

CELIS Institute

CFIS 24 Background Paper on Panel

Investment Screening in Defense Sector: Promoting National Security and Neoliberalism

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The purpose of this Paper is to set the scene and provide the state of play and background information to the participants in the Panel.

***Necessity of Investment Screening Within Defense Sector:** Maintaining a competitive technological edge and ensuring critical production capacity necessitates investment screening to prevent the possibility of foreign espionage or subversion within the defense sector.*

***Impact of Quantum Computing and Artificial Intelligence on Investment Screening:** From encryption to targeting, the multi-purpose uses within the defense sector of quantum computing and artificial intelligence highlight the importance of investment screening mechanisms.*

***Challenges Facing Investment Screening Mechanisms:** Investment screening mechanisms will have to strike a balance between under- and over-inclusivity that allows countries to mitigate national security risks from investments without overburdening the private sector.*

About CFIS 24 | 16 -18 October 2024 | On-site | In private | Paris (France)

The CELIS Forum on Investment Screening (CFIS) is the flagship event of the CELIS Institute, to be held in its 6th edition this year. CFIS is Europe's first and foremost forum to discuss questions on investment screening and economic security. Thought leaders in investment control and economic security from Europe, the US, and beyond discuss current practical challenges and influential ideas to sketch geoeconomic strategies for Europe.

This year space is very limited. If you would like to join, please get in touch with events@celis.intitute.

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¹ The views expressed in the Background Paper do not necessarily reflect the views of the panellists and participants in CFIS 24 and cannot be attributed to them. The CELIS Institute, as a matter of institutional policy, does not take any position but provides a neutral venue for open exchange.



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Table of Contents

A. Foreign Direct Investment: The Dark Side Revealed 3

B. Birth of Investment Screening Mechanisms: Protect Hardware Industries 3

C. Into the Future with the Defense Sector: Artificial Intelligence and Quantum Computing 4

D. Challenges and Considerations in Screening Defense Technology 5

E. List of References..... 8

A. Foreign Direct Investment: The Dark Side Revealed

Foreign direct investment (FDI), such as greenfield investments, mergers and acquisitions, or capital infusions, offer positive benefits to the receiving country in terms of employment, tax revenues, technological, and economic development.² However, FDI can also concentrate the market power of a host country’s industries or sectors under foreign control. In turn, a host country could become reliant on the owners of this FDI to continue thriving economically. Such dependence creates leverage that could adversely affect the host country during times of a national crises involving it and those representing the nationality (or place of incorporation) of the foreign firms.³

B. Birth of Investment Screening Mechanisms: Protect Hardware Industries

In response to this threat, countries have maintained investment-screening mechanisms (ISMs) when examining FDI within their defense sector.⁴ While the exact procedures of them

² Prakash Loungani and Assaf Razin, *How Beneficial is Foreign Direct Investment for Developing Countries?*, 38 Fin. and Dev. (IMF) (2001), <https://www.imf.org/external/pubs/ft/fandd/2001/06/loungani.htm>.

³ U.S. Gov’t Accountability Off., GAO-24-106129, *Defense Industrial Base: DOD Needs Better Insight Into Risks From Mergers and Acquisitions* (2023) (citing that a merger and acquisition resulting in a foreign company or commercial company owning a critical defense supplier could pose a national security risk, namely if it closed the production line supporting defense programs).

⁴ Anna Chojnowska et al., *Navigating the Rise in Foreign Investment Screening*, Boston Consulting Grp. (2024), <https://www.bcg.com/publications/2024/navigating-the-rise-in-foreign-direct-investment-screening>.



differ by country, these reviews generally involve investigating the impact of the control of domestic defense industries and commercial activity by foreign citizens and/or governments.⁵ Namely, how would this FDI affect (1) a country's capability and capacity of its domestic production to meet its national security requirements and (2) its ability to maintain a technological advantage, if one exists, that affords relative superiority to its military?⁶ Traditionally, the reviews have centered on hardware, either component parts, such as semiconductors and microelectronics, or the end products themselves, like aircraft.⁷ However, as the concept of national security has expanded to meet the growing list of national interests, so too has the scope of these reviews.⁸

C. Into the Future with the Defense Sector: Artificial Intelligence and Quantum Computing

Now, critical technologies, especially software-based applications like artificial intelligence and quantum computing, are receiving heightened attention. Namely, they can simulate physical systems and process exponentially large amounts of data, yielding solutions to complex, multivariate problems and offer interconnectivity within a relatively shorter period of time.⁹

⁵ Robin Huang, *China's National Security Review of Foreign Investment: A Comparison with the United States*, 57 Vand. J. Transnat'l L. 1263, 1263-1303 (2023) (comparing foreign investment screening regimes in China and the United States and highlighting similarities and differences between both).

⁶ United Nations Trade and Development, *The Evolution of FDI Screening Mechanisms*, 25 Inv. Pol'y Monitor 1, 10 (2023), <https://unctad.org/publication/evolution-fdi-screening-mechanisms-key-trends-and-features>.

⁷ Toby T. Gati, *Reading in the Duma*, Akin Gump Strauss Hauer & Feld LLP Pol'y Alert (2008), <https://www.akingump.com/a/web/1227/9VkYS/080402-new-draft-law-on-foreign-investment-russia.pdf> (detailing focus of Russian investment screening regime in 2008, whose scope has grown).

⁸ Jeremy B. Zucker et al., *The Evolving Global Foreign Direct Investment and National Security Review Landscape*, Dechert LLP (2024), <https://docs.dechert.com/view/608853383/52/#zoom=true> (comparing various countries' foreign investment screening regimes, but highlighting common theme that concept of "national security" has expanded).

⁹ Cpt. Daniel Choi, USMC, *Quantum Technology and the Military-Revolution or Hype? The Impact of Emerging Quantum Technologies on Future Warfare*, Marine Corps U. (2023), <https://www.usmcu.edu/Outreach/Marine-Corps-University-Press/Expeditions-with-MCUP-digital-journal/Quantum-Technology-and-the-Military/>



Applications of such technologies span across multiple fields, with the promise of advances in medicine, sustainability, and engineering.¹⁰ Commercialization has naturally resulted over the years, with companies investing in resources to further these capabilities.¹¹

At the same time, the speed, accuracy, and predictive nature of these technologies can assist countries in defense of their security. Specifically, quantum sensing can help a country's navy track enemies' submarines to compromise their survivability of sea-based nuclear deterrents.¹² Artificial intelligence can enable the development of lethal autonomous weapons systems and provide a clearer view of the battlefield.¹³ Moreover, quantum computing can enable de-encryption efforts in pursuit of signals intelligence.¹⁴ Thus, whichever country is technologically superior in these spaces will have a military edge against its adversaries. In turn, ISMs have expanded to include these fields so that those lagging behind cannot erode such advantages simply through procurement, acquisition, or exploitation of firms in a host country that support the defense sector.

D. Challenges and Considerations in Screening Defense Technology

Covering both hardware and software, ISMs in the defense sector face a twofold challenge in ensuring that investment screening is not over- or under-inclusive while meeting the stated objective. On the one hand, the dual-use nature of these items and their components means

¹⁰ Ling Zhu, *Quantum Computing: Concepts, Current State and Considerations for Congress*, Cong. Rsch. Serv. 1, 17 (2023), <https://crsreports.congress.gov/product/pdf/R/R47685#:~:text=Researchers%20have%20demonstrated%20the%20potential,modeling%2C%20optimization%2C%20and%20simulation>.

¹¹ Michael Bogobowicz et al., *Steady Progress in Approaching the Quantum Advantage*, McKinsey & Co. (2024), <https://www.mckinsey.com/capabilities/mckinsey-digital/our-insights/steady-progress-in-approaching-the-quantum-advantage/> (highlighting how investment in quantum technology start-ups have gone from less than \$500 million just 6 years ago, to now about \$2 billion).

¹² Kelley M. Saylor, *Defense Primer: Quantum Technology*, Cong. Rsch. Serv. (2023), <https://crsreports.congress.gov/product/pdf/IF/IF11836>.

¹³ *Id.*

¹⁴ *Id.*



that ISMs must take a holistic approach in evaluating a prospective FDI—not only investigating the acquirer or investor but also its subsidiaries, suppliers, and partners. Not doing so risks an under-inclusive review as receiving countries may require their companies to share proprietary information or technology, which they could then use for advances in military applications.¹⁵ Besides increasing the breadth of the review, ISMs must also consider the risks of not pursuing depth. Namely, every step in the supply chain of an item may present a vulnerability to foreign ownership. For example, the acquisition by an adversary of a firm from a non-aligned third-party sovereign could threaten the security of an allied country, especially if the firm produces a sub-component necessary for the allied country's military supply chain (e.g. semiconductors).¹⁶

On the other hand, valid concerns exist that overregulation or enhanced scrutiny based upon capricious factors will stifle modernization and reduce profitability over synergistic efforts.¹⁷ Namely, domestic politics or bilateral relations may lead to ad-hoc reviews or cause delays in resolution once a review has commenced.¹⁸ In turn, the resulting uncertainty over whether a country will approve of an FDI within the defense sector will result in additional costs in terms of time and money for which a prospective investor or acquiring company must account.¹⁹ As

¹⁵ National Counterintelligence and Security Center, *Venture Capital and Supply Chain Vulnerabilities*, Off. of Dir. of Nat'l Intel. (2023), <https://www.dni.gov/files/NCSC/documents/supplychain/Final%20VC.pdf>.

¹⁶ *Id.*

¹⁷ Vasuki Shastry, *How Countries can Regulate Investment Screening*, Chatham House (2022), <https://www.chathamhouse.org/2022/04/how-countries-can-regulate-investment-screening>.

¹⁸ Dr. Andrea Pomana et al., *Reform of the EU Foreign Direct Investment Screening Regulation – How Might M&A Transactions be Impacted?*, Mayer Brown (2024), <https://www.mayerbrown.com/en/insights/publications/2024/03/reform-of-the-eu-foreign-direct-investment-screening-regulation-how-might-m-and-a-transactions-be-impacted/>.

¹⁹ Kristen Eichensehr and Cathy Hwang, *National Security Creep in Corporate Transactions*, 123 Colum. L. Rev. 549, 555 (2023).



a result, it may be reticent to engage and shift its capital resources elsewhere to firms within countries with more permissive but capital-inefficient environments.²⁰

This panel seeks to resolve these challenges that ISMs face when reviewing transactions within the defense sector. First, it will include a brief history of ISMs within this field, comparing how such screening is done within the defense sector as opposed to other civilian ones. Second, it will examine more closely quantum computing and artificial intelligence, specifically analyzing various approaches countries and regions have taken to “right-size” ISMs so that they mitigate security concerns across military supply chains while also promoting and incentivizing defense innovation. Lastly, it will offer a series of recommendations on these matters, specific to the European Union, which is embarking on the ambitious goal of standardizing ISMs across its Member States. As part of this discussion, panellists would discuss how ISMs should treat allies as compared to competitors when reviewing investments. Positing a balance for ISMs to strike amidst an age of great power competition and unprecedented technological advances will ensure that humanity’s progression is not a zero-sum game.

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²⁰ Boston Consulting GRP., *Navigating the Rise in Foreign Investment Screening*; C.f. Lorenzo Bencivelli et al., *The Rise of Foreign Investment Screening in Advanced Economies*, Ctr. Econ. Pol’y Rsch. (2023), <https://cepr.org/voxeu/columns/rise-foreign-investment-screening-advanced-economies> (quoting “the recent tightening of national investment screening mechanisms has not coincided with investors’ reappraisal of the most attractive destinations”).

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