the potential risks posed by foreign investments and may involve conditions or even prohibition if deemed necessary to protect national interests.

No unified approach to FDI screening, with differences in the scope, clarity and transparency in the implementation of these measures.

These regulations allow States to maintain, amend, or adopt mechanisms to screen FDI and outline factors to consider during the screening process, such as critical infrastructure, advanced technologies, and the impact of FDIs in particular sectors.

However, the mechanisms established by some of those countries not only regulate FDI in critical sectors such as technology, infrastructure, and sensitive industries but also aim to balance the benefits of FDI with their national development objectives. For example, the

European Union's approach considers the need to act collectively to address challenges and opportunities arising from globalisation, emphasising the need to increase jobs, growth, and investment while also addressing concerns about foreign investment, especially from State-owned enterprises.

Foreign Direct Investment Screening Mechanisms and Sustainable Development

The 2030 Agenda for Sustainable Development recognises that investment and innovation are significant drivers of productivity and highlights the need for increasing investment in inclusive economic growth, poverty eradication, technology development, renewable energy, and infrastructure to attain the Sustainable Development Goals (SDGs)⁵⁷.

Although FDI is essential for implementing the SDGs, it comes with the condition that such investment aligns with developing and least-developed countries' development plans and programmes⁵⁸. While recent literature identifies that FDI supports economic growth, mainly through the participation in global value chains (GVCs) by emerging and small economies⁵⁹, such participation has been commonly limited to low-value-added activities⁶⁰ rather than enhancing local firms' technological and industrial capacities. Therefore, FDI flows alone cannot achieve inclusive development; a direct link with other complementary elements is needed to achieve tangible benefits in host economies, including increasing schooling rates, human capital, and financial depth.

The past decade has seen an increase in the adoption of ISMs⁶¹. As elaborated on above, these mechanisms have been mainly adopted with the aim of protecting broadly interpreted national security or interests from economic transactions related to sensitive sectors of the economy⁶². However, ISMs can potentially be used to channel FDI in a way that promotes sustainable development and the achievement of national development objectives, including environmental conservation, just transition, and economic resilience. However, to do so, it is necessary to explore the different criteria that States should consider for achieving a balance between ISMs and investment promotion policies. As noted, the EU mechanism provides an example of an ISM clearly linked to industrial policy objectives (see Box 3).

⁵⁷ See: United Nations, Transforming our world: the 2030 Agenda for Sustainable Development, UN Doc. A/Res/70/1 (2015).

⁵⁸ *Ibid.*

⁵⁹ See: Agustín Bénétrix, Haley Pallan and Ugo Panizza, "The Elusive Link Between FDI and Economic Growth", World Bank Group, Policy Research Working Paper 10422 (April 2023), p. 3.

⁶⁰ *Ibid.*, p. 25.

⁶¹ United Nations Trade and Development (UNCTAD), "Outward FDI Policies: Promotion and Facilitation – Regulation and Screening", Investment Policy Monitor, Issue 27 (February 2024), p. 1. Available from https://unctad.org/system/files/official-document/diaepcbinf2024d1_en.pdf (accessed 24.03.2024).

⁶² *Ibid.*

Box 3. Priorities of the European Economic Security Strategy

- **Promoting** our own competitiveness by making our economy and supply chains more resilient bolstering innovation and industrial capacity, while preserving our social market economy. This can be achieved by deepening the Single Market, investing in the economy of the future through sound macroeconomic and cohesion policies, NextGenerationEU, investing in human capital including by upskilling the European workforce. It will require diversifying sources of supply and export markets, or fostering the research and industrial base in strategic areas such as advanced semi-conductors, quantum computing, biotechnology, net-zero industries, clean energy or critical raw materials.

Source: European Commission, Joint Communication to the European Parliament and the European Council (2023)

2.5. Foreign Direct Investment Screening and Industrial Policy

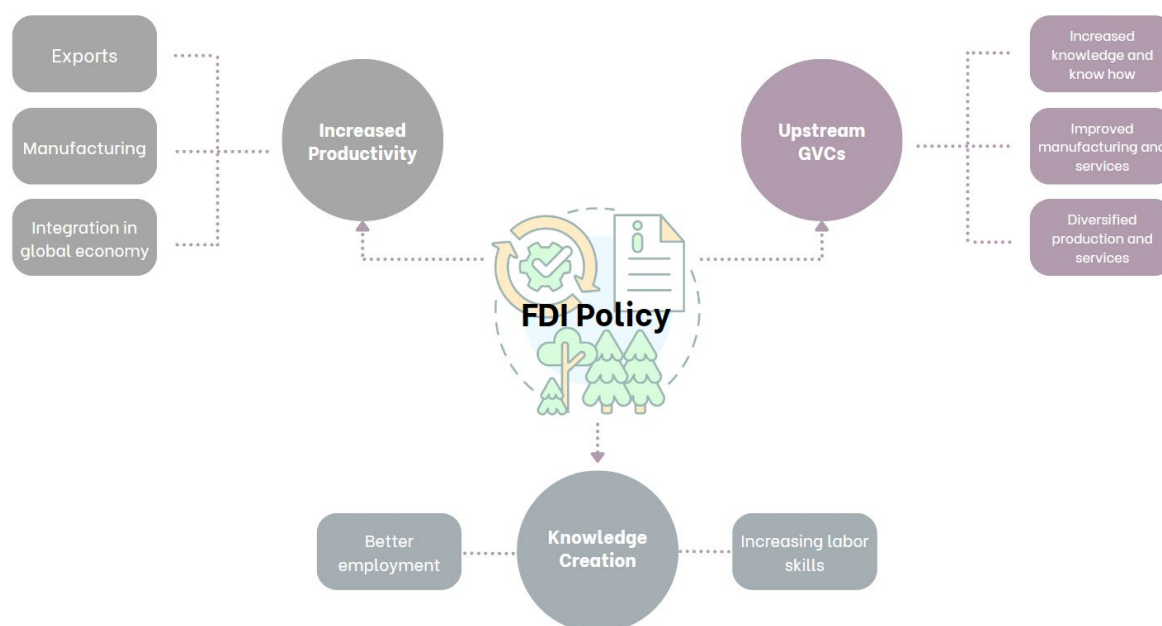
The recognition that investment liberalisation alone is insufficient to achieve economic growth has placed increasing attention on the possible benefits of industrial policy to boost developing countries' exports and participation in high-value-added activities of GVCs⁶³. While liberalisation of FDI assumes that allowing foreign firms and capital to enter the local markets could contribute to development almost automatically with minimum or non-participation of the government, the experience has shown that the government's role in guiding such investment towards development objectives is essential⁶⁴.

Indeed, the benefits of FDI are not automatic but require the 'right mix' of policies to influence the spillovers of FDI for the benefit of the economy and the development of host economies⁶⁵. The policies adopted by States could differ depending on the objectives identified and include actions directed towards increasing productivity in domestic firms, participation in upstream activities of GVCs, transfer and creation of knowledge, better employment and increasing labour skills (see Figure 6).

⁶³ Stephen R. Buzdugan and Heinz Tüselmann, "Making the most of FDI for development: "new" industrial policy and FDI deepening for industrial upgrading", *Transnational Corporations*, Volume 25, No. 1 (2018), p. 5.

⁶⁴ See: Arianto A. Patunru, "Industrial Policy makes a comeback in East Asia", East Asia Forum, 22 December 2023. Available from <https://eastasiaforum.org/2023/12/22/industrial-policy-makes-a-comeback-in-east-asia/> (accessed 20.03.2024).

⁶⁵ Roberto Echandi, Jana Krajcovicova and Christine Zhenwei Qiang, "The Impact of Investment Policy in a Changing Global Economy: A Review of the Literature", World Bank Group, Policy Research Working Paper 7437 (October 2015), p. 30. Available from <https://documents1.worldbank.org/curated/en/664491467994693599/pdf/WPS7437.pdf> (accessed 20.03.2024).

Figure 6. Possible Objectives of Foreign Direct Investment Policies

Source: South Centre (2024)

Experiences from countries of different levels of development have evidenced the role of industrial policy as a tool to support industrial upgrading, structural transformation, and sustainable development⁶⁶. Foreign direct investment also has a role in supporting these objectives. For example, the use of policy measures to increase FDI spillovers in different sectors of the economy can upgrade capacity of production, as well as promote labour skills and better employment if FDI is integrated into local firms, allow for the transfer of technology and expertise (see Box 4). Thus, a linkage between industrial policies and FDI can help the industrial upgrading of local firms⁶⁷.

Box 4. China's Experience in the Car Industry

At the beginning of 1980, China introduced the Law on Joint Venture Using Chinese and Foreign Investment to attract and integrate foreign technology and capital into their domestic firms, particularly in the automotive sector. Some of the biggest foreign automotive companies investing in China were American Motors Corporation, Volkswagen and Peugeot. In 1994, China established the Automotive Industry Policy, which required foreign automakers to sign joint venture agreements with Chinese industries and limit foreign ownership. Under these agreements, local firms benefitted from technology transfer and labour skills. In line with the "Made in China 2025" strategy, China aimed to expand its production globally. By 2022, China sold more than 6.884 million units of Electric Vehicles globally, representing almost 63.6% of the global share.

Source: Yueyuan Selina Xue and Others, China's automotive odyssey: From joint ventures to global EV dominance, Innovation, IMD (2024).

⁶⁶ See: Justin Yifu and Volker Treichel, "Making Industrial Policy Work for Development", in *Transforming Economies*, José Manuel Salazar-Xirinachs, Irmgard Nübler and Richard Kozul-Wright, eds. (Geneva, International Labour Organization, 2014), p. 72. Available from https://www.ilo.org/wcmsp5/groups/public/---dgreports/---inst/documents/publication/wcms_315667.pdf (accessed 20.03.2024).

⁶⁷ See: Buzdugan and Tüselmann, *op. cit.*, p. 7.

A well-designed and structured industrial policy can transform the economy towards promoting new opportunities for small and medium enterprises (SMEs) to access new capital and opportunities for innovation. Still, it will also require changes in infrastructure and institutions⁶⁸ to ensure consistency, efficiency, and coordination in government policies. ISMs can act as a bridge to coordinate investments towards industries and sectors that require significant attention for catalysing economic diversification by incubating nascent industries or attracting foreign direct investment towards sectors defined in national development plans and objectives⁶⁹.

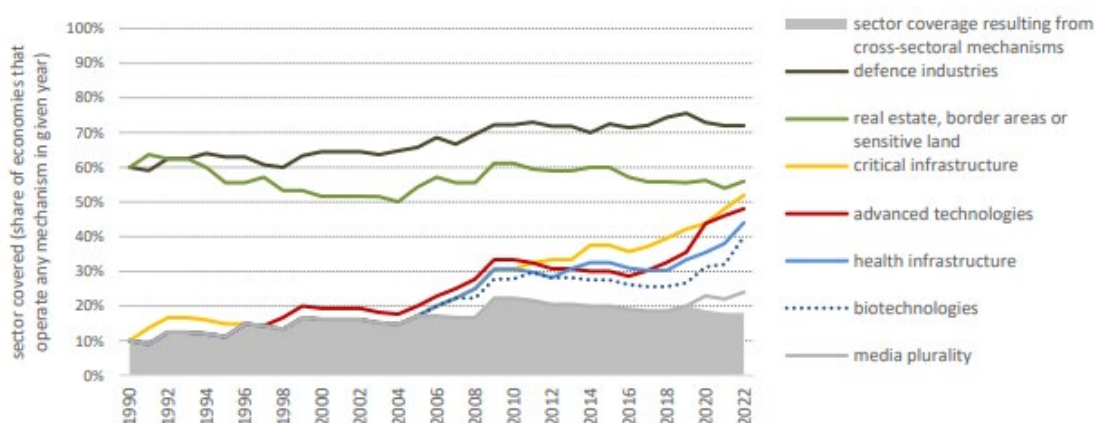
2.6. Promoting Diversification and Sustainable Industries

Investment screening mechanisms can incentivise economic diversification and industrial development by favouring investments in sustainable industries, such as renewable energy, clean technology, and sustainable agriculture, among others. These industries could offer opportunities for economic diversification while supporting environmental and social objectives, including the active participation of communities and populations affected by such investments.

FDI screening mechanisms could focus on facilitating the transfer and advancement of technology to harness its benefits, including capacity building, promoting high-value-added activities in the economy, and participating in higher levels of global value chains⁷⁰.

Guaranteeing that FDI fosters diversification towards sustainable industries would allow countries to promote sustainable investment in infrastructure, education, research and development (R&D), and support emerging industries. For example, the evolution of coverage of health-related sectors by investment screening in OECD countries from 1990 to 2020 (see Figure 7) demonstrates the increasing use of ISMs in cross-sectors, including critical infrastructure, culture and science, technology development, energy transition, transport and communication⁷¹.

Figure 7. Sector Coverage of Policies to Manage Security Implications of Foreign Investment (selected sectors, 1990-2022)



Source: OECD (2023)⁷²

⁶⁸ See: Yifu and Treichel, *op. cit.*, p. 70.

⁶⁹ *Ibid.*, p. 71.

⁷⁰ See: Buzdugan and Tüselmann, *op. cit.*, p. 13.

⁷¹ UNCTAD, *World Investment Report (2023)*, Chapter II, p. 64. Available from https://unctad.org/system/files/official-document/wir2023_ch02_en.pdf.

⁷² See: OECD, *Freedom of Investment Process (2023)*. Available from https://www.oecd.org/content/dam/oecd/en/publications/reports/2023/01/investment-policy-developments-in-61-economies-between-16-october-2021-and-15-march-2023_e848f96a/d93a49bc-en.pdf.

2.7. Risk Assessment and Resilience

ISMs can also become critical tools for countries to assess and manage risks associated with FDI. Given the current extent of globalisation of the economy, ISMs can significantly contribute to enhancing resilience and safeguarding national interests, particularly considering the current economic, environmental, and geopolitical uncertainties the world is facing.

ISMs may allow countries to identify and assess potential risks associated with incoming investments. By assessing the investor's track record, the nature of the investment, and its potential impact on and benefits to the economy, countries can also proactively identify and mitigate risks that may threaten economic stability and sovereignty⁷³.

ISMs can serve as a component of a strategy to direct FDI towards sectors that enhance domestic capabilities and competitiveness. Countries could build resilience against external shocks and market fluctuations, through mitigating risks associated with supply chain vulnerabilities, thereby strengthening the resilience of key industries⁷⁴.

Along these lines, countries can consider the role of ISMs in supporting their risk assessment and resilience-building efforts. These mechanisms can help to identify and manage risks and align investments with sustainable development objectives. By following this approach, ISMs can contribute to building stronger, more resilient economies better equipped to withstand global challenges and uncertainties.

2.8. Climate Action and FDI Screening Mechanisms

Climate change poses significant risks to economies, industries, and communities worldwide. Its impacts range from extreme weather events to disruptions in supply chains and natural resource scarcity⁷⁵. ISMs could allow countries to assess the risks associated with incoming investments, such as vulnerability to physical climate impacts, exposure to regulatory changes, and risks related to energy transition, and take informed decisions to safeguard against potential liabilities and negative impacts on local environments and communities.

Including considerations for promoting climate action into FDI screening processes could allow countries to support energy transition and advance sustainable development goals. It could also allow specialised agencies to consider the best means to channel new investments towards renewable energy, energy efficiency, sustainable transportation, and climate-resilient infrastructure⁷⁶. In addition, screening mechanisms could encourage investors to adopt climate-friendly practices and technologies, driving innovation and competitiveness in climate-friendly industries.

FDI screening mechanisms would also serve as a tool for ensuring that FDI adhere to climate-related commitments and standards, allowing countries to increase policy coherence and international cooperation on climate change mitigation and adaptation. Furthermore, FDI

⁷³ See: OECD, "Investment Screening in Times of COVID-19 and Beyond" (2020), p. 2. Available from https://read.oecd-ilibrary.org/view/?ref=135_135247-ai6t8nmwlr&title=Investment-screening-in-times-of-COVID-and-beyond.

⁷⁴ Wouter Scherpenisse, Evert Stamhuis and Alberto Quintavalla, "Investment Screening Against Strategic Cyber Risks", *Erasmus Law Review*, Issue 4 (2022), p. 290.

⁷⁵ Renée Cho, "How Climate Change Impacts the Economy", *State of the Planet*, Columbia Climate School, 20 June 2019. Available from <https://news.climate.columbia.edu/2019/06/20/climate-change-economy-impacts/>.

⁷⁶ See: Mikko Rajavuori and Kaisa Huhta, "Investment screening: Implications for the energy sector and energy security", *Energy Policy* 144 (2020), p. 4.

screening processes that integrate climate criteria can support countries' efforts to fulfil their nationally determined contributions (NDCs) under the Paris Agreement and other commitments under the United Nations Framework Convention on Climate Change (UNFCCC) while respecting the principle of common but differentiated responsibilities and respective capabilities (CBDR-RC).

CONCLUSIONS AND RECOMMENDATIONS

The number of countries implementing Investment Screening Mechanisms (ISMs) has increased since 1995, especially after the 2008 financial crisis and the COVID-19 pandemic. The practices and experiences examined in this paper allowed for identifying the key elements that define investment screening, which involve assessing, conditioning, or prohibiting FDI based on various grounds or objectives commonly related to national security or public order. At the same time, ISMs have been based on a vague concept of 'national security' as their main objective has been to prevent foreign companies (mainly from China) from accessing critical assets such as advanced technology for semiconductor production.

Nonetheless, a balanced approach to FDI screening mechanisms that align with industrial policy objectives can contribute to inclusive economic growth and sustainable development. This involves implementing policies that promote strategic investment while supporting the growth and development of domestic industries. The relationship between industrial policy and FDI screening mechanisms is essential for achieving economic growth.

Effective industrial policies can support industrial upgrading, structural transformation, and sustainable development. A well-designed industrial policy can also facilitate opportunities for SMEs, innovation, and economic diversification. In this sense, investment screening mechanisms can complement industrial policy by coordinating investments towards priority sectors outlined in national development plans. Policymakers could consider the following recommendations:

- i. **Balanced Approach:** ISMs should promote investments that contribute to economic growth, job creation, and innovation. Striking a balance between openness and selectivity in investment is crucial.

This will require countries to incorporate criteria in their FDI screening mechanisms that prioritise investments aligning with SDGs, such as those related to sustainable industries, renewable energy, clean technology, and sustainable agriculture. This alignment can promote economic diversification while supporting environmental and social objectives.

- ii. **Non-discriminatory and transparent ISMs:** The criteria adopted to apply ISMs should ensure non-discriminatory treatment and transparency. This involves uniformly applying ISMs to all foreign investors, regardless of nationality, and publicly disclosing screening procedures and criteria. Additionally, international cooperation should be promoted to share best practices on the implementation of ISMs.
- iii. **Policy Coherence and Information Sharing:** ISMs should consider the potential impact of investment on national policies and be implemented in a way that is coherent with these policies. This can contribute to align FDI flows with the development objectives of the host State.
- iv. **Continuous Monitoring and Evaluation:** Regular monitoring and evaluation of ISMs should be conducted to assess their impact on national security, economic growth, and other relevant factors and make necessary adjustments to improve their performance over time.
- v. **Safeguarding the Right to Regulate:** Investment agreements and investment regulatory frameworks should safeguard the right to regulate of States to

accommodate new developments while robustly safeguarding critical sectors and infrastructure.

- vi. **Climate Action into Screening Processes:** States should consider incorporating considerations for promoting climate action into FDI screening processes. This involves assessing the risks and opportunities associated with investments in relation to climate change, such as vulnerability to physical climate impacts and exposure to regulatory changes.

FDI screening mechanisms could serve as a tool for encouraging investments in renewable energy, energy efficiency, sustainable transportation, and climate-resilient infrastructure, allowing countries to advance their climate goals while attracting foreign investment.

- vii. **Support Innovation and Technology Transfer:** ISMs can also be designed to promote innovation and technology transfer in key sectors, such as clean energy and biotechnology and to increase the participation of developing countries' SMEs in high-value-added activities and global value chains.

In summary, implementing ISMs may serve as an important tool for promoting and facilitating quality investments and reducing and managing risks associated with incoming investments. They can support countries' efforts to implement the SDGs and climate action and enhance their economic resilience in the face of current and future crises.

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