If You Can't Beat Them, Join Them:
The Rise of Investment Screening in Europe in Comparative Perspective

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Investment screening, the process by which national governments review whether particular foreign investment transactions generate risks to essential security, is finally having a moment in Europe. Since the European Union (EU) created its own investment screening framework in 2019, almost all Member States have reinforced, adopted, or discussed adopting a national Investment Screening Mechanism (ISM). European countries are thereby joining the growing list of advanced industrial democracies on other continents with robust investment screening regulations and practice.

This article analyzes the growth of investment screening in Europe in a broader global context. First, we show how recent policy developments in Europe fit with the way governments regulate inward foreign direct investment (FDI) in other countries. Then we highlight global patterns in investment screening regulations. Third, we explain these recent developments worldwide by focusing on three factors: the rise of China as an outward investor, technological change expanding the security implications of most goods and services, and the diffusion of investment screening norms. Finally, we reflect on the consequences of this recent expansion of investment screening.

1. The recent expansion of investment screening

The recent adoption and expansion of investment screening in Europe has taken place within a broader context of proliferation and reinforcement of investment screening across the world. What may seem like novel regulatory tools in many European countries have actually been used elsewhere for many years, even decades.[1]

Investment screening is not a new phenomenon. Indeed, states around the world 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.

[1] See Bauerle Danzman, Sarah and Sophie Meunier. forthcoming. "Mapping the Characteristics of Foreign Investment Screening Mechanisms: The New PRISM Dataset", *International Studies Quarterly*

Most countries drastically reduced these restrictions through the 1980s and 1990s as FDI was liberalized, though lower- and middle- income countries were generally slower to do so.[2].

Investment screening, however, is distinct from these kinds of investment restrictions. It is the practice by which governments review inward FDI transactions and deny entry to, or require the divestment of, investments that are deemed unacceptable. Investment screening mechanisms are routinized legal processes of investment screening on the basis of predetermined criteria. ISMs, which allow "acceptable" transactions while preventing entry of undesirable investors or the sale of specific sensitive assets to foreigners, can be compatible with liberal investment flows.

In the post-World War II era, many countries screened inward investment *on economic grounds*, based on whether the reviewed transaction would generate a 'net economic benefit' to the host economy. Over time, most states abandoned economic investment screening, seen as overly restrictive, and welcomed FDI because it provides jobs and spillovers in know-how and technological innovation. What is new is the recent multiplication and expansion of ISMs based *on national security grounds*.

The post-liberalization history of FDI screening practices in advanced economies is characterized by the slow, haphazard emergence of varied review mechanisms throughout the late 20th century, followed by rapid acceleration and proliferation in the 21st century. FDI screening measures have been paradoxically most developed, and for the longest time, in the neo-liberal, anti-statist United States. The Committee on Foreign Investment in the United States (CFIUS), created in 1975 to oversee the national security implications of FDI, has become the gold standard of ISMs. Its powers to review FDI have gradually expanded in the 1980s, 2000s, and most recently in 2018 with the bipartisan Foreign Investment Risk Review Modernization Act (FIRRMA). Other ISMs that have been in place for decades and recently expanded are Australia's Foreign Investment Review Board (FIRB) and Canada's Investment Canada Act (ICA).

The creation of investment screening mechanisms in several EU countries, such as France and Germany, in the 2000s, followed by the creation of the EU investment screening framework in 2019 and the subsequent launch of ISMs in most Member States follow in the footsteps of these policies and practices developed over several decades on other continents.

2. Global patterns in investment screening regulations

In order to compare how different countries have screened foreign investment at various points in time, we have created the Politics and Regulation of Investment Screening Mechanisms (PRISM) dataset. To our knowledge, this is the first comprehensive dataset on screening laws in all 38 OECD countries from 2007-2021, including qualitative coding across a range of characteristics, such as

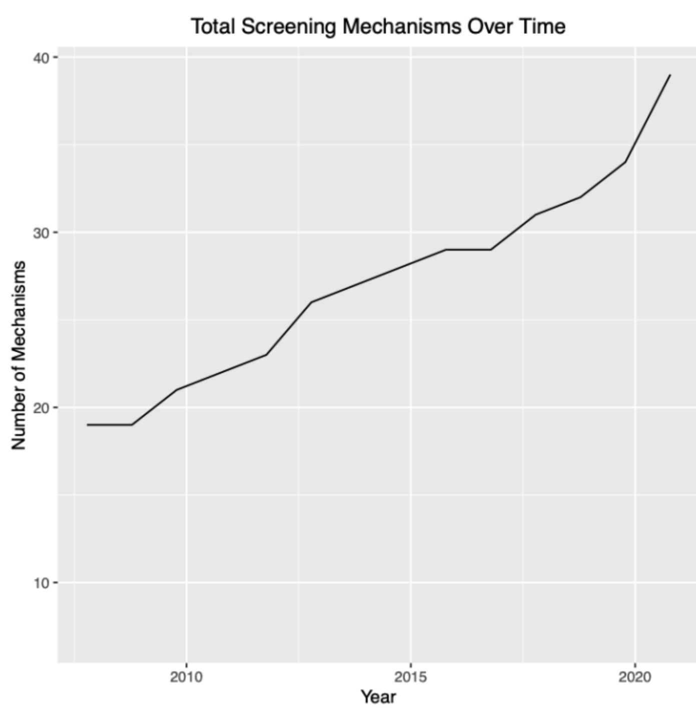
[2] Pandya, Sonal S. 2014. "Democratization and Foreign Direct Investment Liberalization, 1970–2000." *International Studies Quarterly* 58(3)475–488.

scope of the sectors covered, thresholds in value and ownership stake, foreign government ownership, and monitoring and enforcement.[3] Based on the insights from the dataset, we observe three major patterns in the global evolution of investment screening over the past fifteen years.

The rise of investment screening related to national security

The first pattern observed is that the passage of investment review mechanisms and updates to existing laws have seen a dramatic increase in recent years. As shown on Figure 1, ISMs have almost doubled in OECD countries since 2007. These new mechanisms are almost universally based on national security. Among updated mechanisms, some continue to have net economic benefits tests, but recently created screening tools unrelated to national security concerns are rare. While governments have enacted investment review-related measures at an increased rate since the onset of COVID, this represents an acceleration of a trend rather than a major shift.

Figure 1: OECD ISMs Have Doubled Since 2007



Source: PRISM Dataset, Bauerle Danzman and Meunier, forthcoming

The expansion of scope covered by investment screening

The second noticeable pattern is that ISMs have increased their scope of coverage over time. First, more countries have adopted cross-sectoral instruments, which provide governments with broad

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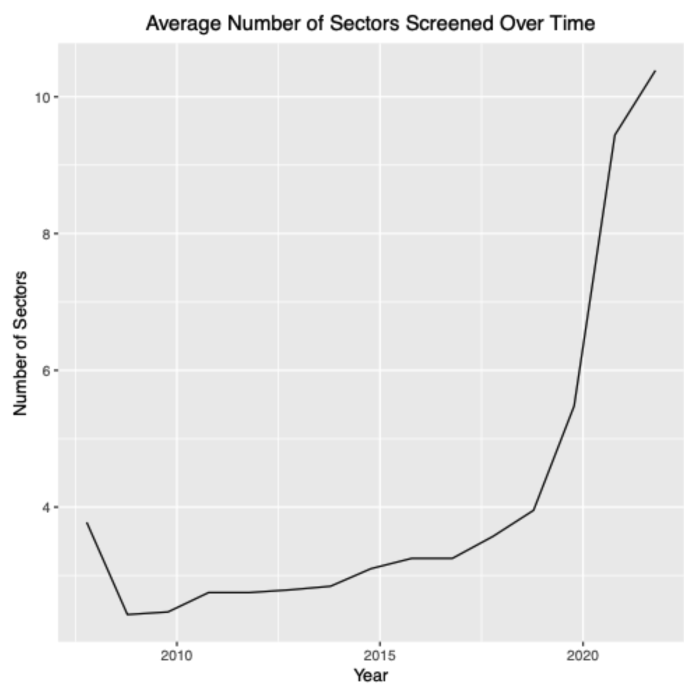
[3] For more detail about the dataset and coding choices, see Bauerle Danzman, Sarah and Sophie Meunier. forthcoming. "Mapping the Characteristics of Foreign Investment Screening Mechanisms: The New PRISM Dataset", *International Studies Quarterly*

review authority over FDI regardless of sector. While initial national security-related concerns over FDI were narrowly focused on foreign influence in defense contracts, governments have expanded national security concerns to critical infrastructure, food security, data security, and dual-use technology. With cross-sectoral screening, which leaves the definition of national security vague, governments do not need to update sectoral lists as views about what sectors may generate risks evolve. Second, some countries - including many EU member states - screen transactions only in specific sectors, but they have expanded the number of sectors subject to review. As shown on Figure 2, which charts this change over time, the average number of sectors screened in OECD countries has more than doubled since 2007.

Figure 2: The Average Number of Sectors Screened have more than Doubled over Time



Source: PRISM Dataset, Bauerle Danzman and Meunier, forthcoming

<u>The lowering of screening thresholds</u>

The third noticeable pattern has been the lowering of screening thresholds and the review of increasingly smaller transactions, measured both in terms of absolute valuation and as percentage of deal size. Many governments set screening thresholds at a specific economic interest percentage of an asset or investment. Countries with mandatory screening sometimes also have size thresholds to avoid subjecting very small transactions to review. Some countries, including the U.S., focus on the concept of "control" rather than set specific ownership thresholds. This allows governments to assess how corporate governance structures may afford an investor with significant control over a company even with a relatively small ownership stake. We also observe more mechanisms requiring mandatory filing requirements over time, particularly in a core area of strategic concern: critical technology, critical infrastructure, and entities that collect and store substantial sensitive personal data of their customers or users.

3. Explaining the expansion of investment screening

Why have investment screening regulations been tightening and expanding so rapidly and drastically in many countries in recent years? And why has Europe been a laggard in adopting these investment screening practices until the last few years? We present three complementary explanations rooted in the rise of new foreign investors, technological change, and regulatory diffusion.

The rise of new foreign investors

The first obvious explanation for the recent expansion of investment screening in many OECD countries has been the recent rise of new foreign investors, above all China. Many of these investment screening regulations have been created or reinforced in direct reaction to the rapid rise of China as a foreign direct investor from the late 2000s until 2016.

The emergence of a new source of foreign investment has historically been regarded by host countries with apprehension, if not downright hostility. The worries surrounding investment by American multinationals in France in the 1960s or Latin America in the 1970s are illustrations of this phenomenon. As the history of investment screening in the US confirms, each successive institutional innovation in the CFIUS process happened in response to the emergence of a new foreign investor: the OPEC countries in the 1970s, Japan in the 1980s, sovereign wealth funds of oil-rich Arab states after 9/11, and China beginning the 2000s. Indeed, the rise of China as a foreign investor, reflecting the broader ascention of China in geopolitics, has coincided with the proliferation and tightening of ISMs worldwide in recent years, though few of these screening mechanisms are overtly discriminatory towards any particular country. Indeed, an ISM that discriminated against specific countries would likely be in violation of WTO commitments.

Some reasons why novel sources of foreign investment are interpreted as threatening and may prompt changes to investment screening procedures are generalizable across historical cases. For one, people in host countries are often suspicious of new foreign actors, which is consistent with the long-held concepts in the management literature about the 'liability of foreignness' and the 'costs of doing business abroad.'[4] Second, new sources of foreign investment may be feared more if the institutional and cultural distance between host and home country is large. Third, novelty seems especially threatening when the change is happening fast, as has been the case with Japanese investment in the 1980s and Chinese investment in the 2010s. Fourth, the geographical and sectoral ubiquity of investments coming from the new investor may prompt suspicion: the surge of Chinese

[4] Zaheer, Srilata. 1995 "Overcoming the Liability of Foreignness," *Academy of Management Journal* 38(2): 341-63.

investments in many sectors and many countries in the early 2010s may have aroused particular worries in many host countries.

While non-EU OECD members focus most of their concern on Chinese investment, European states, and particularly those in Eastern and Central Europe, have also been skeptical of investment with Russian ties, even prior to the Russian invasion of Ukraine in 2022. The role of ISMs in countering threats from Russian investment, and the extent to which Russian FDI generated local demand for such tools, is often underappreciated in the current discourse.[5] Countries that share a border with Russia have developed substantial dependence on Russian investors, particularly in energy and other critical infrastructure projects. For these countries, ISMs are often best understood as tools to manage and reduce deeply ingrained Russian dependencies that generate substantial risks to public order and national security. These concerns have only amplified since Russia's illegal annexation of Crimea in 2014 and its use of its energy dominance in Europe as a point of strategic leverage. For example, Slovakia's government quickly developed and pushed through its ISM in 2021 in direct response to concerns that Russian majority state-owned Sberbank could acquire electrical utility Slovenske Elektrarne, which was formerly Slovakia state-owned until privatization, through bankruptcy provisions.[6] Previous analysis finds that countries that share a border with Russia are statistically significantly more likely to have created an ISM earlier than did EU member states that do not border Russia.[7]

Technological change

A second factor explaining the global proliferation of investment screening mechanisms has been the blurring of the lines between defense-oriented and commercial technologies.

In the past, the line of demarcation between economy and security was clearer than what it is now. Goods and services with potential security implications included those in the defense sector and those that could have a dual use: an airplane could pose a security challenge, but a car or a toaster did not. On the trade front, national security could be preserved by subjecting these goods to export controls. On the investment front, several countries with sizable defense industries mandated the review of transactions in their defense industrial base. This was not a major political issue anyway since most transactions in this sector happened between allies.

Technological developments, however, have dramatically altered the nature of challenges to national security. The digitization of most economic activity and human interaction, notably through the connected "Internet of things" and collection of personal data, has turned every sector of the

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[5] See, for an exception, Lenihan, Ashley Thomas. 2018. *Balancing Power without Weapons: State Intervention into Cross-Border Mergers and Acquisitions*. Cambridge University Press.
[6] Jenčová, Irna. 2021. " Russian Bank opens 'critical infrastructure' debate in Slovakia," *Euractiv* 5 February. https://www.euractiv.com/section/politics/short_news/russian-bank-opens-critical-infrastructure-debate-in-slovakia/
[7] Bauerle Danzman, Sarah and Sophie Meunier. 2022. "Naïve No More: Foreign Direct Investment Screening in the European Union." working paper.

economy into a potential national security challenge. A port or a power plant controlled digitally by a remote owner has become an obvious threat to national security; but so could a car's digital dashboard or a dating app. Furthermore, national dominance in emerging technologies such as artificial intelligence and quantum computing is up for grabs and could have just as transformative implications for military supremacy. As a result, governments are beginning to see certain technologies as important to protect from foreign acquisition, even without immediate connections to foreign military-connected entities. This has led to greater interest in screening investments that pertain to dual-use technologies and, more broadly, irrespectively of economic sector.

Regulatory diffusion

The third factor explaining the global proliferation of investment screening mechanisms is the push of regulatory diffusion. As more countries in the rest of the world expanded or created investment screening measures, it became increasingly difficult for the EU and for European countries not to implement their own. This diffusion has happened both indirectly and directly.

European countries have adopted ISMs in response to a variety of indirect pressures. For one, it has become more costly for a country to have no screening measures in place when all its partners and allies have them. To be sure, not having an ISM could be viewed as a comparative advantage in attracting greater flows of FDI. But if foreign investment ends up locating in that country because it was not allowed to locate elsewhere following a negative outcome of screening, the risks associated with this transaction are magnified and probably not worth the trade-off. It is also easier for a country to adopt investment screening regulations if its main partners also have them because there is less risk of losing out from tit-for-tat reciprocity.[8] Furthermore, the more a country's economic partners have investment screening measures in place, the easier it is to emulate their design features and use them as templates.

European countries faced more direct pressure to adopt investment screening measures both from inside and outside of the EU. The United States has actively encouraged its allies and partners to create new and strengthen existing ISMs in its bid to raise awareness of what it sees as critical risks that some foreign investment - especially from China - create. The discussion around and passage of the 2018 Foreign Investment Risk Review Modernization Act (FIRRMA) ratcheted up diplomatic pressure among European allies to take investment screening seriously in order to retain unencumbered access to investing in the U.S. FIRRMA created a category of "excepted states" whose investors would be exempted from review when taking non-controlling stakes in critical technology, infrastructure, and sensitive personal data U.S. businesses. The legislation did not develop a list of these excepted states, but made it clear that the primary criteria for becoming an excepted state was the existence of a robust ISM in that country. Congress also created provisions

[8] See Renaud Bourles, Vera Eichenauer and Michael Dorsch. 2022. "The rise of investment screening: Norms and diffusion in international economic policy", paper presented at the workshop The Politics and Regulation of Investment Screening Mechanisms, Princeton University, 7 October.

for outreach to allies and partners to encourage them to develop screening mechanisms, to share best practices about mechanism design and implementation, and to share information about specific cases under special circumstances.

Inside the EU, the passage and implementation of the EU investment screening framework provided a strong impetus for Member States to adopt their own national ISM. While the EU framework does not currently require Member States to have an ISM, it does require a national point of contact and creates reporting requirements designed to aid Member States in monitoring investments across the EU that could generate essential security risks to the union as a whole. Practically, this incentivizes the creation of an ISM if for no other reason than to aid data collection and reporting efforts. Additionally, the EU framework creates standards for what Member States' mechanisms should cover and develops an indicative list of sectors that should be considered for coverage. This shared list helps Member States justify their scope of coverage to the general public and to business interests. The consultation process surrounding the development of the EU mechanism - though short - raised awareness and knowledge of these issues among Member States' political leaders and peak business associations. This contributed to a willingness and interest among members to develop their own screening process.

Regulatory diffusion has led to increased similarities across ISMs, especially among EU countries. Though investment review mechanisms have been marked, even recently, by a general lack of convergence toward a single standard,[9] we see evidence that investment review authorities among OECD members are becoming more similar, especially in the wake of COVID. Bureaucrats in many governments had already begun considering enhanced approaches to investment screening prior to 2020. The pandemic gave these policy entrepreneurs an opening to push through "off the shelf" investment screening solutions as a quick response to the economic and security concerns COVID instantiated.

While national level ISMs among EU member states continue to display a substantial degree of variance, there are elements of these tools that seem to be converging. First, EU member states are increasingly reviewing the same set of sectors. This is unsurprising given that the EU regulation specifies a set of sectors that it deems especially relevant to review. Most member states have sector-based mandatory review mechanisms, which is a substantial difference from countries like the U.S. that have cross-sectoral review authorities that operate largely through voluntary filings. Sector-based mandatory review is also an unsurprising design feature in the EU given member states' requirements for information sharing - providing data on relevant investments is much easier when FDI across relevant sectors has a mandatory reporting requirement. Third, and also due to the EU regulation and more general EU law, member states have specified channels for judicial review of ISM determinations.

[9] Pohl, Joachim, and Nicolás Rosselot. 2020. "Acquisition- and Ownership-Related Policies to Safeguard Essential Security Interests – Current and Emerging Trends, Observed Designs, and Policy Practice in 62 Economies." *SSRN Electronic Journal*, no. May.

Despite these growing similarities, there remain substantial differences in how ISMs are administered. First, the location of review varies substantially across member states. While many governments place their review authority in the economic ministry, this design choice is certainly not standard. Some countries - particularly those with less bureaucratic capacity - empower their competition authority to also review transactions for essential security concerns. The location of review authority is likely to resist convergence because countries vary in terms of what kinds of risks are most relevant and also in terms of capacity to administer a new process through an economic ministry with little previous experience with such reviews.

Second, EU Member States vary in how they treat intra-EU investment. If members screen investment from other EU states, this could undermine the European single market. Italy introduced what it called a temporary change to its investment screening authority to do just that during the pandemic. It has not yet lifted this requirement. Slovenia also screens intra-EU investment. Indeed, one argument for screening investment from other Member States is that the single market is only as secure as its weakest link and some members do not have ISMs yet. There are also doubts that some Member States will adequately screen out problematic investment. Sweden's proposed screening mechanism would get around this conundrum by reviewing all controlling transactions in its market - even purely domestic transactions. It remains to be seen how this proliferation of notification requirements for intra-EU transactions will affect the European single market.

Conclusion

Many countries are reassessing their regulatory toolkit in an era marked by strategically managed markets. The return of geoeconomic competition - including the PRC's strategic use of state subsidies and foreign acquisitions to develop technological prowess - and more raw expressions of economic statecraft such as Russia's weaponization of energy markets in support of its invasion of Ukraine are causing governments to become wary of allowing market forces to create trade and investment dependencies. This has resulted in a rapid change in the politics of global trade and investment. Importantly, the impetus for these changes are largely defensive in nature. Governments are searching for tools to insulate themselves against dependence on strategic competitors. The development and proliferation of ISMs should be evaluated in this context.

ISMs are attempts to create more robust guardrails against national security-relevant foreign investment while maintaining an open economy for "benign" and growth-promoting capital flows. They are not motivated by prominent commercially-driven demand for protectionism. And yet, they may have important implications for global investment flows - though these implications have not been conclusively assessed yet.

Though Europe was late to the table in adopting and implementing investing screening, the EU is now leading the way in developing other trade and investment policy instruments that include investigations of distorting foreign subsidies, anti-coercion measures and, more generally, the rise of industrial policy to support strategic autonomy (especially in semiconductors), to promote reshoring of critical supply chains, to seed emerging technologies and to compensate for the displacement effects of globalization.[10]

While the EU and most EU Member States have now put in place investment screening measures, to navigate the increased porousness between economy and national security, several issues may be expected to create challenges in the years to come, including the screening of outward investment, multi-jurisdictional review, international cooperation on investment screening, and the capacity for governments to review past transactions long after they were concluded.

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[10] Meunier, Sophie. 2022. "The end of naivety : assertiveness and new instruments in EU trade and investment policy", EUI Global Governance Programme, 2022/55.