



CELIS Issue Note on Investment Screening in Defense Sector: Promoting National Security and Neoliberalism

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Introduction

The panel related to investment screening within the defense sector seeks to navigate with a diverse group of panelists the thorny and seemingly irreconcilable issues inherent in a sector where the chief objective is protecting against foreign threats. Particularly, there are three strategic issues that stand out and which require CFIS 24's attention:

- a. What defines a country's defense sector?
- b. How comprehensive must investment screening reviews and mitigation plans be to de-risk foreign influence within supply chains?
- c. How can countries promote innovation amidst this increasingly expansive regulatory environment?

Scope: Defining a Country's Defense Sector

Understanding the trajectory of investment screening in the defense sector requires a definitional scoping of the subject matter. Namely, a country must decide which types of transactions, in terms of nature and industry, fall under the specter of its defense sector. This determination becomes challenging when products and services surrounding a foreign merger and acquisition have dual-use purposes. As mentioned in the background paper, quantum computing and artificial intelligence offer promising civilian applications. For example, at Texas A&M University in the United States, researchers used quantum computing to map gene regulatory networks.¹¹ In turn, the knowledge gained from knowing which genes will affect other ones will help scientists look for ways to stop harmful cellular processes, such those

¹¹ Courtney Price, *Researchers Use Quantum Computing To Predict Gene Relationships*, TEX. A&M TODAY (Nov. 20, 2023), <https://today.tamu.edu/2023/11/20/researchers-use-quantum-computing-to-predict-gene-relationships/>.



related to cancer growth.¹² At the same time, there are military applications, such as tracking enemy submarines, that can yield a country a decisive advantage in a future conflict.¹³

While the public can understand why critical technologies, such as the example provided, fall under a country's defense sector, other items may have less intuitive dual-use applications. Namely, the U.S. Bureau of Industry and Security's Commerce Control List requires licenses for parachutes.¹⁴ With each country having the purview to define the scope of its own defense sector, discrepancies may likely exist among investment screening regimes, in which a transaction occurring in one sovereign jurisdiction may elicit concern whereas it would not in another.

Consider investment screening regimes in France. It is one of a handful of advanced European economies that take a liberal, broader view regarding defense.¹⁵ For example, in the context of investment screening, French legislation recently amended the definition of public security sector to cover prison security services, a perspective that other European nations, like Germany, do not hold.¹⁶ Normally, such dissimilarity is banal—a reality of independent nations operating within the international system. However, the European Union is different. Each member state has voluntarily ceded some of its own sovereignty in pursuit of the group's collective interests. Thus, the lack of harmonization among members' investment screening regimes when it comes to defining the "defense" sector impedes achieving the collective goal of protecting against malign influence threats from foreign ownership control.

Arriving at a near-universal understanding of what constitutes the "defense" sector involves informal conversations and formalized consultations within multilateral organizations, such as the European Union. Undoubtedly, tensions will arise between countries oriented to a trade-first agenda and those prioritizing security matters. However, not addressing this issue fundamentally suspends investment screening regimes proverbially in a cryogenic stasis,

¹² Id.

¹³ See Kelley M. Saylor, *Defense Primer: Quantum Technology*, Cong. Rsch. Serv. (2023), <https://crsreports.congress.gov/product/pdf/IF/IF11836>.

¹⁴ "9A018 Equipment on the Wassenaar Arrangement Munitions List" in *Commerce Control List: Category 9—Aerospace and Propulsion*, U.S. BUREAU OF INDUS. & SEC. (Dec. 08, 2023), <https://www.bis.doc.gov/index.php/documents/regulations-docs/2340-ccl9-4/file>

¹⁵ See footnote 5 in Lorenzo Bencivelli et al., *Who's Afraid of Foreign Screening?*, BANQUE DE FRANCE (Working Paper No. 927, Oct. 2023), <https://www.banque-france.fr/system/files/2023-11/DT927.pdf>.

¹⁶ Aline Doussin et al., *French Government Extends the Scope of Application of the French Foreign Direct Investment Screening Regime*, HOGAN LOVELLS (Jan. 16, 2024), <https://www.engage.hoganlovells.com/knowledgeservices/news/french-government-extends-the-scope-of-application-of-the-french-foreign-direct-investment-screening-regime>.



unable to adapt to emerging technologies that modify or even redefine security relationships. In turn, CFIS 24 offers the perfect forum to discuss how to properly scope what constitutes the defense sector given the various government officials attending, each of whom can offer a unique perspective on resolving this issue.

Means: Mitigating Foreign Influence Risks in Supply Chains

Independent of scope, how to conduct an investment screening review deserves its own consideration. Specifically, countries have come to terms with their own threshold for determining when a sufficient review has been conducted and the proper mitigation actions have been implemented. Namely, full certainty that a malign actor cannot gain influence or leverage into a domestic company via the foreign merger or acquisition is an unattainable goal. The multiple layers and networks comprising of a supply chain provide capable adversaries with access to data and information at multiple points, establishing advanced, persistent, and multifaceted threats related to control, subversion, and corporate espionage for nearly any goods or services company.¹⁷

At the same time, without full knowledge that an investment screening regime can sufficiently mitigate the national security risks of a foreign investment transaction, governments must balance security and economic growth. On the one hand, an underinclusive review and/or mitigation plan would expose critical sectors to foreign influence threats. For example, a government that gained foreign ownership control of a company, even if small and indirect, could manipulate the necessary components intended for a particular defense system.¹⁸ Such exploitation can degrade the other country's defense capabilities and effectiveness during potential conflicts.¹⁹ On the other hand, an overinclusive review and/or mitigation plan may ward off a prospective investor, hurting the economic growth of the inbound investment country. For example, in 2022, 57% of the notices (up from 48% in 2021) filed with the Committee on Foreign Investment in the United States involved an extended review (e.g. the second 45-day "investigation" phase).²⁰ Correspondingly, there was an increase in the number

¹⁷ See page 1 of *Supply Chain Risk Management*, NAT'L COUNTERINTELLIGENCE AND SEC. CTR. SUPPLY CHAIN DIRECTORATE (Mar. 17, 2017), [20170317-NCSC-SCRM-Background.pdf \(dni.gov\)](https://www.dni.gov/files/20170317-NCSC-SCRM-Background.pdf).

¹⁸ See page 1 of *Exploitation of Global Supply Chain*, DEF. SEC. SERV. & NAT'L COUNTERINTELLIGENCE AND SEC. CTR., [Exploitation of Global Supply Chain.pdf \(odni.gov\)](https://www.odni.gov/files/20170317-NCSC-SCRM-Background.pdf).

¹⁹ *Id.*

²⁰ David N. Fagan et al., *CFIUS Annual Report Shows Transactions Facing Longer Road to Approval*, Covington & Burling LLP (Aug. 7, 2023) <https://www.cov.com/en/news-and-insights/insights/2023/08/cfius-annual-report-shows-transactions-facing-longer-road-to-approval#layout=card&numberOfResults=12> (referencing CY 2022 *Annual Report to Congress*, COMM. ON FOREIGN INV. IN THE UNITED STATES, https://home.treasury.gov/system/files/206/CFIUS%20-%20Annual%20Report%20to%20Congress%20CY%202022_0.pdf).



of withdrawals from companies that did not end up refiling a notice (from 9 in 2021 to 20 in 2022).

Determining the level of comprehensiveness that investment screening reviews should assume or the obligatoriness of the mitigation steps the prospective acquiring company should take requires dialogue among governments, multinational companies, law firms, and academics. Without a shared understanding of each participant's perspective, an investment screening approach and mitigation plan would be fully biased in favor of what the government, who owns and operates this apparatus, wants—naturally predisposed toward national security. If this issue is not resolved, the private sector faces uncertainty as to how long an investment screening will take or even whether an investment screening regime will approve a transaction (or subject it to remedies). In turn, investors are likely to change the mix of which countries as well as what to invest.²¹ With government, academia, and the private sector taking part in CFIS 24, this conference can shine a spotlight on how countries have adapted the depth and breadth of investment screening reviews and mitigation to meet the growing expansion of transactions with national security implications.

Effects: Promotion of Innovation in Defense Sector Amidst Regulation

Enhanced investment screening reviews and mitigation plans within the defense sector likely puts innovation at risk. Notably, mergers and acquisitions within the defense sector reduce the barriers to invest in research and development (R&D) projects and allow for companies to enhance their capabilities by partnering with others that offer complementary or supplementary competences. In fact, the U.S. Chamber of Commerce found that such investments positively correlate to an average increase, over three to four years, in industry-level R&D expenditure of between USD 299 million and USD 436 million in R&D intensive industries, such as the defense sector.²² Without long-term, sustainable R&D, maintaining technological advantages that afford military superiority for a nation state becomes difficult. At the same time, this concern becomes moot if foreign adversaries utilize foreign transactions to gain control and thus access to patented technologies. In turn, they would become the ones who reap the benefits of R&D while only incurring minimal costs.

²¹ Tim Figures et al., *Navigating the Rise in Foreign Investment Screening*, BOSTON CONSULTING GRP. (Jan. 05, 2024), <https://www.bcg.com/publications/2024/navigating-the-rise-in-foreign-direct-investment-screening>.

²² *Mergers, Industries, and Innovation: Evidence from R&D Expenditure and Patent Applications*, U.S. CHAMBER OF COM. (Feb. 07, 2023), <https://www.uschamber.com/antitrust/mergers-industries-and-innovation-evidence-from-r-d-expenditure-and-patent-applications>.



Encouraging innovation amidst this regulatory regime requires industry firms and government officials to find common ground in their positions and use those similarities to navigate and resolve points of contention. Since both actors value innovation, albeit for different reasons (firms for profits and governments for military superiority), any disagreement in the economic growth-versus-security debate should center around whether the investment regime promotes innovation. If it does not, then the government should refine the process and/or requirements. CFIS 24 can highlight the necessity of innovation in the defense sector and participants can discuss about the collaboration that occurs between government officials and the private sector when approaching investment screening reviews.

Conclusion

CFIS 24 offers a unique opportunity to advance the debate about how a country's investment screening regime within the defense sector evolves in this current era so that the country can meet the rapidly changing threat landscape, which over the last few years has moved from non-states being the focus to countries as the driver of competition and conflict. Hosting this panel will allow for various perspectives to be heard and consensus to be built on how to resolve these strategic issues within the next two to five years.