# Study on State Control

# of Strategic Defence Assets

# (EUROCON)

**FINAL REPORT to DG Enterprise**

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**Volume 1 of 2**

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## Abstract

This document represents the Final Report of the Study on State Control of Strategic Defence Assets – EUROCON. In November 2009 the European Commission, Directorate General Enterprise and Industry, tasked a consortium of European research institutes to examine the current practice of State control of strategic defence assets, to develop Options for a European dimension of this control, to evaluate the Options and to recommend a course of action. The consortium was led by *the Manchester Institute of Innovation Research* (MIOIR) at the University of Manchester (UK) and comprised *Kemmler Rapp Böhlke & Crosby* (KRB&C, Brussels, Belgium); *Institut de Relations Internationales et Stratégiques* (IRIS, Paris, France; *Istituto Affari Internazionali* (IAI, Rome, Italy); and *Natolin European Centre* (CEN, Warsaw, Poland).

Our analysis shows that currently Governments mainly use a combination of three different means of control: State ownership, special rights and investment control legislation. We identify obstacles for the further consolidation of the European defence industry such as the fragmentation of the market for corporate control, a lack of transparency regarding national investment controls, very limited consultation among EU Governments and the continued use of State ownership.

We develop six Options introducing a European dimension in the review of foreign investments in strategic defence assets. Our evaluation shows that any EU action on investment control is likely to be politically and technically challenging. One of the main reasons is disagreement amongst stakeholders with regard to the exact character of the current problem, as well as the appropriate policy response. While most of them see the benefits that some sort of EU level action might have, especially for information exchange and consultation, they do not agree as to its potential character or modus operandi.

We recommended that the Commission adopt a step-by-step approach for the harmonisation of investment controls, which may lead to the publication of a Directive on information exchange and consultation on investments from third countries.

# Preface

This document represents the Final Report (Deliverable D5) for the Study on State Control of Strategic Defence Assets – EUROCON – led by *the Manchester Institute of Innovation Research* (MIOIR) at the University of Manchester (UK) with partners *Kemmler Rapp Böhlke & Crosby* (KRB&C, Brussels, Belgium); *Institut de Relations Internationales et Stratégiques* (IRIS, Paris, France; *Istituto Affari Internazionali* (IAI, Rome, Italy); and *Natolin European Centre* (CEN, Warsaw, Poland). Prof. Martin Trybus of the University of Birmingham (UK) acted as scientific advisor to the consortium.

This document responds to the original technical specifications for the study and the methodology and scope as set out in the Initial Report (D1) submitted to the Commission on 2 December 2009. We delivered a Mid-Term Interim Report (D3) on 7 June 2010, in which we outlined the first results of our analysis and presented draft Options. Following the discussion with the Commission and the acceptance of that report we deepened our analysis, revised the Options and, after an extensive consultation with stakeholders at national and EU levels, formulated our recommendation.

This Final Report consists of four parts:

- An analysis of the current situation regarding State control of strategic assets;
- A presentation and evaluation of Options for EU level action;
- Our evaluation of the different Options and
- Our conclusion and recommendation.

These four parts are contained in Volume 1 of the Report. Volume 2 consists of supporting Appendices. It contains Country Reports about the situation of State control of defence assets in eight EU countries and the United States, information about additional EU countries, case studies illustrating the practice of the State control of strategic defence assets and a list of the experts interviewed for this study.

The information and analysis presented in the report is based on a combination of desk research, expert interviews at national and EU level and consultations with relevant stakeholders. We would like to express our gratitude to all persons and organisations that provided valuable insights and feedback to the study.

# Contents

# Glossary

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| BITs | Bilateral investment treaties |
| CCP | Common Commercial Policy |
| CEN | Natolin European Centre |
| EC | European Communities |
| ECMR | European Merger Control Regulation |
| EU | European Union |
| FDI | Foreign direct investment |
| GAP | Agreement on Government Procurement |
| GATS | General Agreement on Trade in Services |
| GATT | General Agreement on Tariffs and Trade |
| IAI | *Istituto Affari Internazionali* |
| IRIS | *Institut de Relations Internationales et Stratégiques* |
| KRB&C | Kemmler Rapp Böhlke & Crosby |
| MIoIR | Manchester Institute of Innovation Research |
| MoD | Ministry/Minister(s) of Defence |
| (p/s)MS | (participating/subscribing) Member State(s) |
| OJ | Official Journal |
| TEU | Treaty on European Union |
| TFEU | Treaty on the Functioning of the European Union |
| TRIMs | Agreement on Trade-Related Investment Measures |

# EXECUTIVE SUMMARY

The Executive Summary recalls the objectives of the study, outlines the problem and its political and legal context, presents the main findings of the cross-country analysis, gives an overview of the Options we identified for an EU dimension and our recommendation.

### *Objective of the study*

Starting from an initial analysis that the present "patchwork of national legislation on control of strategic defence assets prevents consolidation" and the development of a more efficient defence industry in the EU, the European Commission set out three main goals in the original Call for Tenders, to:

- Provide a "detailed overview of the main policies and measures on foreign investment in place in EU Member States with regard to treatment of foreign investment in the defence sector";
- Identify "potential measures which introduce a European dimension in the review of foreign investment in EU countries" and to assess the advantages and disadvantages of each Option and, finally,
- Formulate recommendations for a "European approach on control of strategic defence assets in the EU".

### *The scope of the study: The problem and its political and legal context*

The particular character of the defence industry means that cross-border consolidation in Europe has taken place with the close involvement of European Governments. The consolidation that has already been reached in the aerospace and defence electronics sectors, for example, has been the result of close negotiations of companies *and* Governments on the terms of the transaction. Given the specific characteristics of the defence industry, Governments will always occupy a position in which they have an array of tools to control the defence industry and shape the expectations of investors using different means of State control.

Governments mainly use three types of instruments to oversee their strategic defence assets: Government ownership, special rights and investment control legislation. We have analyzed the current practice with regard to all three instruments, focusing in particular on legislation for the control of investments in strategic defence assets for three reasons. First, the last five years have seen a number of European Union Member States review and tighten their legislation on the control of foreign acquisitions of what are perceived as strategic assets and to increase scrutiny in some sectors perceived as being of strategic interest. In other Member States there have been discussions about doing likewise. Member States have cited concerns about national security and other essential public interests. Moreover, while in the Treaties there is very little room, if any, for legislative EU measures on the issue of State ownership and while the Commission has already taken action on special rights, the application of Treaty rules to national investment control legislation would represent a rather new and additional step. Finally, an emphasis on investment controls is reflected in the initial Call. Consequently, we give relatively greater weight to investment control legislation, whilst also addressing State ownership and special rights in our analysis, Options development and recommendations.

The starting point for this study is the assumption that this patchwork of different control instruments, in particular of national investment control legislation has hindered the consolidation of the European defence industry and will be an obstacle to effective control of a more European supply chain in the future. It examines in particular the situation of State control of strategic defence assets in nine countries – henceforth called "case study countries": the signatories of the Letter of Intent and the Framework Agreement (LoI countries or LoI Six) i.e. France, Germany, Italy, Spain, Sweden, United Kingdom (UK); and in addition, the Netherlands, Poland and the United States (U.S.). In addition we have conducted a survey in the remaining EU countries ("non-case study countries"). We obtained an answer from a third of all experts contacted in the survey, which has been included in our analysis.[1]

[1] Consequently, the analysis in this Report is limited to those countries from which we obtained information: the nine case-study countries, Austria, Cyprus, Estonia, Finland, Greece, Hungary, Latvia, Romania and the Slovak Republic. In the cases of Bulgaria, the Czech Republic and Slovenia we were able to draw on publicly available information, in particular ISDEFE and ISI. (2009) *Study "Level*

All experts agreed on the fact that to this day there is by no means a common European approach, neither among the LoI/FA countries nor within the EU, as for the appropriate way to handle State controls of strategic defence assets. In fact for many interviewees the topic of defence-related foreign direct investment (FDI) controls is not high on the agenda and only became an issue in the process of the conversation.

### *Key concepts used in the study*

Before we present our findings we will briefly outline some key concepts that are used throughout the study.

- We will below consider as **strategic defence assets** those included in the 1958 list of the arms, munitions and war materiel referred to in Article 346 (2).[2]

- In addition there are defence-related assets, which are either specifically mentioned in national laws such as cryptology, IT security or satellite control *and* holding secret information. Strategic defence assets and defence-related assets will be referred to as "**defence assets**".

- Finally, there are other sensitive assets, used for the production or delivery of potentially any activity, which might either touch upon "public order and security". Strategic defence assets, defence-related assets and sensitive assets form the category of **strategic assets**.

- By Government, public or **State ownership** we mean that a national or regional Government or public body such as a holding or bank owns directly or indirectly a part of the equity of a company.

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*Playing Field for European Defence Industries: the Role of Ownership and Public Aid Practices" EDA contract reference: 08-I&M-001*. Brussels: European Defence Agency.

[2] Council of the EU. (2001) Answer to written question E-1334/01 by Bart Staes regarding the List of 15 April 1958 to which Article 296(1)(b) refers of 4 May 2001. *OJ* C 364 E:85-86.

- **Special rights** are rights attached to one or more shares, or classes of shares, and confer rights upon the owner of the share – in our case the Government – that are disproportionate in relation to the equity they represent.

- Principally we can distinguish three broad categories of regulation that can affect the decisions of investors in defence assets: financial or economic regulation, legislation that indirectly or directly influences investment decisions and specific investment control legislation. As **national investment control legislation** we will consider legislation that has specifically been adopted and is directly applied for the purpose of controlling investments in strategic defence assets. It has to be distinguished from indirect investment control legislation such as laws on the protection of classified information and on security clearance procedures or rules that require investors to register or obtain a permit if they want to develop, manufacture or sell arms.

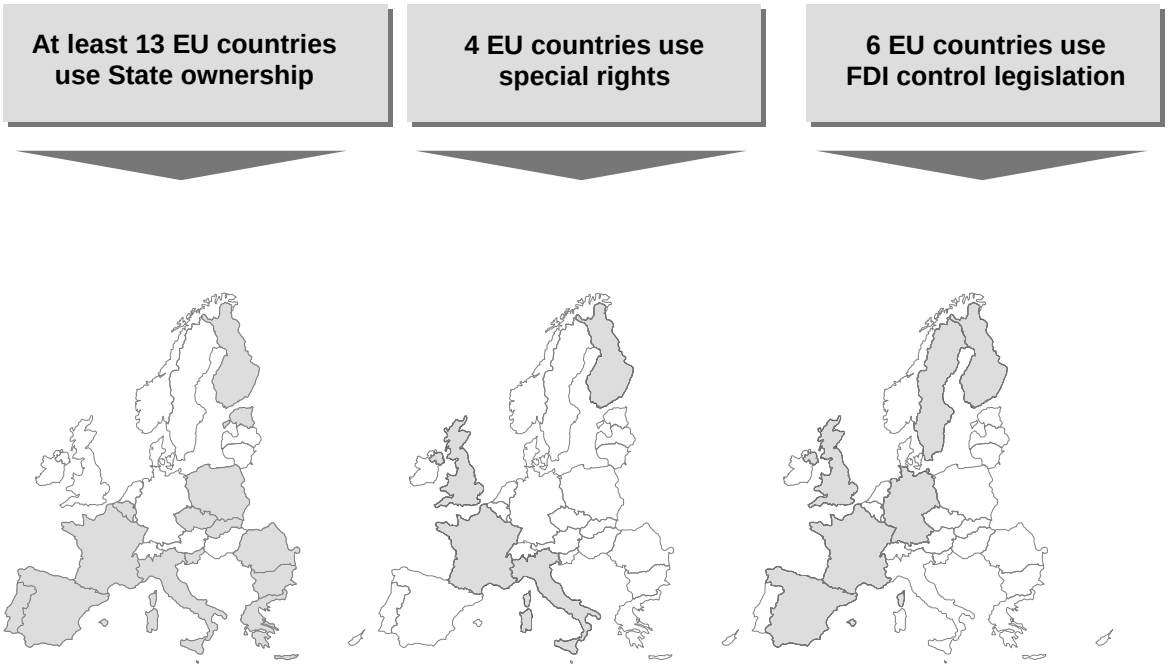
- Defining "**non-EU investor**" is legally challenging given the controversy whether the country of establishment of a company should be the decisive criterion, or whether also the "ultimate control" theory could be applied. As a starting point and based on Article 54 Treaty on the Functioning of the European Union (TFEU) we define as non-EU investors those business entities having neither a registered seat nor their central administration nor their principal place of business in the EU.

### *Cross-country examination of national control regimes for strategic defence assets*

Our analysis confirms that a patchwork of different means of State control of strategic defence assets exists across the European Union with Governments mainly using State ownership, special rights and investment control legislation.

An overview of the application of different control instruments by EU Governments is presented in Figure 1.

Figure 1: Use of different means of control across EU countries

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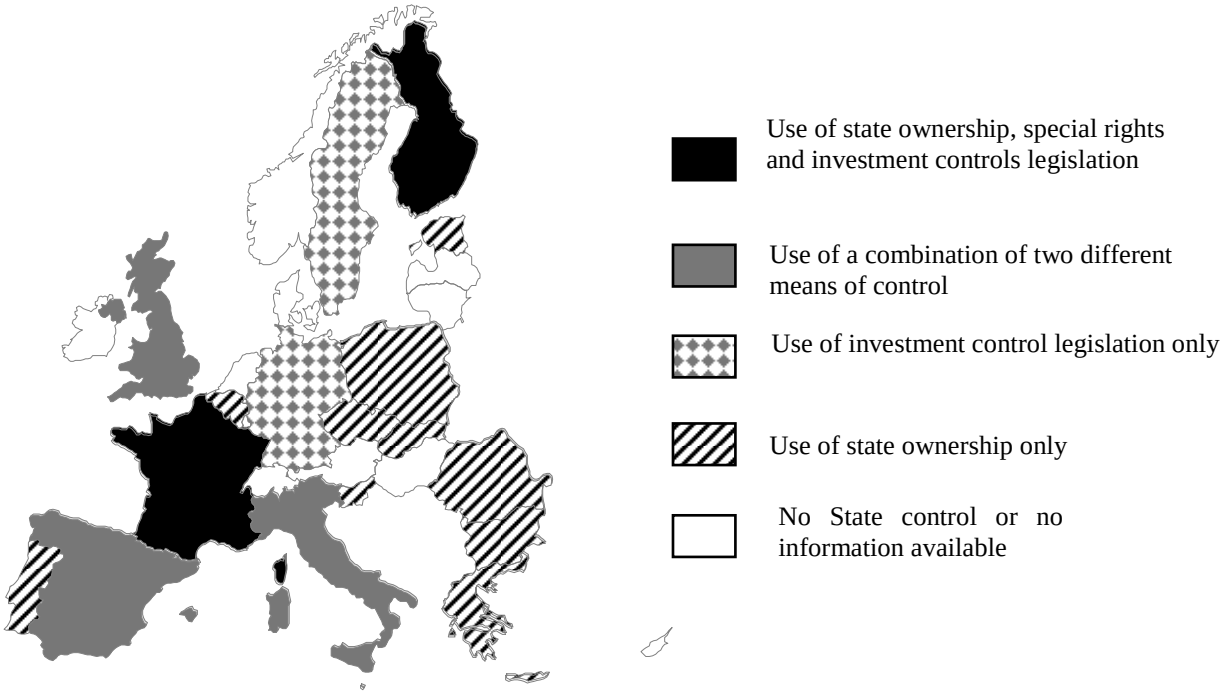
| Four case study countries use State ownership: France, Italy, Spain, and Poland.<br><br>The French Government uses contractual arrangements with key shareholders.<br><br>In non-case study countries State ownership is likewise used (Belgium, Bulgaria, Czech Republic, Estonia, Finland, Greece, Hungary, Portugal, Slovakia, Slovenia and Romania) | Special rights are still used in four EU countries: Finland, France, Italy and the UK.<br><br>Governments of some EU case study countries (France, Germany, Spain, Sweden and the UK) have entered into special arrangements with shareholders, which are subject to private law but the possibility should not be ruled out that they might represent State measures. | Six out of 27 EU countries have dedicated investment control legislation: Finland, France, Germany, Spain, Sweden, and the UK.[3]<br><br>The Netherlands has not State control of strategic defence assets at all. |

Most EU case study Governments use a combination of different means to control the strategic defence assets in their country. Five groups of countries can be distinguished according to the extent to which they make use of State control of strategic defence assets.

[3] Greece has legislation for FDI control, covering strategic defence assets. Since the Greek authorities did not provide us with publicly available information, Greece is not considered in the analysis.

Figure 2: Combination of different means for the control of strategic defence assets




- The first group consists of France and Finland who use all three mechanisms of State control of strategic defence assets. The French Government employs the most sophisticated range of instruments for the State control of defence assets comprising State ownership, contractual arrangements with key shareholders, special rights, undertakings and dedicated investment control legislation. The Finnish Government uses State ownership, special rights and legislation.

- Italy and Spain make use of State ownership and special rights; the UK uses special rights, undertakings and investment control legislation.

- Germany and Sweden both use only investment control legislation.

- A number of other countries for the most part in Eastern and South Eastern Europe use mainly State ownership as a means of control, for example Poland or Romania. Once their companies have been privatised there are only indirect investment control regulations for the oversight of strategic defence assets available. While this does not mean that the private defence companies of these countries are entirely unprotected – after all Governments have other regulatory means at their hand to shape investors' expectations – it does imply that investments are not systematically monitored.

- The Netherlands are an exception in that the Government does not employ any means of State control of strategic defence assets at all.

It should be noted, however, that the number of control instruments used by a Government does not say anything as to the perception held by experts with regard to the relative openness of a Government towards defence investments.

Examining the national investment control legislation we found significant difference across EU case study countries. We have also shown that national legislation on the control of FDI varies considerably as to the types of assets that are to be scrutinised, which implies that to the extent that Member States rely on Article 346,[4] they are likely to do so in a *heterogeneous* manner. The study team did not find any particular cases where Member States made excessive use of Article 346. However, the wide difference in the number of reviewed cases points to large variations in the practice of investment control of strategic defence assets across EU countries. This number varies from country to country, ranging from 2-3 cases in Germany and the UK, even less in Sweden and Finland, to 15 to 40 cases per year in France. Despite these differences, it is extremely rare that reviewed transactions are rejected in EU case study countries.

Moreover, none of the EU case study countries but the UK do publicise neither the opening of a case nor the final decision, means that they do not (need to) explicitly invoke Article 346 for the control of an intended transaction. Consequently, it is *not entirely transparent* when and how Member States decide to apply their control.

Finally, the systematic controls of intra-EU investments in certain Member States on the basis of criteria which are in essence the same as those applied to non-EU investments can be disproportionate. Pursuant to the Commission practice in this field the Member States should grant better conditions to intra-EU investments than to non-EU investments.

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[4] Article 346, complemented by Articles 347 and 348, provides for the possibility for Member States to derogate from the Treaty on a case-by-case basis and under certain conditions for reasons of national security. For details see the discussion below in section 1.3.

***Assessment of the current situation***

We can identify major issues concerned with the further consolidation of the European defence industry: a continued use of State ownership, fragmentation of the market for corporate control, a lack of transparency regarding investment policy, review procedures and mitigation requirement, as well, as very limited consultation among EU Governments. Among stakeholders, however, there is currently no agreement on these issues. While they acknowledge that there is some sort of problem, they do not agree on its exact character and while they accept hat some kind of EU level action might be required, they do not share an idea about the form it could take. Consequently, the enthusiasm for EU level action is still rather muted.

In particular we have identified the following four issues arising in the current situation for the further consolidation of the European defence industry:

- First, State ownership can be said to present an obstacle to consolidation, as it creates a conflict of interest and puts publicly owned firms in a position in which they are able to accept more business risk in comparison to their private competitors. This issue was raised by stakeholders of some countries (UK, Germany, Sweden) but not of other countries (France, Italy, Spain).

- Second, the market for corporate control of defence firms is fragmented and therefore the consolidation of the defence market is made more difficult. For the majority of stakeholders, however, fragmentation is not an issue and not considered as an obstacle to consolidation.

- In addition, a lack of transparency regarding the policies and practice of national investment controls increases the business risk of an investment, a concern that was raised by almost industry stakeholders.

- These three problems impede on the consolidation of the European defence industry as they impair predictability for investors and increase their business risk.

- Fourth, a lack of information exchange and consultation among Governments implies a potential neglect of the security interests of other EU Governments. Given that most EU countries do not have national investment control legislation but might still

harbour companies producing strategically important components, risks to the security of supply might arise. While all experts agree that ensuring security of supply is key to making Governments and companies fully accept inter-dependence and thereby to bringing a broadening of the supply chain, they differ on how such security can be brought about. Some Member States (France and Italy) prefer regulation; others (UK and Sweden and, to a lesser extent, Germany) consider undertakings with companies as a sufficiently reliable means to ensure security of supply. In addition, some Governments (Italy and France) are concerned about the risk that in the current situation where most EU countries do not have national control legislation an investor from a third country could buy a company in an EU country without investment control legislation with the intent to circumvent investment controls by other EU Government ("Trojan horse"-investment).

This set of problems impedes on the consolidation of the European defence industry in an indirect way, as they represent reasons for Governments to maintain strong means of control over strategic defence assets, thereby cementing the existing fragmentation of the market for corporate control.

Despite the drawbacks of the current situation there is no agreement amongst stakeholders as to right way forward. While most of them see the benefits that some sort of EU level action might have, especially for information exchange and consultation, they do not agree at all with regard to its potential character or modus operandi. Hence, the enthusiasm for any EU action on this matter is rather small.

### *Six Options for EU level action*

We have identified six Options introducing a European dimension in the review of foreign investments in strategic defence assets in EU countries:

- **Option 1**: A Directive on notification & consultation about non-EU investments;
- **Option 2:** A Directive harmonising the review of non-EU investments combined with an Interpretative Communication and possibly infringement procedures;
- **Option 3:** A Regulation on the common review of non-EU investments combined with an Interpretative Communication and possibly infringement procedures;
- **Option 4:** Enhanced cooperation enacting Option1, 2 or 3;

- **Option 5:** A CFSP Council Decision regarding national review of non-EU investments combined with an Interpretative Communication and possibly infringement procedures;
- **Option 6**: An EDA Code of Conduct on notification, information exchange and consultation or on review procedures of non-EU and EU investments.

All these Options concern in the first place the external dimension; they are legal instruments designed to address investments in European strategic defence assets from third countries. The Treaty prohibits in Article 63 TFEU restrictions on investments from third countries as well as other Member States (unless justified e.g. by public security considerations in accordance with the criteria defined in CJEU case law). However, in Articles 64(2) and (3) TFEU, it empowers the legislator to regulate the external but not the internal dimension. However, in order to present complete Options we have added to each external measure the appropriate complementary measure dealing with the internal dimension.

As for State ownership we argue that the Treaty leaves little room for action by the EU.

For special rights there already exists case-law of the Court and we suggest that an Interpretative Communication discussed in our Options would provide guidance for governance as to the appropriate use of special rights in the future.

### *Evaluation of Options*

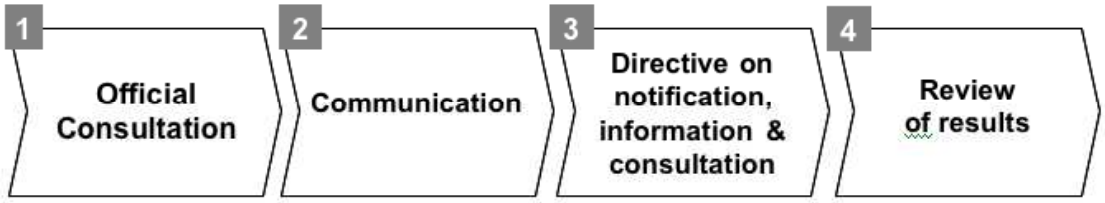
For the evaluation of the Options we developed a Balanced Scorecard outlining four criteria along which we have judged each of the Options: the legal feasibility; its effectiveness in addressing the problems of the current situation; its political feasibility and the technical challenges that implementation of the Option is likely to face.

The appraisal based on our extensive consultation with stakeholders and our own analysis finds that any EU action on investment control is likely to be politically and technically challenging. It reflects the facts that the issue of State control is not seen as being of utmost importance for the consolidation of the defence industry and that there is little eagerness to embrace an EU level approach beyond the lightest form of mutual information sharing among Governments. An overview of the evaluation of the Options can be found at the end of the Executive Summary.

***Conclusion and recommendation***

After summarizing our analysis and evaluation of the Options we formulate recommendations for EU level action. We recommend that the Commission continue to scrutinise the use of special right and their evolvement.

As for a European dimension in the treatment of foreign investment in the European defence sector we suggest that the Commission follows a step-by-step approach. At this point we suggest that it should consist of the following four stages:




We think that such a phased approach rather than the introduction of a particular Option is more appropriate to the problem at hand for four specific reasons.

- First, a clear majority of stakeholders have indicated that they are in the process of transposing the Procurement and Transfer Directives and working out the details of the implementation. Hence it might be advisable to await the first results of the full implementation of the two Directives and only then to take action on the issue of defence investment control.

- As pointed out above, a gradual approach, which allows stakeholders to first apply EU legislation and gain practical experience and only then to complement it in a step-by-step manner, has also been successful in the liberalisation of other sectors such as energy, gas or telecommunications. Equally, the MEPs and a former Commissioner we consulted for this study advised such an approach to ensure the largest possible support for the measure.

- In addition, our main conclusion is somewhat paradoxical: on the one hand, our analysis shows that there are a number of issues arising from the way the control of strategic defence assets is handled at the moment. Moreover, stakeholders from Government and industry concede that there are problematic consequences of the current practice. On the other hand, however, there is among stakeholders neither

agreement as to the importance of these problems nor on how to deal with them and who should be involved in tackling them. In other words, although all the experts we talked to are aware of the drawbacks of the current situation they have yet to reach a common understanding of the problem, its significance, and the remedies. This challenge is further compounded by the fact that nobody felt in the position to foresee the effects of the Procurement and Transfer Directives on the subject of the study.

- Finally, given the lack of a more clearly developed understanding of the challenge most stakeholders – except the MEPs and several experts from industry – are extremely cautious about an involvement of the Commission. They hold that Governments, who procure defence equipment from companies in order to equip their armed forces, are better placed to assess to what extent an investment would pose a threat to national security. However, such a reaction is not limited to this particular topic but can be observed in most subjects to which the Commission turns its attention. The initial reactions to the idea of action in the field of defence and security procurement is a case in point, which also shows that opinions can be altered, attitudes softened and standpoints shifted, as a more refined understanding of the problem at hand evolves. Again, the Procurement and Transfer Directives might be anticipated to show some effects on the subject matter in the mid-term, thereby further "ripening" the idea for the need for EU level action.

Therefore we recommend that in a first step and after stakeholders had the chance to gain experience with the Procurement and Transfer Directives, the Commission should focus on building an understanding of the issues at stake and mobilise the necessary political support for action. In reaction to the feedback received in a public consultation it could then adopt a Communication summarizing the debate, delineating the problem and outlining possible ways forward regarding the internal and external dimensions.

In principle an EDA Code of Conduct (Option 6) would present an alternative to the aforementioned Directive (Option 1). While such a course of action might under certain conditions be the only feasible way forward, we will point below to a number of advantages that Option 1 offers over Option 6. Should such first steps of harmonisation either by the Commission or/and the EDA be adopted we suggest that it is followed up by a critical appraisal after a period of three to five years in order to assess its success and identify the possibilities for further action.

| | **Option 1: Directive on Notification/Consultation** | **Option 2: Directive on Not./Cons. & Review** | **Option 3: Regulation on Not./Cons. & Review** |
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| **Main features** | • Notification: Ex ante notification to national authorities mandatory<br>• Consultation and (limited) exchange of information between MS concerned by a proposed acquisition<br>• Review according to national rules<br>• Decision-making by national authorities | • Mandatory ex ante notification of non-EU investments to national authorities<br>• Consultation and (limited) exchange of information within the Network of MS chaired by Commission<br>• Harmonised set of rules for review of non-EU investments by national authorities<br>• Decision by national authorities after consultation of Committee or Network | • Mandatory ex ante notification to EU body<br>• Consultation and limited information exchange within EU Network or Committee<br>• Single set of rules for review by EU body<br>• EU body decides with input and eventually veto right from MS concerned |
| **Legal feasibility** | • Art. 64(2) TFEU to adopt Directive for the free movement of capital between the Union and third countries<br>• Consultation and (limited) information exchange could trigger invocation of Art. 346 TFEU, which would be difficult to justify and not undermine the Directive as a whole | • Art. 64(2) TFEU<br>• The ordinary legislative procedure applies (unless "step backwards in liberalisation"; Art. 64(3) TFEU would then require unanimity in the Council and only consultation of the EP) | 3 possibilities for adoption of a Regulation:<br>• Art. 64(2) TFEU (unless Art.64(3) would be held to apply; in that case Art. 207(2) TFEU could be used instead)<br>• Art.207(2) TFEU, a framework CCP Reg.<br>• Both these legal bases |
| **Political feasibility** | • Interest in information and consultation has been shown by a majority of Government and industry stakeholders<br>• Consulted MEPs considered such a Directive as an appropriate first step<br>• While some stakeholders are hesitant to an involvement of the Commission, others have pointed out that unless the Commission takes action, little is going to happen in any other forum, i.e. EDA (Option 6) or the Council (Option 5) | • Government and industrial stakeholders show a rather small inclination towards harmonised rules for the review of foreign investments<br>• Stakeholders from Government and industry object, due to concerns about the impact on transatlantic relations and the signal that it would send out of a "Fortress Europe"<br>• However, the Directive cannot be qualified as politically unfeasible in the long run. It may present a way forward once experience with harmonisation in this area (e.g. on the basis of Option 1) has been made. | • Majority of stakeholders from industry and Government were opposed with only a minority being open to this Option<br>• Some stakeholders question legitimacy of EU to regulate investments arguing that "EU does not invest in the defence industry".<br>• Requires common view in EU on the appropriate treatment of defence investments from third countries (esp. U.S.), which as yet does not exist |

| | **Option 1: Directive on notification/Consultation** | **Option 2: Directive on Not./Cons. & Review** | **Option 3: Regulation on Not./Cons. & Review** |
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| **Political feasibility (cont.)** | • Government and industrial stakeholders would have to be reassured that the information and consultation obligation is without prejudice to their rights under Art. 346.1(a) under the condition that they take the security interests of the other MS and of the Union into account | | • Decision-making at EU level is expected to be "even more political" and less transparent than at national level<br>• Risk of "Fortress Europe"-perception and backslash in markets of third countries<br>• However security of supply requires MS to accept inter-dependence, integration and broadening of the supply chain, and a properly functioning EDEM |
| **Technical challenges** | • National authorities would have to be designated to monitor the notification & consultation obligation; considerable admin. burden for MS without existing legislation and even more for MS without defence industry<br>• Burden of multiple filing for third country investors is only mildly increased, as obligation exists today under EMCR and national competition/investment control legislation.<br>• Definition of several complex notions such as "European enterprises", "strategic defence assets", "non-EU investor" required | • Need for legislation and review in all MS (incl. those without industry concerned)<br>• Multiple filing only mildly increases the pre-existing administrative burden of non-EU investors.<br>• Reduction of contradictory decisions by MS through Committee/Network chaired by Commission<br>• Need to agree on additional notions compared to Option 1 e.g. how to treat public investors, define efficient assessment criteria etc. | • Decision on the EU body in charge of implementing the review (Commission or an Agency to be created)<br>• Decision-making process would require MS concerned to share certain information on a proposed acquisition; reliance on Article 346 TFEU in order to protect sensitive information risks undermining the Reg. (but see efficiency)<br>• Modalities of the "cooperation" between MS and Commission/Agency are a legal challenge; e.g. how to involve all relevant bodies, how to synchronise with EMCR & how to grant the MS most concerned a veto right while ensuring the functioning of the Reg. (suggestion: dialogue procedure Art. 348 TFEU)<br>• Commission or Agency in charge would have to acquire new know how in accordance with Art. 21(2) (3) TEU |

| | **Option 1: Directive on notification/Consultation** | **Option 2: Directive on Not./Cons. & Review** | **Option 3: Regulation on Not./Cons. & Review** |
|---|---|---|---|
| **Efficiency** | • Increased transparency for investors and governments<br>• Improvement of quality of review, e.g. more appropriate remedies, increased coherence of national decisions would reduce business risks<br>• Investors and Governments would benefit from more coherent decisions of the different national authorities<br>• Possibility to collect information for a common legislative review system<br>• Option 1 is preparatory and incomplete, as security deficit of the Union and internal dimension are not addressed<br>• Compared to EDA Code of Conduct Option 1 would be legally binding and subject to supremacy, enforcement & legal review by the CJEU | • Increase of security of supply of MS and Union as a whole<br>• Improvement of transparency and predictability for investors and Governments due to harmonised rules on national review mechanism<br>• Recourse to Art. 346 TFEU might undermine the Directive but this is not sure because the Directive would also serve the interests of MS in greater security of supply and transparency<br>• Directive would contribute to the phasing out of the existing national controls of EU defence investments<br>• It would indirectly contribute to consolidation of the European defence industry driven by European firms<br>• However, interest of MS in FDI implies risks regarding uniform application of the common rules, (as comp. to Opt. 3) & of conflict with EMCR | • Reg. would contribute to EU wide protection from security risks linked to non-EU investments; security of supply would be ensured in an efficient, effective & comprehensive manner<br>• Reg. would ensure, together with the ECMR, a coherent review of effects of concentrations involving non-EU investors on security and competition,<br>• Reg. would prepare and allow the phasing out of the existing national controls of EU defence investments<br>• Recourse to Art. 346 TFEU possible but Regulation would also serve interests of MS re security of supply, transparency, coherence; participation of MS in Committee or Network and dialogue procedure (Art.348TFEU) would mitigate the conflicts<br>• Filing to the Commission only would reduce burden on investors to minimum, increasing predictability and transparency |

*Executive Summary of the evaluation of Options (here Options 4-6)*

| | **Option 4: Enhanced cooperation: Opt. 1-3** | **Option 5: CSFP decision** | **Option 6: EDA Code of Conduct** |
|---|---|---|---|
| **Main features** | • Specific features depend on which of the Options 1 to 3 is pursued under enhanced cooperation | • May cause adoption of national legislation on decentralised ex ante notification to national authorities<br>• Consultation and information exchange within Network of MS under auspices of the Council (EDA?)<br>• *Sub-Option: May cause very loosely harmonised set of rules for review by national authorities*<br>• Decisions taken by national authorities | • Might cause national rules on decentralised ex ante notification to national authorities<br>• Might cause consultation & limited information exchange mechanism between representatives of the MS<br>• *Sub-Option: Might cause very loosely harmonised set of rules for review by national authorities*<br>• Decisions taken by national authorities |
| **Legal feasibility** | • Art. 329 TFEU; Council authorisation after it has been established that the objective of the cooperation cannot be attained within a reasonable period on a uniform basis by the Union as a whole;<br>• This condition may be difficult to meet or at least it may be very time consuming to provide evidence thereof<br>• Cooperation must be open to other MS | • May be legally feasible, based on an intergovernmental approach – Art. 23 et seq. and Art. 25 (b) ii and/or 29 TEU<br>• Art. 40 TEU would probably not stand in the way<br>• Precedent: Common Position 2008/944/ CFSP re control of exports of military technology and equipment<br>• Need for unanimity see Art. 31 TEU | • Feasible pursuant to Art. 40 TEU<br>• Art. 45(1)(b) TEU: EDA may contribute to implementing useful measures to strengthen EU defence industry |
| **Political feasibility** | • Government stakeholders and MEPs did not express political interest in such a solution. | • Government and industrial stakeholders gave preference to a mechanism involving the EDA over a CSFP decision.<br>• Consulted MEPs regarded this Option as a clearly inferior solution, as it would increase fragmentation and opacity. | • High acceptance among stakeholders from industry and Government<br>• Consulted MEPs were hesitant to endorse this Option given the lack (a) of a legal enforcement mechanism; (b) a solution to main problems; (c) a preparation of further harmonisation in the future. |

| | Option 4: Enhanced cooperation: Opt. 1-3 | Option 5: CSFP decision | Option 6: EDA Code of Conduct |
|---|---|---|---|
| **Technical challenges** | • In addition to the practical challenges specific to the abovementioned three Options enhanced cooperation would in practice require the initiative of one or more MS (in addition to that of the Commission)<br>• Currently, there is a lack of experience of how to devise, implement and manage enhanced cooperation | • Council would need to designate a structure to function as a forum for the information exchange and consultation.<br>• MS without legislation would have to designate a responsible authority and to adopt legislation.<br>• Delegation to EDA would be possible but association of Denmark to the work of the EDA would need to be addressed. | • Code requires support of largest armaments producing countries.<br>• pMS without legislation would need to designate a responsible authority and to adopt legislation obliging all non-EU investors to notify their transactions.<br>• Compared to Options 1 and 2 pMS would have more leeway as to whether or not to adopt legislation and its application. |
| **Efficiency** | • The added value of the Option chosen for enhanced cooperation among Options 1, 2 or 3 as to security of supply etc would be limited to the cooperating MS but market fragmentation of the EU as a whole and nontransparency would persist.<br>• Both these problems are the more pressing, if one assumes that the number of assets deemed to be of strategic importance for the European defence industry will grow in the future, due to the effects of the Procurement and Transfer Directives. | • Option would take the intergovernmental route towards national information exchange and review systems for non-EU investments providing a solution to part of the issues of the current situation only, in particular to the negative consequences of a lack of consultation among MS.<br>• To the extent that similar rules are adopted investors would benefit from an improved quality of the review.<br>• Governments could better assess the risks for their security of supply.<br>• The Decision would be binding upon the MS but the adoption of national rules by the MS would not be subject to judicial control by the CJEU. The normal enforcement mechanisms for EU law and the EU principles of supremacy and direct effect would thus not apply to the national rules to be created. | • A Code on info exchange & consultation would only solve part of the issues of the current situation: negative consequences of a lack of consultation among sMS.<br>• To the extent that similar rules are adopted investors would benefit from an improved quality of the review.<br>• Governments could better assess the risks for their security of supply.<br>• Compared to Option 1 Code would not extend to the entire Union, risk differences among national legislation and, though binding on sMS, would neither be subject to judicial review by the ECJ nor have direct effect and supremacy over national law.<br>• Compared to Option 1 Code would allow addressing internal dimension of control. However, given market fragmentation and security of supply issues the willingness of sMS to proceed has to be doubted. |

| | Option 4: Enhanced cooperation: Opt. 1-3 | Option 5: CSFP decision | Option 6: EDA Code of Conduct |
|---|---|---|---|
| **Efficiency (cont.)** | | • In comparison to an EDA CoC Option 5 would extend to all 27 EU MS (incl. Denmark) and not only to the 26 participating (and potentially even less subscribing) Member States of the EDA.<br>• The Council structure might find it easier than the EDA to bring together the concerns of the different Departments of Government involved in the information exchange and consultation. | • Possibility to collect information for a common legislative review system; but this step might become more challenging, as no independent institution could control the effectiveness of the Code; Governments could point to an existing solution, independent of effectiveness. |

# A ANALYSIS OF THE CURRENT SITUATION

## 1 THE PROBLEM AND ITS POLITICAL AND LEGAL CONTEXT

### 1.1 Starting point: Current patchwork of controls might prevent defence industrial consolidation

The starting point of our study is the observation by the European Commission that

> *"(T)the current patchwork of national legislation on control of strategic defence assets prevents consolidation, the removal of duplication and the development of more efficient industries. It could also prove ill-suited in the future in securing the control of assets in a more European supply chain. Clearly, it is necessary to strike a balance between freedom of investment and protection of security interests regarding control of material and other assets that are considered essential".*[5]

In the past, while cross-border transactions have occurred in Europe to establish European transnational defence companies such as BAE Systems, EADS, Thales and Finmeccanica, there are still sectors such as the armoured fighting vehicles or naval shipbuilding that remain highly fragmented. The character of the defence industry means that any cross-border consolidation of the European defence industry has taken place through the close involvement of European Governments. The consolidation that has already been reached in the European defence industry has been the result of close negotiations of companies *and* Governments on the terms of the transaction. As national Governments continue to represent the most significant customer for European defence companies and decide about the many regulatory aspects of the companies' operating environment from export controls to R&D support, any consolidation has in the past proceeded not only with their consent and their active involvement be it as negotiators or

[5] European Commission. (2007) A strategy for a stronger and more competitive European defence industry. COM(2007)764.

as procurers. Investors, on the other hand, will be well advised to make sure that the most important stakeholder in their investment projects are kept content.

The issue of State controls on strategic assets has been identified as important by policy makers for a number of reasons, which are in part complementary whilst others illustrate the different interests taken by differing national, political and industrial perspectives in Europe. Thus, stakeholders raised amongst others the following issues regarding the current situation of State control of strategic defence assets:

- *State controls over strategic defence assets present barriers to the cross-border merger and acquisition of defence assets by companies from other European Member States.* As mentioned above, cross-border transactions have occurred in Europe in some sectors, but not in others with the consequence that this fragmentation of the European defence industry has been argued to impair its economic competitiveness and constrains its contribution to the development of the capabilities needed to support the Common Security and Defence Policy (CSDP, formerly ESDP). This has been well documented in European Commission Communications, the work of the European Defence Agency (EDA) and studies undertaken by industry analysts.[6]

- *Government ownership of defence companies has proven to be a significant impediment to intra-European M&A activity.* It is observable that, in the six LoI nations, there has generally been much greater openness to inward acquisitions in the UK, Germany and Sweden – countries which do not have public ownership of defence industry. On the other hand, France, Italy and Spain retain extensive public ownership and have not generally embraced inward investment. Foreign private capital has been largely excluded from making substantive acquisitions in these

[6] ———. (1997) Implementing European Union strategy on defence-related industries. (COM(97)583, ———. (2003) European defence-industrial and market issues. Towards a EU Defence Equipment Policy. COM(2003) 113. Brussels, EDA. (2004) A strategy for the European Defence Technological and Industrial Base, Brussels, 14 May 2007, James, A.D. (2005) European military capabilities, the defence industry and the future shape of armaments cooperation. *Defence & Security Analysis* 21:5-20. The 2008 European Defence Agency study entitled "Level Playing Field for European Defence Industries: the Role of Ownership and Public Aid Practices" (ISDEFE and ISI, 2009) has some limited overlap with the current Study. However, there are considerable differences with regards to the objectives, methodology, and substance of the two studies. For a detailed comparison see Appendix 5.

markets, except in the cases such as CASA (acquired by DASA and later incorporated into EADS) and Santa Barbara, acquired by General Dynamics from the U.S.

- *The current patchwork of national legislation on control of strategic defence assets makes further consolidation difficult.* National legislation, policy and processes differ considerably between Member States. These differences are argued to have the effect of making cross-border acquisitions more difficult. These national regulations may either relate specifically to the defence sector or be of general application, through merger controls and other means. There are significant differences in national practice and perspective and these represent a major barrier to the further restructuring of the European defence industry. On industry's side, companies may be deterred from entering into transactions because of the perceived difficulties of making an acquisition in another country (even where there may be few barriers in reality). There is a lack of clarity and consensus on the definitions used in these instruments such that Member States have different interpretations of what is meant by a "strategic" industry, "public order" and "national security". At the same time, the notion of national security is seeing a blurring of the boundaries between defence and security and recent changes in legislation in Member States has seen new attention to energy security; critical infrastructure; and, financial stability.[7]

- *The emergence of trans-European supply chains means that Governments recognise that a merger or acquisition in another Member State may have potential security of supply implications for their own defence equipment programmes.* The European Letter of Intent/Framework Agreement process recognised in its work on security of supply that this was a matter of concern to the six Member States. Unfortunately, the security of supply initiative has failed to reach agreement on its programme of reforms. The French Presidency recognised the need for action in this regard and

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[7] OECD. (2007) Freedom of investment, national security and "strategic" industries: An interim report. In *International investment perspectives: Freedom of investment in a changing world*, edited by OECD, pp. 53-63. Paris, GAO. (2008) *Foreign investment. Laws and Policies Regulating Foreign Investment in 10 Countries. Report to the Honorable Richard Shelby, Ranking Member, Committee on Banking, Housing, and Urban Affairs, U.S. Senate. GAO-08-320*. Washington: United States Government Accountability Office.

suggested a voluntary exchange of information on non-European investment in strategic defence companies in 2008.[8]

- *The existence of strong U.S. controls of strategic defence assets means that the transatlantic situation is unbalanced and raises questions about the need for reciprocity.* There is a feeling amongst some stakeholders in some European countries that the national practices of the United States need to be taken into account. There is a feeling that the existence of strong U.S. controls of strategic defence assets (not least the CFIUS[9] review process and the FOCI[10] control process) mean that the transatlantic situation is unbalanced.[11] U.S. companies, some critics argue, are free to make acquisitions in Europe. However, those same critics contend, U.S. processes make it more difficult for the defence industry from some European countries to make acquisitions in the United States. This has led to calls for "reciprocity" and talk about the introduction of a European equivalent to the CFIUS process. This matter has been raised informally by individuals within industry (particular amongst French companies) but rarely has it been raised "on the record". Academic analysts have written on such matters. For instance, Röller and Véron have argued that Europe should develop a policy framework that is at least as open, comprehensive and sustainable as CFIUS and that such a policy framework should be based on a common legislative framework but implemented at national level. Such legislation should, they argue, include a common objective of defending national and European

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8 Council of the European Union. (2008) Declaration on Strengthening Capabilities, Brussels 11 December.

9 CFIUS stands for Committee on Foreign Investment in the United States.

10 FOCI stands for Foreign Control and Influence.

11 CFIUS is the Committee on Foreign Investment in the United States, a committee chaired by the Secretary of the Treasury comprising representatives from the U.S. Department of Defense, U.S. Department of Homeland Security, U.S. Department of Commerce, the U.S. intelligence community and others authorized to review transactions that could result in control of a U.S. business by a foreign person, in order to determine the effect of such transactions on the national security of the United States. The FOCI review process refers to the review conducted by the U.S. Department of Defense when a company subject to a DOD Facility Security Clearance is deemed to come under foreign ownership, control or influence (FOCI). A review is conducted to establish the means of negating or mitigating the risk of foreign ownership or control. The FOCI is an on-going process for so long as the establishment holds a Facility Security Clearance and is under FOCI. We describe these instruments and their application in detail in the Country Report on the United States in Volume 2 of this Report.

security, as well as a harmonised process to significantly reduce the legal uncertainty that may be associated with fragmented national approaches.[12] This view is highly contested with others arguing that the U.S. market is more open to acquisitions by European companies than are some European defence industries. Our United States Country Report notes that European defence companies from the United Kingdom, Italy and France amongst other countries have all made acquisitions of U.S. defence companies.[13]

- *U.S. acquisitions of European defence assets may act as investments that undermine European defence industrial capabilities and competitiveness.* U.S. companies have made some acquisitions in Europe not least the General Dynamics which has made major inroads into the European land systems industry through acquisition. Equally, there are concerns that U.S. acquisitions of lower-tier suppliers to European prime contractors may also have implications for European competitiveness. There are anxieties that U.S. acquirers could close down European capabilities making Europe dependent on U.S. ITAR controlled technology transfers. Equally, there are concerns that European technologies in U.S. acquired companies could become subject to ITAR controls against European efforts to become "ITAR-free".

- *Concerns about Sovereign Wealth Funds (SWFs) have led Member States to pay new attention to controls over foreign acquisition.* SWFs are State-owned entities that manage national savings for the purpose of investment. The growth of SWFs has prompted a fear that some funds might be used for overt or tacit political purposes and/or concerns that SWFs could be used to take control of strategically important industries, extract technology and other forms of intellectual property. Thus, in 2007, a joint letter to the European Council from President Sarkozy and Chancellor Merkel called for action on Sovereign Wealth Funds and separately Chancellor Merkel expressed fear that Sovereign Wealth Funds were driven by "political and other motivations" rather than economic returns. In 2008, the European Commission set out

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[12] Röller, L.-H. and N. Véron. (2008) A European framework for foreign investment',Vox, 6 December.

[13] For details see the Country Reports on France, Italy, and the UK in Volume 2 of this Report.

principles for a common EU approach to the treatment of SWFs as investors and proposed a Code of Conduct for SWFs to improve governance and transparency. The emphasis of the Commission's Communication was on striking the right balance between addressing concerns about SWFs and maintaining the shared benefits of an open investment environment. The Communication sets out principles for a common EU approach to the treatment of SWFs as investors, as follows:[14]

- **"Commitment to an open investment environment**: in line with the Lisbon Strategy for growth and jobs, the EU should reaffirm its commitment to open markets for foreign capital and to an investor-friendly investment climate. Any protectionist move or any move perceived as such may inspire third countries to follow suit and trigger a negative spiral of protectionism.

- **Support of multilateral work:** the EU should actively drive forward work carried out by international organisations, in particular the IMF and the OECD. The EU welcomes an open dialogue with SWFs owners and recognises the benefits of a global approach to a common framework for SWF investment.

- **Use of existing instruments**: the EU and the Member States already have specific instruments that enable them to formulate appropriate responses to risks or challenges raised by cross-border investments, including investments by SWFs, for reasons of public policy and public security.

- **Respect of EC Treaty obligations and international commitments:** the EU and its Member States will continue to act in a way fully compatible with the principles laid down in the Treaty establishing the EC and with international obligations of the EU.

- **Proportionality and transparency**: measures taken for public interest reasons on investment should not go beyond what is necessary to achieve the justified goal,

[14] European Commission. (2008) A Common European Approach to Sovereign Wealth Funds, Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions, Brussels, 27.2.2008 COM(2008) 115 final. Brussels: European Commission.

in line with the principle of proportionality, and the legal framework should be predictable and transparent."[15]

These principles are in part also applicable to the development of a European approach to the control of strategic defence assets and we will return to them in the evaluation of our proposed Options for EU level action.

## 1.2 Politicians seek to reconcile national security and a liberal trade order

By way of introduction this section will provide some background information on the legal and political context of our study. We should begin by noting that the last five years have seen a number of European Union Member States reviewing and tightening their legislation on the control of foreign acquisitions of what are perceived as strategic assets in an attempt to discourage foreign participation and/or increase scrutiny in some sectors perceived as being of strategic interest. In other Member States there have been discussions about doing likewise.[16] Member States have cited concerns about national security and other essential public interests. There have been similar developments in the United States and in several other advanced economies.[17]

### *1.1.1 Foreign Direct Investment is a key element of economic globalisation*

The 1980s and 1990s saw moves towards a more open global investment regime and free flow of capital with financial liberalisation and a decline in capital controls on foreign direct investment. The international policy community has seen foreign investment as playing a key role – alongside domestic product and capital markets – in strengthening national economies by providing channels for enhanced competitive pressures, physical and human capital accumulation and dissemination of innovations. Globalisation saw the growth of transnational companies through M&A as well as greenfield investments

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[15] Ibid.

[16] OECD. (2006) OECD Roundtable III on Freedom of Investment, National Security and "Strategic" Industries, 6 December 2006, Summary. Paris: OECD.

[17] GAO. *Foreign investment. Laws and Policies Regulating Foreign Investment in 10 Countries. Report to the Honorable Richard Shelby, Ranking Member, Committee on Banking, Housing, and Urban Affairs, U.S. Senate. GAO-08-320*.

### 1.1.2 FDI has been the subject of long standing national security concerns

The growth of foreign investment in the 1980s saw a growth in concern in the United States about Japanese & European acquisition of "strategic sectors" of the U.S. economy. Strategic trade theory argued that the characteristics of high technology industry violated many of the assumptions of free trade theory and that a nation's competitive position in commercial aircraft; semiconductors and other "strategic industries" was a function of strategic interactions between an economy's firms and its Government. This thinking prompted calls for tighter controls in the United States over foreign investment and led to the 1988 Exon-Florio Amendment to the Defense Production Act which introduced new U.S. controls on foreign acquisitions with a national security dimension.

### 1.1.3 Several reasons have caused a renewed interest in FDI controls

The issue of controls on foreign acquisitions of strategic assets has come back onto the international policy agenda in the United States, Europe and elsewhere since 2001. A number countries have ether introduced or considered introducing new legislation or amendments to existing legislation in the field. Those countries include the United States, Germany, France, Russia and China.[18]

A report from the Organisation of Economic Cooperation and Development (OECD) identified some of the reasons for the re-emergence of this policy issue and noted that:[19]

- Security priorities in many countries have been realigned since 11 September 2001
- An actual and potential scarcity of raw materials has led countries to reconsider their perceptions of sectors of strategic importance
- Public concern over individual acquisitions on grounds of concerns about the impact on jobs

[18] Ibid.

[19] OECD. (2006) Roundtable on freedom of investment, national security and "strategic" industries. Paris, France - 6 December 2006. Summary of discussions. Paris: OECD.

- The growing role of non-OECD countries as outward investors which may have heightened concerns that not all countries and companies may necessarily play by common rules or promote high standards of business conduct.

#### *1.1.4 Governments across the world have tightened their FDI controls*

A number of detailed reviews of national policies towards foreign acquisition of strategic assets (including defence companies) have been undertaken in recent years. Those studies have looked at legislation and processes in the United States, Europe, Russia, China amongst other countries.[20] Looking across these countries, these reviews highlight a number of key points:

- There is a lack of clarity and consensus with regard to the key terms by different countries, including definitions of what constitutes a "strategic industry", what is meant by "public order" and the meaning of "national security".

- The notion of national security is adapting to the changes in the economic, technological and international security environments to include energy security; critical infrastructure; and, financial stability.

- The process of review, appeals processes and mitigation arrangements are very different between countries.

- The transparency of these processes and the extent to which they are subject to political intervention varies considerably between countries.

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[20] Ibid, GAO. *Foreign investment. Laws and Policies Regulating Foreign Investment in 10 Countries. Report to the Honorable Richard Shelby, Ranking Member, Committee on Banking, Housing, and Urban Affairs, U.S. Senate. GAO-08-320*, Bialos, Jeffrey P. and Christine Fischer. (2009) *Fortresses & icebergs: The evolution of the Transatlantic defense market and the implications for U.S. national security policy*. Washington: Center for Transatlantic Relations, The Johns Hopkins University and the U.S. Department of Defence, Hogan & Hartson MNP. (2005) Controle des investissements étrangers et sécurité nationale, Tietje, Christian and Bernhard Kluttig. (2008) Beschränkungen ausländischer Unternehmensbeteiligungen und -übernahmen. Zur Rechtslage in den USA, Grossbritannien, Frankreich und Italien. In *Beiträge zum transnationalen Wirtschaftsrecht*. Berlin: Gesellschaft zur Förderung von Auslandsinvestionen e.V.

Most Governments have changed or considered changing their legislation. An OECD study observes: "Citing legitimate concerns about national security and other essential public interests, authorities have reviewed and in some cases sought to discourage foreign participation in sectors perceived as being of strategic interest. A few countries have tightened their legislation in this respect and in several others there are discussions about doing likewise."[21] Similarly, a study of ten countries by the U.S. Government Accountability Office, noted that: "Each country has changed or considered changing its foreign investment laws, policies, or processes in the last 4 years; many of the changes demonstrate an increased emphasis on national security concerns. In some cases, specific transactions were catalysts in the reconsideration of policies and the development of new ones."[22]

## 1.3 The EU legal context is favourable to European solutions

In this section we will review the EU legal context which governs the present study, i.e. the provisions and policies of the EU Treaties, in particular the Treaty on European Union (TEU) and the Treaty on the functioning of the European Union (TFEU). To that effect we have to distinguish

- the EU legal context which is relevant for the status quo, i.e. for the measures that are now in place at the national level in order to control strategic defence assets
- and the legal context that is relevant for a possible European dimension in this control.

### *1.1.5 Extensive use of Treaty derogations explains the status quo*

The present study concerns the legal treatment of investments in the defence industry. Legally, such investments are subject to one of the fundamental freedoms guaranteed by

[21] OECD. Roundtable on freedom of investment, national security and "strategic" industries. Paris, France - 6 December 2006. Summary of discussions.

[22] GAO. *Foreign investment. Laws and Policies Regulating Foreign Investment in 10 Countries. Report to the Honorable Richard Shelby, Ranking Member, Committee on Banking, Housing, and Urban Affairs, U.S. Senate. GAO-08-320*.

the TFEU: the free movement of capital. Article 63 (1) TFEU prohibits all restrictions on the movement of capital between Member States and between Member States and third countries. It is specific to the rules on the free movement of capital to address restrictions in relation to other Member States and to third countries in the same manner.

In spite of the direct and full applicability of these Treaty rules, the situation in Member States with respect to the control of foreign defence investments is a patchwork where some Member States apply national review legislation, others special rights, again others rely on State ownership and those remaining have no control measures.

Let us mention here that this patchwork situation continues to exist even though neither the TEU nor the TFEU provide for any *categorical* derogation with regard to national security or the defence industry.[23] Neither the relevant legislation on internal market, competition, public procurement, and State aid entail any specific or derogative rule for defence companies. This means that as a rule, the EU internal market and competition legislation as well as other rules on common policies do apply to the defence industry.

The TFEU provides only for the possibility to derogate from the general rules of the Treaties under certain defined conditions. For present purposes, derogations for reasons of public and national security are pertinent to the extent that, rightly or wrongly, they form part of the legal context of the present patchwork situation. In addition, the possibility for derogation in the European merger control regulation may be mentioned.

### *a) Treaty derogation for public security reasons: Art. 65 TFEU*

First, the TFEU provides for the possibility to derogate from its provisions on the free movement of capital on grounds of public security. Article 65 (1) (b) TFEU allows Member States to derogate from the free movement of capital and payments regime of the Treaty *inter alia* for reasons of public security.

In line with the other public security exemptions from the free movement regimes (for example Article 36 TFEU for the free movement of goods), the use of this exemption is

[23] See also Case 222/84 *Johnston* Rec. 1986 p. 1651, C-273/97 *Sridar* and C-285/98 *Kreil*, point 16.

subject to a strict proportionality test. The leading judgment on the public security part of this provision in a defence context is *Albore*[24] in which the Court of Justice of the European Union (CJEU) pointed out that "a mere reference to the requirement of defence of the national territory, … cannot suffice" to justify a measure contrary to the Treaty.[25] "The position would be different only if it were demonstrated", said the Court, that to refrain from that measure contrary to the Treaty "would expose the military interest of the Member State concerned *to real, specific and serious risk* which would not be countered by less restrictive procedures."[26] Thus a risk for the military interest ("specific") of the Member State has to actually exist ("real"), the risk has to be military-specific and the risk has to reach a certain level ("serious"), possibly excluding smaller risks. This represents a detailed three-limb suitability test as part of the proportionality test. Moreover, the measure has to be adequate ("which would not be countered by less restrictive procedures").

Hence the field of application of Article 65 TFEU is narrow; it can only be used on a case-by-case basis, applies only in relation to the free movement of capital and is subject to the intense judicial scrutiny of the Court of Justice.

### *b) Treaty derogation for national security reasons: Art. 346 TFEU*

Second, the TFEU allows for the possibility to derogate from its provisions and from those of the TEU, in particular from the provisions on the free movement of capital, freedom of establishment, State aids, and competition for reasons of national security. The latter provisions are laid down in Articles 346, 347 and 348 TFEU. They need to be read together to fully appreciate the letter and spirit of the Treaty.[27]

- Article 346 (1) (a) TFEU allows a derogation in cases where Member States consider this to be required for reasons of secrecy. There is no clarifying judgment on this

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[24] Case C-423/98, *Alfredo Albore* v. *Italy* [2000] ECR I-5965).

[25] Case C-423/98, *ibid.*, at paragraph 21.

[26] Case C-423/98, *supra* note 21, at paragraph 22.

[27] Further down, these provisions are jointly referred to as "Article 346 TFEU".

provision but as is the case with all derogations it has to be interpreted narrowly,[28] can only be used on a case-by-case basis, and are subject to judicial review, see Article 348 TFEU discussed below. This interpretation is also confirmed by the interpretation of especially Article 346 (1) (b) TFEU discussed in the next paragraphs below.

- Article 346 (1) (b) TFEU allows any Member State of the EU "to take such measures as it considers necessary for the protection of the essential interests of its security which are connected with the production or trade in arms, munitions and war material…". Moreover, Article 346 (1) (b) TFEU provides that "… such measures shall not adversely affect the conditions of competition in the (internal) market regarding products which are not intended for specifically military purposes." In 1958 the Council drew a list of products to which Article 346 (1) (b) TFEU applies[29] (according to Article 346 (2) TFEU) which includes most types of modern weapons, such as tanks, fighter aircraft, and missiles.

- Article 346 (1) (b) TFEU enables the Member States to derogate from the application of the Treaties if they can justify that measures concerning production or trade in arms, munitions and war material are necessary for national security reasons and if the measure do not negatively affect the conditions of competition in the common market for non-military items. This means that measures otherwise prohibited and therefore unlawful, e.g. under the fundamental freedoms or the competition regime of the TFEU, can be justified with reference to Article 346 (1) (b) TFEU.

However, as with all derogations from the TFEU the use of this provision is limited. In the leading judgment of Commission v. Spain ("Spanish Arms Exports") the Court of Justice clarified that Article 346 (1) (b) TFEU does not represent an automatic or

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[28] This is a general rule based on consistent case law of the Court of Justice which applies to all exemptions from the TFEU: Case C-222/84, *Marguerite Johnston v Chief Constable of the Royal Ulster Constabulary* [1986] ECR 1651, [1986] 3 CMLR 240, at paragraph 26. See also Case C-13/68 *SpA Salgoil v Italian Ministry of Foreign Trade* [1968] ECR 453, at 463, [1969] CMLR 181, at 192 and Case C-7/68 *Commission v Italy* [1968] ECR 633 at 644.

[29] Council of the EU. Answer to written question E-1334/01 by Bart Staes regarding the List of 15 April 1958 to which Article 296(1)(b) refers of 4 May 2001.

categorical exclusion of armaments from the application of the TFEU.[30] As a derogation it needs to be narrowly defined, because: "(i)f every provision of Community law were held to be subject of a general proviso, regardless of the specific requirements laid down by the provisions of the Treaty, this might impair the binding nature of (Union) law and its uniform application".[31] Member States need to specifically invoke and substantiate the exemption and prove that a situation justifying its use actually exists.[32] Therefore the judgment in Commission v. Spain clarified the narrow interpretation of Article 346 (1) (b) TFEU, an interpretation reiterated in an Interpretative Communication of the Commission[33] and recent CJEU case law.[34] Despite this narrow interpretation, Member State practice before and after the judgment in Commission v. Spain reveals that the authorities of many Member States, in ignorance or defiance of the relevant case law, treat Article 346 (1) (b) TFEU as an automatic or categorical exclusion of armaments from the regime of the Treaty.[35] However, as with all exceptions they have to be interpreted narrowly, they can only be used on a case-by-case basis and are subject to judicial review. Article 346 (1) (b) TFEU is [a derogation] accommodating exceptional circumstances not a provision categorically excluding arms from the Treaty.

- Article 347 TFEU allows derogation in a number of particularly serious national security situations including war, obliging Member States to consult each other in such cases on how to prevent negative effects on the internal market. Again, while the Member State margin of discretion is probably the widest in the context of this derogation, it still has to be interpreted narrowly, can only be used on a case-by-case

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30 Case C-414/97, [1999] ECR I-5585, [2000] 2 CMLR 4.

31 Case C-222/84, *Johnston*, *supra* note 22, at paragraph 26.

32 See on the interpretation of Article 346 (1) (b) TFEU (then 296 (1) (b) EC Treaty) in detail Trybus, Martin. (2002 ) The EC Treaty as an instrument of European defence integration: judicial scrutiny of defence and security exceptions *Common Market Law Review* 39:1347-72.

33 European Commission. (2006) Interpretative Communication on the application of Article 296 of the Treaty in the field of defence procurement. COM(2006)779. Brussels.

34 See the recent not yet reported series of cases confirming C-414/97, *Commission* v. *Spain*, C-372/05, C-490/05, +C-141/07, *Commission* v. *Germany*; C-294/05, *Commission* v. *Sweden*; C-38/06, *Commission* v. *Portugal*; C-284/06, *Commission* v. *Finland*; C-294/05, *Commission* v. *Greece*; C-461/05, *Commission* v. *Denmark*; C-239/06 and 387/05, *Commission* v. *Italy*.

35 Ibid.

basis in highly exceptional cases,[36] and is subject to judicial review.[37] There is no clarifying case law on the provision.[38] Article 347 TFEU is a derogation accommodating highly exceptional circumstances not a provision categorically excluding defence from the Treaty.

- Finally, Article 348 TFEU foresees a role for the Commission and the Court of Justice. The provision calls for consultations between the Commission and the Member State in order to adjust the measures as to allow for the functioning of the internal market including the market for military items.[39] It also provides that the Commission and any Member States can bring the matter directly before the Court of Justice if they deem that another Member State makes "improper use" of the powers provided under Articles 346 and 347. In addition, the Articles 258 and 259 TFEU on infringement proceedings apply.

The use of these derogations forms part of the legal background to the continued fragmentation of the European defence industry. The 2006 Interpretative Communication on Article 346 and the defence package aim to address this situation in a Union (old Community) context.[40]

### *c) The derogation in the merger control regulation: Art. 21*

For completeness sake let us add that Article 21(4) of the European merger control regulation also provides a limited opportunity for Member States to justify interference in a transaction that has been or will be subject to competition scrutiny by the

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[36] See in detail Trybus, Martin. (2004) At the borderline between Community and Member State competence: the triple-exceptional character of Article 297 EC. In *European Union Law for the 21st Century: Defining the New Legal Order*, edited by T. Tridimas and P. Nebbia. Oxford: Hart.

[37] See in detail Ibid.and Tridimas, T. and P. Nebbia. (2004) *European Union Law for the 21st Century: Defining the New Legal Order*. Oxford: Hart.

[38] Only the Advisory Opinion of AG Jacobs in C-120/94, *Commission* v. *Greece ("FYROM")* [1996] ECR I-1513.

[39] Indeed Article 348 (1) must refer to the market for military goods, because it refers to measures covered by Articles 346 and 347. Such measures by definition of Article 346 (1) (b) do not adversely affect the competition in civil markets.

[40] European Commission. Interpretative Communication on the application of Article 296 of the Treaty in the field of defence procurement. COM(2006)779.

Commission.[41] Article 21(4) states that Member States are entitled to "take appropriate measures to protect legitimate interests other than those taken into consideration by (the ECMR) and compatible with the general principles and other provisions of Community law". However, unless these "legitimate interests" fall within the narrowly defined categories of public security, plurality of the media or prudential rules, authorisation must be requested from the Commission before taking any measures.

In conclusion, at this stage, any Member State measure, whether legislation or golden share, monitoring, controlling or otherwise regulating foreign investment in EU defence assets must comply with the conditions of one of the derogations laid down in the TFEU. Under the case-law of the CJEU, derogations from the general rules of the Treaty have to be narrowly construed, can only be used on a case-by-case basis, and are subject to varying intensities of judicial review. The extensive and sometimes misguided use of these derogations forms the legal background to the continued fragmentation of the European defence industry.

### *1.1.6 EU law allows for several European solutions*

Let us now consider some of provisions of the European treaties that are relevant here. First of all it should be noted that under new provisions in the Lisbon Treaty security-related objectives can now legitimately be pursued not only by intergovernmental measures under the CFSP but also by policies concerning the external action of the Union under the TFEU. For our purposes this means that a policy concerning the free movement of capital between the Union and third countries or EU measures under the Common Commercial Policy may now pursue the objective of safeguarding the security, independence and integrity of the Union - which was up to now been the sole preserve of the CFSP. In the alternative, the rules on CDSP might also allow for an intergovernmental approach.

In more detail the present legal situation is as follows:

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[41] Council of the European Union. (2004) Council Regulation (EC) No 139/2004 of 20 January 2004 on the control of concentrations between undertakings (the EC Merger Regulation).

### *a) Art. 21 TEU extends the areas in which the Union can pursue security policy objectives*

Article 21(2) TEU lays down that the Union "*shall define and pursue common policies…in order to safeguard its values, fundamental interests, security, independence and integrity.*" This provision is similar to the former Article 11 TEU.

Article 21(3) TEU adds that the Union shall pursue said security objectives "in the different areas of the Union's external action covered by this Title and by Part V of the TFEU and of the external aspects of its other policies". This provision is new under the Lisbon Treaty. It means that the Union shall henceforth pursue security objectives in its own right not only, as already before, in the CFSP but also

- In the Union's external action defined in Part V of the TFEU, for instance in the common commercial policy
- And with respect to the external aspects of its other policies, for instance in connection with the free movement of capital, to the extent that the relation between the Union and third countries is concerned.

This enhances the possibilities for the EU to act in the security field.

Let us add for completeness sake that the protection of *national* security has always been and will remain the sole responsibility of the Member States. This fact has not only been recognised in connection with the derogation in Article 346 TFEU, but is now also expressly mentioned in Article 4(2) TEU. Already prior to the Lisbon Treaty the fact that national security was the sole responsibility of the Member States did not prevent the Union from harmonising subjects linked to the security of the Member States. Under the Lisbon Treaty the Union may still harmonise national rules while at the same time pursuing also the objective of safeguarding the security of the European Union.

### *b) Art. 63, 64, 65 TFEU on the free movement of capital allow for harmonisation*

As mentioned above, Article 63 (1) TFEU prohibits all restrictions on the movement of capital between Member States and between Member States and third countries.

The security derogations discussed under the previous heading above create the potential for barriers to trade as Member States may legally introduce restrictions on the free movement of capital and payments. These barriers hinder the free flow of investments in defence assets. The EU mechanism to bring down such barriers is harmonisation: Harmonisation ensures that the laws of the Member States created to address the relevant security concerns are harmonised in order to reduce any distortive effects on the internal market.

The legal basis for the purposes of this Study would be provided by Article 64(2) which entitles the European Parliament and the Council to adopt "measures" on the movement of capital to or from third countries – but not within the EU – involving direct investment. As mentioned, the Union could also pursue the objective of safeguarding the security of the Union and its Member States.

Let us add that according to the case-law of the CJEU harmonisation is not permitted where directly applicable Treaty provisions apply.

Given the fact that Article 63 has direct effect and that Article 64 grants the power to regulate certain issues with regard to third countries, in this case to address security issues, the scope of a Directive would be limited to direct investments originating in third countries (not portfolio investments). An interpretative measure clarifying the interpretation of Articles 346 TFEU with regard to the control of investment in strategic defence assets originating in other EU Member States would suffice in such circumstances.

#### *c) Art. 207 TFEU allows for CCP framework regulations*

Moreover, the rules of the TFEU on the common commercial policy, Articles 206 and 207 (2) TFEU provide the basis for a framework regulation. The CCP constitutes external action of the Union. Accordingly such regulation would be limited to the external dimension.

#### *d) The CFSP rules of the TEU might allow for alternative solutions*

The rules of the TEU would allow for certain common measures under the intergovernmental method.

Article 40 TEU is the conflict norm which delineates action under the TFEU from action under the TEU. The interpretation of this article is subject to judicial control by the CJEU (Article 24(1) 2 TEU). The choice of either the TFEU or the TEU is thus not a matter for discretion but subject to strict legal interpretation. Article 40 TEU is less straightforward than its predecessor, the former Article 47 TEU, and its interpretation has not yet been subject to any case law of the CJEU.

The following rules of the TEU would be of importance:

- Pursuant to Article 25 b) ii TEU the Union shall conduct the CFSP *inter alia* by adopting a decision defining positions to be taken by the Union or by strengthening systematic cooperation between Member States in the conduct of policy.

- Moreover pursuant to Article 29 TEU the Council shall adopt decisions, which shall define the approach of the Union to a particular matter of a geographical or thematic nature.

- These two provisions can be the bases of Council decisions defining the approach of the Union to subjects such as the legal treatment of defence investments.

Moreover, Article 45 TEU constitutes the legal basis of the European Defence Agency EDA. A Code of Conduct managed by the EDA would likewise provide an alternative approach.

#### *e) The internal market and competition rules complete the legal context*

The wider EU legal context includes the TFEU rules on the freedom of establishment and of services, Articles 49 et seq. and 52 et seq. TFEU. In addition to the internal market regimes the TFEU seeks to reduce distortions of free competition through competition law and the regulation of State aids whilst the merger control regulation provides a specific legal instrument to permit effective control of certain concentrations in terms of their effect on the competition in the Union.

Articles 101 to 106 TFEU deal with the rules on competition. First, Article 101 (1) TFEU prohibits agreements between undertakings, decisions by associations of undertakings and concerted practices which prevent, restrict or distort competition and which may affect trade between Member States. Second, the merger control regulation deals with

mergers, acquisitions and certain joint ventures between companies of a certain worldwide turnover, to control the potential distortive impact of these transactions on the competition in the EU. Third, State aids are defined in Articles 107 to 109 TFEU. Public support constituting State aid may be in breach of Article 107 EC if the measure distorts or threatens competition and is capable of affecting trade between Member States.

## 1.4 A European solution would be compatible with international law and agreements

The Commission requested the study team to consider whether the adoption of a common mechanism monitoring foreign direct investment (FDI), i.e. investments from third countries, in EU defence assets would be compatible with international law. The common mechanism could be based on the provisions of the TFEU on the internal market and on the common commercial policy.[42] Given that the mechanism would concern investments in defence assets, Articles 346 and 347 TFEU on the possibility of Member States to derogate from the Treaty in cases involving national security would have to be duly taken into account.

Any common rules so adopted would have to comply with international law which binds the EU and its Member States. The main question is whether the common mechanism – which may have restrictive effects on such investments – would comply with international agreements requiring liberalisation of investment.

The international law to be looked at comprises in particular multilateral and plurilateral agreements which have an impact on FDI and to which the European Union and the Member States are parties. Moreover, bilateral trade agreements concluded between Member States and third countries will have to be taken into consideration.

[42] In particular the rules on the free movement of capital, Articles 63, 64(2) TFEU and on the common commercial policy, Articles 206, 207(1) and (2) TFEU are relevant for present purposes.

### *1.1.7 Multilateral/Plurilateral agreements*

The main international trade agreements to which the European Union and all Member States are contracting parties are the General Agreement on Tariffs and Trade (GATT), the Agreement on Government Procurement (GPA), the General Agreement on Trade in Services (GATS) and the Agreement on Trade-Related Investment Measures (TRIMs). All of these agreements contain derogations similar to Articles 346 and 347 TFEU discussed above.

The **General Agreement on Tariffs and Trade (GATT)** applies only with respect to measures concerning trade in goods and is thus inapplicable to the present context. The "national security exception" laid down in Article XXI GATT is nevertheless of interest. It effectively provides a possibility to derogate from the obligations entered into under the GATT[43], possibly justifying action taken by a WTO member State who considers such action necessary to protect its "*essential security interests with relation to war materials, fissionable materials or measures taken in a time of war or emergency*".[44]

The **Agreement on Government Procurement (GPA)** is a plurilateral agreement binding only between its signatories within the WTO. This has included all EU Member States as of 1 January 2007. It provides a set of procurement principles, which apply to goods and services. It is therefore, like the GATT, only of indirect interest in the context of FDI, but is nonetheless illustrative of the prevailing international stance. Similar to the TFEU discussed under 4.2.1.2 above, armaments are subject to a special exemption. According to Article XXIII GPA "(n)othing in this Agreement shall be construed to prevent any Party from taking any action … which *it considers necessary* for the protection of its *essential* security interests relating to the procurement of arms, ammunition or war materials, or to procurement *indispensable* for national security or for national defence purposes." This provision is comparable to similar armaments

[43] See, for example, Schloemann, Hannes, L. and Stephan Ohlhoff(1999) Constitutionalization and dispute settlement in the WTO: National security as an issue of competence. *AJIL* 424-51.

[44] GATT. (1947) General Agreement on Tariffs and Trade - Consolidated text.

exemptions in the other WTO agreements.[45] Moreover, Article XXIII (1) GPA is not applicable to those member States, which have already excluded armaments in their Annexes.[46] While the exemption would probably have to be specifically invoked by the member State in question and its use be reviewed by WTO panels or the Appellate body, such a case has not occurred yet. Hence its interpretation is difficult. The wording "*considers* necessary" rather than "necessary" suggests that compared to other exemptions in the GPA a different and more flexible standard of review is intended, probably only ruling against acts of abuse (bad faith).[47] However, the wording "*essential* security interests" and the express references to "arms, ammunitions, and war material", and "procurement *indispensable* for national security or for national defence purposes" clearly set limits to its use.[48] Nevertheless the provision let to a *de facto* categorical exemption of armaments from the GPA, not too different from the situation under Article 346 (1) (b) TFEU.

The **General Agreement on Trade in Services (GATS)** is a multilateral agreement which applies to trade in services including financial services and investments. The agreement applies to measures by Members affecting trade in services, the Union being a Member since 1995.

Article XIV of GATS refers specifically to security exceptions and lays down that

> *1. Nothing in this Agreement shall be construed: (a) to require any Member to furnish any information, the disclosure of which it considers contrary to its*

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[45] See Article 73 Agreement on Trade Related Aspects of Intellectual Property Rights (TRIPS): "Nothing in this Agreement shall be construed […] (b) to require any contracting from taking any action which it considers necessary for the protection of it's essential security interests […]" in addition to the provisions in the GATT and GATS mentioned above and below.

[46] Arrowsmith, Sue. (2003) *Government Procurement in the WTO*. London: Kluwer Law International..

[47] Ibid. and Schloemann, Hannes L. and Stephan Ohlhoff. (1999) Constitutionalization and dispute settlement in the WTO: National security as an issue of competence. *American Journal of International Law* 93:424-51.

[48] US International Trade Commission. (1979) 6 MTN Studies, Agreements being negotiated at the MTN in Geneva, prepared for the US Senate Committee on Finance, International Trade Subcommittee, 96th Congress, 1st Session (Comm. Print 96/27, 1979), cited by Reich, A. (1999) International Public Procurement Law: The Evolution of International Regimes on Public Purchasing. London: Kluwer Law International.

> *essential security interests, (b) to prevent any Member from taking any action which it considers necessary for the protection of its essential security interests: (i) relating to the supply of services as carried out directly or indirectly for the purpose of provisioning a military establishment…*[49]

We submit that direct investments in strategic defence assets fall within the scope of this exception. The Union (as well as its Member States) can rely on this exception when taking measures considered necessary for the protection of its/their essential security interests, such as the "Options" discussed below. The question remains whether direct investments in strategic defence assets can be qualified as "*services carried out directly or indirectly for the purpose of provisioning military establishments*". The European defence related industries which produce or develop "strategic defence assets" necessary in the event of a crisis are not "military establishments". However, the terms "directly and indirectly" are important. Foreign investments may be said to be services carried out indirectly for the purpose of provisioning military establishments. Therefore the GATS does not prevent an EU instrument either.

The **Agreement on Trade-Related Investment Measures (TRIMs)**. affects all WTO/GATT contracting parties, which includes the European Union and its Member States and applies "to investment measures related to trade in goods" (Art. 1). However, we consider direct investments in shareholdings not to be investment measures related to trade in goods, and accordingly not covered by the Agreement. Moreover, Article 3 TRIMs incorporates by reference all exceptions laid down in GATT 1994 and therefore offers the same derogations as noted above.

The OECD's **Code of Liberalisation of Capital Movements** though not binding on the EU, contains legally binding rules for most EU Member States. It stipulates in combination with the Code of Liberalisation of Current Invisible Operations a progressive, non-discriminatory liberalisation of capital movements, the right of establishment and current invisible transactions (mostly services). It covers among others

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[49] WTO. (1995) General Agreement on Trade in Services, Article XIV *bis*.

the freedom of direct investment and portfolio investment. Article 3 of the Code on public order and security states:

> *"The provisions of this code shall not prevent a Member from taking action which it considers necessary for:*
> *i) the maintenance of public order or the protection of public health, morals and safety;*
> *ii) the protection of its essential security interests;*
> *iii) the fulfilment of its obligations relating to international peace and security".*

Given that the Article is quite broadly formulated and that it is not binding on the EU we do not see that the Code would prevent an EU instrument for investment control.

### *1.1.8 Bilateral agreements*

As to the question whether agreements concluded between Member States and third countries may prevent the EU from adopting a common mechanism on FDI in the defence area, the following considerations apply.

The Lisbon Treaty has amended the provisions on the common commercial policy (CCP) laid down in part V TFEU on the external action of the Union. Articles 206 and 2007 TFEU as amended lay down that the CCP now includes the "*commercial aspects of foreign direct investment*". This amendment is all the more important as under Article 3(1)e TFEU, the CCP forms part of the Union's "exclusive" powers.

Accordingly, it is for the Union – and no longer for the Member States – to conclude agreements on the commercial aspects of FDI and adopt a common framework implementing the CCP in accordance with Article 207(2) FEU. In other words, it has exclusive power to negotiate FDI agreements on commercial aspects in all sectors and to adopt the appropriate legislation.[50]

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[50] See Balan, Georges-Dian. (2008) The Common Commercial Policy under the Lisbon Treaty. Paper presented at the Jean Monnet seminar, Advanced Issues of European Law, 6 th session, April 20-27, 2008, Dubrovnik, Re-thinking the European Constitution in an Enlarged European Union.; Bungenberg, Mark (Ludwig-Maximilians University Munich, Faculty of Law) and available at <www.asil.org/files/ielconferencepapers/bungenberg.pdf>. pp.13-15. (2008) Centralizing European BIT Making under the Lisbon Treaty, Paper (draft version) to be presented at the 2008 Biennial Interest Group Conference in Washington, D.C., November 13-15.

Given this distribution of tasks, we conclude that pre-existing bilateral investment treaties (BITs) of Member States are still applicable under international law and, under the Vienna convention on the law of the treaties, would prevail until terminated. However, BITs can be expected to have a limited impact on common measures adopted in accordance with the provisions on the CCP, since they typically have fairly broad national security carve-outs.

In sum, investments in strategic defence assets appear at this stage not to be subject to liberalisation under the relevant multilateral trade agreements. Nor does it appear that bilateral agreements at the level of the Member States restrict the competence of the European Union to install a common monitoring scheme for EU and non-EU investments in European defence assets.

Let us add for completeness sake that external measures, which are part of the Options discussed in chapter 5 would sometimes include an express reservation, i.e. that they have been adopted and will be applied "*without prejudice to existing international obligations*" of the European Union. This proviso has for example been used in the Directives concerning common rules for the electricity and gas sectors in connection with third country control of certain energy infrastructures. We mention this Option without however seeing an imperative need to use it in the present case.

#### *1.1.9 The OECD discussions on FDI controls provide valuable input*

Initiatives have been undertaken by the members of the Organisation for Economic Cooperation and Development (OECD) in the field of foreign direct investment.

The OECD has paid particular attention to the potentially protectionist aspects of Government controls over FDI and their potentially negative effects on free trade. In 2006, the OECD established a forum for discussions on this matter among its members as well as non-member countries like Brazil, China, Russia and South Africa. The central focus has been on how Governments can "reconcile their duty to safeguard essential

security and other interests of their people with the need to protect and expand an open investment system".[51]

The OECD has agreed certain key principles for the establishment of national control mechanisms and participants have agreed on certain guidance for investment policy measures designed to safeguard national security. Participants in the OECD forum have agreed that measures designed to safeguard national security should be based on the following principles:[52]

- Non-discrimination
- Transparency/predictability
- Codification and publication
- Prior notification
- Consultation
- Procedural fairness and predictability
- Disclosure of investment policy actions as a first step in assuring accountability
- Regulatory proportionality
- Essential security concerns are self-judging
- Narrow focus.
- Appropriate expertise
- Tailored responses
- Last resort
- Accountability

These criteria provide valuable input for a European solution for the control of foreign defence investments.

### *1.1.10 LoI mechanisms are no obstacle to EU action*

The six Letter of Intent/Framework Agreement (LoI/FA, short LoI) countries (France, Germany, Italy, Spain, Sweden and United Kingdom) have agreed to set up an information and consultation mechanism regarding FDI in their defence industry, which has, however, not yet been implemented. The "Framework Agreement Concerning Measures to Facilitate the Restructuring and Operation of the European Defence Industry" was signed on 27th of July 2000 by the six countries and entered into force in

[51] OECD. (2008) Eighth roundtable on freedom of investment, national security and "strategic" industries. Paris, France - 8 October 2008. Summary of discussions prepared by the Secretariat. Paris: OECD.

[52] ———. (2008) Freedom of investment, national security and 'strategic' industries. Progress Report by the OECD Investment Committee.

September 2003. The issue of the control of foreign investments is addressed in the "Security of Supply" area and was further specified in an Implementing Arrangement adopted in December 2003.

Article 7 paragraph 1 of the Framework Agreement entails the basis for the information and consultation mechanism:

> *"To ensure the security of supply and other legitimate interests of the Parties on whose territory the companies involved in the restructuring are located and those of any other Party who relies on those companies for its supply of Defence Articles and Defence Services, the Parties shall consult in an effective and timely manner on industrial issues arising from the restructuring of the European defence industry".*[53]

This procedure should be based on a prior notice issued by the concerned company if the latter intends to form a transnational defence company or if "any significant change which may affect its situation" such as the passing under direct or indirect foreign control, or the abandonment, transfer or relocation of part or whole of key strategic activities. As soon as a Government becomes aware of such a situation it should inform the other LoI countries, who may then raise "any reasonable concerns". These will then be considered "on their merit during any national regulatory investigation" in a review process "by the Parties where the transaction qualifies for consideration according to their own national laws and regulations".[54] Only in exceptional cases may one of the parties retain "certain defined key strategic activities, assets and installations on national territory for reasons of national security".[55]

The Implementing Arrangement specifies the information that the parties agree to exchange. Since it requires the cooperation of defence companies the Governments agree to "endeavour to obtain this information either by mandatory or voluntary means,

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[53] LoI Countries. (2000) Framework Agreement.

[54] Ibid.

[55] Ibid.

depending on the national laws and regulations, in sufficient time to allow consultation with other involved Participants".[56] To this end, the Implementing Arrangement provides for the subscription of the companies to a "Code of Practice for Restructuring" aimed at being a consistent basis for the six LoI Parties. The Code is voluntary and is especially foreseen for those Parties "who cannot obtain prior information from national regulations".[57]

While an analysis of the implementation and application of the LoI mechanism would be beyond the purview of this study, three observations arise from our stakeholder consultation:

- First, none of the experts has expressed any concern that these agreements could prevent the establishment of an EU control mechanism of FDI in the defence industry.

- Second, although the Implementing Arrangement has yet to be implemented, all stakeholders have pointed to practical problems. Thus, not all defence companies are happy to provide the required information, as it could compromise commercial and defence secrecy. Moreover, while the formulation of the Arrangement implies that *all* Parties are informed and may raise their concerns, in practice, information exchange and consultation have occurred generally on a *bilateral* basis, e.g. during Armament Committee meetings. Formal consultations have occurred mostly between EU Governments if defence firms of "their" countries have been involved in the transaction but not for cases involving a non-EU investor. For example, when Abu Dhabi Mare acquired shares of the German ThyssenKrupp Marine Systems, the German desk officer advised his Swedish counterpart *informally* rather than through the LoI process.

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[56] LoI Countries - Defence Ministers. (2003) Implementing Arrangement on security of supply pursuant to the Framweork Agreement "Measures to facilitate the restructuring of the European defence industry".

[57] Ibid. The latter sentence refers specifically to Italy, who has also overseen the negotiation of this Implementing Arrangement. For details on the Italian legislation please see Country Report Italy.

- Finally, it is our impression that such practical problems also arise because the sharing of information and consultation is voluntary, as no legal obligation to do so was agreed upon. The Arrangement also leaves room for different interpretations, for example as to the exact scope of the agreement, the type and size of target companies involved, the time period for informing and consulting with the other Parties etc. As no central authority exists to clarify such issues, lengthy negotiations would be required. We also got the impression that in some cases a Government might not wish to share the information that a particular company is to be sold, in others it might prefer to find a national rather than an EU or non-EU investor for reasons it wishes not to reveal.

We wish the Commission to acknowledge that these observations are based on our engagement with stakeholders focusing on the topic of this study rather than the LoI Implementing Arrangement on Security of Supply. A systematic analysis of the strengths and weaknesses and the challenges of the Security of Supply Implementing Arrangement might yield important lessons for any measures envisaged at EU level.

# 2 CROSS-COUNTRY EXAMINATION OF NATIONAL CONTROL REGIMES

The following section presents the results of our cross-country examination of national control mechanism for strategic defence assets and forms one of the three major pillars of this Report. In line with the Proposal and the Initial Report we have focused our analysis on State ownership, special rights and on legislation for investment controls. However, in our examination we will point to two other forms of control especially arrangements between Governments and other shareholders, which we discuss under the topic of State ownership; and undertakings between the Government and the defence company presented under the heading of special rights.

We start by discussing Government ownership and special rights with regard to defence assets, before pointing to the variety of regulatory means that Governments have to control "their" national defence industry, prompting us to distinguish between "indirect" and "direct" legislation on investment control. The latter takes the form of legislation explicitly or implicitly concerned with control of strategic defence assets.

## 2.1 Government ownership is still a significant means of control

By Government or public ownership we mean that a national or regional Government or public body such as a holding or bank directly or indirectly owns a part of the equity of a company. Our examination shows that there are still four case study countries with significant Government ownership of strategic defence assets: France, Italy, Poland and Spain.

In all cases the Government has set up specific holdings to manage their shares and responsibilities in industrial enterprises such as *Agence des participations de l'Etat* (APE) in France, SEPI in Spain, or Bumar Group in Poland. In the latter country the Ministry of National Defence also operates significant defence industrial production activities. However, this arrangement is an exception, as in all other cases of Government ownership, defence industrial development and production activities are usually organised in the form of corporations i.e. joint stock companies.

Table 2.1 shows the pattern of Government ownership of strategic defence assets in the nine case study countries.

Table 2.1: Government ownership of defence companies[58]

| Country | Companies under total/partial State ownership | Nature of State ownership structures |
|---|---|---|
| **France** | • Nexter<br>• SNPE<br>• DCNS<br>• Safran<br>• Thales<br>• EADS | • 100%<br>• 100%<br>• 75%<br>• 30%<br>• 27%<br>• 15% |
| **Germany** | No State ownership | |
| **Italy** | • Finmeccanica<br>• Fintecna, which controls 99,35% of Fincantieri<br>• Avio<br>• Elettronica SpA<br>• Thales Alenia Space Italia<br>• Telespazio<br>• Joint Venture IVECO-Oto Melara<br>• Orizzonte Sistemi Navali | • 30,18 %<br>• just under 100%<br>• Finmeccanica (15%)<br>• Finmeccanica (31,33%)<br>• Finmeccanica (33%)<br>• Finmeccanica (67%)<br>• Oto Melara (controlled by Finmeccanica) holds 50%<br>• Fincantieri (51%) and Finmeccanica (49%) |
| **The Netherlands** | No State ownership | |

[58] In this table the shareholdings of EU case study countries in defence companies are presented. Only in the case of Italy the shareholdings also include indirect shareholdings. We have decided to do so in order to illustrate how the Italian Government is effectively controlling the most significant strategic defence assets. Thereby and in combination with the variety of regulatory control instruments the Government also has the power to control investments in these assets, despite the fact that Italy has no specific legislation for the control of investments in the defence sector.

Table 2.1: Government ownership of defence companies (continued)

| Country | Companies under total/partial State ownership | Nature of State ownership structures |
|---|---|---|
| **Poland** | Majority of armaments companies State controlled e.g.<br>• Aviation & Radio-Electronics Capital Group (holding)<br>• Munition-Rocket-Armour capital group (holding)<br>• Several overhaul-and-production enterprises and units | • State Treasury (100%)<br>• State Treasury (100%)<br>• Ministry of National Defence (100%)<br>• Ministry of National Defence (100%) |
| **Spain** | • Navantia<br>• INDRA<br>• EADS | • SEPI (100%)<br>• Caja Madrid (20%)<br>• SEPI 5.4% |
| **Sweden** | No State ownership | |
| **United Kingdom** | No State ownership | |
| **United States** | No State ownership | |

State ownership is still a prevalent means of controlling defence assets in four EU case study countries, notably France, Italy, Spain and Poland, whilst Germany, the Governments of the Netherlands, Sweden, the UK and the United States do not own defence companies. In some countries, the defence industries have traditionally been privately owned (German, the Netherlands, Sweden, the U.S.) with the State stepping in as an owner only in exceptional situations (for example in Sweden in case of the insolvency of the Nobel Group in the late 1980s). In the case of the UK, defence companies that were nationalised in the 1970s (e.g. British Aerospace, Rolls-Royce and some shipbuilders) were privatised in the 1980s. The UK has also privatised the larger part of its Government defence research establishments, selling its remaining stake in QinetiQ in 2008.

Among the non-case study countries State ownership is even more prevalent. For example, in Greece and Finland the Government holds significant shares in large defence companies. In Romania the Government still owns significant parts of the defence

industry despite first privatisation efforts.[59] The situation is similar in Bulgaria, Hungary, the Czech and Slovak Republics and Slovenia.[60] Recent attempts to sell the remaining share of the Romanian aviation company IAR Brasov to the long-term industrial partner Eurocopter failed, as the Government demanded a higher price, more cash contributions and more extensive environmental investments.[61]

In the four case study countries where the Government continues to play an ownership role, it does so with two different functions in mind. On the one hand, there are assets for which Governments are in principle willing to relinquish ownership (but not necessarily control). Public ownership has in these cases economic rather than (security) policy motivations and the companies might be privatised "if the conditions are right".[62] This is the case notably in Poland where part of the defence firms are still owned and managed by the Ministry of National Defence and other parts are owned by the State Treasury; but also in Spain, Italy and France, where the Governments are in principle willing to privatise parts of the naval shipbuilders Navatia, Fincantieri and DCNS respectively (in France also the land armaments manufacturer NEXTER and ammunition company SNPE) if the right conditions are in place.[63]

What the "right conditions" are considered to be differs from country to country. It comprises a mix of economic and political aspects. Thus, the Spanish and French Governments might opt for privatisation if it was part of a wider European consolidation in the case of Navantia and NEXTER respectively; the Italian Government puts the emphasis on the right market conditions. The current economic climate and budgetary situation are found by some experts to be not favourable for a privatisation. These companies can not be expected to become completely private in the short-term. However,

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[59] Information provided by the Romanian MoD and Bialos and Fischer. *Fortresses & icebergs: The evolution of the Transatlantic defense market and the implications for U.S. national security policy*.

[60] Kogan, Eugene. (2005) European Union (EU) Enlargement and its Consequences for Europe's defence industries and markets. In *BICC Paper 40*. Bonn: Bonn International Centre for Conversion.

[61] Bialos and Fischer. *Fortresses & icebergs: The evolution of the Transatlantic defense market and the implications for U.S. national security policy*.

[62] Government officials from France and Spain.

[63] For additional information see the Country Reports on France, Italy and Spain.

in general Governments can in these cases be expected to finally give up their shares and ensure control by means other than ownership.[64]

On the other hand, Governments maintain ownership, or more precisely a shareholding, in some defence assets mainly or exclusively due to security considerations. Examples of this category comprise State ownership of France's nuclear production facilities, its share in Safran, the French and Spanish Government's indirect and direct shareholdings in EADS, or the Italian Government's ownership of roughly a third of the shares of Finmeccanica. State ownership in these cases is tied to the ability to oversee strategic management decisions and to represent political interests at board level. Hence, it can be expected that Governments will hold on to their shares in these companies.

In addition to State shareholding, Governments of some countries have entered into special arrangements[65] with shareholders, which are subject to private law but the possibility should not be ruled out that they might represent State measures. It is often difficult to get public access to these agreements or find public information about their content. The arrangements occur at the beginning of the privatisation or the merger of State controlled companies and determine who the company is sold to. In such cases the controlling shareholders are trusted, often national companies, and the agreements will normally concern disposal of shareholdings. Although challenging such measures could be difficult because it would have to be proven that these are State measure, such a possibility should not be excluded. Hence, we will briefly review them here as additional means to control strategic defence assets.

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[64] The remarks by President Sarkozy on occasion of the launch of the first Franco-Italian frigate are indicative of such an attitude: "he [Sarkozy] would be pleased if a major industrial take a part of the shareholding of DCNS". He added "we believe in the European arms industry but not at any price: we believe in it if our German friends want to work with us like our Italian friends". Sarcozy, Nicolas. (2010) Discours à l'occasion du lancement de la Frégate "Aquitaine" à Lorient.

[65] "*Action spécifique*" in French. For examples and a more extensive discussion see the Country Report on France.

***On arrangements between the Government and other shareholders of defence companies***

Arrangements between the Government and shareholders are used by the French, German and Spanish Governments with regard to EADS and by the French Government and Dassault Aviation regarding Thales. As for EADS the Sogeade Agreement, the Participation Agreement, the Contractual Partnership Agreement and the Agreement between the French State and Daimler concern various governance issues such as voting rights and procedures, as well as the rights of the different Governments in EADS.[66]

In the case of Thales the French Government and Dassault consented in a Participation Agreement on such issues as stable shareholdings for a limited period of time and on the right of the French Government to cancel the arrangement, should the control of Dassault change in the future.[67] The Specific Convention between the French Government and Alcatel/Lucent from 2006 was transferred to Dassault, when the latter acquired the formers' shares in Thales in 2009. It stipulates rules for the handling of sensitive information, for the citizenships of Thales' Board Members and of Dassault personnel responsible for Thales, as well as the location of the head office of the company. This convention was motivated by the fact that citizens from the United States could have become members of the board of Thales due to the merger between Alcatel and Lucent.

## 2.2 Special rights are used in four EU countries

Finland, France, Italy and the UK use special rights. Special rights are attached to one or more shares, or classes of shares, and confer rights upon the owner of the share – in our case the Government – that are disproportionate in relation to the equity they represent. In part this is due to the historical development of special rights. The UK was the first country to introduce a "golden share" with special rights anchored in law when privatizing parts of its defence companies in the 1980s; meanwhile other Governments notably the French have followed. With the switch from ownership to special rights

[66] For more details see the Country Report on France.

[67] For more details see the Country Report on France, in particular Annex 5.

Governments change the nature of their control over defence assets by selling off shares of the equity of the defence firm, allowing private ownership and management of the organisation but reserving specific rights with regard to issues they wish to control. Examples of powers attached to golden shares include veto powers, especially against takeovers, the right to block any one shareholder from acquiring more than a specific proportion of the equity, or to nominate members of the Board of Directors of the company.

Special rights can be laid down in the company's Articles of Association and can moreover be anchored in national law. Special rights laid down in the Articles of Association have been qualified as State measures *inter alia* where the State in its capacity as the legislature authorised the creation of the golden share within the company (e.g. in case C-171/08 Commission v. Portugal [Portugal Telecom], paras 52-54) or where the State acting in its capacity as a public authority, approved the Articles of Association and the share in accordance with national legislation (e.g. in Case C-98/01 Commission v UK [BAA], para 48). In both cases, they have been considered as State measures, given that the special powers were written into the Articles of Association when the State owned and controlled the company,. As State measures they have to comply *inter alia* with the rules on the free movement of capital, Articles 63 et seq. TFEU and are subject to judicial review by the CJ EU.[68]

As Table 2.2 shows, the use of special rights for controlling strategic defence assets is limited to three of the nine case study countries: France, Italy and the UK. In all three cases the content of the special rights concerns similar issues – comprising the right to control the shareholding structure, to appoint a non-voting director, and to oppose specific decisions – but variations occur with regard to the specific characteristics.

[68] See as to the ECJ case law on "golden shares" Cases C-98/01 *Commission v UK* ECR(2003) I-4641; C-463/00 *Commission v Spain* ECR(2003) I-4581; C-483/99 *Commission v France* ECR(2002) I-4781; C-112/05 *Commission v Germany* ECR(2007) I-8995; Opinion AG of 2 December 2009 Case C-171/08 *Commission v Portugal* ECR(2010) 0000.

Table 2.2: Special rights

| Country | Companies subject to special rights provision | Nature of special right |
|---|---|---|
| **France** | Thales | Special rights anchored in Decree N° 97-190 of 4 March 1997 adopted in application of Article 10 of Law N° 86-912 of 6 August 1986, as amended<br>▪ to control any increase beyond 10% of any direct or indirect holding in the company;<br>▪ to appoint a representative of the State as a non-voting director of the board;<br>▪ to oppose decisions with regard to specific assets. |
| Germany | No special rights | |
| **Italy** | Finmeccanica | Special rights anchored in Article 4.327 of Act No 350 of 24 December 2003<br>▪ to veto acquisitions of shareholdings exceeding 3% of the equity;<br>▪ to appoint a non-voting member of the board;<br>▪ to oppose agreements among shareholders representing more than 3% of the equity;<br>▪ to oppose any decisions to dissolve, merge or split the company, or to transfer its legal seat abroad, or to change the scope of its activities. |
| **The Netherlands** | No special rights | |
| **Poland** | No special rights | |
| **Spain** | No special rights | |
| **Sweden** | No special rights | |
| **United Kingdom** | • BAE Systems<br>• VSEL<br>• Rolls Royce<br>• QinetiQ<br>• Devonport Dockyards<br>• Others | • Special rights vary between companies and are contained in the Articles of Association |
| **United States** | No special rights | |

In France the Articles of Association of Thales provide in Article 6 that the French State holds a special share in the company.[69] This golden share confers upon the French State the right *inter alia* to control any increase beyond 10 percent of any direct or indirect holding in the company; appoint a representative of the State as a non-voting director of the board; and the right to oppose decisions with regard to specific assets.

In case of the Italian firm Finmeccanica the special rights of the Government are slightly more extensive. They comprise of the right to veto acquisitions of shareholdings exceeding 3% of the equity; to appoint a non-voting member of the board; to oppose agreements among shareholders representing more than the 3% of the equity; to oppose any decisions to dissolve, merge or split the company, or to transfer its legal seat abroad, or to change the scope of its activities.[70]

The UK has made use of special right provisions as part of the privatisation of defence companies. The special rights are contained in the Articles of Association of the company concerned. The golden share is held by the Department of Business, Innovation and Skills (BIS) in the case of BAE Systems and Rolls-Royce and by the Ministry of Defence (MoD) in the case of the other companies such as QuinetiQ. It is important to emphasise that the special share does not give the Government direct management control over the company concerned. For example,

- Foreign shareholding limits – foreign shareholding limits were introduced as part of the privatisation of British Aerospace (now BAE Systems) and Rolls-Royce. These have been relaxed over time but there is still a 15% limit on individual foreign shareholdings in BAE Systems and Rolls-Royce. Aggregate foreign shareholding has risen above 50% in both companies at certain points in their recent history;

- Disposals – the special shareholder has certain rights with regard to consultation and veto powers over the sale of the company and some specific assets and in some cases

[69] For details regarding the Articles of Association and legal texts see Country Report France.

[70] For details regarding the Articles of Association and legal texts see Country Report Italy.

has the option to purchase certain Strategic Assets in certain circumstances (for example, in the case of QinetiQ);

- Nationality of directors – in the case of BAE Systems and Rolls-Royce, a simple majority of the Board, including the Chief Executive and any Executive Chairman must be British;

- Compliance system – in the case of QinetiQ and because of the sensitivity of the intellectual property and capabilities held by the company, and the importance of its advice and consultancy services for MoD remaining objective and impartial, the special share confers certain rights with regard to the monitoring of the compliance system established as part of its privatisation.[71]

The Governments of the remaining case study countries do not hold golden shares (Germany, the Netherlands, Poland, Spain, Sweden and the U.S.) to control strategic defence assets.

As for the non-case study countries who responded to the survey, we could identify use of special rights by the Government of Finland for control in a maintenance and support company.[72] As for Romania the situation is not conclusive, since the publicly available information disagrees with the information provided to us by the MoD. A publication in the Romanian Journal of Economic Forecasting from 2008 stated that "Romania has limited, but not fully eliminated, the use of golden share to affect strategic decisions of firms", without specifying the sectors in which theses shares were held.[73] In 2009 it was reported that the Government held special rights in eight defence companies.[74]

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[71] For details see the Country Report on the UK.

[72] For details see Appendix 2 in Volume 2 of this Report.

[73] Fay, Marianne, Donato De Rosa and Pauna Calalin. (2008) Product regulation in Romania: A comparison with OECD countries. Part II. *Romanian Journal of Economic Forecasting* 3:5-29.

[74] Bialos, J.P. and Fischer, C. (2009) *Fortresses & icebergs: The evolution of the Transatlantic defense market and the implications for U.S. national security policy*. Washington: Center for Transatlantic Relations, The Johns Hopkins University and the U.S. Department of Defence.

Some Governments have chosen to adopt other control-enhancing mechanisms, which are not anchored in any law but rather based on undertakings between the Government and the defence company.

***On undertakings between the Government and the defence company***

The undertakings considered here, are not the undertakings that form part of the mitigation process. They are rather agreed as part of the privatisation process between a Government and a defence company and concern specific obligations of the company most often with regard to issues of governance, security of supply and security of information. The particular forms in which these agreements are concluded vary from country to country.

The French Government, for example, signed a "Ballistic Missiles Contract" with EADS providing it with the right to oppose certain decisions regarding the missile business of the company. In the case of Safran, the French Government agreed with the company to obtain consent from the French authorities for all asset disposals concerning any nuclear deterrence activity. Similarly, with MBDA to French Government agreed on measures safeguarding the activities related to the airborne nuclear component.

In Poland such undertakings are part of the privatisation agreement between the Government and the investor and cannot – unlike a company's Articles of Associations – be altered by the company's shareholders.

The Spanish Government uses another type of clauses in the privatisation process. In the case of *Santa Barbara Sistemas*, for example, it had decided with General Dynamics that the MoD could for five years investigate the way privatisation agreements were implemented in terms of workload and the retainment of technologies on the Spanish soil.

As mentioned above, though it might be difficult to prove that these measures are State measures, they are not in themselves immune to being challenged.

## 2.3 National regulation of control varies significantly across EU countries

### *2.3.1 Governments have multiple regulatory means of control*

Our examination of the nine case study countries shows that the Governments of these countries have a variety of means for the control and influence of "their" domestic defence industry. These instruments are grounded in the specific characteristics of the defence industry and market.

In our interviews we often found that the topic of State control of defence assets and especially the issue of investment controls was not considered as a top-priority issue by stakeholders from Government or industry. A major reason was control by Governments has to be considered as the result of the combination of all the regulatory instruments at their disposal. It is, hence, not surprising that many experts feel that their Governments have sufficient sway over strategic defence assets.

Principally we can distinguish three broad categories of regulation that can affect the decisions of investors in defence assets: financial or economic regulation, legislation that indirectly or directly influences investment decisions and specific investment control legislation.

1. As for the financial and economic regulation it suffices here to point out that the monopsony position of the Government and the power to shift considerable orders away from one supplier to another, help to deter possible unfriendly acquisition of domestic companies. Defence procurement policies including R&T contracts for new defence systems can be regarded as a similar means of control.

2. In addition, national legislation shaping policies with regard to secrecy, access to production facilities and the provision of security clearances for company personnel represents another important means of control. In almost all countries companies need to register or even obtain a permit if they want to develop, manufacture or sell arms.[75]

[75] Similarly, some Governments restrict the board membership to individuals with certain characteristics: in Sweden only natural persons who are domiciled and in Austria those who are nationals can be elected to the management board. The UK too, can include such provisions in mitigation requirements.

Especially in case of exports, companies require a license for every single business transaction – until the full implementation of the Transfer Directive also for intra-EU transfers. The possibility to deny such permissions and licenses presents a powerful tool in the hands of Governments to make an investment unattractive and thereby to control the domestic defence assets. Given that the legislation is not directly aiming at investments but affect expectations of investors nevertheless, albeit indirectly we will call them here "indirect" regulatory means of investment control.

3. Finally, there is legislation explicitly dedicated to the control of investments in strategic defence assets. We will refer to this legislation as "direct" means of investment control.

Three countries have only indirect investment control regulations:

- The Netherlands is generally considered to be very open to foreign investors and this openness also applies to their defence industry.

- In Poland the majority of defence firms are still State owned and thereby State controlled. The Government is not so much eager to control but rather to attract foreign investments to successfully privatise armaments companies. Hence, the country has no direct national investment control legislation.[76]

- Italy requires armaments firms to register with the Ministry of Defence, albeit without any powers of the latter to control or restrict them or their ownership structure. Currently, no information as for the ownership structure is requested for the entry in the Register. Should information on ownership structure be requested in the future Government still would have a better monitoring of the sector but still lack the

[76] The Act on Special Powers of the Treasury and their Exercise in Companies of Special Importance for Public Order or Public Security from June 3, 2005 which was subject to EC infringement procedure was replaced on March 18, 2010 (in force from April 1, 2010) by The Act on Special Powers of the Treasury and their Exercise in Companies of Electricity, Oil and Gas sectors. The new bill has a narrower scope of application, and covers the energy related sectors and those companies which own the infrastructures considered as critical by the competent national authorities. It explicitly excluded defence companies to be covered by state's special powers. Any future steps aimed at expansion of the act would therefore require the full parliamentary procedure for amending the bill.

legislative power to amend or ban investments.[77] However, as mentioned above, approximately 80% of the Italian defence industry is under the wing of State controlled firms – Finmeccanica and Fincantieri; hence, only the remaining 20% can currently not be monitored.

Six out of the nine case study countries – France, Germany, Spain, Sweden, the UK and the U.S.), as well as Finland – have in addition to indirect regulation also regulation specifically directed at the control of investments in strategic defence assets.

Table 2.3: Case study countries and their national investment control regulation

| **Countries with only indirect investment control regulation** | **Countries with indirect *and* direct investment control regulation** |
|---|---|
| 1. The Netherlands<br>2. Poland<br>3. Italy | 1. France<br>2. Finland<br>3. Germany<br>4. Spain<br>5. Sweden<br>6. United Kingdom<br>7. United States |

Two qualifications are in order: Among the 19 non-case study countries only Finland and Greece have direct defence investment control legislation. While we received and could find publicly available information about the Finish legislation this was not the case for Greece. Hence, only Finland will be considered appropriately in the analysis of countries with national control legislation.[78]

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[77] The only tool that is currently available to acquire this kind of information is suggested in the LoI Implementing Arrangement on Security of Supply.

[78] The Greek authorities did not respond to our questionnaire requesting information about the existence and character of national investment control legislation. The Greek defence industry association reported that no such legislation exists specifically for the defence sector. However, since 2008 the Commission contests the Greek Law on investment in strategic companies (Law 3631/2008) which provides for an ex-ante authorisation system, according to which the acquisition of voting rights by shareholders other than the State is limited to 20%, unless prior approval has been granted by the Inter-

In the following we will examine in more detail the legislation that has specifically been adopted and is directly applied for the purpose of controlling investments in strategic defence assets. Hence, our analysis will in most cases, if not otherwise mentioned, be restricted to the six case study countries with direct investment control legislation and to Finland.

### *2.3.2 Direct investment control legislation varies along several dimensions*

The following discussion compares the legislative means of investment controls according to twelve different dimensions: (a) notions of "strategic defence asset"; (b) purpose of legislation; (c) notion of "national security interests"; (d) European dimension in the definition of "national security interests"; (e) investors falling under the legislation; (f) threshold triggering a review; (g) authority responsible for the review process; (h) need for a notification; (i) review process and duration; (j) assessment criteria; (k) possible outcomes of the review; (j) obligation to publish the decision and possibility for an appeal against the decision.

#### *a) Notions of "strategic defence asset" differ considerably*

Our analysis of the case study and non-case study countries shows that the notion of which assets and investments should be scrutinised varies considerably from country to country. It includes not only strategic defence and defence-related assets but – after legislative changes in recent years – in some countries also other sensitive assets. The differing legislation and practice imply that to the extent that Member States rely on Article 346, they do so in a heterogeneous and nontransparent manner.

In principle, national legislation deals with this issue in two different ways:

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ministerial Privatization Committee. Moreover, it provides for an ex-post approval system, according to which certain important corporate decisions as well as certain decisions concerning specific management matters need, for their validity, the approval of the Minister of Economy and Finance. For further details on Finland and Greece see Appendix 2 in Volume 2 of the Report.

- Either the laws specify the activities related to certain products (France, Spain and Sweden, as well as Finland and Germany in the case of their defence-related regime[79]) or the sectors (France) that are subject to control or

- the legislation stipulates general rules as to how to determine the investments that are to be scrutinised. Thus the UK merger rules specify that any investments falling under the merger regulation affecting the "public interest" or defence contractors[80] holding secret information might become subject of control, regardless of the activities or products that the target company produces.

The Finnish and German control legislation combine two complementary sets of control rules: one addressing all non-national investors and another applying to domestic producers of strategic defence assets. The latter are defined in Germany by the German War Weapons List and in Finland by reference to their activities and products. This is the "defence-related" regime.

A second set of rules in Finland and Germany applies to non-European Economic Area (EEA) investors and – in principle – to the entire economy for reasons of "important national interests" (Finland) or "public order and security" (Germany). In practice, however, Government experts stated that this legislation is used only for "rare and isolated cases" without further specifying how these cases are selected. This set of rules will be referred to as the "security-related" regime. Unless expressly specified, we will below discuss the defence-related regime.

Based on our analysis of the legislation we suggest the following distinction of three different types of strategic assets i.e. assets that are subject to investment control legislation: "strategic defence assets", "defence-related assets" and "sensitive assets".

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[79] For a qualification in the case of Germany see next paragraph.

[80] Also the French legislation provides for the case that any company that is a contractor of the MoD might become subject of investment controls.

- We will below consider as strategic defence assets those included in the 1958 list of the arms, munitions and war materiel referred to in Article 346 (2).[81] None of the case study countries under investigation defines the notion of "strategic defence assets" with reference to this list.[82] All Governments explicitly refer in their legislation to defence industrial activities or products (Sweden, Spain, France, Germany, U.S.) or imply the defence sector by reference to "national security interests" (UK). Hence, the defence industry is at the core of those assets that are potentially shielded from foreign investments.

- In addition there are defence-related assets, which are either specifically mentioned in national laws such as cryptography, IT security or satellite control (Germany, France, U.S.); or which are defence contractors (France) *and* holding secret information (UK). Strategic defence assets and defence-related assets will be referred to as "defence assets".

- Finally, there are other sensitive assets, used for the production or delivery of potentially any activity, which might either touch upon the "public order and security" (Germany) or "important national interests" (Finland). Similarly, in other countries sectors that are not linked to the defence or public security of the country can be subject to investment controls such as gambling in France or certain means of transportation in Poland.[83] In the case of the United States the 2007 Foreign Investment & National Security Act (FINSA) added new factors that CFIUS should consider in its analysis of national security such as the effect of the investment on U.S. critical infrastructure and on U.S. critical technologies or whether the transaction is "a foreign Government-controlled transaction"

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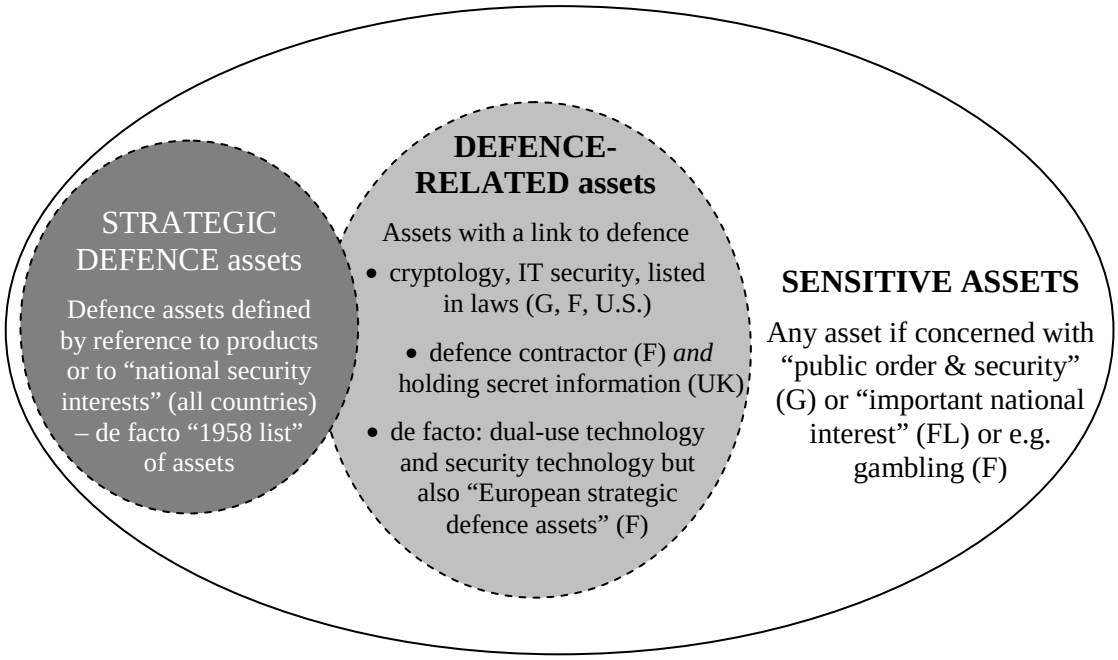
[81] Council of the EU. Answer to written question E-1334/01 by Bart Staes regarding the List of 15 April 1958 to which Article 296(1)(b) refers of 4 May 2001.

[82] A recent attempt by the German aerospace industry association to determine the "strategic defence industrial capabilities" led to a rather comprehensive list of existing industrial assets.

[83] It should be noted that to the extent that these sectors have not been excluded yet, it is likely that they will be in the future by any settlement with the Commission.

Figure 2.1: Model of "strategic assets"




The national notion of "strategic assets" has been extended in recent years in some case study countries. The most obvious example is Germany with a change of the law in 2009 to include potentially any firm in the economy and the United States. In France, on the other hand, the sectors that fall under control provision had to be clarified more specifically following a ruling by the CJEU in 2005 on *Église de scientology* .[84]

Figure 2.1 reflects the fact that Article 346 with its reference to the "1958 list" would allow Governments to control investments in strategic defence assets only and not investments in the other kinds of assets and only under certain conditions and not as a general rule. However, the figure also indicates that for the Member States the types of defence assets to be protected under national rules or practices includes defence-related and other sensitive assets and is incongruent with this list and is moreover subject to change over time.

[84] Case C-54/99 *Église de scientology*.

As for defence-related assets – many of which did not exist back 1958 and were not included in the aforementioned list – the EU legislator has accepted that the 1958 list has to be interpreted in "'a broad way in the light of the evolving character of technology, procurement policies and military requirements which lead to the development of new types of [defence] equipment'".[85] The EU legislator insists, however, that such flexibility is only appropriate "provided that the equipment is *specifically* designed or adapted for military purposes" (our emphasis).[86] Should Member States control FDI in defence-related assets the legitimacy of the (implicit) application of Article 346 cannot be automatically be assumed.

Our analysis shows that national legislation on the control of FDI varies considerably as to the types of assets that are scrutinised and that the legislation of some countries (France, Germany and the UK) includes in principle the control of assets, which are not products referred to in Article 346 (2) and accordingly not covered by this derogation. Provided that the relevant conditions are fulfilled legislation of this kind may nevertheless be justified on the basis of other public order and security derogations contained in the Treaties such as Article 65 TFEU.

The existence of substantial differences in particular with regard to the scope of national control legislation and administrative practices implies that Member States relying on Article 346 TFEU and other Treaty-based derogations are likely to do so in a heterogeneous manner. As a result of these disparities the segment of the national economies that national measures are designed to "protect" varies considerably across the EU.[87]

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[85] Council of the European Union and European Parliament. (2009) Directive 2009/81/EC of 13 July 2009 on the coordination of procedures for the award of certain works contracts, supply contracts and service contracts by contracting authorities or entities in the fields of defence and security, and amending Directives 2004/17/EC and 2004/18/EC. *OJ* L 216:76-136.

[86] Ibid.

[87] For example, we found that *de facto* the French control legislation is applied also to what is called "European strategic defence assets", to dual-use technology and to security technology. These distinctions are not referred to in the legal text but rather in practice. Interviews with officials from the French MoD, Paris April 2010. The French White Paper reflects similar notions in the discussion of "three circles of [defence] industrial policy": national, European and world-wide.

Moreover, in face of the fact that all Governments but the UK do publicise neither the opening of a case nor the final decision, means that they do not (need to) explicitly invoke Article 346 for the control of an intended transaction. Thus it remains unclear under what exact conditions these Member States deem it necessary to control an investment and when not. It has to be doubted that such a nontransparent practice is compatible with a proper exercise of the retained rights under Article 346 TEU.

Such a heterogeneous and nontransparent practice of investment control is neither conducive to forming a level playing field in the European defence industry nor does it contribute to establish a common investment regime, a situation that is likely to present an impediment for third country investors.

### *b) Purpose of legislation is to safeguard public and security interests*

The purpose of most direct investment control legislation is to safeguard public security or other legitimate public interests. We say "most" because not all countries employ this kind of language but refer to these purposes only by implication. The legal texts of France, Finland, Germany, Spain, the UK and the U.S. mention the goal of "security" and some sort of public security interest. The Swedish legislation implies that its application has to serve a public interest, namely to be in line with Swedish defence and security policy and not to contradict the foreign policy of the country.

Our analysis refers to the formulation of the legislation only. The purpose of the direct investment legislation has, however, to be seen in a wider context. For example, it has to be viewed in relation to other stipulations of the law such as the criteria that authorities should use in order to assess the cases under review. In addition, the wider political practice has to be taken into account. For example, in Spain and France the legislation is considered by some experts to provide the Government an additional bargaining chip in their negotiations with foreign investors and EU partner Governments that might be used to gain concessions. We will return to this aspect in our assessment of the current situation from a European perspective further below under (c).

### *c) Notion of "national security interests" is very broadly defined*

The exact meaning of "public interest", "national security interests" remains in most cases unspecified. The Swedish legislation simply refers in the broadest possible sense to "security policy and defence policy reasons".[88]

The UK Enterprise Act (2002) provides for the Secretary of State for Business Innovation and Skills to serve a "European intervention notice" to protect legitimate interests under Article 21(3) of the ECMR. National security is specified as a legitimate interest under the Enterprise Act. Chapter 2, 58 (2) of the Enterprise Act defines "national security" to include public security and "public security" has the same meaning as in Article 21(3) of the ECMR. The Act also provides for an exceptional category of mergers which can be referred on public interest consideration grounds only ("special merger situation"). These are mergers involving a Government contractor (past or present) who holds confidential material related to defence – so triggering the consideration of national security – but who does not meet the normal qualifying thresholds relating to turnover or the share of supply.[89] The Enterprise Act 59(9) makes clear that "defence" has the same meaning as in section 2 of the Official Secrets Act 1989 (6); and "Government contractor" includes any sub-contractor of a Government contractor, any sub-contractor of that sub-contractor and any other sub-contractor in a chain of sub-contractors which begins with the sub-contractor of the Government contractor.

Spanish legislation includes next to "public order" and "public security" also "public health".[90] German legislation refers to the goals of preventing "a disturbance of the peaceful coexistence between nations", or "a major disruption of the foreign relations" as

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[88] Swedish Ministry of Foreign Affairs. (2000) The Military Equipment Act (1992:1300). With amendments up to and including SFS 2000:1248 (Swedish Code of Statues, unofficial translation from the Ministry of Foreign Affairs).

[89] The provisions of the Enterprise Act mean that, in normal circumstances, mergers can only be considered by the UK competition authorities if the turnover in the UK of the enterprise being taken over exceeds £70m or the merger creates or increases a 25% share in a market for goods or services in the UK or a substantial part of it.

[90] Spanish Government. (1999) Royal Decree 664/1999, of April 23, on Foreign Investments (Real Decreto 664/1999, de 23 de abril, sobre inversiones exteriores).

well as to "military security precautions" of the country[91] but also specify that altogether the restrictions are to guarantee Germany's "essential security interests"[92].

The French notion of "national security" is reflected in the following statement: "The national security strategy is aiming at identifying all kinds of threats and risks likely to impact the life of the Nation, especially regarding protection of population, integrity of territory and sustainability of the institutions of the Republic, and to find the appropriate answers to be provided by the authorities. All the public policies contribute to national security. The defence policy is aiming at ensuring the integrity of territory and protection of the population against armed aggressions. It contributes to fight against other threats likely to affect national security. It is the custodian of alliances, treaties and international agreements".[93]

In Finland the notion of national security refers to "(1) securing national defence; (2) preventing such serious economic, social or environmental sectoral or geographic troubles as are likely to be permanent, and (3) safeguarding public order and the population's safety and health".[94]

In the case of the United States, the definition of national security used by the Committee on Foreign Investment in the United States (CFIUS) is very broad indeed and the U.S. note that: "Ultimately, under section 721 (of the Defense Production Act) and the Constitution the judgment as to whether a transaction threatens national security rests within the President's discretion".

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[91] Bundesministerium der Justiz. (2009) Außenwirtschaftsgesetz in der Fassung der Bekanntmachung vom 27. Mai 2009 (BGBl. I S. 1150), das durch die Verordnung vom 17. Dezember 2009 (BAnz. 2009, 4573) geändert worden ist.

[92] Ibid.

[93] Gouvernement de France. (2009) Code de la défense, Article L1111-1, Modifié par LOI n°2009-928 du 29 juillet 2009 - art. 5.

[94] Ministry of Trade and Industry of the Republic of Finland. (1992) Act on the monitoring of foreigners' corporate acquisitions in Finland (1612/1992; amendments up to 623/1999 included).

### *d) "National security (interest)" is largely defined without an EU reference*

Formally, the notions of „national security interest" or „public interests" are understood in national terms without any reference to a European dimension but in two cases:[95] German legislation differentiates between investments in the defence industry and other strategic sectors. Control of investments into the latter aims at protecting the "public order and security of the Federal Republic of Germany within the meaning of Articles 46 and 58(1) EC Treaty" (now Articles 52 and 65(1) TFEU). In the UK, as mentioned above, Chapter 2, 58 (2) of the Enterprise Act defines "national security" to include public security and "public security" has the same meaning as in Article 21(3) of the ECMR.

While the formal reference to a European text sets both legislation apart from that of all other countries, this can hardly be regarded as adding a European dimension to the national security interest because the concepts concern the public order and security of the Member State in question and not that of other Member States or of the Union.

### *e) Direct legislation of most countries applies to non-national investors*

This criterion of analysis compares which types of investors are subjected to control: all investors, only non-national investors, only non-EU investors.

- In Sweden and UK no distinction is made between domestic, EU and non-EU entities i.e. any obligations equally apply to all investors.

- Legislation specifically designed to control foreign investment in defence assets usually distinguishes between national and non-national investors, i.e. investors that are located outside the country, subjecting only transactions intended by the latter group to control (France, Germany, Spain, the U.S.).[96]

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[95] While we focus here on the formal aspects, the practical side of this problem is discusses below at 3.7.

[96] The German wider security regime applies only to "non-EU" investors. It moreover treats investors from the EEA countries like EU investors. Given that EEA = EU + Liechtenstein, Iceland and Norway, that regime applies only to non EEA investors. See the Country Reports on France and Germany for further details.

### *f) Threshold triggering a review varies regarding indicator and size of indicator*

This criterion considers the minimal size of the investment, measured in terms of shares of equity or the voting rights, that triggers a control. As for this dimension too, the national legislations differ widely.

- In Spain, Sweden and the U.S. all changes in the ownership of equity and the voting rights need to be notified.

- In Germany an investment has to be notified to authorities in case the transaction leads to an acquisition of 25% of the voting rights of the target company. In France transactions of non-EEA investors are controlled in case they acquire sufficient shares that would allow them to block any decision (33,3% of the voting rights in a French "*société anonyme*") of a French defence firm or of a French firm from a "strategic sector". While investors do not have the control over the company they can effectively paralyze its business. By contrast, investments from EEA countries are only reviewed if they would lead to the acquisition of a controlling stake in the French company.

- While in the UK such changes do not need to be notified, they can prompt an examination if they fall under the merger regulation. Mergers can only be considered (a) if the turnover in the UK of the enterprise being taken over exceeds £70m or the merger creates or increases a 25% share in a market for goods or services in the UK or a substantial part of it; or (b) if the transaction involves a Government contractor (past or present) who holds confidential material related to defence.[97]

### *g) In most countries the Ministry of Economy is responsible for the review*

The dimension of which department in the Government is vested with the authority to oversee the control of FDI shows the highest commonality across countries: in all countries it is the Ministry dealing with economic and trade matters are in charge of

[97] Office of Public Sector Information. (2002) Enterprise Act 2002.

investigating the control of foreign investments. The Ministry will in any event consult with the Ministry of Defence on investments in defence-related companies and with other Ministries in case of investments in other sectors deemed of strategic importance.

While the Ministry concerned with economic and trade matters (henceforth "Ministry of Economy") is in all EU case study countries responsible to oversee or conduct the review[98], the authority to adopt a binding decision lies in some cases not with the Ministry but with the entire Government (France, Spain, Sweden, Finland for restrictive decisions, Germany for restrictive decisions concerning security-related investments) or the President (in exceptional cases in the U.S.).

In the UK, it is the Secretary of State for Business, Innovation and Skills who has power to intervene under the Enterprise Act (2002) by means of serving an intervention notice on the Office of Fair Trading (OFT). The OFT conducts the review seeking representations from the Ministry of Defence and other interested parties.

In the United States, the Department of the Treasury is the chair of the Committee on Foreign Investment in the United States. Under the 2007 FINSA, the Secretary of the Treasury can (and in practice does) appoint a lead agency to conduct the review. The lead agency in the case of defence industry transactions will be the Department of Defense and in the case of critical infrastructure may be the Department of Commerce (telecommunications); the Department of Energy or Department of Homeland Security. The Director of National Intelligence is also charged with undertaking a review of all transactions that fall under CFIUS scrutiny. At the same time, other agencies who are part of CFIUS may also undertake reviews if they so choose. At the same time, under the FOCI process, a review is undertaken by the Department of Defense and led by the Department of Defense – Defense Security Service.

[98] In Finland the Ministry of Economy only oversees non-defence transactions, while the Ministry of Defence oversees defence transactions.

### *h) Almost all countries require notification of the intended investment*

I n all countries with legislative means for investment control but the UK and (formally at least if not in practice) the United States the investor has to notify the transaction to the authorities.[99]

In France, Spain and Sweden the investment has to be notified before the transaction takes place, as investors have to seek approval or obtain a permit from the authorities for the transaction to go ahead. Consequently, the failure to notify a transaction can result in a fine and may even be considered a criminal offense (France, Sweden). Practice in Spain suggests that the authorities deal with such issues rather pragmatically, as the investment of the 3i Venture Capital fund in Tecnobit in 1999 shows.[100] In Germany, notification is obligatory under the defence-related system and has to be made within three months from the conclusion of the contract.[101]

In the United States, formally the CFIUS process is voluntary but in practice it is effectively mandatory for foreign acquisitions involving companies that hold security clearances or are engaged in critical infrastructure.

In the UK no notification is required and the authorities have three and six months respectively from the conclusion of the contract or public offer to initiate proceedings.[102] However, as mentioned, upon receipt of a voluntary and complete application, the authority has only two months to open proceedings in the absence of which the transaction is deemed to be cleared.

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[99] In the case of Germany only defence-related investments have to be notified. In the case of security-related investments the authorities have three months from the contract or the public offer to open proceedings. See the Country Report on Germany.

[100] For details see the Country Report on Spain.

[101] No notification is required under the German security-related regime. For details see the Country Report on Germany.

[102] The OFT usually issues a decision within one month. See GAO. *Foreign investment. Laws and Policies Regulating Foreign Investment in 10 Countries. Report to the Honorable Richard Shelby, Ranking Member, Committee on Banking, Housing, and Urban Affairs, U.S. Senate. GAO-08-320*.

While all countries but the UK require the investor to notify the transaction to the authorities, there are some differences as to the exact obligations of the investor.[103] In France, Spain and Sweden the investment has to be notified *before* the transaction takes place, as investors have to seek approval or obtain a permit from the authorities for the transaction to go ahead. In Finland and Germany authorities have to be informed about the investment within one and three months respectively.

### *i) Review process: similar phases with different duration*

The review process and duration differs from country to country, though the essential steps are similar. Once a review has been announced, the investor is required to submit specific documents to the Government. When all documents have been completely submitted to the authorities, the latter have to finalise the review and respond within a period of several months (within one month in Germany under the defence related regime; two months in France; six months in the UK). In all countries but Sweden the transaction will be considered automatically as approved if the authorities have not responded within the prescribed period of time.

### *j) Assessment criteria focus on legislative purposes and at times at additional aspects*

(Intended) transactions are assessed in all countries as to whether they jeopardise the purpose for which the legislation was put in place, i.e. whether they affect the security or public interests or the public order. In France the law specifies as criteria the preservation of sustainability of activities, of industrial capacities, of capacities for research and development or associated know-how, security of supply and the execution of contractual obligations of the enterprise.

In practice Governments emphasise additional aspects, especially the security of supply (France, UK and Germany). In Spain authorities assess the effects on public order and

[103] In the case of Germany only defence-related investments have to be notified. In the case of security-related investments the authorities have three months from the contract or the public offer to open proceedings. See the Country Report on Germany.

health but aim at responding to national industrial policy need (e.g. to maximise the offsets in case of foreign takeover). In Sweden, it is reviewed whether the transaction is in line with Swedish security and defence policy. In practice this formulation includes defence industrial collaboration in support of Sweden's military cooperation.

The United States uses a broad definition of strategic sector that covers "national security" and the 2007 FINSA expanded factors to be considered to formally include critical infrastructure for the first time. FINSA has expanded the list of factors to be considered by CFIUS in determining whether a proposed transaction threatens U.S. national security. The new factors include:

- The effect on U.S. critical infrastructure , including major energy assets;
- The effect on U.S. critical technologies;
- Whether the transaction is "a foreign Government-controlled transaction";
- Adherence of the country in which the foreign person is located to non-proliferation control regimes, its cooperation in counter-terrorism efforts and the adequacy of its national export control laws and regulations;
- Long-term U.S. requirements for energy and other critical resources and material;
- Any other factors the President or CFIUS determines to be appropriate.

In Finland the authorities have to establish whether the acquisition jeopardises "important national interests" specified as (1) securing national defence; (2) preventing such serious economic, social or environmental sectoral or geographic troubles as are likely to be permanent, (3) safeguarding public order safety and health.

### *k) Practically similar possible outcomes of the review in all countries*

While in principle there are four possible outcomes of a review procedure – a Government can not oppose a transaction, give formal clearance, impose amendments to it and agree on mitigations or ban it. All these are possible outcomes in all countries but in Finland where mitigation is not possible and the UK, where a case can formally not be banned.

However, the possible outcome in the UK, to refer a case to the Competition Commission for an assessment of its effects on the conditions of competition, presents a practical equivalent to a ban of the transaction. Companies will prefer to conclude undertakings in lieu of a reference to the Competition Commission, given the complexity and length such a review could imply.

It cannot be stressed enough that the entire process in all countries is designed to avoid the maximal confrontation reflected in a ban. Investors are advised to consult with the Ministry of Defence or the Ministry of Economics in advance. These informal contacts are used to "prepare" the transactions and to adjust them if necessary. In some countries, notably the UK but also Sweden, these informal contacts can be an important part of the process. In Sweden, investors have in the past first contacted the authorities through the Swedish defence industry in order to sort out any possible objections. In the UK, "(a)ccording to a lawyer familiar with the UK review process, the formal process primarily serves to provide a public comment period for the decisions that have already been made as part of the informal process".[104]

### *l) Decisions are mostly not published but can be appealed*

In none of the countries except the UK do the authorities publish the decisions following a review. It is only made accessible to the investor whose transaction was reviewed. In other words, competitors, other Governments or the wider public have no access to this information (or need to rely on leaked information), to look after their interests. Publication would improve the transparency of the entire process.

Finally, all EU countries grant the investor a right to appeal a decision to an administrative court. In some cases the possibilities for a review are limited to minor administrative matters only (Sweden); in others such as France the judge is allowed a

[104] GAO. (2008) Foreign investment. Laws and Policies Regulating Foreign Investment in 10 Countries. Report to the Honorable Richard Shelby, Ranking Member, Committee on Banking, Housing, and Urban Affairs, U.S. Senate. GAO-08-320. Washington: United States Government Accountability Office.

"deep" examination of the case in order to determine whether the Government has applied the law correctly. There is no possibility to appeal a decision of U.S. authorities.

In sum, the national legislation for the control of strategic defence assets differ considerably in terms of general approach, design, and procedure. The following table summarises our findings.

Table 2.4: National legislation for investment control in strategic defence assets

| | France | Germany "Defence" | Germany "Security" | Italy | NL | Poland | Spain | Sweden | UK | U.S. | Finland |
|---|---|---|---|---|---|---|---|---|---|---|---|
| **What is the name of the laws & regulations?** | French Financial and Monetary Code, in particular Decree n° 2005-1739 of 30th December 2005 | Foreign Trade and Payment (FTP) Act Articles 7(1)1-3 and (2)5, read together with Article 52 FTP Regulation | Foreign Trade and Payment (FTP) Act Articles 7(1)4 and (2)6 read together with Article 53 FTP Regulation | | | | Royal Decree 664/1999, of April 23, on Foreign Investments (*Real Decreto 664/1999, de 23 de abril, sobre inversiones exteriores*) | The Military Equipment Act (1992:1300) | Enterprise Act (2002) | Section 721 of the Defense Production Act (1950) as amended by the Foreign Investment and National Security Act of 2007 (FINSA) and as implemented by Executive Order 11858, as amended, and regulations at 31 C.F.R. Part 800. | Act on the Monitoring of Foreigners' Corporate Acquisitions in Finland |
| **What is the purpose of the review?** | To safeguard public order and security | To guarantee the essential security interests of the FRG; | To guarantee public order and security of Germany within the meaning of Articles 46 and 58(1) EC (now Articles 52 and 56(1) TFEU) | | | | To safeguard public order, public security and public health (Articles 8 and 10). | To ensure alignment with security policy and defence policy | To safeguard public interest including "national security", which includes public security | To guarantee the national security" "interpreted broadly and without limitation to particular industries" | To safeguard "important national interests" |

| | France | Germany "Defence" | Germany "Security" | Italy | NL | Poland | Spain | Sweden | UK | U.S. | Finland |
|---|---|---|---|---|---|---|---|---|---|---|---|
| **Are EU interests taken into account in the notion of "national security"?** | No; not systematically either in informal contacts | No; not systematically either in informal contacts | No; not systematically either in informal contacts | | | | No; not systematically either in informal contacts | No; not systematically either in informal contacts | No; not systematically either in informal contacts | No; not systematically either in informal contacts | No; not systematically either in informal contacts |
| **What is the scope of the review?** | Activities which can disrupt public order, public security or national de-fence interests specified as 11 sectors such as defence, dual-use technology, gambling<br><br>Research activities, production or marketing of weapons, ammunitions, gunpowder, explosive substances. | Goods specified in the German "War Weapons List",<br><br>specially designed motors<br><br>cryptographic systems<br><br>companies which manage high value satellite data systems | Any company from any sector incl. defence sector | | | | All companies with activities related to the marketing or production of weapons, ammunitions, explosives or war materials | All companies with activities related to the marketing or production of weapons, ammunitions, explosives or war materials | Any company from any sector incl. defence | Any company from any sector incl. defence | Defence-related regime: Any organisation or business undertaking producing defence material or provide for the purposes of military national defence vital ancillary services or goods<br><br>Wider security regimes: Any company with either Sales > € 170 million/year; Employees >1,000; or Balance sheet total> € 170 million (Section 3) |

| | France | Germany "Defence" | Germany "Security" | Italy | NL | Poland | Spain | Sweden | UK | U.S. | Finland |
|---|---|---|---|---|---|---|---|---|---|---|---|
| **Which investors are concerned?** | All non-French investors with a minor distinction between EEA and non-EEA investors; acc. to the location of the HQ, incl. French investors controlled by foreign entity | Applies to all non-German investors acc. to the location of residence or HQ including German investors in which a non-resident has at least 25% voting rights | Applies to non-EEA residents and companies including German investors or investors from EEA States in which persons or companies from a non-EEA country hold at least 25 percent. | | | | All non-Spanish investors according to the location of the HQ of the investor but excluding Spanish subsidiaries of foreign companies | All investors | All investors | All non-U.S. investors | Any non-Finnish (domiciled) organisation or person and any Finnish organisation controlled by a foreign owner<br><br>In case of non-defence assets<br><br>Any non-EEA investors (Section 12) |
| **What is the threshold triggering a review process?** | Acquisition of a controlling share of the voting rights (for EEA investors); of 33% of voting rights for non-EEA investors | Acquisition of at least 25% of the voting rights | Acquisition of at least 25% of the voting rights | | | | Acquisition of any share in a defence firm<br><br>For traded companies the threshold is 5% of the equity or any quota necessary for accessing the administration of the company | De facto, the acquisitio n of any share in a defence company | Acquisition of a firm with a UK turnover >£70m or merger creating =/>25% market share; or if gov. contractor holding confide. ma-terial related to defence is involved | Acquisition of any share in a defence company | Acquisition of 33% of the voting rights<br><br>Or if the investor becomes the owner of the company<br><br>For defence-related companies also in case if the investor obtains dominant control (Section 5) |

| | France | Germany "Defence" | Germany "Security" | Italy | NL | Poland | Spain | Sweden | UK | U.S. | Finland |
|---|---|---|---|---|---|---|---|---|---|---|---|
| **Which organisation responsible for review?** | Ministry of the Economy | Federal Ministry of Economics and Technology taking into account input from MoD and Foreign Ministry | Federal Ministry of Economics and Technology taking into account other ministries concerned<br><br>Decision to be taken by the Federal Government | | | | *Junta de Inversiones exteriors*, an interdepartmental committee of the Minister of Industry, Tourism and Trade | ISP-*Inspektionen för strategiska produkter* or Swedish Agency for Non-Proliferation and Export Controls under the Ministry of the Economy | Office of Fair Trading (OFT) | CFIUS | Ministry of Trade and Industry for security-related cases<br><br>In defence-related cases the Ministry of Defence<br><br>Both can only confirm acquisition<br><br>Council of State to decide in case of jeopardy of important national interest (Section 8) |
| **Is a notification required?** | Yes, prior to transaction | Yes, within 3 months from the conclusion of the contract | No, voluntary | | | | Yes, prior to the transaction | Yes, prior to transaction | No | Legally no but in practice yes | Yes, within 1 month of an acquisition (Section 7) |

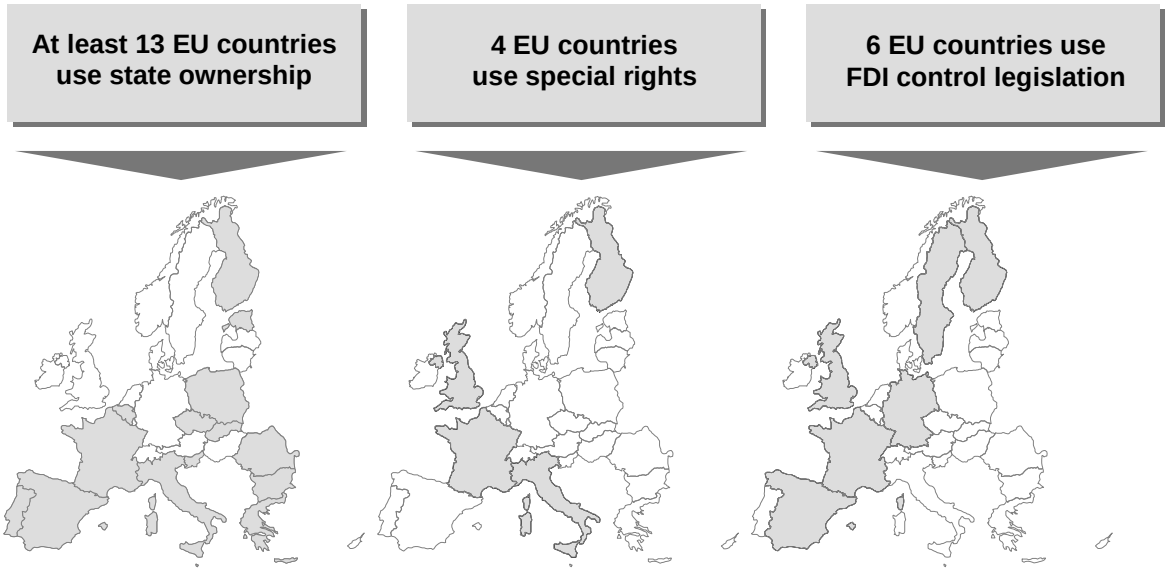
| | France | Germany "Defence" | Germany "Security" | Italy | NL | Poland | Spain | Sweden | UK | U.S. | Finland |
|---|---|---|---|---|---|---|---|---|---|---|---|
| **What are the assessment criteria?** | Preservation of sustainability of activities, of industrial capacities, of capacities for R&D or associated know-how, security of supply or the execution of contractual obligations of the enterprise *as* licensee or sub-contractor in the framework of public contracts or of contracts concerning public security, of interests of national defence or of research, production or trade of war material | Whether the acquisition jeopardises the German essential security interests | Whether the acquisition jeopardises the German public order and security. The latter is defined with explicit reference to TFEU. | | | | Whether the transaction jeopardises Spanish public order, public security and public health | Whether the transaction is in line with Swedish security and defence policy. (This includes collaboration in support of military cooperation).<br><br>No conflict with Foreign Policy | Whether the transaction jeopardises UK public interests, in particular security interests | (1) The effect on U.S. critical infrastructure, incl. major energy assets; (2) The effect on critical technol.; (3) Whether the transaction is "a foreign Government-controlled" one; (4) Adherence of the country in which the foreign person is located to non-proliferation control regimes, its cooperation in counter-terrorism efforts and the adequacy of its national export control laws & regulations; (5) Long-term U.S. require-ments for energy & other critical resources & material; (6) Any factor acc. to President or CFIUS | Whether the acquisition jeopardises "important national interests" (Section 8,9), specified as<br><br>(1) securing national defence;<br><br>(2) preventing such serious economic, social or environmental sectoral or geographic troubles as are likely to be permanent,<br><br>(3) safeguarding public order safety and health (Section 2) |

| | France | Germany "Defence" | Germany "Security" | Italy | NL | Poland | Spain | Sweden | UK | U.S. | Finland |
|---|---|---|---|---|---|---|---|---|---|---|---|
| **Is there a right of appeal against the decision following the review?** | Possibility to appeal to an administrative Court | Possibility to appeal to the Administrative Court in Berlin | Possibility to appeal to the Administrative Court in Berlin | | | | Possibility to appeal to an administrative Court | Possibility to appeal to an administrative Court with regard to the cancellation of a permit | Yes | No | Possibility to appeal to the Supreme Administrative Court |
| **Are the decision and the appeal made public?** | No, only to the applicant | No, only to the applicant | No, only to the applicant | | | | No, only to the applicant | | Yes | No, only to the applicant | No, only to the applicant |
| **Is there an Option for mitigation agreements?** | Yes | Yes | Yes | | | | Yes | Yes | Yes | Yes | No |
| **Comment** | | | | Law for defence companies to register | | | | | | Foreign acquirers of defence companies are also subject to FOCI review | |

## 2.4 Most EU case study countries combine several means of State control

Our analysis confirms that currently there exists a patchwork of different means of State control of strategic defence assets across the European Union. An overview of the application of different control instruments is presented in Figure 2.2.

Figure 2.2: Use of different means of control across EU countries

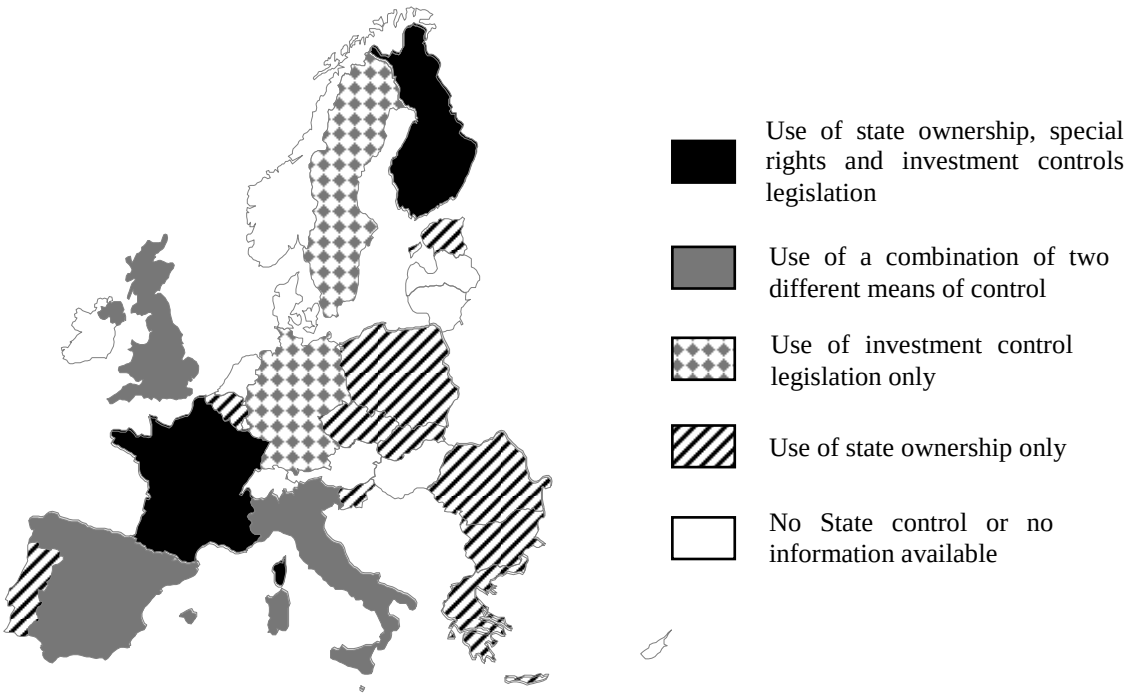



| | | |
|---|---|---|
| Four case study countries use State ownership:<br>• France;<br>• Italy;<br>• Spain;<br>• Poland.<br>The French Government uses contractual arrangements with key shareholders<br>State ownership is likewise used (Belgium, Bulgaria, Czech Republic, Estonia, Finland, Greece, Hungary, Portugal, Slovakia, Slovenia and Romania) | Special rights are still used in four EU countries:<br>• Finland;<br>• France;<br>• Italy;<br>• the UK.<br>Governments of France, Germany, Spain, Sweden and the UK have entered into special arrangements with shareholders, which are subject to private law but the possibility should not be ruled out that they might represent State measures. | Six out of 27 EU countries have dedicated investment control legislation:[105]<br>• Finland;<br>• France;<br>• Germany;<br>• Spain;<br>• Sweden;<br>• the UK.<br>The Netherlands has not State control of strategic defence assets at all. |

[105] Greece has legislation for FDI control, covering strategic defence assets. Since the Greek authorities did not provide us with publicly available information, Greece is not considered in the analysis.

Our analysis has also shown that most EU case study Governments use a combination of different means to control the strategic defence assets in their country. Five groups of countries can be distinguished according to the extent to which they make use of State control of strategic defence assets.

Figure 2.3: Combination of different means for the control of strategic defence assets




- The first group consists of France and Finland. The French Government employs the most sophisticated range of instruments for the State control of defence assets comprising State ownership, contractual arrangements with key shareholders, special rights, undertakings and dedicated investment control legislation; followed by the Finnish Government using State ownership, special rights and legislation.

- The Italian and Spanish Governments make use of State ownership and special rights; the UK Government uses special rights, undertakings and investment control legislation.

- Germany and Sweden both use only investment control legislation.

- A number of other countries mainly in Eastern and South Eastern Europe use mainly State ownership as a means of control, for example Poland or Romania. Once their

companies have been privatised there are only indirect investment control regulations for the oversight of strategic defence assets available. While this does not mean that the private defence companies of these countries are entirely unprotected – after all Governments have an array of regulatory means at their hand to shape investors' expectations – it does imply that investments are not systematically monitored.

- The Netherlands are an exception in that the Government does not have any of means for establishing State control of strategic defence assets at all.

As for the application of national investment control legislation we can say that in Germany, Sweden and the UK the number of reviewed cases has been all in all rather small, compared to France and the U.S. where considerably more intended transactions have been reviewed. Despite these differences the number of rejected cases as compared to the cases that have been accepted has been rather small in most countries. This is a familiar effect of authorisation procedures – only those who might expect to have a good chance of passing will actually apply and attempt a take over.

Taking into account what has been said above, namely that applications for transactions are rarely "rejected" but more often withdrawn we present both results in the same column.

Table 2.5 Number of reviewed and "rejected" transactions in selected countries

| Country | Number of reviewed transactions | Number of "rejected" transactions |
|---|---|---|
| **Germany** | Defence: 2-3 cases per year (total of 14 cases since 2004)<br>Security 2 since 2009 | 0 |
| **France** | 15 in 2007<br>40 in 2009 | "extremely rare" |
| **Sweden** | 5 (major cases) | 0 |
| **UK** | 7 cases (2004-2009) | 0 |
| **U.S.A.** | 7 in 2006<br>8 in 2007<br>23 in 2008 | 5 withdrawals & 2 Presidential decisions<br>5 withdrawals<br>5 withdrawals |

The study team did not find any particular cases where Member States made excessive use of Article 346. However, the wide difference in the number of reviewed cases points to large variations in the practice of investment control of strategic defence assets across EU countries.[106]

- We have already pointed to the fact that (with the exception of the UK) Governments do not publicise the opening of a case nor the final decision and that this means that they do not (need to) explicitly invoke Article 346 for the control of an intended transaction. Consequently, it is *not entirely transparent* when and how Member States decide to apply their control.

- We have also shown that national legislation on the control of FDI varies considerably as to the types of assets that are to be scrutinised, which implies that to the extent that Member States rely on Article 346, they are likely to do so in a *heterogeneous* manner.

- Moreover, the systematic controls of intra-EU investments in certain Member States on the basis of criteria which are in essence the same as those applied to non-EU investments can be disproportionate. Finally, we wish the Commission to note two qualifications:

- First, while the study team has attempted to systematically collect also quantitative information on the application of FDI control legislation, most Governments have been neither very forthcoming nor precise with regard to information on the number of notified, reviewed, accepted and rejected cases.

- Second, the number of control instruments used by a Government doesn't say anything as to the openness that investors ascribe to the defence investment regime of a particular country. For example, while the Governments of Italy and the UK both employ two different means of control, both countries are perceived in a very different manner as to their openness for defence investments by the experts we interviewed. An analogous observation can be made with regard to Germany and Sweden. We will present indicative

[106] For details of the following see the discussion above under 2.3.2 (a).

results regarding the perceived openness of countries to defence investments as part of the next chapter, in which we will assess this patchwork of control mechanisms across Europe with regard for its implications for the consolidation of the European defence industry.

# 3 ASSESSMENT OF THE CURRENT SITUATION

In the previous Chapter, our cross-country analysis showed how national practices with respect to the control of strategic defence assets differ considerably in terms of general approach, design and procedure. The purpose of this Chapter is to critically assess the current situation regarding the national control of defence assets from a European perspective.

We can identify major issues for the further consolidation of the European defence industry: a continued use of State ownership, fragmentation of the market for corporate control, a lack of transparency regarding investment policy, review procedures and mitigation requirement, as well as very limited formal consultation among EU Governments.

It ought to be noted that an assessment of the status quo is particularly challenging since it has to take into account the *possible* effects of the Directives on Defence and Security Procurement and intra-Community transfers.[107] Member States are still in the process of transposing both Directives and neither their means of implementation nor its effects on the European defence industry nor on the European Defence Equipment Market (EDEM), can be assessed with any certainty at this stage.

## 3.1 Political will remains single most important driver for consolidation

Politically, it has to be acknowledged that cross-border consolidation of the European defence industry has been and can be anticipated to remain a function of the political will of Governments. The experience of European defence industrial consolidation has been that political will of Governments has been crucial for any cross-border transaction of major European defence companies. This was the case for Eurocopter, Agusta Westland, EADS, Thales (in the case of the merger with the Dutch company Signaal) and MBDA. Political will

[107] Council of the European Union and European Parliament. (2009) Directive 2009/43/EC of 6 May 2009 simplifying terms and conditions of transfers of defence-related products within the Community. *Official Journal*:L146/1-L46/36., ———. (2009) Directive 2009/81/EC of 13 July 2009 on the coordination of procedures for the award of certain works contracts, supply contracts and service contracts by contracting authorities or entities in the fields of defence and security, and amending Directives 2004/17/EC and 2004/18/EC. *Official Journal of the European Union*:L216/76-L16/136.

alongside industrial and economic logic have driven consolidation of the large defence firms in the past and can be expected to do so in the future.

In all cases cross-border transaction have taken place through the close involvement of European Governments, be it as initiator, facilitator or regulator of the transaction. This fact is not surprising given that EU Governments are the most important customers for these defence firms; that Governments make the procurement decisions; determine the regulatory framework in which the companies operate; support the marketing and sales activities and finance significant parts of the research and technology efforts of the defence industry. Due to the large number of mostly highly skilled employees in the defence industry any restructuring is likely to have significant social and economic effects, which most Governments are unlikely to ignore. Hence, Governments will continue to claim to have a say in the consolidation process. Potential acquirers recognise these as important factors in their operating environment and act accordingly. Governments will always occupy a position in which they have an array of tools to control the defence industry and shape the expectations of investors.

Ultimately, therefore, there is a recognition on the part of all stakeholders consulted and all experts interviewed that the political will of Governments will determine the pace and character of any change to the State control of strategic defence assets. This should, however, not be read as saying that strictly national approaches will be followed with regard to this issue. We will identify a number of issues arising from the fact that State controls lack any meaningful European dimension at the moment.

Hence, it should be recognised that there is potential for some sort of a European dimension in the State control of strategic defence assets. It is reflected in the Commission's initiatives towards a European Defence Equipment Market, most visibly in the Procurement and Transfer Directives. The Council has recognised this potential in the Declaration on Strengthening Capabilities of the European Council from December 2008;[108]

[108] See Conclusions of the Council of the European Union. Declaration on Strengthening Capabilities, Brussels 11 December, in the following also referred to as French Presidency Conclusions of 2008. *In fine*: "*Non-European investments in strategic defence enterprises can in certain cases have an impact on defence*

so have the Governments of the largest armaments producing countries. The LoI Implementing Arrangement on Security of Supply addressed the issue of consultations in the case of cross-border investments.

## 3.2 Governments invoke Art. 346 to avoid application of EMCR, albeit in a varying manner

In principle the EMCR also applies to businesses involved in the production of or trade in arms, munitions and war material. This means that concentrations with a Community dimension have to be notified to the Commission by the defence firms concerned, that they have to be assessed according to the EMCR rules in light of competition criteria and that a decision by the Commission has to be implemented.

It should be recalled that

- while there is no general exclusion of the defence industry from the rules of the TEU and TFEU on the free movement of capital, State aids, and competition regimes, it provides for a number of national security exemptions from these rules or the Treaty as a whole: Articles 346 and 347 provide for a derogation from the Treaty for reasons of national security; Article 348 provides for a special possibility for the Commission (or any other Member State) to challenge the inappropriate use of the aforementioned two Articles before the CJEU;

- Article 65 (1) (b) TFEU allows Member States to derogate from the free movement of capital and payments regime of the Treaty *inter alia* for reasons of public security, albeit the use of this exemption is subject to a strict proportionality test and

- Article 21(4) of the European Community Merger Regulation also provides a limited opportunity for Member States to justify interference in a transaction that has been or will be subject to competition scrutiny by the Commission.

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*security or supply security. In this regard, Member States will exchange information when they deem it appropriate to do so*."

Under the case-law of the CJEU, these derogations from the general rules of the Treaty have to be narrowly construed.

However, with respect to the EMCR the practice that has evolved seems to suggest that at least some Member States (and defence companies) do not regard the EMCR as the appropriate tool to assess mergers of strategic defence assets that have a European dimension. It has to be stressed though that there is no consistent practice among Member States in this respect. While some Member States have urged their companies to notify a transaction including the military aspects others have urged their firms to avoid notification.[109] The latter Governments have invoked Article 346 by pointing to the military character of goods claiming that non-notification is covered by the derogation.

In exceptional cases such as the creation of MBDA in 2001, the Member States concerned relying on Article 346 did not notify the intended merger to the Commission at all. Due to the increasing role of dual-use technology many defence firms produce items for military as well as civil markets and the Commission insists on the principle that any defence investment be notified. So far there have not been cases in front of the CJEU challenging Member States' invocation of Article 346 to cover the non-notification of the military aspects of a transaction under certain conditions.[110]

The Commission then proceeds to assess the consequences of an intended transaction for the conditions of competition for the civil or dual-use part of the business. For this purpose the Commission has in some cases successfully requested information concerning military items even after Article 346 had initially been invoked.[111] After its assessment of the civil and

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[109] Interview with an official of the European Commission, Brussels September 2010.

[110] The Commission seems not to formally oppose the non-notification of the military aspects on the condition that (1) "the part of the concentration which has not been notified only relates to the production of or trade" in the items of the 1958 list; (2) the measures taken by the [Member State] are necessary for the protection of the essential interests of its security"; (3) "there are no spill-over effects from military activities on non-military activities" of the acquiring company and (4) "the merger will have no significant impact on suppliers and sub-contractors of the undertakings concerned and on Ministries of Defence of other Member States". Case No IV/M.528 – *British Aerospace/VSEL*, 1994: 2. The similar conditions are listed in Case No IV/M.529 – *GEC/VSEL*, 1994: 2-3.

[111] Levy, Nicholas, Mark Nelson and Derek Rydyard. (2005) *European Merger Control Law: A Guide to the Merger Regulation*. Lexis Nexis.

dual-use parts of the business the Commission will adopt a decision, which is negative, positive, or positive with certain remedies.

Member States can then implement the decision of the Commission or, in case they wish to implement another solution, go ahead with the transaction as they see fit. In the latter case, however, the Member States have to invoke Article 346. The Commission (or any other Member State) can again challenge this invocation of Article 346 should they deem that the Member States concerned have made improper use of their powers.

In sum, it appears that so far Member States have not fully accepted that defence investments with a European dimension have to be assessed according to the EMCR. There seems to be a varying practice among Member States as to the invocation of Article 346 when it comes to the notification of the military aspects of defence M&A. It remains opaque when and under what conditions recourse to the derogation is made and when it is legitimate. Hence, a heterogeneous and non-transparent pattern has emerged in the practice regarding the application of the ECMR for defence investments. In this respect there is no difference between defence investments from non-EU and from EU countries.

## 3.3 Perceptions about openness of EU countries towards defence FDI vary

We asked our interviewees about their perceptions of the openness of the case study countries to foreign investments into the defence industry.[112] It has to be noted that experts based their assessment not so much on a detailed knowledge of the legislative situation but grounded on their own experience. The "broad picture" that emerged from this practical experience is also shaped by the knowledge of stakeholders about successful mergers and acquisitions in the defence sector, about State ownership and, finally about public statements about policy goals.

[112] Not all interlocutors were prepared to express their perceptions in a way that would allow for comparison and consolidation of the information. For details on perceptions of relative openness see the Country Reports in Volume 2 of this Report.

### 3.3.1 Experts see large differences among EU countries regarding openness to FDI

The perceived openness of the case study countries varies significantly. Based on the rankings we received and on our interviews we conclude that Sweden, the UK and the Netherlands are considered to be the three countries where the Government is most open to FDI in defence assets. Germany occupies a middle-rank followed by Poland, Spain and the United States. Italy and France are considered to be the least open countries to FDI in the defence industry, albeit for different reasons. It should be noted that there was considerable variance in perception of the openness of the United States amongst European respondents.

An overview of our findings can be found in Table 3.1. We should note that these findings are broadly in line with the findings of other studies on a similar sample of countries.[113] We wish to stress, however, that these rankings are by no means a representative picture of the opinion neither of the Government nor the defence industry of each individual country.

[113] See for example Bialos and Fischer. *Fortresses & icebergs: The evolution of the Transatlantic defense market and the implications for U.S. national security policy*, Tietje and Kluttig. Beschränkungen ausländischer Unternehmensbeteiligungen und -übernahmen. Zur Rechtslage in den USA, Grossbritannien, Frankreich und Italien.

Table 3.1: Perceptions of the relative openness of countries to foreign acquisitions of defence companies

| Country | Ranking by interviewees from 1=most open – 9=most closed | | | | | | Comment |
|---|---|---|---|---|---|---|---|
| | G | I | NL | Sw | UK | U.S. | |
| France | 5 | 9 | 6 | 9 | 9 | 9 | "Clearly, French policy seems to favour French control. On the other hand, France is realistic, see the realities of EADS and Thales, both of them with significant control from outside France."<br><br>"France strives ultimately for control of security of supply, very much like Sweden during the cold war."<br><br>"[France has] a very nationalistic defence industrial policy and defence acquisition strategy; continues national ownership of parts of its defence industrial base." "France has historically been extremely protective." |
| Germany | 1 | 5.5 | 5 | 5 | 5 | 6.5 | "A little bit like France, be it that the official policy is much more open. A complicating factor is the influence of the States inside the Federal Republic, leading to a practice that is not as far removed from the French position as Berlin likes to present."<br><br>"Germany is open to investment but they have a rigid review process."<br><br>"Arguably recent legislation and decisions to block some deals suggest that Germany is less open than it was."<br><br>"The German Government is willing but their labour and tax (laws are) difficult." |

Table 3.1: Perceptions of the relative openness of countries to foreign acquisitions of defence companies (continued)

| Country | Ranking by interviewees from 1=most open – 9=most closed | | | | | | Comment |
|---|---|---|---|---|---|---|---|
| | G | I | NL | Sw | UK | U.S. | |
| Italy | 4 | 4 | 4 | 8 | 8 | 4 | "The Italian position is always a compromise between various policies. A U.S. investment was originally at the basis of Selenia, othe companies have long-time Italian roots. In practice, one can always find a way out, with patience and flexibility."<br>"Their companies are very closely linked with the MoD."<br>"Foreign investment is very difficult but not impossible." "The rules are very unclear."<br>"They seem to be implementing a more open defence acquisition strategy but still give preferential treatment to quite a few of the big domestic players." "They are willing but labour issues remain difficult." |
| The Netherlands | 2 | 2.5 | 2 | 3 | 4 | 3.5 | "There is no legislation requiring Dutch control. There is still no restricting policy in this respect "<br>"The Netherlands do not have that much of a defence industry but are generally very open towards FDI."<br>"The Dutch Government is focusing on niche capabilities and willing to procure these from foreign suppliers." |
| Poland | 9 | 4 | - | 7 | 6 | 3 | "The situation in Poland is unknown to me."<br>"Poland seeks an alternative to the big European companies and to remain in control."<br>"There is a high "engagement" of the U.S. in Poland, which affects its openness (negatively)."<br>"They are pretty open and use M&A as a tool to get technology." |

Table 3.1: Perceptions of the relative openness of countries to foreign acquisitions of defence companies (continued)

| Country (Sum total of rankings) | Ranking by interviewees from 1=most open – 9=most closed | | | | | | Comment |
|---|---|---|---|---|---|---|---|
| | G | I | NL | Sw | UK | U.S. | |
| Spain | 4 | 5 | 4 | 7 | 7 | 4.5 | "In practice Spanish companies are to some extent open to joint ventures (see Spanish participation in EADS). The Spanish naval sector on the other hand seems particularly closed."<br><br>"Spain doesn't interact with the EU very much."<br><br>"France, Italy and Spain retain extensive public ownership and have not generally embraced inward investment."<br><br>"They are open but have tough labour and Government issues." |
| Sweden | 3 | 5.5 | 3 | 1 | 1 | 3.5 | "Even if Sweden has legislation in this respect, they are realistic enough to seek co-operation. Also, the growing influence of companies like BAE Systems and of U.S. companies gives a pretty open picture."<br><br>"We are leading the liberal creed in the Nordic countries and are very open now; whether that is so sensible for defence remains to be seen."<br><br>"Sweden has shown itself to be open and welcoming to foreign acquisition."<br><br>"They have shown the willingness to sell almost its entire defence industrial base to foreign owners." |

Table 3.1: Perceptions of the relative openness of countries to foreign acquisitions of defence companies (continued)

| Country | Ranking by interviewees from 1=most open – 9=most closed | | | | | | Comment |
|---|---|---|---|---|---|---|---|
| | G | I | NL | Sw | UK | U.S. | |
| United Kingdom | 5 | 2 | 5 | 2 | 2 | 1 | "Even if the UK claims an open policy and an open mind in these matters, practice looks more like the French approach than say the Dutch approach. One explanation is the UK history plus the fact that the UK considers its Defence industry as a Strategic asset (like France) and unlike the Netherlands. "<br>"Have been very open but have become more cautious."<br>"Our policy is clear and open to foreign investment but the process is less transparent than it could be."<br>"There are several signs for openness: the defence industrial strategy officially favours "best value" irrespective of country of origin; acquisition decisions taken based on this strategy; privatisation of Government defence organisations; accepting of foreign ownership of defence companies." "Historically the UK has been most open." |
| United States | 9 | 3.5 | 8 | 7 | 3 | 2 | "Clearly, although foreign ownership of Defence companies is not forbidden (once Magnafox was a Philips subsidiary, today BEA-S is large and active in the U.S., the management in those cases have to be largely American, with little control from the (European) owner."<br>"The U.S. is generally open; but they control their defence assets tightly against foreign companies."<br>"Clarity of policy is important – the U.S. has lots of regulations but they are clear and transparent and you know what the rules are when you invest"; "The U.S. is rather closed in relation to other countries, except for the UK."<br>"The U.S. are open to acquisition (by) foreign entities, and has put in place entities and processes for doing so rapidly to support ongoing operations." "The U.S. is very open to most nations." |

While France, Italy and Spain are considered by most interviewed experts to be the least open countries to FDI in the defence industry, these assessments are made for different reasons. A majority of the experts we interviewed for the purpose of this study hold that in Italy, the entire foreign investment process is considered to be relatively non-transparent. The defence industry is centralised around very few State controlled firms and hence there have been few successful mergers and acquisitions in Italy.

France by comparison represents a larger market. Stakeholders were aware of the French legislation on investment controls but less clear as to the policy and long-term goals of the Government. Many interlocutors agreed that the French Government ultimately seeks to ensure control over defence assets even if it allowed an investment to proceed.

Spain is perceived as closed too, especially by Swedish and British experts. The country's involvement in EADS cannot outshine its rather tied control mechanisms. Moreover, some experts were aware of the fact that Spain is seeking transatlantic links rather than relations with European partners that are often perceived as too strong and dominating.

The openness of the U.S. towards foreign investments in their defence industry has been judged in a manner that seems to be rather contradictive on first sight. However, taking into account that the only major European defence investments in the United States have been made by British defence firms and recently also by Finmeccanica it comes as no surprise that Swedish experts were more sceptical about the country's attitude to defence FDI. Moreover, they have expressed a nuanced view, assessing the market as open but the control as rather tight.

### *3.3.2 Countries with State ownership are perceived as relatively more closed to defence FDI*

State ownership was a relevant element shaping the perceptions of experts about the relative openness of countries to FDI in defence assets. In this context it should be noticed that stakeholders in countries with no State ownership (Germany, Sweden, the UK) clearly expressed a concern about the continued significant public ownership of defence assets in some EU countries, particularly France and Italy. These countries were conceived of as specifically closed to foreign investments. The fact that the Government

holds part of the equity contributes to a more general impression of low degree of transparency in terms of investment policy and decision-making.

### 3.4 State ownership is seen by some stakeholders as impeding consolidation

Since 2003 the European Commission has set out a number of policy measures to promote the consolidation of the European defence industry.[114] In May 2007 the EDA Steering Board adopted a Strategy for the European Defence Technological and Industrial Base, which is seen as a "fundamental underpinning" for CSDP. Defence Ministers declared that "such an EDTIB will also need to be more integrated, less duplicative, and more interdependent" with increased degrees of specialisation ("centres of excellence") at all levels of the supply chain.[115]

The European Commission and European Defence Ministers have stressed the importance of increased competition in a "level playing field" and the establishment of "equity amongst competitors".[116] The EDA's Code of Conduct on Defence Procurement and the related regime, as well as the Defence and Security Procurement Directive represent first measures to this end. They formulate procurement rules for defence and security products that are adapted to the specific needs of these markets. Both sets of rules seek to make it easier for companies, including SMEs to compete EU wide for certain defence contracts.[117]

Stakeholders in some countries regard State ownership as a direct and major obstacle to further consolidation of the defence industry. It is seen as impeding the creation of a

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[114] European Commission. European defence-industrial and market issues. Towards a EU Defence Equipment Policy. COM(2003) 113, ———. (2007) A strategy for a stronger and more competitive european defence industry COM/2007/0764, ———. (2008) Defence Package - Towards an EU Defence Equipment Policy.

[115] EDA. (2007) *A strategy for a European Defence Technological and Industrial Base*. Brussels: European Defence Agency.

[116] Ibid.

[117] Europe Economics. (2009) *Study on the competitiveness of European small and medium sized enterprises (SMEs) in the defence sector*. Brussels: European Commission.

"level playing field" and the establishment of equal opportunities amongst competitors.[118] However, this view was not shared by all stakeholders. We hold that Government ownership can be seen as a continued impediment to further consolidation of the defence industry and the creation of an EDEM for two reasons. First, publicly owned firms are viewed by their industrial competitors as being willing to take on more risk in comparison to their private competitors, which they can translate into an advantage in terms of price or conditions.[119]

Second, it creates a conflict of interest, as the Government has an incentive to favour the defence contractor in which it holds an equity share.[120] The latter problem is compounded in case of a country with control legislation *and* State ownership of a target company. In this case public ownership increases the bargaining power of the company in which the State holds an equity share and voting rights and creates a conflict of interest. The investor faces the Government in two roles, as an owner who sells and a regulator who controls the intended transaction. Not only is the investor in a disadvantaged bargaining position but the Government can be assumed to be in a conflict of interest between its two roles. More generally, the Government has to balance between the goals of the defence company and the wider economic, industrial, technology policies that a Government might want to pursue, using the defence company as a means to these ends.

This argument is supported by the perception of some stakeholders from industry and Government who fear undue influence by the Government in the affairs of the company in which it holds shares (Germany, Sweden, and the UK). This perception is not shared by stakeholders in the other EU case study countries, who also more generally hold that Government ownership does not impede on the consolidation of the European defence

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[118] This view is generally held in Germany, the Netherlands, Sweden, and the UK but is not shared by stakeholders in France, Italy, Poland and Spain as far as EU case study countries are concerned.

[119] ISDEFE and ISI. (2009) *Study "Level Playing Field for European Defence Industries: the Role of Ownership and Public Aid Practices" EDA contract reference: 08-I&M-001*. Brussels: European Defence Agency.

[120] Given that in the case study countries the Governments decisions regarding shareholding and procurement are taken by different departments, this risk is lowered. However, such a separation of responsibility seems not to be the case in all EU Member States, e.g. not in Portugal and might not be followed in the future in Eastern European countries.

industry. While we do not wish to take issue here with this general argument, we maintain that in a situation where State ownership and investment control legislation exists, a private investor who intends to acquire a share in a State owned company is put at a disadvantage and a conflict of interests for the Government owning a share in the target company is created.

As we will outline in greater detail in Chapter 6 the possibilities to act with regard to State ownership are very limited, if any, for the Commission.

## 3.5 Fragmented market for corporate control does not worry most stakeholders

The fact that only six out of 27 EU countries have investment control legislation and that their national approaches differ contributes to fragmenting the market for corporate control. There is a patchwork of rules for those Member States where the bulk of the European defence industry is located. Moreover, our analysis has shown that considerable differences exist among EU countries as to the "modalities" of the national legislation on investment controls, in particular regarding the type of activities and the characteristics of investors concerned, the threshold for a review, the assessment criteria and the publication requirements.

The fact that investment controls can extend well beyond the boundaries of the defence and even defence-related industry is further complicating the situation for investors. While France explicitly lists specific sectors of the economy, making this part of the law very transparent, other countries, notably Finland, Germany or the UK stipulate provisions that allow for the review of potentially any investment. While in the case of the UK this general clause is balanced by a clearly stated defence industrial (and investment) policy, as well as a relatively longer track record of "light" application of the law, Germany is not perceived by most experts interviewed for this study as open towards defence investments.[121]

[121] For details see Table 7.1 in this chapter.

Governments effectively control investors' access to defence investments, which does not allow capital to be channelled into its most efficient use. Any investor from inside or outside the EU is required to approach different "entry points" if their investment concerns facilities in different EU countries, as a variety of national rules, practices and arrangements governs investments in the defence industry.

A fragmented market for corporate control also increases inefficiency and hampers the possibility to use the threat of takeover as a discipline on management. Furthermore, in the current situation there exists an incentive for Governments who have no control legislation, to implement such legislation. In Italy, for example, such a step is currently contemplated, which would further fragment the European market for corporate control. Finally, legislation improves a Government's bargaining position in negotiations with investors for extracting better conditions, for instance for offsets.

However, most Government stakeholders do not see the current fragmentation as an important issue. First, they argue that defence companies are satisfied with the existing regime. Industrial stakeholders in all countries but Italy confirmed their satisfaction with the current control regime. Only stakeholders in Sweden and the Netherlands pointed to the fact that opportunities for consolidation of the European defence industry and the creation of centres of excellence were too restricted and that large third country investors might not find such a fragmented market an attractive investment environment. The investor seeks an investment environment where Government policy towards foreign acquisition is transparent, the regulatory process is clear and the outcomes of that process are perceived to be predictable. Perceived business risk is an important consideration in foreign investors' willingness to make investments in the defence industry of a country.

## 3.6 Current situation lacks transparency and increases uncertainty for investors

The current situation is not favourable for the free flow of capital into the EU and across EU countries, since the investment regime of the European defence industry lacks transparency. This conclusion was voiced by most interviewees in different countries from Government, as well as industry. This lack of transparency increases business risks for investors interested in investing in the EU defence sector and thereby hampers the

strengthening of a competitive European Defence Technological and Industrial Base that could possibly be achieved through increased cross-border consolidation.

About a quarter of the companies surveyed in a recent study has gone through rationalisations.[122] They yielded synergies through the creation of centres of excellence, the combination of supply chains but also the multiple use of R&D results and the increase of manufacturing volumes. The aforementioned Directives on Procurement and Transfers can be expected to further increase the possibilities for defence companies to consolidate operations across the EU.

In the current situation, however, a lack of transparency can be identified with regard to the policy, the legislation and its application.[123]

### *3.6.1 Policy behind investment controls is often not clearly declared*

A lack of transparency in terms of policy means that it is not clear what policy goals a Government pursues with its investment control legislation. On the one end of the spectrum stands the Netherlands, which are perceived as having declared to be entirely open to any investment into its defence industry and not possessing any legal means to control transactions. Next to the Netherlands countries like Sweden and the UK are seen as publicly announcing that their defence industrial base is open to foreign investors regardless of the origin of the latter as long as certain conditions are met. While for Sweden the condition is to foster defence industrial collaboration with allies and thereby military and security policy ties; the UK wishes to retain certain industrial and technological capabilities on shore.[124]

Poland and Spain are seen to follow *in practice* a similar policy of being open to any investment into its defence industry. In this case the condition to be met by the investor is to offer the largest possible direct offset to support the growth of a domestic defence

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[122] ISDEFE and ISI. *Study "Level Playing Field for European Defence Industries: the Role of Ownership and Public Aid Practices" EDA contract reference: 08-I&M-001*.

[123] The following refers, if not mentioned otherwise, to those case study countries with a legislative control mechanism in place i.e. not to the Netherlands, Italy and Poland.

[124] For further details see the Country Report on the UK.

industry. However, this policy is implicitly followed rather than stated in official documents. Moreover, it is important to recognise that this policy is partly deliberately directed to shield the own industry from too much influence of other EU countries. Non-EU investors, particularly from the U.S. provide a suitable means to "balance" such unwelcome pressure.[125]

While the policy goals of Germany are perceived to be rather vague and thereby protective, France and Italy are perceived by most interlocutors to be openly protective of their defence industries and, hence, closed to foreign investments. The two latter are said to ultimately strive for national control of their defence assets, even at the prices of dissuasion of foreign investors. The United States is seen as "generally open" to foreign investment in declarations but with a clear cut policy to control their defence assets tightly against foreign companies.[126] The latter fact has contributed to the perception of some stakeholders of the U.S. as being relatively closed towards FDI in their defence industry.[127]

While the formal purpose of legislation for the control of foreign defence-related investments can be found in the text of the legislation the practical concerns were partly revealed in interviews or are based on an analysis of the national control practice. As mentioned above, most of the existing legislation states as a purpose for investment controls the guarantee of public or national security interests. However, in two countries, notably Finland and France these notions are either specified in a rather broad manner or encompass additional sectors beyond defence.

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[125] For further details see the Country Report on Poland and Spain.

[126] For further details see the Country Report on France, Italy and the U.S.

[127] Our analysis has shown that the U.S. legislation is indeed more complex and less transparent as the perceptions of some stakeholders would imply: there are two different processes; they are overseen by different departments of Government; ultimately the decision on a transaction is at the discretion of the President; the President's decision is not subject to a juridical review; finally the mitigation agreements are not published. For further detail see the U.S. Country Report.

In the Finnish case, for example, legislation refers to "preventing such serious economic, social or environmental sectoral or geographic troubles as are likely to be permanent";[128] and in the French case industrial policy considerations seem to be included in the assessment criteria, which mention the goal to "assure the durability of activities, industrial capacities, capacities of research and development and associated statecraft", as well as „the needs of target enterprises (public markets or contracts which deal with public order)".[129] The rather inclusive formulations wording creates a doubt as to whether the French regulation could be interpreted as a way to protect French national industry.

In these cases a clarification of the legitimate purposes of the application of national legislation for the control of investment in strategic defence assets would delineate the appropriate boundaries for Government action.

However, it should be borne in mind that beyond the text of the legislation the purpose of investment control in some case study countries is clearly directed at protecting the domestic defence industry from pressure and influence from other EU countries. This is notably the case in Spain and Italy[130] The legislation is but a means to change the "balance of power" of these Governments vis-à-vis potential investors and other EU Governments in their own favour, be it for purposes of economic or security policy. Such practice presents a stark contrast to the aforementioned public declarations of Governments on their commitment to a European Defence Equipment Market.

### *3.6.2 Variety of legislative duties across countries obstructs transparency*

Our analysis has shown that considerable differences among EU countries exist as for the legislation of investment controls, in particular regarding the purpose of investment

[128] See Appendix "Overview of non-case study countries, National regulation of investment control" in Volume 2 of this Report.

[129] French Government. (2005) Code monetaire et financier. Titre V: Les relations financieres avec l'etranger.

[130] See the Country Reports for further evidence on this issue. Moreover, in Poland and many other Eastern European countries the defence industry is still in a process of transition and the issue of legislative means of investment control might only arise in the future.

controls, their scope i.e. what are "strategic assets" and the conditions for falling under the control legislation.

The fact that investment controls can extend well beyond the boundaries of the defence and even defence-related industry is further complicating the situation for investors. While France explicitly lists specific sectors of the economy, making this part of the law very transparent, other countries, notably Germany or the UK stipulate provisions that allow for the review of potentially any investment. While in the case of the UK this general clause is balanced by a clearly stated defence industrial (and investment) policy, as well as a relatively longer track record of "light" application of the law, Germany is considered as a rather nontransparent case due to a perceived political application of the law.

Any investor from inside or outside the EU is required to approach national Governments for each individual investment separately, as no one set of rules governs investments in the defence industry.

### *3.6.3 The assessment criteria of EU countries remain underspecified*

One reason for the perception that the U.S. has a "very transparent" system is the fact that the CFIUS criteria according to which intended investments are reviewed, as well as information about the review process are exactly spelled out and actively publicised in a comprehensible manner. Compared to the U.S. the assessment criteria of EU countries remain underspecified. While information about the legislation is publicly available for all countries there is little overview and awareness about the national control mechanisms.[131]

Moreover, we found that national experts were, with some exceptions, often not aware of the situation in other European countries. While experts from one country often agreed

[131] In one case even experts working on issues closely related to investment controls were not aware of the fact that their own country actually had legislation combined with practices in place that allowed for an effective investment control. It also has to be stated that the legislation in some countries combined with the publication practice of amended laws makes it rather challenging to comprehend and follow the legal stipulations.

with regard to the perceived openness of other States towards FDI in the defence industry, few of them had any specific and often incorrect ideas about the legislation and control mechanisms in other countries. Such a lack of information can present an impediment to decision making as well as cooperation on defence industry and market issues on the side of Governments as well as investors.

#### *3.6.4 Informal practice and lack of publicised results hamper competition*

As we have mentioned above, all countries encourage investors to "test the waters of an investment" through informal contacts with the authorities prior to an announcement of the intended acquisition. On the one hand, these informal contacts allow potential investors to sort out issues with the Government in question and to speed up the investment process without any public scrutiny and nervous reactions from (financial) markets. On the other hand, the informal negotiations often lead directly to an agreement about the deal in principle and about the undertakings necessary to accommodate the concerns of national security and/or public interest. The investment is thereby shielded from outside scrutiny and intervention from potential competitors for the target company.

As for the publication of the review results, no Government, except for that of the UK publishes the results of a review and of an appeal against a review decision. In the UK, the Office of Fair Trading makes public the review decision public and the mitigation agreement.

In this context it has been a challenge for the study team to obtain accurate and comprehensive information about the application of the legislation i.e. the number of cases, their nature or the decision-making criteria. If decisions are not published then the Governments is not forced to justify them and to make a case in light of former and potential future decisions. Countries like France, Finland or Germany refer to defence secrets, as the agreement given to foreign investment refers to key defence components and technology, or to the protection of commercial secrets in order to systematically not to publish the decisions. Moreover, a comparison across EU countries is more challenging. Last but by no means least, potential competitors do not have a chance to challenge the decision, a possibility that would add further dynamic to open up investment opportunities.

## 3.7 Lack of consultation implies risks for Governments, particularly for security of supply

### *3.7.1 Security interests of other MS and the EU as a whole are currently not considered*

Our interviews and consultation with stakeholders found that there is a lack of formal and systematic information exchange and consultation among Governments, implying a potential neglect of the security interests of other EU Governments that might be concerned by a transaction. There is a lack of systematic and continued mutual information and consultation, no matter whether an investment is reviewed under existing national investment legislation or a State owned defence company is privatised, i.e. sold to a third country investor in an EU country without such regulation. Hence, other EU Governments cannot assess the consequences of a transaction for their security interests, in particular for their security of supply, a concern raised by some Government and industry stakeholders but not by others.

The latter point out that while none of the countries takes the security interests of other Member States systematically into account or addresses those of the EU as a whole, Government stakeholders state that in one way or another they already request information about the main customers of the target company in the control process, which they *might* use to consider the security interests of other EU Governments. However, the information is not collected for the *purpose* of assessing the security interests of other Member States or the EU as a whole, hence it might only be suitable for a first step but not for an adequate assessment. Moreover, the follow up on the information seems not to be systematic. Also, different practices would evolve across Europe of how to take the security interests of other Member States into account. The security interests of the EU as a whole would not be addressed at all.

Furthermore, these stakeholders point to the fact that the number of reviewed cases is very small and the number of cases with an EU-dimension even smaller.[132] Hence, the

[132] For the number of intended transactions that are reviewed see section 2.4, in particular Table 2.5.

need for a consideration of other EU Governments' interests or a consultation rarely arises. When asked whether they expect the number of such transactions to rise in the future due to the transposition of the Procurement and Transfer Directives, stakeholders said that they cannot yet assess, to what extent the Directives will change this situation. In general they do not expect any major shifts.

As we have already noted, *some* Member States have themselves recognised that information exchange and consultation could be increased by some kind of an EU level mechanism, in particular with regard to investments from third countries. This is reflected by the fact that information exchange provisions relating to M&A were included in the Letter of Intent Security of Supply Implementing Arrangements in 2003 and also in the aforementioned Declaration on Strengthening Capabilities. In other words, the lack of systematic and continued mutual information and consultation among Member States – according to some stakeholders – bears particular (but not exclusively) risks for the security of supply.[133]

### *3.7.2 Risks for security of supply might hamper the drive to broaden the supply chain*

Security of supply in defence can be understood as "a nation's ability to guarantee and to be guaranteed a supply of defence articles and defence services sufficient to discharge its commitments in accordance with its foreign and security policy requirements".[134] Security of Supply has several dimensions. For example the industrial dimension – i.e. the capacity of a supplier to deliver defence equipment over a long period of time and to meet increased demand in times of crisis – can be differentiated from the political

[133] Based on our interviews we got the impression that the issue of security of supply was included in the LoI negotiations at the insistence of some countries, in particular France. The Italian Government subsequently led the LoI working group on security of supply, which might also be read as reflecting a certain interest in the subject matter. Finally, the fact that the aforementioned Declaration on Capabilities referring to a consultation mechanism on third country investments in the defence industry was adopted under the French Presidency in 2008 might be a further indication for the importance attributed to the subject by the French Government. Council of the European Union. Declaration on Strengthening Capabilities, Brussels 11 December.

[134] LoI Countries - Defence Ministers. (1998) Letter of Intent between 6 Defence Ministers on measures to facilitate restructuring of European defence industry.

dimension. The latter usually means political willingness of the country where the supplier is operating to grant an export license, which has also been the case for transfers within the EU. Experts interviewed for this study were almost exclusively concerned with the political dimension of security of supply, which explains our focus on this aspect.

In order to ensure security of supply in a broadened supply chain all the participants of the chain have to be reliable suppliers. While all experts agree that ensuring security of supply is key to making Governments and companies fully accept inter-dependence and thereby to bringing a broadening of the supply chain, they differ as to how such security can be achieved and, consequently, about the significance of the issue for broadening the supply chain and for a properly functioning EDEM. There appear to be two approaches.

#### *a) Regulation in combination with information exchange and consultation*

Some Governments, notably France and Italy, prefer regulation of review mechanisms and consultation among Governments as a strategy to address security of supply issues arising from foreign (non-EU) investments in the defence industry. They argue that unless third country investors have to notify their intended transactions (*and* EU Governments inform and consult each other about it) they will consider themselves in the current situation as either vulnerable (Italy) or only sufficiently protected through their national investment control legislation (France). Consequently, proponents of such a view are therefore likely to be hesitant to further broaden the defence industry supply chain across Europe and to support additional consolidation of the defence industry.

It should be stressed that it does not matter whether the third country investment is carried out in an EU Member State with or without investment control legislation; equally, it is not important that most defence assets are in fact controlled by Governments through the use of one of the three means of control discussed above.[135] As long as Member States do not inform and consult with each other, security of supply cannot be

[135] At present the majority of defence industrial assets are located in the six LoI countries. All of the LoI Six but Italy have national investment control legislation. Other significant defence industrial assets are located in Bulgaria, Finland, the Czech Republic, Greece, Hungary, Poland, the Slovak Republic and Romania. They control their defence assets mainly through State ownership except for those companies that have recently been privatized, for example in Romania.

adequately addressed even if all EU Member States introduced investment control legislation.

In other words, using the "regulation strategy", security of supply issues among EU countries that arise from third country investments can only be addressed in one of two ways: either a combination of national investment control legislation in all EU countries *and* information exchange and consultation among all EU countries; or by installing an EU level control mechanism for defence-related FDI from non-EU investors.

Some Government and industry stakeholders go as far as to say that such a mechanism has to be in place for the emergence of a European Defence Equipment Market, representing a level playing field in which centres of excellence emerge. Otherwise, so the argument, the EU would be much more vulnerable than before, as the combination of different national mechanisms of control is considered to be ineffective to defend competitiveness of the industry and ensure sovereignty with regard to foreign and security policy.[136]

### *b) Contracts*

Other Governments, such as the UK and Sweden and, to a lesser extent, Germany point to an alternative strategy to ensure security of supply. They consider contractual agreements with investors and suppliers as a sufficiently reliable means. As the analysis has shown some Governments such as the UK and Sweden and, to a lesser extent, Germany, have several and highly effective ways to ensure the security of supply, for example, through contracts with the investor and procurement contracts with prime contractors. The defence firms are contractually required to provide information about the changes in their ownership structure to Governments. Prime contractors in turn bind their partners further down the supply chain through contracts. Assuming that an investment is driven by the interest to conduct business a supplier would have every incentive to honour such commitments, assuming that the company would want to and be able to continue supplying the foreign Governments.

[136] See for example the Country Report on Sweden. Similar thoughts were expressed by experts in France.

One reason why there seems to be less of a concern in these countries might be the different structure of procurement contracts. While the UK has ample experience with through-life cycle procurement contracts, this is not the case, for example in Italy. Here procurement contracts are structured in a way to cover only the delivery of military equipment but not the support and maintenance throughout the life-cycle. An EU wide investment control regime regarding EU-inward investments that would ensure the information and consultation of all Governments would remedy these concerns.

However, there are two issues with the second strategy. First, the new owner of a defence supplier might need to act even against his own economic interest, if for example an investment by a SWF. EU policy has reflected the fact that among the public investors from third countries, Sovereign wealth funds require special attention.[137] Thus, the Communication on a common approach to SWF draws attention to the fact that investment decisions of SWF can be influenced by the political interest of the SWF's owners and might reflect a desire to obtain technology and expertise to benefit national strategic interests.[138]

An investor might also be required to act against economic interests, if it starts using products that fall under the ITAR rules.[139] In such a case, the transfer of the products from one Member State to another requires approval from U.S. authorities. Such a situation would make the security of supply among EU countries directly dependent on the support of the U.S. Government, which would not only hamper the creation of an EDEM but could also undermine solidarity and thereby the political project of establishing the EU as an international actor. While such an issue might also arise, if an EU wide investment controls regime covering information and consultation were in

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[137] See, for example, European Commission. (2009) Proposal for a Directive of the European Parliament and of the Council on Alternative Investment Fund Managers and amending Directives 2004/39/EC and European Commission (2008) A Common European Approach to Sovereign Wealth Funds. COM(2008)115 final.

[138] See European Commission (2008) A Common European Approach to Sovereign Wealth Funds. COM(2008)115 final.

[139] European Commission. (2009) Annex to the Proposal for a Directive on the coordination of procedures for the award of certain public works contracts, public supply contracts and public service contracts in the fields of defence and security - Impact Assessment.

place, such a regime would at least ensure that a decision would be made in full knowledge of the consequences for all Governments concerned.

Second, in the future the transaction cost associated with establishing and maintaining a rising number of individual contracts might rise, possibly to a prohibitive extent. The Defence and Security Procurement Directive is expected to open up a significant part of the defence market to EU wide competition for public defence and security contracts, a development which is further facilitated by the Directive on Intra-EU Transfers of Defence Products. Similarly, the aforementioned EDA Strategy for the European Defence Technological and Industrial Base makes the broadening of the supply chain an explicit policy goal, encouraging Western European defence companies to invest more in the new Member States.[140] It is anticipated that both acts will have a positive effect on the involvement of SMEs in defence procurement and the emergence of trans-European supply chains.[141]

With the likely broadening of the supply chain in the future, it can be expected that also defence firms of non-case study countries will become more involved in the development and production of arms and the provision of services due to an economic and a political reason: on the one hand, the cost of production in these countries is lower; on the other, extending the supply chain is seen by MS with a larger defence industry as a way to interest non-case study countries in the Common European Security and Defence Policy. Especially SMEs in the non-case study countries might represent attractive targets for third country investments, which raises the question to what extent the current situation regarding the control of strategic defence assets is already and will increasingly so in the future undermine the security of supply of the armed forces with military equipment.[142]

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[140] EDA. (2007) Strategy for the European Defence Technological Base.

[141] Europe Economics. *Study on the competitiveness of European small and medium sized enterprises (SMEs) in the defence sector*.

[142] The LoI countries define security of supply in defence as “a nation's ability to guarantee and to be guaranteed a supply of defence articles and defence services sufficient to discharge its commitments in accordance with its foreign and security policy requirements” LoI Countries - Defence Ministers. Letter of Intent between 6 Defence Ministers on measures to facilitate restructuring of European defence industry.

The argument is not to be easily discarded by pointing to the fact that the LoI countries, most of them equipped with specific investment control legislation harbour 87% of the EU's production of defence equipment. Further down the supply chain, the production capabilities are wider spread across the EU and the LoI Six are host to only 52% of defence-related SMEs.[143] SMEs typically operated as Tier 2 and Tier 3 suppliers and, hence, it is reasonable to assume that a risk may arise from the fact that many suppliers are located in countries without a dedicated investment control regime.

If the implementation of the Transfer and Procurement Directives will reduce barriers for cross-border exchange of defence goods and promote cross-border procurement, then procuring Governments will have a strong interest to be informed about the ownership structure of their major suppliers in order to assess the industrial capacity and reliability of the supplier. The Directives already address this issue and a regulative measure on the control of FDI in strategic defence assets at EU level would complement them. Such a solution might be less costly and less of an administrative burden than an increasing number of contractual agreements on information requirements in the case of a change of ownership structure between Governments and their suppliers from other EU countries. As argued below the least administrative burden would be achieved through a comprehensive investment control mechanism at EU level (Option 3), the implementation of which presents, however, a formidable political challenge.

Increased transparency and consultations about defence investments involving non-EU investors seems to be a step that might calm concerns among stakeholders and Governments with regard to security of supply. However, two things should be born in mind for the following discussion of Options for EU level action. On the one hand, investment control is but one aspect of the wider field of security of supply, all of which are difficult to tackle. On the other, given the continued disagreement about the relevance of this issue and the best remedy among interviewees, it is no wonder that the efforts among the largest European armaments producing countries, the LoI countries have, as mentioned above, not led to any substantial result. The Ministries of Defence have agreed

[143] For more information on defence-related SMEs see Europe Economics. *Study on the competitiveness of European small and medium sized enterprises (SMEs) in the defence sector*.

on a mechanism for the exchange of information on investments in the defence industry and a Code of Conduct on the Supply Chain referring to obligations of defence companies in this regard. As mentioned earlier the LoI agreements have not yet been implemented. In as much as Member States feel that their security of supply interests cannot be adequately addressed they are likely to be hesitant to accept a broadened supply chain and thereby increased inter-dependence in the European defence industry.

### *3.7.3 "Trojan horse"-investments might endanger countries with investment controls*

In addition, the stakeholders of some countries (Italy, Netherlands but also France) point to a risk that is concerned with investments coming from EU companies, which are subsidiaries of non-EU companies. In the current situation where most EU countries do not have national control legislation an investor from a third country could buy a company in an EU country without investment control legislation with the intent to circumvent investment controls by other EU Government ("Trojan horse"-investment). The main risks associated with "Trojan horse"-investments are that foreign controlled EU subsidiaries invest in defence assets in other EU countries (with control legislation), thereby getting access to sensitive technology and potentially undermining the security of supply, as the investor might for political reasons, and against economic interest (continued supply of existing customers), close down the operation.

The issue concerns the question of what represents a non-EU investor.[144] Defining this term correctly is legally challenging. The question arises whether the country of establishment of a company should be the decisive criterion, or whether in cases such as the present one exceptionally also the "ultimate control" theory could be applied. Under the latter, a company located within the EU may nevertheless be viewed as a non-EU company if it is indirectly (ultimately) controlled by a company located in a third

[144] We discuss the notion of what represents a non-EU investor in greater detail below. See Option 1, point 5.1.2 (e).

country. Whether or not the ultimate control theory may apply is a point of controversy between lawyers and has been the subject of prolonged debate. [145]

Based on Article 54 TFEU, which sets out the conditions under which foreign companies have to be granted national (and therefore also EU) treatment, non-EU investors are business entities having neither a registered seat nor their central administration nor their principal place of business in the EU. Article 54 implies that mere "letterbox establishments" would not count as EU investors.

The potential investment activities of fictitious companies would specifically concern those case study countries without investment control legislation, in particular Italy and the Netherlands, where stakeholders showed indeed some concern about this problem. In the other EU case study countries the existing investment control legislation would allow Governments to review transactions by investors from other EU countries: Finland, France and Germany can review all defence investments from non-national investors, including those coming from other EU Member States. Sweden and the UK can control all investments irrespective of the nationality of the investor. In Spain, the Government can only review investments by non-Spanish residents i.e. an entity controlled by a non-EU national but resident in Spain would not be screened. Consequently, the risk of "Trojan horse"-investments is here particularly high too.

The consulted stakeholders of most countries did not express a concern with this particular issue. French stakeholders from Government and industry, however, pointed out that they are concerned about potential "Trojan horse"-investments down the supply chain.

However, the "Trojan horse"-investment scenario provides an argument for the existence and application of national investment control legislation, thereby cementing the existing fragmentation of the market for corporate control.

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[145] In fact, this is a particularly uncertain area and has been since 1968 when a case was taken by the Commission to the CJEU on "control theory". Subsequently in the early 1990s there were infringement procedures against several Member States who relied on control theory rather than place of establishment. The Member States in question modified their legislation and cases never went to Court.

An EU level control mechanism would in this case remedy the problems that countries without investment control *legislation* face, lower the incentives for those Governments to adopt specific legislation in the future and remove one argument supporting the continued existence and use of national control legislations. Thus an EU level control mechanism could review a transaction by an EU company controlled by a third country investor targeting a defence company in another EU country if a justified belief existed about the malicious intend of the investor, as it is currently the case in the German and French legislation.

Finally, regarding the possibility that a malicious investor might undermine security of supply by deliberately closing down operations for political reasons and against better economic judgement. Currently, this possibility is very unlikely, as there is only a small part of all European defence assets that are not protected by some kind of State control. As mentioned above most strategic defence assets, also in countries without national investment control legislation, are still State controlled due to the fact that most strategic defence assets in the non-case study EU countries are still State owned. The only parts of the European defence industry that seem to operate at the moment without being protected by any means of State control, are privately held defence companies in those countries without investment control legislation and special rights such as the Netherlands, Greece, Hungary or Romania. However, if in the future more strategic defence assets can be expected to be privatised in the latter three countries and if the supply base of European defence contractors is broadened, then the share of strategic defence assets that is not controlled by Governments is likely to increase.

#### *3.7.4 Lack of EU level action might risk proliferation of sensitive technology*

Related to the issue of security of supply is the question of proliferation of sensitive technology. An investment into strategic assets, e.g. a dual-use company, in country with no investment control could unintentionally favour the proliferation of sensitive technology, especially if the investment was made with the intention of appropriating a key technology in order to close down a competitor or to circumvent export controls.

This issue has occasionally been raised by stakeholders as being linked to questions of investment control. They pointed to the practical challenges of controlling proliferation of intangibles. By controlling who can buy into strategic defence assets some Government

stakeholders hope also to reduce the risk of the proliferation of such intangibles such as blueprints or software applications. Stakeholders from the governments of Germany, Finland, France, UK, as well as from industry in the Netherlands and Sweden pointed out that proliferation of sensitive technology is a complex issue that has to be addressed by a variety of means, including the possibilities provided by export control legislation. Without specifying details, these stakeholders suggested that export and FDI control legislation should complement each other.

Nevertheless, it should be noted that a common EU legislation for the control of defence-related investments from non-EU countries would seem to be a complementary instrument in support of export controls.

## 3.8 Impact of Transfer & Procurement Directives on M&A is for experts too early to judge

The Directive on Defence Procurement establishes new rules that recognise the specificities of the defence market and thereby limit in the field of Government procurement the use of Article 346 TFEU to exceptional cases, as stipulated by the CJEU. It lays down that by 21 August 2011 Member States shall have adopted and published the laws, regulations and administrative provisions necessary for the transposition into the national legal systems.

The Transfer Directive focuses on simplifying the licensing process for defence transfers within the EU and establishes new rules to enable the opening up of supply chain opportunities to competitive SME tenders, helping to make the European market more dynamic. It lays down that Member States shall adopt and publish, no later than 30 June 2011, the laws, regulations and administrative provisions necessary to comply with this Directive. They shall apply those measures from 30 June 2012.

Several questions arise, for example: How will the Directives affect mergers and acquisitions in the European defence industry; and how will that impinge on the practices of Government control of strategic defence assets; what are the implications for a European dimension of investment control?

We begin by assuming that all Member States will fully transpose the Directives into national law. We assume that the opening of national defence markets implies in the first

place that the – then easier – exchange of defence related goods and services between the Member States is likely to increase.[146] More important, however, experience shows, that the opening up of the national borders for products and services results in an increase of cross border mergers, in other words the number of transactions such as joint ventures and concentrations tends to increase noticeably as a result of liberalisation.

The electricity and telecommunication sectors may serve as an example:

- During the 1990s, when most of the national energy markets were still monopolised the European Union and the Member States decided to gradually open up these markets to competition. The first liberalisation Directive concerning electricity was adopted in 1996 and was transposed into Member States' legal systems by 1998. This Directive took a gradual approach towards market opening and for that reason further Directives were adopted in 2003 and 2009 respectively. The same approach was chosen for the gas sector. In spite of the limited market opening of the electricity sector achieved by 1998 the effect of the first electricity Directive upon energy cross border transactions and indirectly upon market consolidation was considerable: between 1990 and 1997 only 7 concentrations concerning the electricity sector were subject to the Merger Control Regulation[147], i.e. on average one per year. In 1998 and 1999 there were 7 cases per year, in 2000 15 cases. In 2001 and 2002 the number of concentrations rose to 26 cases per year.[148]

- A comparable development characterises the telecommunications sector where the number of concentrations (often in the form of joint ventures) rose considerably in

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[146] It should be noted that many stakeholders don't necessarily share this assumption. They point out that some of the major EU countries see a risk of proliferation due to the fact that some of their EU partners have less stringent national regulations. Consequently, these stakeholders expect that there will be, at least at the beginning, a rather hesitant use of general licences and only for items without key technology.

[147] Then Regulation 4064/89 of the Council, now Regulation 139/04 of the EP and the Council. The EU Merger Control Regulation apprehends only very large concentrations, i.e. having "Community dimension", whereas the national competition authorities examine concentrations without this dimension.

[148] European Commission. (2010) Search competition cases., using the simple search function, selecting "all"-box for "Policy areas" and D for the NACE sector code.

1998 and 1999 following Community legislation liberalising 1998 voice telephony and provision of infrastructure effective January 1998.[149]

Let us add that the increase in transactions in real terms exceeds by far the figures just indicated. In fact, the concentrations having a Community dimension are only a small part out of the total number of transactions and concentrations taking place within the Union as a whole.

Reasoning in analogy to these two markets,[150] we would expect that the effects of the liberalising measures of the Procurement and Transfer Directives will not be limited to furthering interstate commerce in defence goods and services but are likely to lead to an increase in the number of cross border concentrations and joint ventures in the European defence sector as well.

Can the analogy between the defence and the utility markets be justified? We would answer in the affirmative, though one might argue that the boost is probably going to be smaller than in the utility markets, given the difference of the structure of the defence market, where there is a single buyer as opposed to millions of electricity, gas, or telecommunications customers. Consequently, one of the main incentives for companies to pursue cross border M&A instead of cross border trade – gaining access to an additional large customer base – will be less prevalent in the defence market. However, a cross-border transaction in the defence sector does not only allow a company to strengthen its position as a supplier to a particular Government but often also opens up support for exports to further destinations. Moreover, a defence investment is likely to pave the way for an investor to gain contracts in the support and maintenance business, which is often allocated to national firms, even if the goods are supplied by an international contractor. Hence, the experience in other markets can be used as an

[149] The number of cases jumped from 17 in 1996 and 18 in 1997 to 21 in 1998, 33 in 1999 and 56 in 2000, 54 in 2001. Ibid., using the simple search function, selecting "all"-box for "Policy areas" and J for the NACE sector code.

[150] We wish the Commission to note that these deliberations on the likely effects of the two Directives are not the result of a comprehensive and systematic analysis, which is not the topic of the EUROCON study, but are only presented here as a side aspect to the central questions of the project. As such we have addressed them with stakeholders and most of them did not express an opinion about the anticipated effects of the Directives.

orientation. It suggests that the number of defence investments along the supply chain is likely to increase a short period of time after the transposition of the aforementioned two Directives.

It is in this perspective of a European defence market where defence products and services circulate (more) freely and where accordingly the number of cross border defence investments increases that the review of EU investments for security reasons based on purely national regimes becomes an even more pressing issue than today. As long as defence investments remain subject to national discretion, or in other words as long as national security interests continue to be used as a reason, and sometimes an alibi, for restricting the market access of foreign investment the consolidation of the defence sector is impeded. As we will show below, European measures addressing the external and internal dimensions can help liberalise defence investment activities, reduce to a minimum the use by Member States of Article 346 TFEU while at the same time properly address potential security risks.

However, as already mentioned above, most stakeholders from Government and industry state that it is impossible for them to anticipate the consequences of the transposition of both Directives for investment markets and their control at this stage. They stress the need to see first results of the application of the Directives before their effects can be judged. Industrial stakeholders stress that the effect of both Directives on industrial consolidation is likely to be limited if it is not going to be accompanied by a consolidation of the demand side. Some Government stakeholders stress that much will depend on how the Directives are applied in practice. While some experts expect that the Directives will have an impact on industrial consolidation but caution that it might not always strengthen the defence industry; others do not anticipate much of a change in defence industrial mergers and acquisition activity. Hence, the latter group of experts sees little need to adapt their investment control practices.

## 3.9 Stakeholders are uncertain as to the most appropriate way forward

### *3.9.1 Most experts show little enthusiasm for European level action*

We found a paradox in the response of stakeholders. Despite a shared feeling that the current situation is not optimal, most industrial and Government stakeholders we

consulted show little enthusiasm for EU level action, let alone as to the form of a "European dimension" in the control of investments in strategic defence assets. The response of some Member States with large defence industries is even more paradoxical since the Letter of Intent Security of Supply Implementing Arrangements include – as we have noted – provisions for information exchange on mergers and acquisitions and Governments see a continued need to find a workable solution to address the problem. Equally, the French Presidency Conclusions included reference to voluntary notification of third country acquisitions of European defence companies.[151]

All experts agree on the fact that to this day there is by no means a common European approach, neither among the LoI/FA countries nor within the EU, as to the appropriate way to handle foreign investments in the defence industry. There is also agreement that the current situation is far from optimal, however, there is no shared notion of what exactly the problem is, let alone of what should be done about it.

Generally, stakeholders do not see the fact that the EU States with the main European defence industrial assets use different means of State controls and different investment control regimes as a considerable issue. While they admit that the current situation presents to a certain degree an obstacle to the consolidation of the European defence industry (and the formation of a European Defence Equipment Market), they do not hold it to be the key problem. While Government and industrial stakeholders in Germany, Sweden and the UK stress that State ownership of defence assets is the main obstacle to consolidation and that any change in the investment control regime requires adjustments in these areas too, French stakeholders from industry and Government point to the lack of common military doctrine, of a common procurement policy and of the coordination of defence R&T. They, therefore, call for a consolidation of the demand side at the European level. For Spain the consolidation of the European defence industry and the creation of a defence equipment market is far from being a political priority. Conscious of the weaknesses of the national DTIB, Spain rather prefers to protect its national market, and to pick up on a case by case basis foreign investors when necessary (the

[151] See Conclusions of the Council of the European Union. Declaration on Strengthening Capabilities, Brussels 11 December.

investment decision for Santa Barbara Sistemas being a case in point) with prior political negotiations on the quantity and quality of offsets offered by the investor. The Polish Government follows a similar approach.

Most experts agree that the current situation in the EU is not transparent as to the rules and the practice of defence-related FDI and their controls. They hold that it would be good to have some sort of information exchange at EU level. There are different views as to how such an information exchange should be managed, by the EDA or another EU structure; with or without the involvement of the Commission.[152] At the same time most experts point to the fact that so far the information exchange even among the six LoI countries has been very limited and the agreed upon procedures have been hardly followed. An EU level mechanism for an information exchange and consultation might face similar challenges. However, we wish to note that legally binding rules with the Commission to monitor their actual implementation differ from looser politically binding rules, accordingly there is a considerable chance that the former will be more effective than the envisioned LoI solution.

### *3.9.2 Some experts consider EU control of non-EU investments as a precondition for EDEM*

Beyond information exchange, only a few experts hold that an EU level control mechanism for defence-related investments from non-EU countries is required in order to create a truly European defence industry.

Some experts – notably in Sweden and France – point out that such a mechanism would be a prerequisite for the EU "to take a stronger stand" in the world. In this context it should be noted that several interviewees regard EU level investment control legislation as a kind of bargaining chip that buttresses the EU's position, for example in negotiations about market access, in particular vis-à-vis the United States but also towards other emerging powers such as China and India. In this context it was recommended that for

[152] See for example the Country Report on Italy.

the development and design of a common EU level approach the control mechanisms and practices of those countries should be examined.[153]

These experts also argue that unless, some sort of EU control mechanism was in place, the fragmentation of the European Defence Equipment Market could not be overcome, since issues of security of supply and the proliferation of sensitive technologies would remain unresolved.[154]

However, other experts stress that security of supply is not an issue to be solved necessarily by an EU level mechanism. Contracts between Governments and suppliers, as well as between suppliers and subcontractors are regarded as being sufficiently effective to ensure the security of supply.[155] Even those experts who agree that an EU mechanism for the control of third country investments might be desirable warn that it would add "red tape" and that it would be extremely challenging to implement.

One important reason for the diverging view on the need for EU level action consists in fact that EU Governments also use the investment control legislation to conduct industrial policy and strengthen their industry (and bargaining position) vis-à-vis their partners in the EU. As shown in the Spanish, Italian and French cases, an investment in a defence company will always be a highly political and politicised decision, to be taken at the highest level of Government.[156] If the investment review was to be carried out at EU level, or if the Member States would have to apply a harmonised EU framework, the Member States would find it more difficult to protect their national DITB; and already an information exchange and consultation would increase the transparency and therefore improve the present situation.

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[153] For details see the Country Report on Sweden.

[154] See for example the argumentation in the Country Report on France and Sweden.

[155] For details see the Country Report on the UK.

[156] While the entire Government can be concerned with an investment decision also in Germany, Sweden and the UK it is so in practise only in very rare cases.

By way of conclusion we can say that the current situation of State control of strategic defence assets has a number of negative implications for the consolidation of the European defence industry.

- First, State ownership can be said to present an obstacle to consolidation, as it creates a conflict of interest and puts publicly owned firms in a position in which they are able to accept more business risk in comparison to their private competitors, which can translate into price advantages. This issue was raised by stakeholders of some countries (UK, Germany, Sweden) but not of other countries (France, Italy, Spain).

- Second, the market for corporate control of defence firms is fragmented and hinders the free movement of capital, not allowing capital to be channelled into its most efficient use, increasing inefficiency and hampering the possibility to discipline management. Moreover, a fragmented market represents an incentive for Governments who have no control legislation yet, to implement such legislation.

- In addition, the current situation is characterised by a lack of transparency regarding the policies, review processes, and mitigation requirements of national investment controls, which increases the risk of an investment and might prevent certain transactions.

- These three problems impede the consolidation of the European defence industry because they represent impair predictability for investors and increase their business risk. While industrial stakeholders acknowledged the transparency issues, they were not particularly concerned about the fragmentation of the market, stating that the fragmentation would not represent much of an obstacle to their consolidation attempts. They acknowledge the fact that the acquisitions in each country require the consent of the Government and they would seek to obtain it prior to any deal. Government stakeholders were similarly concerned more about the lack of transparency than the fragmentation of the market.

- Fourth, in the current situation there is a lack of information exchange and consultation among Governments, implying a potential neglect of the security interests of other EU Governments that might be concerned by a transaction. While Governments maintain that the number of reviewed cases is overall very small and

the number of cases with an EU dimension even smaller, this might change in the future after the transposition of the Procurement and Transfer Directives. Moreover, given that most EU countries do not have national investment control legislation but might still harbour companies producing strategically important components, a minority of Government and industrial stakeholders raise concerns over the security of supply. Finally, some Governments (Italy and France) are concerned about the risk of "Trojan horse" investments in EU countries without investment control legislation, which can then be used for defence investments in other EU countries. This concern might prompt other EU countries without investment control legislation to contemplate the adoption of such laws in the future. Most countries with existing control legislation do not see an issue here, at the moment.

The latter three problems impede on the consolidation of the European defence industry in an indirect way, as they represent reasons for Governments to maintain strong means of control over strategic defence assets, in particular to keep national investment control legislation, thereby cementing the existing fragmentation of the market for corporate control.

We have further argued that judging by the effects of liberalisation of other sectors such as energy, gas or telecommunications the transposition of the Procurement and Transfer Directives is likely to lead to an increase of investments. Such a rise of the number of cross border mergers, acquisitions or joint ventures can be expected to add further stress to the current situations. However, most experts are still very cautious to voice an opinion as to the consequences of the Directives and want to await first practical results of its application.

Despite the drawbacks of the current situation there is no agreement amongst stakeholders regarding the appropriate way forward. While most of them see the benefits that some sort of EU level action might have, they do not agree at all with regard to its potential character or modus operandi. Hence, the appetite for any EU action on this matter is rather small and this point must inform the character of any policy initiative in this field at the EU level.

# B OPTIONS FOR EU LEVEL ACTION

The purpose of the following chapters is to discuss and evaluate some potential Options that would give a European dimension to the control of strategic defence assets and help to remedy the problems we have identified above. Our analysis has shown that the fragmentation and the nontransparency are *inter alia* the result of ongoing national review instruments and measures of similar effect applied to foreign investments. These national measures are designed to ensure the security of the Member States and apply without significant distinction to EU and non-EU investments alike.

## 4 PRELIMINARY CONSIDERATIONS

The Commission has asked us to identify potential measures ("Options"), which introduce a European dimension in the review of foreign investment in EU countries distinguishing between an internal and an external dimension of control. The internal and external dimensions of control concern transactions by EU investors and by third, non-EU country, investors respectively. Measures with regard to both categories are linked: as long as no effective control mechanism for non-EU investments exists, Member States can insist on being allowed to apply their national control legislation with regard to investments from non-EU countries, as well as EU countries. The latter type of investments may for example entail risks associated with "Trojan horse"-investments and for security of supply. Hence, action addressing investment control legislation with regard to EU investments needs to be preceded, or accompanied by, measures providing an effective control for third country investments.

Any potential In view of the assessment of the status quo we see our task in a discussion of EU instruments, which give a European dimension to the control of strategic defence assets and help to remedy the problems we have identified above. Our analysis has shown that the fragmentation and the nontransparency are *inter alia* the result of ongoing national review instruments and measures of similar effect applied to foreign investments. These national measures are designed to ensure the security of the Member States and apply in most EU case study countries without significant distinction to EU and non-EU investments alike.

The EU instrument must have as its objective to reduce or end the market fragmentation and its consequences while at the same time adequately protecting the Member States and the Union from the security risks that may be linked to foreign investments. Only such EU instruments can legitimately reduce the scope for national measures in this field.

## 4.1 The Options address main security risks linked to non-EU investments

The security risks linked to foreign investments are therefore of central importance. They can be summarised as follows:

- The risk of a dependence of the EU or of one or more Member States upon a foreign-controlled supplier of strategic defence assets who might delay, deny or place conditions upon the provision of defence products necessary to a functioning EU defence industrial base; this risk relates to the availability or reliability of defence equipment supplies in times of crisis; below this is referred to as a risk for the "security of supply";

- The risk of a transfer of defence-related technology or other expertise to a foreign-controlled entity that might be deployed by the entity or its Government in a manner harmful to European or national security interest; the risk is here the dependency on foreign technology; this risk is below referred to as "proliferation of technology";

- And eventually the potential capability for infiltration, surveillance or sabotage into the provision of those defence products, which are crucial to a functioning EU defence industrial base.[157]

As to the appropriate legal treatment of these risks we are guided by the consideration that serious security risks may well be linked to certain investments from third countries, whereas this is less likely to be the case with respect to investments from other Member States. Therefore we are of the opinion that the Union has to cope with these risks through legislative measures addressing, *inter alia*, security concerns. The risks are of

[157] See Röller and Véron. A European framework for foreign investment',Vox, 6 December.

particular relevance in those cases where foreign States or entities controlled by them are the investors in European defence assets.

Investments from other Member States will normally not threaten the essential security interests of the recipient Member States. Therefore the Treaty normally prohibits controls of investments from other Member States. An Interpretative Communication on the application of Article 346 in the area of investment control would clarify the prohibition and could facilitate infringement proceedings.

## 4.2 Most Options combine measures regarding the external and the internal dimensions

In order to address the risks that may be linked to third country investments EU instruments have to be identified which deal with the relationship between the Union and third countries and apply to third country residents. These instruments can be found in the rules of the Treaties concerning the Union's external action.

- EU instruments concerning the external action may be based on the rules of the TFEU on the free movement of capital between the Union and third countries and on the common commercial policy conducted by the Union in relation to third countries.

- The rules of the TEU, which cover the external action of the Union, are those on the CFSP and on the CDSP.

As to the internal dimension, i.e. the legal treatment of investments crossing the internal borders of the Union, we could either identify legal instruments which concern the Union's internal action or refer to the correct application of the applicable Treaty rules.

## 4.3 Despite Article 346: possibilities for harmonisation exist but are limited

Article 346 TFEU is a Treaty derogation that can be invoked, on a case-by-case basis, by Member States in clearly defined and exceptional cases and that has to be interpreted strictly. It is a provision of primary law and Member States can invoke it within the limits identified by the Court. No piece of secondary legislation can change this legal possibility.

The defence procurement Directive recognises this legal situation in the following terms:

> "*Articles 30, 45, 46, 55 and 296 of the Treaty [now Articles 34, 52, 62, 65, 346 TFEU] make provision for specific exceptions to the application of the principles set out in the Treaty and, consequently, to the application of law derived therefrom. It therefore follows that none of the provisions of this Directive should prevent the imposition or application of any measures considered necessary to safeguard interests recognised as legitimate by these provisions of the Treaty.*" (recital 16).

Similar statements can be found in the ICT Directive. [158]

In view of this legal situation, all that EU legislation can do is to try to create the conditions to avoid extensive use by Member States, by taking the specificities of the defence sector into account.

Four of the Options to be further discussed below would aim at "harmonisation". Given that harmonisation cannot exclude recourse by Member States to Article 346 TFEU and to other Treaty derogations, EU legislation which applies to situations where Member States could legitimately invoke Article 346 TFEU risks being undermined by recourse to this provision.

Harmonisation measures would therefore best be designed in such a way as to avoid any potential overlap with Article 346 TFEU. However, in view of their subject matter, i.e. harmonising the conditions of free movement of strategic non-EU defence assets, while at the same time addressing also related security concerns, one cannot totally avoid but only try to minimise the overlap between legislation and derogation compatible with the Treaty.

As to this risk of overlap a distinction may be drawn between cases where Member States rely on a Treaty derogation in a manner which is incompatible with the Treaties and those other cases where the Member States invoke the derogation in a Treaty compatible way.

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[158] See for instance recitals 2 to 9, 10, 13 "subject to Articles 30 and 296", 14, and Article 1(2) and 1(3) of the ICT Directive. See also recitals 1 and 16 of the Defence Procurement Directive.

In this regard it should first be noted that any discriminatory, disproportionate, heterogeneous, nontransparent or otherwise incorrect use of Article 346 TFEU – which definitely transgresses the limits of the derogation – may not only be addressed by corrective measures on a case by case basis such as infringement proceedings in accordance with Articles 258 et seq. TFEU. Another efficient "remedy" for infringements of this kind can be found in EU legislation providing for common binding rules defining the Treaty compatible approach of the subject matter at issue. As the EU practice shows, harmonisation often puts Treaty infringements to an end. On the other hand, it should also be recalled that in cases where EU legislation has been adopted, national measures based on derogations such as Article 346 TFEU may well be capable of undermining the efficiency of common rules which inter alia address also security concerns. For precisely this reason we have stressed that EU legislation concerning defence FDI must aim at minimising such risk.

Having looked at the factual and legal situation prevailing in the case study countries with regard to Article 346 TFEU we have not been made aware of specific cases where the limits of the derogation have not been respected.

In more general terms however we can make the following observations with respect to the national use of Article 346 TFEU:

- First of all, Member States are not always aware of the fact that their various measures or practices regarding FDI fall within the scope of Article 346 TFEU.

- Second, as we have mentioned under 3.3.2 above, notions of "strategic defence assets" differ substantially across the countries. Already for this reason the Member States can be said to invoke Article 346 in a heterogeneous and inconsistent manner. The variety of the national measures and practices designed to control foreign defence investments provides further evidence thereof.

- Third, the actual practice on recourse to the derogation is rather opaque and lacks predictability; therefore it is not up to the standards of legal certainty that businesses would require and that should apply in the area of defence and security.

- Fourth, in most of the Member States having a review mechanism neither the opening of a case nor the final decision are normally subject to any publication, this implies

that it is not transparent when and under what conditions these MS invoke Article 346. Such a situation makes a proper analysis and legal review more difficult.[159]

- Fifth, the systematic controls of intra-EU investments in certain Member States on the basis of criteria which are in essence the same as those applied to non-EU investments can be disproportionate.

In sum, even if we have not found any particular cases where the limits of Article 346 would not have been respected, there are many indicators that point to a lack of transparency, of proportionality and moreover to a degree of heterogeneity that would warrant harmonisation.

### 4.4 Six Options for EU level action can be envisaged

We have identified six Options introducing a European dimension in the review of foreign investments strategic defence assets in EU countries:

- **Option 1**: A Directive on the notification, information exchange and consultation with regard to non-EU investments;
- **Option 2:** A Directive harmonising the review of non-EU investments combined with an Interpretative Communication and possibly infringement procedures;
- **Option 3:** A Regulation on the common review of non-EU investments combined with an Interpretative Communication and possibly infringement procedures;
- **Option 4:** Enhanced cooperation enacting Option1, 2 or 3;
- **Option 5:** A CFSP Council Decision regarding national review of non-EU investments combined with an Interpretative Communication and possibly infringement procedures;

[159] See also Articles 41 and 47 of the Charter of fundamental rights of the EU.

- **Option 6**: An EDA Code of Conduct on notification, information exchange and consultation or on review procedures of non-EU and EU investments.

All six Options concern in the first place the external dimension; they are legal instruments designed to address investments in European strategic defence assets from third countries. While the Treaty prohibits restrictions on investments from third countries and from other MS (Article 63 TFEU), it empowers the Union legislator to regulate the external dimension, see Article 64(2) and (3) TFEU. No legal basis is provided by the Treaty to regulate also the internal dimension. However, in order to present complete Options – covering both investments from non-EU and EU countries – we have added to each external measure the appropriate complementary measure dealing with the internal dimension.

Four of these Options are EU instruments under the TFEU whereas the two further Options are EU instruments under the CFSP provisions of the TEU.

The following table presents the Options combining the dimension(s) they address and the governance method under which they are adopted.

Table 4.1: Overview of possible Options

| | **Addressing only the external dimension** | **Addressing the external and internal dimensions** |
|---|---|---|
| **EU instruments under the TFEU** | **Option 1**: Directive on notification, information and consultation regarding non-EU investments & Policy Communication on EU investments | **Option 2:** Directive harmonising the national review procedures for non-EU investments & Interpretative Communication on EU investment control<br><br>**Option 3:** Regulation on a common review procedure for non-EU investments & Interpretative Communication on EU investments<br><br>**Option 4:** Enhanced cooperation on Options (1), (2) or (3) |
| **EU instruments under the CFSP provisions of the TEU** | | **Option 5:** A CFSP Council decision aimed at national review procedures for all investments & possibly an Interpretative Communication on EU investment control<br><br>**Option 6:** EDA Code of Conduct concerning national review procedures for all investments |

The four measures adopted under the TFEU are legally binding, enforceable and subject to legal control. The CFSP Decision under Option 5 is legally binding but it is not enforceable nor subject to the judicial review by the CJEU. The EDA Code of conduct is politically binding.

We will present the Options adopted under the TFEU in an "ascending order", as the Options build on each other, involving an increasing scope of cooperation, and then turn to the remaining two Options under the TEU. We will characterise each Option along the following criteria: legal basis and objective; function and modalities; scope and organisation; and rationale.

# 5 SIX OPTIONS FOR INVESTMENT CONTROL

## 5.1 Option 1: Directive creating notification & consultation obligations for non-EU investments

This Option consists of a Directive harmonising the national rules on the notification of certain non-EU investments in European strategic defence assets and on information exchange and consultations between Member States that are concerned by a proposed acquisition. More precisely, the Directive would create an EU wide obligation for non-EU investors to notify certain investments the characteristics of which would have to be defined in the Directive. Notification would however be for information purposes only whereas a review would only follow in those Member States which apply legislation to that effect. Moreover the Directive would determine that national decisions on non-EU investments which have an impact on several Member States shall only be taken after consultation between all Member States concerned by a proposed acquisition.

### *5.1.1 Legal basis and objective*

The Union is competent to legislate under the TFEU on defence market issues. It can in particular harmonise national measures in order to ensure the good functioning of the internal market. In doing so, the Union can also address security concerns. This does not affect the existence and the legal scope of Treaty derogations such as Articles 346 and 65 TFEU. Addressing the security concerns will reduce Member States' recourse to such provisions in that it will be more difficult for Member States to prove, in the specific cases where the derogations are invoked, that the application of such derogations is necessary and proportionate.

This approach is confirmed by the Defence Package Directives, which make clear that the Directives do not affect – in legal terms – the Treaty derogations but should create the conditions for their strict application as requested by the CJEU.

The Directive here under discussion would have as its subject matter and content the movement of capital to or from third countries whereas among the aims pursued would also be the good functioning of the internal capital market. As will be discussed in more

detail below, Article 64(2) TFEU on the free movement of capital could serve as legal basis for the Directive.

### *a) Article 64(2) TFEU as a legal basis*

Articles 63 et seq. TFEU concern the free movement of capital within the Union and between the Union and non-EU countries. Article 63 TFEU sets out that all restrictions on the movement of capital between Member States and between Member States and third countries shall be prohibited. Article 64(2) TFEU entitles the European Parliament and the Council to adopt "measures" on the movement of capital to or from third countries involving direct investment.

The Directive here under discussion could be based on Article 64(2) TFEU. The Directive would only concern the *external* dimension of the free movement of capital, i.e. the movement of capital between the Union and third countries. More particularly direct investments from third countries in European defence industries would be dealt with. The Directive would aim at harmonising the national provisions which regulate the notification of non-EU investments to national authorities. In addition it would aim at establishing the obligation of the reviewing Member States to consult those other Member States which are likewise concerned by the proposed investments, and to exchange information to that effect. Both obligations, the obligation to notify and the obligation to consult and exchange information, are limited to acquisitions or concentrations proposed by non-EU investors and therefore concern the movement of capital from third countries into the Union.

Use of this legal basis would not affect – in legal terms – the Treaty derogations laid down in Articles 65 TFEU and 346 TFEU.

### *b) Endeavour to achieve the free movement of capital*

The Directive on non-EU investments would have to pursue the objective of achieving the free movement of capital between the Union and third countries. More particularly, Article 64(2) TFEU requires the legislator to adopt measures (only) "whilst endeavouring to achieve the objective of free movement of capital between the Union and third countries to the greatest possible extent". Accordingly the use of this provision as a legal basis for the harmonisation of notification obligations requires demonstration of the fact

that the intended legislation aims at facilitating the movement of capital between the Union and third countries. This condition is met for the following reasons.

The introduction of an EU wide notification system for investors from third countries would not, in legal terms, amount to a restriction in trade between Member States and third countries. A notification system which is not followed by a screening mechanism (as is the case in this Option 1) is a mere procedural requirement designed to increase transparency. It does not hinder the access to the European investment market. On the contrary, a general obligation to notify acquisitions would increase the transparency of the movement of capital between third countries and the Union and in this sense aim at furthering the free movement. Moreover, the overall objective of the Directive is a more open internal market, and indirectly this objective will also influence the movement of capital between the Union and third countries.

***c) Safeguard the security, independence and integrity of the Union, Article 21(2) and (3) TEU***

Though based on provisions on the free movement of capital the Directive may moreover pursue security-related objectives.

In this respect, Article 21(2) TEU is relevant which sets out policy objectives for EU policies and actions. According to this provision, safeguarding the security, independence and integrity of the Union makes part of the objectives which shall be pursued by the Union. According to Paragraph 3 of this provision – which is new under the Lisbon Treaty – the Union shall pursue these security related objectives in the "external aspects of its other policies" laid down in the TFEU. This implies that a Directive harmonising certain external aspects of the free movement of capital, as is here the case, may also aim at increasing the security, independence and integrity of the Union.

***d) Article 40 TEU would be respected***

Article 40(2) TEU does not stand in the way of using Article 64(2) TFEU as a legal basis. The legal treatment of non-EU defence investments in the European defence sector is a matter for the Treaty rules on the free movement of capital between the Union and third countries rather than for the CFSP.

### *e) Legal instrument*

The term "measures" in Article 64(2) TFEU implies that the legislator may adopt either a Directive or a Regulation. For present purposes a Directive would be appropriate (but a regulation would not be excluded). Though binding as to the result to be achieved, a Directive leaves to the Member States the choice of form and methods (Article 288 TFEU). A Directive has also been the preferred choice with regard to defence procurement and intra Union transfer, as the respective EU Directives demonstrate.

### *f) Legislative procedure*

Pursuant to Article 64(2) TFEU the European Parliament and the Council would to act in accordance with the ordinary legislative procedure, i.e. with qualified majority.

It should be added that pursuant to Article 64(3) TFEU only the Council, acting in accordance with a special procedure, may unanimously and after consulting the European Parliament, adopt measures which constitute "*a step backwards in Union law as regards the liberalisation of the movement of capital to or from third countries*". Therefore the use of Article 64(2) TFEU as a legal basis requires furthermore evidence of the fact that the proposed harmonisation would not entail a step backwards in Union law as regards the liberalisation of the movement of capital from third countries.

The Directive would meet this requirement. As already mentioned in connection with the requirement to facilitate trade, the EU wide notification system for investors from third countries as it would be subject of the Directive would not, in legal terms, amount to a restriction in trade between Member States and third countries. A notification system which is not followed by a screening mechanism is a mere procedural requirement designed to increase transparency. It does not hinder the access to the European investment market. Therefore it does not represent a "step backwards in Union law" within the meaning of Article 64(3) TFEU.

Unanimity is thus not required.

### *g) Consistency with Commission Communications*

The Directive harmonising notification obligations for non-EU investors would have to be in line with the Commission Communication of 7 July 2010 "towards a

comprehensive European international investment policy".[160] This Communication forms, together with a proposed Regulation, first steps in the development of a European international investment policy. Moreover consistency with the Commission Communication on Sovereign Wealth Funds[161] will have to be ensured.

#### *h) Objective*

The overall policy objective of the Directive would be twofold: first, to ensure - through an EU wide obligation for non-EU investors to notify defined investments in European strategic defence assets – greater transparency and better knowledge as to an appropriate future European treatment of such investments. In light thereof, decisions as to possible further appropriate measures may be facilitated. Second, obligations of the Member States to consult the other Member which are also concerned by those investments would aim at increasing the coherence of national decisions concerning one and the same notified acquisition and at furthering the broadening of the supply chain.

### *5.1.2 Function and modalities*

The Directive would create an initial stage of a common defence investment screening system. It would leave the existing national mechanisms fully intact.

On its basis measures could be prepared which may furthermore be needed in order to cover the security risks which exist at this stage at the level of the Union and to improve the conditions of a consolidation of the defence sector.

As to the modalities, the Directive would have to lay down an obligation for the non-EU investors to notify defined acquisitions.[162] It would moreover require Member States applying national review mechanisms to consult those other Member States which are

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[160] European Commission. (2010) Towards a comprehensive European international investment policy. COM(2010)343 final.

[161] European Commission A Common European Approach to Sovereign Wealth Funds. COM(2008)115 final.. For a more extensive discussion on public investors see 5.2.2 (c).

[162] The details of the notification are outlined further below.

also concerned by a notified acquisition (or state that the latter have the right to be consulted, but normally a Directive lays down obligations).

These obligations are justified *inter alia* by the consideration that Member States accepting or rejecting investments from third countries in strategic defence assets take decisions which, though national in scope, have because of the existence of an internal market necessarily Union-wide effects, in fact and in law. Whereas the decisions are at this stage taken in the sole perspective of national security consideration they impact also on the security of the other Member States and the Union as a whole.

The Directive would have to describe the proposed acquisitions that will be subject to notification and consultation. To that effect certain key notions would have to be defined, e.g. concerning the European defence enterprises, strategic defence assets, non-EU investors, threshold for notification, and Member States concerned by a proposed transaction. Defining these notions is a challenge, EU legally speaking, in particular the notion of strategic assets and non-EU investors. As to any further modalities of the Directive, *inter alia* the Merger Control Regulation (EMCR) could provide useful guidance.

**Key notions to be defined**:

***a) European defence enterprises manufacturing or developing strategic defence assets***

The Directive should define the European companies that are targeted by the investors. These are European defence enterprises which have their registered seat, central administration or principal place of business within the European Union and manufacture or develop strategic defence assets (as defined below).

The Directive should as a rule apply to operations involving all undertakings meeting these criteria and larger than SME's. SMEs are made up of enterprises which employ

fewer than 250 persons, have an annual turnover not exceeding EUR 50 million, and/or an annual balance sheet total not exceeding EUR 43 million.[163]

It should remain for the Member States to decide whether the Directive applies also to establishments without legal personality (branches), SMEs, micro enterprises and start-ups. Such firms may be specifically innovative, hold strategically important defence technologies and have been subject to reviews in the past, for example in France.

The Directive should also apply to companies producing dual-use goods/technologies or military and civil goods/technologies (as is the case of most companies in this area). Their inclusion is necessary, compatible with Article 346 (1) b) TFEU and also current practice under the EMCR.

### *b) Strategic defence assets*

The definition should be based on the consideration that defence equipment is vital for the security and the sovereignty of the Member States and for the security, independence and integrity of the Union as a whole.[164] It is moreover relevant that according to the CJEU a restriction of the free movement of capital may be justified in relation to equipment which is necessary in order to ensure the security of supply of the Member States in energy *in a situation of crisis*. In a case concerning the energy sector the CJEU qualified the distribution infrastructure held by the Belgian operator Distrigaz as a strategic asset necessary in case of an energy crisis.

Applying this case law to the defence sector we can say that only those defence assets may be "strategic" which will be necessary in case of a "crisis" related to the security of one or more Member States or the Union as a whole. In other words only defence assets necessary in the event of a military crisis may provide the material basis for a justified restriction on the free movement of capital.

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[163] It remains to be discussed whether this threshold is too low and therefore the obligation to notify overly restrictive or too high i.e. exempting from the protection small but highly innovative firms and start-ups.

[164] See Case C-54/99 *Église de scientologie* [2000] ECR I-1335 paragraph 18 ; Case C-503/99, *Commission v Belgium* (Distrigaz) [2002] ECR I-04809.

In line with this crisis related notion of strategic defence assets we would suggest using as a starting point for a definition of this notion the List of arms, munitions and war materials drawn up by the Council in its Decision 255/58 of 15 April 1958[165] expressly referred to in Article 346(2) TFEU. In the system of the TFEU this List represents the product types of military equipment which may be necessary in the case of a security crisis.

The defence procurement Directive 2009/81/EC also refers to this List, though in its recital 10 only. Its approach to the Council List of 1958 is as follows: Article 2 of Directive 2009/81/EC states that subject to Articles 30, 45, 46, 55 and 296 of the EC Treaty, the Directive applies to contracts awarded in the fields of defence and security for *inter alia* the supply of military equipment, including any parts, components and/or subassemblies thereof. Article 1 of said Directive contains a general definition of the notion of "military equipment" as equipment designed or adapted for military purposes and intended for use as an arm, munitions or war material. Recital 10 adds that Member States may limit themselves when transposing the Directive to the product types included in the list of arms, munitions and war material of 1958 and referred to in Article 346(2) TFEU.[166] Still according to said recital this list is to be "interpreted in the light of the evolving character of technology, procurement policies and military requirements", in simplified terms the List has to be applied in an updated version.

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[165] Council of the EU. Answer to written question E-1334/01 by Bart Staes regarding the List of 15 April 1958 to which Article 296(1)(b) refers of 4 May 2001.

[166] See recital 10 of Directive 2009/43 which reads as follows: "*For the purposes of this Directive, military equipment should be understood in particular as the product types included in the list of arms, munitions and war material adopted by the Council in its Decision 255/58 of 15 April 1958. (Decision defining the list of products (arms, munitions and war material) to which the provisions of Article 223(1)(b) — now Article 296(1)(b) — of the Treaty apply (doc. 255/58). Minutes of15 April 1958: doc. 368/58), and Member States may limit themselves to this list only when transposing this Directive.* ***This list includes only equipment, which is designed, developed and produced for specifically military purposes****. However, the list is generic and is to be interpreted in a broad way in the light of the evolving character of technology, procurement policies and military requirements which lead to the development of new types of equipment, for instance on the basis of the Common Military List of the Union. For the purposes of this Directive, military equipment should also cover products which, although initially designed for civilian use, are later adapted to military purposes to be used as arms, munitions or war material*." (Emphasis added). Council of the European Union and European Parliament. (2009) Directive 2009/43/EC of 6 May 2009 simplifying terms and conditions of transfers of defence-related products within the Community. *OJ* L 146:1-36.

We suggest therefore that the present Directive defines its scope in accordance with the procurement Directive, taking the Council List of 1958 as a *starting point* but requiring its application in light of the evolving character of technology, procurement policies and military requirements. Using in essence a similar scope for several EU instruments concerning the defence sector is in itself an advantage in terms of coherence and simplicity.

However, it would be useful to "*shorten this list"* by removing a maximum of items which in reality would not warrant recourse to Article 346 TFEU. For instance, it would be appropriate to exclude from the scope military equipment, belonging to one of the product types of the 1958 list, which represents commercial-off-the-shelf (COTS) technology.[167]

If political agreement can be reached to such a reduction the risk that Article 346 TFEU continues to be relied upon with regard to those same items would a priori be reduced.

Below we will therefore refer to the "shortened 1958 List" of the Council.

It cannot be denied that this relatively large scope in accordance with the procurement Directive creates an overlap with Article 346 TFEU. However, this would also be true if the scope was limited just to the "most strategic" military items.[168]

If a general notion needs being added to this list it might refer to "the military equipment needed in a military crisis affecting the security of one or more Member States or of the Union as a whole".

### *c) Direct investments*

According to the express terms of Article 64(2) TFEU only *direct* investments can be subject of legislative measures. Direct investments have been defined in the nomenclature

[167] The Commission services assume that in reality only a small portion of the military items of this list will affect the essential security interests and entitle the Member States to rely on this provision.

[168] The overlap with Article 346 TFEU is discussed in more detail with respect to Option 2 at point 5.2.1 c) below.

set out in Annex I to Council Directive 88/361, and the explanatory notes appearing in that annex. [169] Points I and III in the nomenclature indicate that direct investment in the form of participation in an undertaking by means of a shareholding or the acquisition of securities on the capital market constitute capital movements for the purposes of Article 56 EC. The explanatory notes state that direct investment is characterised, in particular, by the possibility of participating effectively in the management of a company or in its control.

Accordingly, portfolio investments (securities which do not meet the criteria of direct investments) would have to be excluded from the scope of the Directive. [170]

### *d) Threshold triggering notification*

The question arises when the obligation to notify should start: with an acquisition of 100%, of 51% or of 25% of the target company? Legally speaking, the threshold should be set at a level, which is *not more restrictive* than necessary to address the *security risks* run by the target company and "its" Member State and/or the Union as a result of the proposed acquisition:

- One risk is linked to the purchaser's power to influence the market conduct of the target company, which governs the issue of security of supply.
- Another risk is implied in his power (or practical possibilities) to obtain insight in secret technology and know-how of the target company.

The thresholds granting this respective power vary under the national company law and have not been subject to harmonisation. Commission experts in the field of harmonisation of company law hold that 33 % of the voting rights normally give shareholders the possibility of influencing the management of a listed company. The use of this threshold would thus cover the risk related to security of supply. However, the risk of obtaining

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[169] See the Council of the EU. (1988) Council Directive 88/361/EEC of 24 June 1988 for the implementation of Article 67 of the Treaty. *OJ* L 187:5-18.

[170] Let us recall though that this Directive does not cause a restriction of trade.

access to secret technology and know-how of the target company is not linked to control and governance and requires rather a threshold below 33%.

This leads us to suggesting that the acquisition of 25% or more of the voting rights of an EU company of a certain size engaged in strategic defence assets would provide a necessary but sufficient threshold. At the same time this threshold would a priori suggest that the investment aims at creating lasting economic links and accordingly is a direct, not a portfolio investment.

#### *e) Non-EU investors*

As mentioned above, defining this term correctly is a particular legal challenge.[171] The notion of non-EU investors has to be defined first of all on the basis of Article 54 TFEU. This article forms part of the rules on the freedom of establishment and sets out the conditions under which foreign companies have to be granted national (and therefore also EU) treatment. It provides that national treatment has to be granted to companies having their registered office, central administration or principal place of business within the Union. Accordingly, non-EU companies are business entities having neither registered seat nor central administration nor principal place of business in the EU.

In order to reduce the risk of circumvention, one could clarify in accordance with the case law of the CJEU concerning Article 54 TFEU the conditions, which would *not* justify the national and European treatment of a non-EU investor. To that effect one might specify e.g. that mere branches, permanent establishments and "letterbox establishments" (all not mentioned in Article 54 TFEU as requiring national treatment) belonging to a non-EU investor do not suffice to make him an EU resident.[172]

Moreover, the – as mentioned: controversial – question arises how to deal with the cases of an *indirect acquisition* where the EU based affiliate of a non-EU investor is the purchaser. The previous definition of the non-EU investor *on its own* would *exempt* from

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[171] See above the discussion under 3.6.3.

[172] This proposal is inspired by Article 53(1) 4th sentence FTR, the German legislation concerning a reviewing mechanism in the wider security sector. For details see the Country Report on Germany.

the screening process all those third country defence groups that have or will acquire an affiliate within the Union which may act as the purchaser. Given that all significant enterprises have a subsidiary within the EU, these cases cannot be ignored.[173] If EU companies controlled by third country companies are not subject to the common rules to be created, the Directive risks having little effect, if any. In order to give the EU rules "*effet utile*" and combat circumvention one should lay down that an EU resident company in which a non-EU resident holds at least (25%) of the voting rights may be treated as a non-EU investor subject to notification.[174]

A comparable clause has been included in the 2009 Energy Directives. It addresses the acquisition of EU energy networks. Article 11 of Directive 2009/72/EC on common rules on the internal market of electricity lays down that where an Electricity transmission system owner or operator is *controlled by a person from a third country* he shall only be certified once the Commission has examined whether granting the certification will not put the security of energy supply of the Member State and the Community at risk.[175] The threshold for intervention under the Electricity Directive is control, and both direct and indirect control, are apprehended, see Articles 10(2) and 11(1) of the Electricity Directive.

With respect to the defence sector one has to recognise that in this sector the indirect acquisition is more widespread than in the sector of energy distribution and transmission, that defence equipment serves to cover even higher risks than electricity transmission equipment, and that the risk of proliferation of defence technology has to be properly

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[173] According to the motivation of the German Foreign trade regulation (FTR) (13th amendment) all enterprises operating globally have a permanent establishment within the EU. This situation has influenced the German legislation. Bundesministerium der Justiz. (2009) Thirteenth Act amending the Foreign Trade and Payments Act and the Foreign Trade and Payments Regulation of 18 April 2009.

[174] This same clause continues to make part of the German defence related regime, see Article 52 FTR. The German wider security regime however has limited the above provision to cases of circumvention where the investors are EU residents (i.e. in application apparently of the rules on the freedom of establishment which do not apply to third country investors). In the Directive here discussed the investors are by definition from third countries.

[175] See Council of the European Union and European Parliament. Directive 2009/81/EC of 13 July 2009 on the coordination of procedures for the award of certain works contracts, supply contracts and service contracts by contracting authorities or entities in the fields of defence and security, and amending Directives 2004/17/EC and 2004/18/EC.

addressed. Therefore the application of a lower threshold for intervention in the defence area would be justified. Accordingly, in the present context the threshold for intervention should not be the indirect *control* but already the indirect *participation* of (25 %) or more in the EU resident investor. The indirect acquisition of an EU defence company by an EU affiliate in which a third country defence group holds 25% of the voting rights would thus be subject to notification.

We suggest that this approach, i.e. to include also the cases of an indirect acquisition, is not only required in the interest of an *effet utile* of the rules but also necessary in order to protect the security interests of the Member States and the Union as a whole. Moreover, let us recall that the present Directive is limited to notification, information exchange and consultation and altogether does not amount to a *restriction* of trade with third countries. The Directive's low impact may increase the acceptability of the suggested solution.

An as efficient alternative solution is not available. In theory one might limit the provision just proposed to those cases where indications of circumvention can be established. To that effect one would have to say that an acquisition by an EU resident in which a non-EU resident holds at least (25%) of the voting rights may be subject to notification only if there are indications of arrangements aimed at circumventing the law.[176] Such a provision would however be subject to legal challenge. Moreover, it will only rarely be possible to establish the existence of circumvention. In other words, a provision of this kind would not be sufficiently effective.

Accordingly we suggest that a non-EU investor is not only a company having neither registered seat nor central administration nor principal place of business in the EU but can also be an *EU company* in which a non-EU investor holds 25 % or more of the voting rights.

[176] See German legislation of 2009 amending FTA and FTR concerning a reviewing mechanism in the wider security sector; our proposition is inspired by Article 53(1) 5th sentence of the FTR as amended. Bundesministerium der Justiz. Thirteenth Act amending the Foreign Trade and Payments Act and the Foreign Trade and Payments Regulation of 18 April 2009.

### *f) "Member States concerned"*

"Member States concerned" are those Member States that may directly or indirectly also be concerned by a national review decision. This is certainly the case of the members of a group of companies which is targeted by an acquisition, i.e. the affiliates located in other Member States.

The definition should however not stop here but take into account the EU interest in a broadening of the supply chain and in furthering EU wide common military projects. These supply chains and projects could in theory be put at risk as a result of take-overs which put an end to the cooperation of the target company in the chain or project. If the consultation includes the authorities of the Member States whose industries are involved in such chains or projects, the reliability of this cross-border cooperation would be increased. Small Member States would be the beneficiaries. Accordingly we suggest that the consultation should extend to the Member States whose industry participates in a supply chain or a common project.

The "Member State most concerned" is the one who would receive the FDI or who hosts the only target company or the parent company of the targeted companies.

### *g) Notification obligation*

The Directive would have to provide for an *ex ante* obligation of non-EU investors to notify proposed transactions reaching or exceeding the threshold as just defined. Sanctions should be laid down in case of disregard.

The question arises whether multiple filing should be required when the target is a group of companies. Multiple filing means notification not only of the proposed acquisition of the parent company but also of the acquisition of the affiliates to the authorities of the respective Member States.

In the present context, multiple filing would be the appropriate approach, in spite of the administrative burden on investors which it entails, because the risks linked to a given acquisition for the security of supply of the different Member States differ and have to be assessed individually. Multiple filing is moreover the solution which prevails at this stage under national law in the Member States applying review mechanisms. For present

purposes it is in particular important that multiple filing facilitates consultation between the Member States concerned which host the members of a group of companies because their authorities would have obtained the information required to engage in fruitful consultations.

Let us add that the Member States concerned which do not host a target company but participate in common projects or supply chains can only be consulted if they are informed of the existence of a notification. The same applies to all those Member States which host affiliates but do not receive notifications because they have no screening mechanism. As the EMCR shows, the publication of a short notice informing (along the model used under the EMCR) on the filing of a notification all the parties involved would be necessary in order to include also these Member States into the consultation mechanism.[177]

The notification obligation of non-EU investors is, as stated, no restriction in trade between the Union and third countries. Nor does it fall under Article 346 TFEU because it does not impinge on essential security interests of the Member States. In fact, notification is an issue which is still confined within one and the same Member State.

The publication of such a notice would not impinge on essential security interests either given that no sensitive information would have to be published and that the fact alone that there is an investment project would not amount to a military secret within the meaning of Article 346(1)a TFEU.

By the way, the obligation to notify laid down in the Directive would not be really new but in essence mirror the obligation to notify which applies since many years to investors under the EMCR. While the latter applies to all defence equipment/technologies, strategic or not, within the scope of Article 346 TFEU or not, provided only the conditions of a Community dimension are met, the present Option would be somewhat broader in terms of acquisition and notification thresholds.

[177] The MCR provides for publication in the OJ C, a solution which is not open to Member States. Therefore another technical solution would be required.

### *h) Information exchange*

Should the Directive in addition provide that Member States concerned have to exchange certain information, e.g. the information that is useful for an informed consultation? We suggest that providing for the obligation to exchange information is necessary in order to ensure the efficiency of the consultation.

It should be taken into account that Article 346 (1) (a) TFEU may apply if information exchange is provided for. Under this provision the Member States are not obliged to supply information the disclosure of which they consider contrary to the essential interests of their security. They could rely on this provision in order to prevent information exchange, in particular security relevant elements. The information requested could thus be refused and it is in practice difficult to prove that the disclosure of the information is in reality *not* contrary to essential security interests.

Member States may thus either grant the information requested or refuse it on the basis of Article 346 TFEU. Recourse to the infringement procedure of Articles 258-260 TFEU would be possible.

Therefore it is important to know whether the present Directive with its limited scope could also function in those cases where an exchange of information is refused by the reviewing Member State.[178] We are of the opinion that the Directive would have useful effects also if not in all cases the entire information were divulged.

### *i) Consultation obligation*

The Directive would provide that national decisions on non-EU investments which have an impact on several Member States shall only be taken after consultation between all Member States concerned by a proposed acquisition.

[178] The situation under the following Options 2 and 3 concerning review is different; there the overlap with Article 346 TFEU is more important.

The Member States would thus be obliged to consult the other Member States which are concerned by a notified acquisition (and these other Member States have a right to be heard).

Also the obligation to consult with other Member States could lead to the invocation of Article 346 (1) (a) TFEU whenever a MS claims the sensitive nature of certain information.

However, Member States concerned which would not be given the occasion of being heard or would not have received the information required for a proper consultation would have the possibility to act either under Article 259 TFEU or to signal problems with other MS' compliance with EU law to the Commission, leaving it to the latter to take action under Article 258 TFEU as appropriate. It would then be for the CJEU to address the legal questions so raised such as the possible scope left by the Directive for reliance upon Article 346 (1) (a) TFEU.

Altogether, the overlap is not such as to question the functioning and the effectiveness of the Directive as a whole. It is in particular difficult to imagine a situation in which the reviewing Member States could establish that their essential security interests are hurt by the mere fact that they have to delay the decision by a certain period of time in order to consult the other Member States.

How would the consultation mechanism work in practice?

The reviewing Member State would have to set out a delay of a certain number of months from the publication of the notification during which the other Member States concerned can express their views and refrain from any action during that period of time ("stand-still"). If the delay so fixed has elapsed the decision may be taken, whether or not consultations have taken place. Member States concerned which would not be given the occasion of being heard would have the possibility to act under Article 259 TFEU or to signal problems with other MS compliance with EU law to the Commission, leaving up to the latter to take action under Article 258 TFEU as appropriate. It would then be for the CJEU to address legal problems such as the possible scope left by the Directive for reliance upon Article 346 TFEU.

The question remains how the other Member States concerned can be informed of the existence of a proposed acquisition or take-over.

The Member States with national review systems (Finland, France, Germany, Spain, Sweden and the UK) which host the *target parent company or one of the affiliates* would have received a notification and other information about the envisaged acquisition in their own right. Accordingly they possess the information necessary to assess the possible risks attached to the proposed acquisition for their national security of supply and their technology. Under these conditions the new obligation for these Member States to consult each other would in all probability lead to a fruitful exchange of views between the various national authorities concerned. In other words, the consultation would work, in spite of the risk that in certain cases the exchange of information may be refused on the basis of Article 346 TFEU.

As mentioned, it would moreover be desirable to expand the consultation to the further Member States concerned, in particular to those which host *affiliates but have no national screening mechanism* and also to those whose industries just participate in a *supply chain or other cross border military project*. If these Member States are duly informed of the existence of a take-over project – the publication of a notice on the notification in an EU wide accessible instrument would be required to that effect – they would have the possibility to express their views on the basis of the information given in the published notice. Their role would be to convey on the authorities of the reviewing Member State information as to the risks run by the project or supply chain if the investor discontinues the cooperation of the target company in the project or chain.

The consultation mechanism would increase the legitimacy of a national review procedure which pursuant to the Treaty rules on the right of establishment Articles 49 et seq. TFEU extends its effects to the entire EU. It would increase also the chance of coherent decisions and improve the evaluation of security risks in the interest of Member States, investors and target companies.

Should the Member State reviewing the acquisition also be legally *bound* to take the results of the consultation duly into account? We do not think that a legal provision of this kind would have any useful effect whereas it can well be expected to create an issue under Article 346 TFEU. We are inclined to maintain that also without such a legal

obligation the consultation process just outlined would have useful effects in comparison to the status quo.

#### *j) No review*

The present "light" Option would not extend to a review of the notified operations. Nor would if affect the choice of the Member States to apply a national screening procedure.

### *5.1.3 Scope and Organisation*

The Member States would have to designate authorities in charge of receiving the notifications from non-EU investors and ensuring the exchange of information and the consultations. However, under the Directive, they would not have to open proceedings or take decisions. Only the authorities of those Member States which already have a review system would continue to take decisions on non-EU investments.

The role of the Commission in the consultation process would be limited. As mentioned, Member States concerned who would not be given the occasion of being heard would have the possibility to act under Article 259 TFEU or to signal problems with other MS compliance with EU law to the Commission, leaving up to the latter to take action under Article 258 TFEU as appropriate.

Given this Option 1 is very light, the creation of a network of representatives of the Member States would not appear necessary and appropriate.

### *5.1.4 Rationale*

Option 1 on its own would neither address the current security deficit of the Union nor make a substantial contribution to the consolidation of the European defence industry. It represents a first step towards a more efficient solution.

Nevertheless, the added value could be argued to be significant. In the present patchwork situation where different national regimes coexist the consultation and information exchange mechanism might enable the Member States applying review systems to assess the acceptability of non-EU investors on the basis of better information and better knowledge of the security considerations of other Member States. The mechanism might improve the evaluation of the security risks and the coherence of the different national

decisions, in particular in connection with cross border supply chains and groups of companies.

#### *5.1.5 Complementary EU instrument for the internal dimension*

This "light" Directive would not create binding rules on a review mechanism for non-EU investments. Nor would it address the fact that the Member States maintain their current restrictive measures with respect to both investors from third countries and from other Member States. In short, the Directive would not provide guarantees as to the security of notified acquisitions by non-EU investors.

For so long as there is no EU wide effective control of non-EU investments, national controls concerning EU residents may in certain cases still be justified and compatible with the Treaties. Member States may continue to rely on Article 346 TFEU arguing *inter alia* that investments from other Member States may in reality be hidden non-EU investments which have not been subject to prior review in another Member States but enjoy the benefits of the freedom of establishment pursuant to Article 54 TFEU.

In view of the limited subject matter of this Directive the adoption of an *Interpretative* Communication concerning the interpretation and application of Article 346 TFEU with regard in particular to the internal dimension of investment controls would not be the right complementary approach. We will suggest the adoption of such an interpretative communication concerning the internal dimension in relation to the legislative Options 2 and 3 below.

However, the Commission might well issue a general "*Policy* Communication on the control of strategic European defence assets" and on possible ways forward with regard to the external and the internal dimension of control. The purpose of such a "policy Communication" could be

- to complement the Directive envisaged as Option 1 which is characterised by a limited concept and limited legal instruments (i.e. addressing notification and consultation but not the review);
- to provide the ongoing discussion with a shared vocabulary and key concepts;

- to set out for Member States and all stakeholders what the Commission would consider as good practice in the field of the national review of investments, whether non-EU or EU investments, in European strategic defence assets;

- to underline that the Commission fully recognises and appreciates the particular character of the defence industry and the role that Governments and Parliaments play for it;

- to set out how it expects the Procurement and Transfer Directives to impact on industry and its relations to Governments;

- to set out the different options that are at the Union's disposal for the regulation of the subject matter and explain their added value for a European DTIB;

- to address the concerns of stakeholders regarding the transatlantic relationship.

Such a Communication would be a useful step, not least because several Government stakeholders expressed an explicit interest in greater transparency with respect to national controls of defence investments.

To summarise, Option 1 on a Directive on mandatory notification & consultation and can be described as follows:

| **Notification** | **Consultation** | **Review** | **Decision-making** |
|---|---|---|---|
| Ex ante notification mandatory<br><br>To national authorities | Consultation and (limited) exchange of information between MS concerned by a proposed acquisition | | |

Complementary measure concerning the review of non-EU and EU investments: A Policy Communication.

## 5.2 Option 2: Directive harmonising the review of non-EU investments & Interpretative Communication

This Option consists of a Directive, which rather than being limited to notification and consultation requirements, would harmonise also the national provisions concerning the review of direct investments from non-EU countries in defined European defence assets. The Member States would have to transpose the rules of the Directive into their national law and designate or create competent authorities, which are in charge of reviewing proposed acquisitions and taking the necessary decisions.

In order to cope with the internal dimension concerning investments from other Member States, the Directive should be "combined" with an Interpretative Communication and possibly infringement procedures. The latter instruments would be aimed at the gradual phasing out of the restrictive national measures addressing investors from other Member States.

### *5.2.1 Legal basis and objective*

#### *a) Articles 64(2) TFEU as a legal basis*

The legal basis would be provided by Article 64(2) TFEU. This provision entitles the European Parliament and the Council to adopt "measures" on the movement of capital to or from third countries involving direct investment.

#### *b) Facilitate the free movement of capital*

As mentioned, Article 64(2) TFEU requires the legislator to endeavour to achieve the objective of free movement of capital between the Union and third countries. Accordingly the use of this provision as a legal basis requires a demonstration of the fact that the intended legislation aims at facilitating the movement of capital between the Union and third countries.

We submit that these legal requirements would also be met by a Directive harmonising the national provisions subjecting non-EU investments to a review mechanism. The overall objective of the Directive is a more open internal market, and this objective influences favourably also the movement of capital between the Union and third

countries. Moreover we read the clause here under discussion ("endeavour to achieve") as a best efforts clause, not more, and doubtless the Union legislator adopting the Directive will use its best efforts to leave the Union as open as possible to foreign investment. At any rate the clause at issue does not prevent the Union from adopting adequate and proportional measures designed *inter alia* to ensure the security of capital movement.

Further arguments will be presented in connection with the legislative procedure under e) below concerning the question whether the Directive would constitute a step backwards in liberalisation.

### *c) Safeguard the security, independence and integrity of the Union, Article 21(2) and (3) TEU*

The Directive should moreover pursue security-related objectives in accordance with Article 21(2) and (3) TEU.

### *d) Legal instrument and procedure*

As a result therefore, Article 64(2) TFEU can be used as a legal basis for the harmonisation of national provisions on the review of non-EU defence investments.

The term "measures" in Article 64(2) TFEU implies that the legislator may adopt either a Directive or a Regulation. For present purposes a Directive would be appropriate to coordinate the national rules and procedures and establish "policy harmonisation". A Directive has also been the preferred choice with regard to defence procurement and intra Union transfer, as the respective EU Directives demonstrate.

The European Parliament and the Council would have to act in accordance with the ordinary legislative procedure.

It should be added that pursuant to Article 64(3) TFEU only the Council, acting in accordance with a special procedure, may unanimously and after consulting the European Parliament, adopt measures which constitute "*a step backwards in Union law as regards the liberalisation of the movement of capital to or from third countries*". Accordingly the use of Article 64(2) TFEU as a legal basis requires substantiation of the fact that the proposed harmonisation would *not* entail a step backwards in Union law as regards the

liberalisation of the movement of capital from third countries. We think that the Directive would not constitute such a step backwards for the following reasons:

- The Directive would be a step backwards in Union law if secondary legislation in the field of defence would exist and determine that defence investments shall have free access. The situation under primary law as it stands is however less clear: on the one hand Article 63 TFEU establishes the free movement of capital also with third countries and on the other hand there is Article 346 TFEU which leaves ample room for restriction by Member States.

- The existence in the Treaty of Article 346 TFEU (which has its parallels in the international trade agreements, see at 2.4 above on the international context) together with the frequent and heterogeneous use of this derogation by the Member States furnishes evidence of the fact that in the field of defence investments no full liberalisation has as yet taken place. Already for this reason the Directive would not constitute a step backwards in liberalisation.

- According to legal literature it is sufficient for Article 64 paragraph 2 (rather than paragraph 3 requiring unanimity) to apply if the common regime is not less liberal than the present (liberal) practice of the majority of the Member States.[179] This would mean that for the necessary comparison of the envisaged Directive with the existing Union law also the practice of the Member State would have to be taken into account. In this regard it may be of interest that, as the country reports have shown, the Member States with a significant defence related business and therefore perhaps of particular interest to investors (France, United Kingdom, Germany, Sweden, Spain, Finland and Poland) apply restrictive measures, whether through legislation, State ownership, special rights or contractual arrangements. Five Member States account for 75% of the total defence equipment and R&D expenditure of all Member States participating in the EDA. Moreover a number of other Member States use public ownership as a means for controlling foreign defence investments. Under these

[179] See Kiemel, W. (2003) Kommentar zu Artikel 59 EGV. In *Kommentar zum Vertrag über die Europäische Union und Vertrag zur Gründung der Europäischen Gemeinschaft*, edited by H. von der Groeben and J. Schwarze. Baden-Baden.

circumstances the status quo of the Union and its Member States could not be qualified as being open to investors from third countries.

As to the legislative procedure we come thus to the result that the Directive is not a step backwards in liberalisation because of Article 346 TFEU. Accordingly it would be adopted by the Council and the European Parliament in the ordinary procedure.

Otherwise the Council would have to act unanimously and only have to consult the European Parliament.

#### *e) Consistency with Commission Communications*

The Directive harmonising notification obligations for non-EU investors would have to be in line with the Commission Communication of 7 July 2010 "towards a comprehensive European international investment policy" as well as with the Commission Communication on Sovereign wealth funds.[180]

#### *f) Objectives*

The Directive aims at facilitating the free movement of capital between third countries and the Union. It harmonises the national rules aimed at reviewing non EU investments while pursuing at the same time the objective of protecting the security interests of the Union within the meaning of Article 21(1) and (3) TEU.

### *5.2.2 Function and modalities*

The function of the review Directive would be to create common rules which allow on a case-by-case basis and with due respect for the proportionality principle the screening of non-EU investments in European defence enterprises which may be problematic from the perspective of the security of the Union or the Member States. Its function is moreover to provide for consultations and information exchange among those Member States that are directly or indirectly concerned by a proposed transaction.

[180] See European Commission A Common European Approach to Sovereign Wealth Funds. COM(2008)115 final.

The Member States would have to transpose the rules of the Directive into their national laws.

As to the modalities, those concerning *inter alia* the notions of defence enterprises concerned, strategic defence assets, non-EU investors have already been discussed with regard to a Directive limited to notification and consultation under Option 1 above. A legal challenge of this option is to address the problem of its overlap with Article 346 TFEU.

***a) Notification obligation***

Notification *ex ante* to the competent national authorities should be mandatory. An opposition procedure *ex post* would be less burdensome for investors but also less efficient. Acquisitions which concern the items on the Military List of the Council referred to in Article 346 TFEU (which might be shortened, see scope in 5.1 above) would have to be notified.

***b) Information exchange and consultation obligations***

The Directive should lay down that the reviewing Member State has to consult the other Member States concerned by the notified transactions and that it has to provide these Member States with the information necessary for an informed consultation. These two obligations would create an overlap with Article 346 TFEU. The fact that such a Directive might also require the creation of a consultative Committee or Network to be chaired by the Commission adds to this problem. At any rate given that the role of the Commission in this Directive is limited, the Commission would not have to be included into an exchange of sensitive information.

As with respect to Option 1 we would say that the consultation obligation cannot be obstructed by reliance on Article 346 TFEU. Consultation cannot be validly refused under Article 346 TFEU. Moreover consultation of other Member States concerned is in the interest of the reviewing Member States. Member States concerned may also expressly be granted a right to appeal the review decision in cases where they have not been duly consulted.

As likewise mentioned with respect to Option 1, the information exchange obligation may well be undermined by Article 346 TFEU.

However, we are of the opinion that the mere fact that Member States may refuse to release or exchange information with other Member States would not undermine the review Directive as a whole. Consultation of the other Member States would nevertheless be possible.

In the alternative, the Directive could provide for a dialogue procedure among the Member States concerned in accordance with Article 348 TFEU. This procedure is described in more detail with respect to Option 3 below.

### *c) Public investors*

Public investors in European defence assets may be non-EU States or entities controlled by them. These investors may in some cases pursue ends other than the maximising of return, which normally guides private investors and this very fact implies risks for the security of the Union. Said risk is specific to public investors and one of the reasons which justify a Directive addressing non-EU investments.

As mentioned above, among the public investors from third countries, Sovereign wealth funds require special attention. The Commission adopted in 2008 a Communication on a common approach to SWF.[181] It draws attention to the fact that investment decisions of SWF can be influenced by the political interest of the SWF's owners and might reflect a desire to obtain technology and expertise to benefit national strategic interests.

Also an OECD Declaration on Sovereign Wealth Funds and recipient country policies adopted in 2008 sets certain standards in this field.[182] The U.S. Foreign Investment and National Security Act contains specific rules on Government controlled transactions. Pursuant to this Act a transaction involving third country investors may not only be

[181] See Ibid.

[182] See OECD. (2008) Sovereign Wealth Funds and recipient countries - Working together to maintain and expand freedom of investment.

prohibited if it threatens to impair the national security but also "*if the transaction is a foreign Government controlled transaction*".[183] The U.S. legislator uses thus a special standard applying to public investors. The Union should however not follow this model but apply one and the same standard to both public and private sector investors.

Applying stricter standards to the public rather than the private sector in relation to non-EU countries would a priori constitute unjustified discrimination and raise political issues, all the more so as the EU itself has an important public sector. The CJEU has ruled[184] that "the Treaty provisions on the free movement of capital do not draw a distinction between public undertakings and private undertakings". Even though the case concerned in fact public investors from other Member States the Court's statement applies *a priori* in the same manner to public investors from third countries. Accordingly, there can only be one set of criteria applying to private and public investors alike.

The assessment criteria (see c) and d) below) will therefore have to be sufficiently broad as to allow the proper assessment of the risks that are potentially linked to both public and private investors from non-EU countries and to allow for a ban where the risks implied would require and a ban and less restrictive remedies are not available. It should moreover be stressed that with respect to public investors from third countries the possible remedies are of importance. It is necessary to ensure that the scope for remedies is sufficiently large to take not only the risks of foreign private but also of foreign public investors properly into account. To that effect remedies would have to be able to secure *even post-acquisition* the secret know-how, secret technology as well as an autonomous market conduct of the target enterprises. The range of remedies should therefore include the possibility of an *ongoing monitoring of the influence*, which may be exercised by the foreign investor on the EU target enterprise, together with possible further "arms length" guarantees. [185]

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[183] See the Country Report on the U.S.

[184] See Case C-174/04, *Commission v Italy*, paragraph 32.

[185] See the Commission's remedy policy in relation to merger control. A legislative example is provided by Article 19 et seq. of European Parliament and the Council. Directive 2009/72/EC concerning common rules for the internal market in electricity and repealing Directive 2003/54/EC. on the internal

### *d) Assessment criteria*

According to the case law of the CJEU the free movement of capital within the Union and between the Union and third countries may be restricted only by national rules which are justified by reasons referred to in Article 65(1) TFEU, among which public order and public security, or by overriding requirements in the general interest.[186] The CJEU also held that the requirements of public security must be interpreted strictly. To that effect public security may be relied on only if there is a "*genuine and sufficiently serious threat to a fundamental interest of society*". As to such a fundamental interest of society the CJEU recognised that the objective of guaranteeing energy supplies in the event of a crisis, falls undeniably within the ambit of a legitimate public interest and can justify a restriction.[187] This case law supports the conclusion that safeguarding the EU defence equipment necessary in the event of a crisis affecting the security of the Member States or the Union falls likewise within the ambit of a fundamental interest of society which may justify a restriction of the free movement of capital in relation to third countries.

Considerations similar to those just mentioned in relation to Article 65(1) apply also to Article 346 TFEU. The latter article provides for a derogation from "the Treaties" and therefore also from the rules on the free movement of capital where the essential security interests of the Member States so require. It is relevant in this respect that the notion of public security interests has not only an internal but also an external dimension[188] and may therefore include the notion of essential security interests.[189] In relation to strategic defence equipment the notion of the essential security interests is however more specific than that of public security.[190]

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market in electricity aimed at securing the independence of the so-called "Independent Network Operator" from its parent company.

[186] See Case C-54/99, *Église de scientologie* [2000] ECR I-1335, paragraph 18.

[187] See Case C-503/99, *Commission v Belgium* (Distrigaz) [2002] ECR I-04809 paragraph 46.

[188] Since Case C-367/89 *Richardt* ECR (1991) I-4261, 4652, paragraph 22.

[189] The CJEU may however give more discretion to the Member States in the context of Article 346 than of Article 65 TFEU.

[190] The German review legislation on strategic defence assets is therefore called *lex specialis* in relation to the legislation introducing a wider security regime; see the motivation of the latter legislation.

The criteria to be defined should also take into account the Commission Communication concerning Sovereign Wealth Funds.[191] It defines SWF as tate-owned investment vehicles, which manage a diversified portfolio of domestic and international financial assets. Risks are seen in the fact that investment decisions of SWF can be influenced by the political interest of the SWF's owners and reflect a desire to obtain technology and expertise to benefit national strategic interests, rather than being driven by normal commercial interests in expansion to new products and markets. Moreover the Commission points to a lack of transparency.

Against this legal background, the criteria designed to assess the "acceptability" of a given defence investment in European strategic defence assets should be defined so as to avoid, to the extent possible, overlap with Articles 65 and 346 TFEU.

On the basis of these considerations we suggest to define the assessment criteria by addressing the two major risks which may be linked to foreign defence investments, i.e. the risk for the security of supply and the risk of proliferation of sensitive defence technology. Subsequently these two criteria should be completed by a reference to the security objectives laid down in Article 21(2) TEU, as follows:

*The national authorities in charge would have to examine whether as a result of a proposed acquisition*

- *the supply with a strategic defence good or technology risks to be compromised with no possibility to find an second source within the EDTIB which can affect the security or*
- *there is a risk of proliferation of defence know how or technology*

*and whether as a result thereof the security, independence or integrity of the Member State or of the Union may be severely jeopardised.*

[191] European Commission A Common European Approach to Sovereign Wealth Funds. COM(2008)115 final.

### *e) How the assessment criteria would work*

The question arises how these criteria would work in practice and how they would cope with the fact that recourse by Member States to Article 346 TFEU cannot be excluded.

The assessment criteria would have to be seen together with the (shortened) Military List of the Council referred to in Article 346 TFEU. A notification would have to be made for the items which are on this list.

The national authorities would apply the above criteria to the non-EU investment. They would have to find out whether there is a risk of a denial of supply or a risk of proliferation and moreover whether this risk is such as to jeopardise their security or that of the Union as a whole.

As to the interpretation of the notions of security, independence and integrity, reference might be made, *mutatis mutandis,* to the European Security Strategy (ESS), which was drafted under the responsibilities of the High Representative for CFSP and approved by the European Council in 2003 . This Strategy might be seen as a policy instrument providing certain guidance for the interpretation of said objective.[192]

In spite of the Directive the Member States would be in a position to rely on Article 346 TFEU. They might try and apply the criteria in a protectionist manner, use further criteria or try and extend the scope to items beyond the scope of the Directive. This risk is however reduced to the extent that the Directive addresses also security concerns.

The Commission might determine on a case-by-case basis whether Article 348 TFEU applies or whether infringement proceeding might be an appropriate remedy. It has in this area a large margin of discretion.

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[192] The key threats and challenges facing the EU identified by the ESS are: proliferation of weapons of mass destruction, terrorism and organised crime, regional conflicts, state failure, maritime piracy, small arms and light weapons, cluster munitions and landmines, energy security, impact of climate change and natural disasters, cyber-security, and poverty (see EP report of March 2010). As to the interpretation of the ESS see resolutions and reports of the EP.

### *f) Clearance*

The national authorities would have to decide within a reasonable period of time from the receipt of the complete notification. In the absence of a decision the transaction would be deemed to be cleared. In no way could the investments be made subject to prior approval.

### *g) Decision*

If a proposed acquisition is caught by the assessment criteria the competent authorities may impose conditions and obligations or conclude mitigation agreements.

These conditions and obligations would be imposed and the final decisions would be taken by the authorities of the Member States. The coherence of the national policies in this field would be increased if the Directive were to lay down that decisions can only be taken after consultation of the Committee or Network.

An acquisition may only be banned if this is indispensable and if no less restrictive measure mitigating the security risks can properly address the security concern. A reporting mechanism could be included in the Directive giving Member States the possibility to refer a case to the (European Commission/a European Agency) for a decision.[193]

### *h) Justification*

The CJEU has set very high standards as regards the justification of any restriction to capital movement intra and extra European Union.[194] We submit that these standards

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[193] Regulation 139/04 on Merger Control provides in Articles 5 and 9 an example of a referral system. Another model for cooperation in the decision making process can be found in the Directive Electricity 2009/72/EC and Gas 2009/73/EC, Articles 10 et seq. where the Commission gives an opinion to the competent national authorities.

[194] See CJEU in Case C-54/99 *Église de Scientologie* paragraph 17: "*It should be observed, first, that while Member States are still, in principle, free to determine the requirements of public policy and public security in the light of their national needs, those grounds must, in the Community context and, in particular, as derogations from the fundamental principle of free movement of capital, be interpreted strictly, so that their scope cannot be determined unilaterally by each Member State without any control by the Community institution (see, to this effect, Case 36/75 Rutili v Minister for the Interior [1975] ECR 1219, paragraphs 26 and 27). Thus, public policy and public security may be relied on only if there is a genuine and sufficiently serious threat to a fundamental interest of society (see, to this effect,*

would be met by the Directive here under discussion. The Directive addresses a genuine and most serious threat to a fundamental interest of society, i.e. the risks for the security and the independence of the Union or one or more of the Member States that are potentially linked to FDI targeting European defence assets that are indispensable in case of a military crisis situation. Availability and reliability of strategic defence equipment in times of crisis are vital concerns. The absence of a screening mechanism could lead to a situation where a relationship of dependency, in terms of foreign capital and technology, could develop with regard to investment drawn from specific countries, not only but in particular in cases where the investors are foreign States. Thus, the Directive does not serve economic ends. The investors concerned benefit from adequate legal guarantees such as transparency, proportionality, and judicial review.

### *i) Proportionality*

This requirement would be met under the following conditions: The Directive would not subject foreign investments to a prior approval requirement. The assessment criteria just mentioned are objective, stable, public and would leave no room for discretion on the part of the Member States[195]; accordingly they would meet the conditions required by the case law of the CJEU referred to above. A ban should only be possible as a last resort. These requirements would by the way also meet the criteria established by the OECD guidelines, in particular concerning the "predictability of the outcomes". Moreover the application of the common rules has to pay particular attention to the proportionality principle in those cases where the recipient company produces not only defence but also products not caught by the Directive.

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*Rutili, cited above, paragraph 28, and Case C-348/96 Calfa [1999] ECR I-11, paragraph 21). Moreover, those derogations must not be misapplied so as, in fact, to serve purely economic ends (to this effect, see Rutili, paragraph 30). Further, any person affected by a restrictive measure based on such a derogation must have access to legal redress (see, to this effect, Case 222/86 Unectef v Heylens and Others [1987] ECR 4097, paragraphs 14 and 15).* See also Case 112/05 *Commission v Germany* (Volkswagen), paragraph 72.

[195] See the Country Report on the U.S. "Ultimately, under section 721 and the Constitution the judgment as to whether a transaction threatens national security rests within the President's discretion", annex to the report at p. 289.

#### *j) Enforcement*

In order to ensure its proper enforcement, the Directive would have to determine that a foreign acquisition not notified or not subject to review in accordance with its rules shall be prohibited. Disregard of said prohibition should entail the nullity of the acquisition pursuant to the civil legislation of the Member States. In addition penalties could be laid down but the enforcement may be more complicated.

#### *k) Publication and appeal*

The main lines of a decision would have to be published by the national authorities in charge of the reviewing mechanism. The confidentiality of sensitive information (see Article 346 (1) a) TFEU) must be respected but regulatory objectives and practices should be made as transparent as possible so as to increase the predictability of outcomes. Appeal to the national courts must be possible.

### *5.2.3 Scope and organisation*

The Directive would apply to all Member States and probably be with EEA relevance.

As to the organisation the following considerations apply:

- **National authorities:** the Directive would require the designation or creation of national authorities in all Member States. This implies a heavy administrative burden and may imply the risk of incoherent decisions. The creation of national authorities might also increase the risk that mergers involving third country investors may not be notified to the Commission in accordance with the EMCR.

- **Committee or Network:** The Directive should provide for the creation of a Network or a consultative Committee in order to ensure the coherence of the national decisions. The Committee or Network should include the national authorities dealing with FDI of all the Member States and be chaired by the Commission. The operational rules and procedures applicable to the Committee or Network and defining the rights of its members would have to be established. The national authorities decide after consultation of the Committee or Network.

- **Consultation among Member States concerned:** Member States deciding on a proposed transaction should be bound to consult with those other Member States which may also be concerned by the decision to be taken (for details see Option 1).

The Commission should be mandated in the Directive to report to the European Parliament and the Council on the implementation of the Directive and on whether, and to what extent its objectives will have been achieved.

#### *5.2.4 Rationale*

The Directive lays external review in the hands of the Member States. Its value added would be a more comprehensive protection from risks linked to non-EU investments in comparison to the status quo because all Member States would apply the rules. As the following discussions show, it may also contribute to reducing recourse to Article 346 TFEU with respect to investments from other Member States. The national review competences might however increase the risk that mergers involving third country investors may not be notified to the Commission under the EMCR. Also recourse to Article 346 TFEU may be a problem.

#### *5.2.5 Complementary EU instruments for the internal dimension: Interpretative Communication*

The Directive just discussed is based on Article 64(2) TFEU and cannot address the treatment of inward investments. Addressing the internal dimension is nevertheless necessary given that currently six Member States apply regulatory instruments, which include the review of EU defence investments and further Member States apply special rights or contractual arrangements with similar effects or maintain State ownership.

Secondary legislation on intra-EU investments cannot be adopted under Article 64(2) TFEU. Only Article 114 TFEU could provide a legal basis.

Normally, the correct application of Article 63 TFEU which has direct effect is sufficient to deal with inward investments. Given however the specificities of the defence sector a complementary Interpretative Communication dealing with the internal dimension only provides the appropriate and legally correct approach. An Interpretative Communication

on inward investments constitutes an appropriate corollary in relation to a Directive laying down binding common rules on the review of non-EU investments.

#### *a) Legal basis and objective*

The Commission might adopt a Communication on the interpretation of Articles 346-348 TFEU in the field of intra-EU defence investments. Such a Communication clarifies the law, is non-binding on investors and Member States but binds the Commission. It prepares the ground *inter alia* for proceedings of the Commission pursuant to Articles 258-260 TFEU against Member States where the control of investors from other Member States exceeds the limits in particular of Article 346 TFEU.

A Communication does not create rights or obligations and accordingly does not require a legal basis. The Commission acts in its role as the "guardian of the Treaties" under the control of the CJEU. The role is defined in more detail in Article 17(1) TEU.

The objective of an Interpretative Communication of the Commission is to ensure the correct application of the European law. The Interpretative Communication here at stake would aim to prevent possible misinterpretation and misuse of Article 346 TFEU in the field of EU internal cross-border investments in strategic defence assets and concentrations. More practically speaking the Communication would aim at the phasing out of any EU internal control measures and ultimately at clarifying the applicability of the EMCR to concentrations concerning military or dual use goods and technology.

#### *b) Function and modalities*

The Communication is meant to complete the Directive which has just been discussed. Accordingly the Communication is based on the assumption that the Directive under Option 2 (or the Regulation discussed as Option 3 below) will have been adopted.

In essence, the Communication would have to clarify the rights retained by the Member States in particular under Article 346 TFEU.

In addition the interpretation of Articles 52(1) and 65(1) TFEU may be addressed to the extent that they refer to public security.

The Communication would have to set out that Member States must properly respect the limits of the Treaty derogations, and that accordingly they may restrict EU investments only in exceptional cases where this is justified on grounds of security interests which have *not* been addressed by the abovementioned Directive.

In particular the Communication could address the following aspects:

- **Case law of the CJEU on Article 346 TFEU:** The Court has made it clear that any derogation from the rules intended to ensure the effectiveness of the rights conferred by the Treaty must be interpreted strictly.[196] Moreover, it has confirmed that this is also the case for derogations applicable in situations which may involve public security. In *Commission v Spain*, the Court ruled that articles in which the Treaty provides for such derogations (including the former Article 296 TEC, now 346 TFEU) deal "*with exceptional and clearly defined cases*". Because of their limited character, those articles do not lend themselves to a wide interpretation but have to be applied strictly. [197] According to the case law "*it is for the Member State which seeks to rely on (Article 296 TEC now 346 TFEU) to furnish evidence that the exemptions in question do not go beyond the limits of such (clearly defined) cases*" and to demonstrate "*that the exemptions … are necessary for the protection of the essential interests of its security*".*[198]* Moreover the Court has stated repeatedly, and this is of particular interest for the Communication, that the Member States may no longer rely on Treaty derogations to the extent that the general interests such as public security have been subject to harmonisation.[199]

- **Structure:** Taking the Commission Communication of 7 December 2006 "*on the application of Article 296 EC in the field of defence procurement*" as an obvious model, the new Communication could address the following subjects: the provisions

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[196] See CJEU Case C-367/89 *Richardt and Les Accessoires Scientifiques*, paragraph 20; Case C-328/92 *Commission v Spain*, paragraph 15; Case C-324/93 *Evans Medical and Macfarlan Smith*, paragraph 48.

[197] See *inter alia* Case C-367/89 *Richardt and Les Accessoires Scientifiques*, paragraph 20.

[198] See CJEU Case C-414/97 *Commission v Spain*, paragraph 22.

[199] See CJEU Case 112/05 *Commission v Germany* (Volkswagen), paragraph 72.

to be interpreted, i.e. Articles 65(1) and 346 TFEU; the field of application: i.e. investments in defined defence and security assets (the notion as defined in the Directive could be used), the conditions of the derogation: i.e. the criteria under which a restriction continues to be justified even where a mechanism reviewing non-EU investments is in place (i.e. the notions of essential security interests, the notion of affecting adversely the conditions of competition in the internal market), and finally the role of the Commission e.g. in relation to the EMCR and eventual infringement proceedings.

- **Intra-EU investments:** The Commission would have to clarify that the legal appraisal of defence related investments from other Member States changes as a result of the existence of common rules protecting from the risks that may be related to defence investments from non–EU countries. As soon as binding rules concerning non-EU investments will be in force and applied EU wide, the proportionality of national control measures will be more difficult to justify. The reason is that the Directive would address also security concerns. Accordingly the Member States could no longer rely on the "Trojan horse"-argument – which is mentioned frequently by Government stakeholders – according to which in the absence of comprehensive controls concerning non-EU investments also EU investments imply unknown risks. The Commission would therefore set out that in view of the (proposed) Directive and the further development of Union law investments from other Member States can as a rule no longer be seen as jeopardising essential security interests of the recipient Member States.

- **Public investor**: In practice, the conditions of Article 346 TFEU may continue to be met more easily in the case of public than in the case of private investors from other Member States. However, given the Treaty requirement of equal treatment of private and public EU investors the Communication could not refer to this issue.

#### *c) Scope and organisation*

The Interpretative Communication would have EU-wide relevance. The Commission would be responsible, acting under the control of the CJEU.

#### *d) Rationale*

The rationale of the interpretative Communication is to clarify the extent to which EU defence investments may circulate within the Union without national security checks and to contribute to the full application of the EMCR in this area. EU investors, EU defence operators, national authorities and courts would benefit from greater legal certainty.

### *5.2.6 Complementary EU instrument for the internal dimension: Infringement proceedings*

The Communication would be a useful tool but probably on its own not be capable of bringing the national measures fragmenting the EU to an end. The possible complementary use of infringement proceedings is therefore of interest. However, the Commission has in this area a wide margin of discretion.

Articles 258–260 TFEU provide the legal basis for infringement proceedings. Moreover, Article 348 TFEU provides for special procedural rules, which may be applied to infringements of Articles 346 and 347 TFEU.

The CJEU would of course retain final responsibility for assessing, also in the light of the legal framework set up by the Directive under consideration, under what conditions Member States can legitimately rely on Article 346 TFEU.

Infringement proceedings may be instituted by the Commission (Article 258 TFEU) or by a Member State (Article 259 TFEU). Court rulings confirming infringements would set precedents for the other Member States not to maintain restrictions vis-à-vis other Member States.

Option 2 on a Directive on mandatory notification, consultation and review can be summarised as follows:

| Notification | Information & Consultation | Review | Decision-making |
|---|---|---|---|
| Mandatory ex ante notification of non-EU investments to national authorities | Consultation and (limited) exchange of information within the Network of MS chaired by Commission | Harmonised set of rules for review of non-EU investments by national authorities | By national authorities after consultation of Committee or Network |

Complementary measure for EU investments: An Interpretative Communication

## 5.3 Option 3: Regulation on a common review of non-EU investments & Interpretative Communication

This Option consists of a Regulation establishing a single common procedure for reviewing investments from non-EU countries in European defence assets. In order to extend effects to intra-EU investments the Regulation could be "combined" (like the Directive just discussed) with an Interpretative Commission Communication on Articles 346-348 TFEU and, potentially, with infringement procedures.

The discussion below will be limited to those points, which are specific to a possible Regulation. Notions such as European defence enterprises, European strategic defence assets and non-EU investors have already been discussed with respect to the preceding Options 1 (see at 5.1.2 above). Specific to the Regulation here under discussion is in particular the application of the Regulation by a single authority, the Commission or a European Agency. Problematic is also the relationship between the Regulation and the EMCR.

A legal challenge is moreover the identification of the right legal basis and legislative procedure, the definition of the assessment criteria and of a decision making process which ensures the adequate participation of the Member States. In particular the Member State hosting the target or the parent company (the "most concerned Member State") should be able to influence the security considerations which are relevant for the final Commission decision.

### *5.3.1 Legal basis and objective*

As will be shown, the Regulation could either be based on the rules of the TFEU on the free movement of capital or on those of the Common Commercial Policy (CCP) or possibly on both.

#### *a) Article 64 (2) TFEU as a legal basis*

The first legal basis would again be provided by Article 64(2) TFEU which provides for legislative "measures" and accordingly leaves the Union legislator the choice to adopt a Directive or a Regulation. As to this choice the consideration is decisive that in order to

ensure an efficient control of third country investments and avoid *aleas* such as a high regulatory and administrative burden, incoherent application of the law, multiple filing, the risk of forum shopping and red tape the establishment of a "one-stop shop" may be preferable to the operation of 27 national authorities. These policy objectives require a Regulation.

Pursuant to Article 64(2) TFEU the Union legislator would adopt the Regulation in the ordinary legislative procedure. Only if the Regulation would have to be qualified as a "step backwards" in the free movement of capital the procedure would be different; here the Council would have to adopt it by unanimity in accordance with Article 64(3) TFEU. For further details as to this legal basis see above at points 5.1.1 and 5.2.1.

#### *b) Article 207(2) TFEU as a legal basis*

The Regulation could have another legal basis, i.e. Article 207(2) TFEU. This Article entitles the Union legislator to adopt regulations defining the framework for implementing the CCP. The competences of the Union in the area of the CCP have now been expressly qualified as "exclusive", see Article 3(1)(e) TFEU. In the context of exclusive competences only the Union may adopt binding acts, the Member States are able to legislate only if empowered by the Union to do so or for the implementation of Union acts, see Article 2(1) TFEU.

The TFEU has also amended the definition of the CCP in 207(1) TFEU which now explicitly includes the subject of "direct foreign investments". Clearly therefore the powers of the Union in CCP matters include the adoption of legislation concerning FDI.

New in the TFEU is also Article 207(6), which subjects the exercise of the legislative Union competences in the area of the CCP to certain conditions. Having examined these conditions we come to the conclusion that the Union is not prevented by this latter provision from using the legislative competences granted to it by Article 207(2) TFEU, for the following reasons:

Pursuant to the first condition laid down in Article 207(6) the exercise of the legislative powers "*shall not affect the delimitation of competences between the Union and the Member States*". The delimitation of competences between the Union and the Member States has been defined in Articles 2 to 6 TFEU. These articles define exclusive, shared,

coordinative and supportive competences of the Union and delimitate them from the competences of the Member States in the areas so defined. The adoption of a CCP regulation would leave this delimitation of competences fully intact. One cannot validly argue that a Regulation harmonising the FDI screening rules reduces the scope for the Member States to rely on Article 346 TFEU and so affects competences of the Member States. Such an argument would overlook that Article 346 TFEU is a Treaty derogation and which gives the Member States room to leave the general rules of the Treaty unapplied under certain conditions and on a case-by-case basis. Therefore a CCP regulation would not affect the delimitation of competences between Union and Member States.

Pursuant to the second condition a CCP regulation "*shall not entail harmonisation where the Treaties exclude harmonisation*". However the "harmonisation" in the sector at issue is not excluded in the Treaties. The Treaties exclude harmonisation in areas where the Union has neither exclusive nor shared competences; this is not the case here. The TEU furthermore excludes legislative acts in the area of CFSP, but this is not our case either; such acts are not excluded in the area of CCP.

Accordingly Article 207(6) TFEU does not stand in the way of using Article 207(2) TFEU as a legal basis for the CCP framework regulation.

The European Parliament and the Council would adopt the CCP framework Regulation in accordance with the ordinary legislative procedure.

### *c) Dual legal basis*

The question arises whether rather than using but one of these legal bases the Union legislator could opt for the concurrent use of Articles 64(2) and 207(2) TFEU.

We think that this would indeed be possible, in spite of the fact that Article 64(2) TFEU concerns shared and Article 207(2) TFEU exclusive Union powers (see Articles 3, 4 TFEU). According to the case-law of the CJEU recourse to a dual legal basis is not possible where the procedures laid down for each legal basis are incompatible with each

other. In the present case the legislative procedure would be the ordinary legislative procedure under both legal bases; therefore the use of the dual basis would encroach neither on the Parliament's nor on the Council's rights.[200]

However, if the Regulation would have to be based on Article 64(3) rather than 64(2) TFEU, in other words if it were held to entail a step backward in liberalisation, the concurrent use of this provision with Article 207(2) TFEU would be excluded. As mentioned, it would be for the Council to act in a special procedure and by unanimity. This procedure would be incompatible with the ordinary legislative procedure foreseen for the CCP framework Regulation.

#### *d) Compliance with Commission Communications*

The Directive harmonising notification obligations for non-EU investors would have to be in line with the Commission Communication of 7 July 2010 "towards a comprehensive European international investment policy" as well as with the Commission Communication on Sovereign wealth funds.[201] They are in particular of interest with regard to the assessment criteria to be chosen and their application as well as the notion of public investor.

#### *e) Objective*

The objective of the Regulation would be to create a single set of rules on the review of defence investments from third countries while at the same time, in accordance with Article 21(2) and (3) TEU, also addressing the security concerns which may be linked to them. Another objective is the creation of a Committee or Network of the competent authorities of all Member States and the Commission in order to allow for the participation of the Member States in the decision making process. The major indirect objective is to phase out the current restrictions on EU defence investments.

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[200] See for instance Cases C-155/07 paragraph 37 and 75 and C-300/89, paragraphs 17-21.

[201] European Commission A Common European Approach to Sovereign Wealth Funds. COM(2008)115 final. For a more extensive discussion on public investors see 5.2.2 (c).

### 5.3.2 Function and modalities

The function of the Regulation would be to create a single review procedure applying to third country investors which would replace national systems where existing ("one-stop shop").

The Regulation would have to be shaped so as to allow for the maximum of freedom of movement of capital in the area of defence investments, not only between the Union and third countries but also, though indirectly only, within the Union. As to the concrete modalities of this Option those discussed above with respect to the Directive Option 2 apply *mutatis mutandis* to the Regulation. The following aspects are specific to the Regulation:

#### *a) Relationship with the ECMR*

We suggest adopting a Regulation which would follow closely the ECMR in procedure and modalities but would be limited to a security check of the "strategic" defence industry as here defined. In fact we are inclined to hold that the political dimension of transactions in military products involving third country investors and the possibility for Member States to veto decisions would best be recognised by a separate piece of legislation.

The choice of a distinct legal instrument would also be justified by the specificities of the defence sector and the differences between the Regulation and the EMCR: the Regulation as suggested below would be distinct from the EMCR e.g. in terms of geographic scope (non-EU investments only), threshold for intervention (25% only), criteria (security-related), expertise required, committee required (involvement of MoDs advisable), decision making rules (substantial participation of the Member States up to a veto right) and impact of Article 346 TFEU.

Regulation and ECMR would thus apply in parallel. In the interest of all parties concerned the two procedures would have to be closely synchronised.

Legally, an alternative approach would likewise be possible and require modifications to the EMCR along the lines discussed with respect to the Regulation below. The

modification of the EMCR would avoid the creation of two parallel procedures and facilitate the decision making process.

### *b) Notification*

It should be mandatory and to the Commission (or a European Agency to be created for this purpose, for details see under "Scope and Organisation"). The intended acquisition of all those strategic defence assets would have to be notified which are on the (shortened) Military List of the Council referred to in Article 346 (2) TFEU. Again we suggest the threshold to be 25% of the voting rights. As to further details of the notification see the EMCR.

Let us add that, as mentioned above,[202] there have been cases under the EMCR where companies or the Member States concerned tried to avoid notification concerning transactions involving defence companies or the military part of dual use companies. This could hinder the assessment of the effects of an envisaged transaction on the competition in the EU with respect to all economic sectors and therefore also where defence-related or dual use companies are concerned.[203]

The notification here discussed under the Regulation would aim at ensuring that all proposed transactions concerning the acquisition of 25% or more of the voting rights of defence or dual use companies can be security checked. The specificity of the rules on notification, consultation, information exchange and moreover the participation of the Member States in the decision making process would provide an added value over the status quo in terms *inter alia* of a more limited recourse to Article 346 TFEU, but also in terms of legal certainty and transparency and last but not least also in terms of a comprehensive notification of transactions involving defence business activities under the Regulation and the EMCR.

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[202] For more details as to this point see 3.2 above.

[203] Interview with an official of the European Commission, Brussels, September 2010.

### *c) Information exchange and consultation*

Under the Regulation, it would be for the Commission to ensure that Member States concerned have the occasion of being consulted.

An information exchange obligation would have particular importance under the Regulation. Member States would as a rule have to release the information required to ensure a security check. The obligation would in the first place aim at the correct information of the Commission or Agency. The Commission would require information in order to adopt a correct decision whereas the Member State may have reasons not to release sensitive or even "classified Government information.

It should be stressed that any information acquired by the Commission as a result of the application of the Regulation would be used only for the purposes of the relevant investigation (see e.g. Article 17 EMCR with regard to information that may include business secrets). This would provide a certain degree of protection.

The information here discussed would not include business secrets but information that requires a particular high degree of protection. The Regulation should therefore contain special rules on classified information designed to ensure the secrecy of classified information released by a Member State.

In spite of these guarantees the obligation to supply the information necessary to make a security check will create overlap with Article 346 TFEU. Refusal to supply this information may obstruct the functioning of the Regulation but on the other hand the Governments have also an interest in having a transaction correctly security checked.

In case of recourse to Article 346 TFEU the dialogue procedure may apply between the Commission and the Member State concerned; as to this procedure see below at 5.3.3 b).

### *d) Assessment criteria*

They have to correspond to objectives, which may be pursued by the Union in pursuit of its external action in the areas of the CCP and the free movement of capital. As mentioned pursuant to Article 21(2) TEU the Union shall "*define and pursue common policies…in order to safeguard its values, fundamental interests, security, independence and integrity*". Article 21(3) TEU adds that the objective of safeguarding the security,

independence and integrity of the Union shall be pursued by the Union through its external action. Article 205 TFEU read together with Article 21(3) TEU - which refers expressly to "Part V of the TFEU" – clarify that the Union shall pursue this security policy also in connection with its CCP. As a result, the Union shall pursue these objectives with the instruments of its external action, jointly with the objectives that are specific to each policy.

The present Regulation could therefore aim in the first place at furthering trade in defence investments with third countries but in addition take also the Union interest in safeguarding its security, independence and integrity duly into account. This is of particular interest for the determination of the assessment criteria designed to evaluate the security risks that are potentially linked to non-EU investments. As in the case of the Directive discussed as Option 2 the criteria should be derived from the objective of safeguarding the security, independence and integrity of the Union.

On the basis of these considerations we suggest to define the assessment criteria by addressing the two major risks which may be linked to foreign defence investments, i.e. the risk for the security of supply and the risk of proliferation of sensitive defence technology. Subsequently these two criteria should be completed by a reference to the security objectives laid down in Article 21(2) TEU, as follows:

*The Commission (or European Agency) would have to examine whether as a result of a proposed acquisition*

- *the supply with a strategic defence good or technology risks to be compromised or*
- *there is a risk of proliferation of defence know how or technology*

*and whether as a result thereof the security, independence or integrity of the Union or of one or several Member State may be severely jeopardised.*

*An acquisition may only be banned if this is indispensable and if no less restrictive measure mitigating the security risks is available.*

As to the interpretation of the notions of security, independence and integrity, reference might be made, *mutatis mutandis,* to the European Security Strategy (ESS), which was

drafted under the responsibilities of the High Representative for CFSP and approved by the European Council in 2003. This Strategy might be seen as a policy instrument providing certain guidance for the interpretation of said objective.[204]

Moreover, also the Commission Communications, on SWF and on a comprehensive European investment policy respectively, may give guidance as to the further refining and application of the assessment criteria.

#### *e) Proportionality*

The Regulation must be applied so as to extend to the utmost extent possible to defence investments the traditional openness of the Union to foreign investment, which underlies both the rules on free movement of capital and the common commercial policy.

### *5.3.3 Scope and organisation*

The Regulation would directly apply in all EU Member States. It may have relevance for the European Economic Area.

As to the organisational aspects, in particular the choice of the authority in charge of implementing the Regulation and the need to create in addition a Network of national authorities the following considerations apply:

#### *a) The choice of the authority*

The question arises as to which should be the authority at issue. Choosing the EDA for managing and ensuring application of a Regulation adopted under the TFEU in the fields of internal market and/or the common commercial policy would not be legally possible under the existing Treaties. The EDA is a body of the CSDP created by the Council and operating in accordance with the intergovernmental method. Its tasks have been defined

[204] The key threats and challenges facing the EU identified by the ESS are: proliferation of weapons of mass destruction, terrorism and organised crime, regional conflicts, state failure, maritime piracy, small arms and light weapons, cluster munitions and landmines, energy security, impact of climate change and natural disasters, cyber-security, and poverty. European Council. (2003) A secure Europe in a better world. European Security Strategy.

in Article 45 TEU. They are related *inter alia* to the European defence industry but do not extend to the implementation of a common policy in the field of capital movement or CCP. Implementation by the High Representative would appear to be excluded for similar reasons. The competencies of the High Representative have been defined in Article 27 et seq. TEU; they concern the Union's CFSP and do not extend to the implementation of common policies adopted under the TFEU. As to the national authorities, we have mentioned the interest of the foreign investors in one proceeding and identified certain advantages of a single mechanism. In addition, a regulation setting up a common centralised review system would necessarily need to be managed by a central authority at EU level. Accordingly, the implementation should be the responsibility of either the Commission or a European agency to be created.

The choice of one rather than 27 national authorities would entail the least disturbance of the free movement of capital with third countries. In fact, choosing a one-stop shop rather than an administrative structure entailing multiple filing would alleviate the burden of the investors. Reducing the administrative burden of investors and Member States alike is all the more appropriate as the cases raising security concerns may in the end prove to be rare.

Moreover, the choice of one single authority would be a guarantee for the uniform application of the rules which may be an issue in view of the high interest in defence investments. Review at the national level might lead to "forum shopping" where third country investors could seek clearance (or create an affiliate) preferably in Member States which show a particular interest in the investment; once so established they enjoy the benefits of the internal market and are no longer subject to the screening rules (see Article 54 TFEU). Therefore, the operation of but one competent authority would provide efficiency gains. The Regulation may be more conducive to phasing out the internal control measures than a decentralised application of the rules.

Article 348 TFEU constitutes a strong argument in favour of the Commission to be this single authority. The Article mandates the Commission to examine, together with a Member State which relies on Article 346 TFEU, how the disputed national measures can be adjusted to the rules in the Treaties. We suggest including this dialogue procedure into the Regulation (see under c) below).

Also the need for a coherent application of both the Regulation here under discussion and the EMCR with respect to non-EU concentrations advocates heavily in favour of the Commission. The choice of the Commission would allow the coherent analysis of both the competition and security considerations and accordingly contribute to ensuring the proper functioning of the EMCR in the defence sector.

Accordingly, below we refer only to the Commission as the authority in charge.

Choosing the Commission would however mean that the Member States would have to participate in the decision making process. This is particularly necessary for those Member States, which are concerned by an intended acquisition. The degree of participation and influence must adequately reflect the rights retained by the Member States under Article 346-348 TFEU.

***b) The Committee or Network***

To that effect the creation of a Committee or Network comprising the national authorities and chaired by the Commission should be foreseen in the Regulation. The representatives of the Member States should include the MoD or the authorities in charge of national screening measures. Any measure of the Commission would require the consultation of the Committee. Member States concerned should thus have a possibility to influence the decision making process whereas the target Member State might even be given a veto right (see under c) and d) below).

***c) How the assessment criteria would work***

The question arises how these criteria would work in practice and how they would cope with the fact that recourse by Member States to Article 346 TFEU cannot be excluded (overlap).

The assessment criteria would have to be seen together with the (shortened) Military List of the Council referred to in Article 346(2) TFEU. A notification would have to be made for all the items which are on this list. Applying the abovementioned criteria to these items would probably lead to the result that only a limited number thereof would meet the substantive criteria defined, i.e.

- that the proposed acquisition risks entailing a deny of supply or the proliferation of important know how or technology
- and thereby threaten the security of the reviewing Member State, other Member States or even of the Union as a whole.

However, the application of the criteria would not prevent that in spite of the Regulation the Member States would be in a position to rely on Article 346 TFEU. They might try and maintain an own reviewing system and apply this in addition to the applicability of the Regulation. Such a development might undermine the Regulation.

The EMCR has "solved" similar problems through exclusive jurisdiction: pursuant to Article 21 EMCR this Regulation alone shall apply to certain concentrations and the Commission shall have sole jurisdiction to adopt the decisions provided for in it. Conflicts with Member States have nevertheless arisen but not to an extent as to affect the good functioning of the EMCR.

In the defence area however, Article 346 TFEU may stand in the way of such an approach, let alone for political reasons.[205]

In view of the above we suggest that in the present context the risk of conflicts between Commission and Member States should be addressed through a high degree of participation of the Member States in the decision making process (see under d) below).

For completeness sake let us add that the Commission would have to determine on a case-by-case basis whether an infringement proceeding might be an appropriate remedy. It has in this area a large margin of discretion.

### *d) Clearance and decision*

The Commission supported by the Committee of the representatives of the Member States, should examine the notification and have (5 or more months in view of translation

[205] Even though use of Article 207(2) TFEU as a legal basis would enable the Commission to act within an exclusive competence Article 346 TFEU would place limits on this competence.

and procedural requirements, see below) from the receipt of complete notification to decide. If no decision is taken within the delay the transaction would be deemed to be security cleared.

The Commission would take the decision after consultation of the Committee or Network and of Member States concerned by the investment. The Member State which is most concerned because it hosts the target company or the parent company of the target company should have the possibility to veto a draft decision and amend it in cooperation with the Commission.

Such a "dialogue procedure" is expressly laid down in Article 348 TFEU. It provides that if measures taken in the circumstances referred to in Article 346 and 347 TFEU have the effect of distorting the conditions of competition in the internal market, the Commission shall, together with the State concerned, examine how those measures can be adjusted to the rules laid down in the Treaties.

Article 348 TFEU foresees a role for the Commission and the Court of Justice. The provision calls for consultations between the Commission and the Member State in order to adjust the measures as to allow for the functioning of the internal market including the market of military items.[206] It also provides that the Commission and any Member States can bring the matter directly before the Court of Justice if they deem that another Member State makes "improper use" of the powers provided under Articles 346 and 347. In addition, the Articles 258 and 259 TFEU on infringement proceedings apply.

In both the specific procedure laid down in Article 348 TFEU and in the infringement procedure defined in Articles 258 and 259 TFEU the Commission enjoys a large margin of discretion.

We suggest that a procedure reflecting the dialogue mechanism Commission/Member States laid down in Article 348 TFEU should be included into the Regulation.

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[206] Indeed Article 348 (1) must refer to the market for military goods, because it refers to measures covered by Articles 346 and 347. Such measures by definition of Article 346 (1) (b) do not adversely affect the competition in civil markets.

If no agreement can be reached in the dialogue the opinion of the Member State most concerned should prevail as to the security assessment. The Commission would have to adopt the view of that Member State.

In accordance with Article 348 TFEU the Commission would have the possibility to bring the matter directly before the CJEU. Legally, the Court would thus have the last word to say.

In the result therefore, if the assessment of a given case leads to the conclusion that the acquisition raises security concerns, the Commission can either impose conditions and obligations or adopt a ban.

A ban should however only be possible where mitigation measures would be insufficient to properly address the security risks. A ban would put an end also to the merger procedure.

If the assessment comes to the result that the acquisition does not raise security concerns a formal decision to that effect is not required, the automatic clearance mentioned above or subsequently the publication of a notice binding the Commission may suffice.

#### *e) Publication and appeal*

The general lines of a decision should be published by the Commission. The necessary secrecy of sensitive information should also be respected but regulatory objectives and practices be made as transparent as possible so as to increase the predictability of outcomes.

An appeal to the General Court of the EU would be possible in accordance with the general rules.

### *5.3.4 Rationale*

The Regulation would contribute to an EU wide protection from security risks linked to non-EU investments, facilitate the phasing out of national security checks, and allow, together with the ECMR, a more coherent review of the effects of concentrations involving non-EU investors on security and competition. It would thus provide added value also to the European defence industry.

#### *5.3.5 Complementary EU instruments for the internal dimension*

The Regulation would deal with the external dimension only. It should be combined with non-legislative instruments designed to address the internal dimension. The complementary measure should here as well be an Interpretative Communication possibly followed by infringement proceedings. As mentioned, the Communication should clarify that as a result of the Regulation reliance on Article 346 TFEU becomes more difficult. For details see point 5.2.5 above.

Alternatively an internal measure could consist of an EDA Code of Conduct addressing the internal dimension. For details see Option 6 below.

Option 3 on a Regulation on mandatory notification, consultation and common review can be summarised as follows:

| Notification | Information & Consultation | Review | Decision-making |
|---|---|---|---|
| Mandatory ex ante notification to EU body | Consultation and limited information exchange within EU Network or Committee | Single set of rules for review by EU body | EU body decides with input and eventually veto right from MS concerned |

Complementary measure for EU investments: An Interpretative Communication.

### 5.4 Option 4: Enhanced cooperation enacting Option 1, 2 or 3

This Option consists of enhanced cooperation of at least 9 Member States who would put in place between them one of the abovementioned legislative Options 1, 2 or 3 concerning the control of investments from third countries in strategic European defence assets.

Enhanced cooperation works only “as a last resort”. The main pre-condition is that said Options could not materialise within a reasonable period of time at the level of the Union. At any rate this form of cooperation would have to remain open for other EU Member States to join at a later stage.

### 5.4.1 Legal basis and objective

Enhanced cooperation is covered by Article 20 TEU read together with Articles 326 to 334 TFEU. Article 329 TFEU would provide the legal basis of enhanced cooperation concerning foreign defence investments.

Pursuant to Article 329 TFEU the Council would act on a proposal from the Commission and after obtaining the consent of the European Parliament. The authorisation to proceed with enhanced cooperation shall be granted by a decision of the Council. Unanimity is only foreseen for cooperation in the field of CFSP[207] and would therefore not here be required.

Article 330 TFEU adds that all members of the Council may participate in its deliberations, but that only members of the Council representing the Member States participating in enhanced cooperation shall take part in the vote.

In addition, the following conditions have to be met in order to establish an enhanced cooperation:

- A minimum of nine Member States is required to engage in such cooperation
- The Council must establish that the objective of the cooperation cannot be attained within a reasonable period on a uniform basis by the Union as a whole
- It has to be open to all Member States
- It can only be established within the framework of the Union's non-exclusive competences, see Article 21(1) TEU.

The second condition may be difficult to meet in our case. At any rate it can be expected that demonstrating that none of the three Options above can be attained within a reasonable period will take quite a long time.

[207] Compare for instance, Priollaud, François-Xavier and David Siritzky. (2008) *Le Traité de Lisbonne, Texte et commentaires des nouveaux traités européens (TUE-TFUE)*. Paris: La Documentation française.

As to the latter condition, it requires that in order to qualify for enhanced cooperation, the Regulation on a common review procedure discussed in Option 3 could only be based on the rules on the free movement of capital and not on the rules on the CCP, the latter forming part of the Union's *exclusive* competences.

If the conditions of enhanced cooperation are met the institutions of the Union (Commission, Parliament, Council) are entitled to act and adopt legislation pursuant to the rules of the TFEU.

The objective pursued by this Option would thus be for a minority of Member States to proceed with one of the Options 1-3 dealt with above.

#### *5.4.2 Function and modalities*

The Option would lead to a Directive or a Regulation on capital movement adopted on the basis of Article 64(2) TFEU and designed either at harmonising the rules on notification and consultation (in accordance with Option 1) or at harmonising the rules on a screening mechanism (in accordance with Options 2 or 3). Article 207(2) TFEU cannot be used as a legal basis because acts in the exclusive competence of the Union cannot be adopted under enhanced cooperation (see Articles 3 (1) e) TFEU and 20 (1) TEU).

The measures so adopted within enhanced cooperation are meant to anticipate harmonisation by the Union as a whole.

The modalities would be those described in relation to Options 1-3, see above.

#### *5.4.3 Scope and organisation*

As for the scope, cooperation may commence with 9 Member States but have to be open to all other Member States. The organisational aspects are those described with respect to Options 1 – 3.

#### *5.4.4 Rationale*

The rationale would be for certain Member States to start with a fully-fledged EU instrument. Any protection from the risks, which are potentially linked to certain investments from certain third countries, would thus be limited to them.

#### 5.4.5 Complementary EU instrument for the internal dimension

As to the EU instrument complementary to enhanced cooperation that would address investments from other Member States, this depends on the Option chosen by the enhanced cooperation. The instruments complementary to Options 1, 2 and 3 have been discussed at points 5.2.5, 5.2.6 above.

## 5.5 Option 5: CFSP Council Decision on review of non-EU investments & Interpretative Communication

This Option consists of a CFSP Decision of the Council defining the approach of the Union to non-EU defence investments and inviting the Member States to introduce national mechanisms to that effect.

It contains two sub-Options, one aimed at a mechanism for the exchange of information and for consultations and the other at national screening systems.

#### 5.5.1 Legal basis and objective

##### a) Article 40 TEU

The present Option would have to be based on an intergovernmental approach in accordance with the CFSP rules, Articles 23 et seq. TEU. Article 40 TEU delineates action under the CFSP rules of the TEU from action under the TFEU. As it is subject to judicial control by the CJEU the delineation of competences is subject to strict legal control.

The legal situation as to this delineation was slightly clearer under the former TEU than it is today. In essence, the former Article 47 EU provided that nothing in this TEU (and accordingly nothing in the rules on CFSP) shall affect the EC-Treaty and acts modifying or supplementing it. This amounted to a protection of the "acquis" reached under the EC Treaty. According to the ECOWAS case-law of the CJEU[208] concerning the former

[208] Case C-91/05 *Commission v Council.*

Article 47 EU, if it is established that the provisions of a measure adopted under Titles V or VI EU, on account of both their aim and their content, have as their main purpose the implementation of a policy conferred by the EC Treaty on the Community, and if they could properly have been adopted on the basis of the EC Treaty, the Court must find that those (CFSP) provisions infringe Article 47 EU.[209]

According to that case-law it had to be assessed whether the centre of gravity of a particular measure lies with the EC Treaty (now TFEU) or with CFSP. A measure in the field of control of direct investments as the one here under discussion would certainly have its centre of gravity within the areas of internal market law and free movement of capital, but it would also pursue CFSP objectives such as security of supply or non proliferation. In other words, an assessment of the centre of gravity has already in the past been complex and often unpredictable.

The Lisbon Treaty has further complicated the applicable legal framework. The (new) second paragraph of Article 40 TEU also protects the CFSP "acquis". This makes it extremely hard to predict whether the ECOWAS reasoning may be upheld in the future and how the Court would rule on a similar case today.

In light of these considerations one cannot rule out that a CFSP Option is legally feasible.

#### *b) The legal basis in Articles 25 and 29 TEU*

Pursuant to Article 25 (b) ii TEU the Union shall conduct the CFSP *inter alia* by adopting a decision defining positions to be taken by the Union or by strengthening systematic cooperation between Member States in the conduct of policy. Moreover pursuant to Article 29 TEU the Council shall adopt decisions that shall define the approach of the Union to a particular matter of a geographical or thematic nature.

In the present context a Council decision defining the approach of the Union to a particular matter of a thematic nature would be required, i.e. defining the approach of the Union to the legal treatment of non-EU defence investments.

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[209] Ibid. paragraph 60.

Let us also recall that Article 24(1) TEU prohibits in the area of the CFSP the adoption of legislative acts: "*the adoption of legislative acts shall be excluded*". A decision of the Council pursuant to Articles 25, 29 TEU would probably not set aside this provision. A Council decision recommending to the Member States to adopt a certain policy or measure is not in itself a legislative act.

The use of this legal basis is supported by precedents. It may be recalled that a "predecessor" of Article 29 TEU, i.e. the former Article 15 TEU concerning the adoption of Common Positions, has been used in connection with the Union's Code of Conduct on arms exports. In June 1998 the Council adopted the EU Code of Conduct on Arms Exports on the basis of the earlier adoption of common criteria by certain Member States. This Code of Conduct has subsequently been subject of Common Position 2008/944/CFSP of 8 December 2008 defining common rules governing control of exports of military technology and equipment.[210] This Common Position is considered to be binding upon Member States.

Based on these precedents, and assuming their applicability, Articles 25 and 29 TEU would thus provide a legal basis for a Council Decision defining the approach of the Union to non-EU investments in strategic defence assets. Council action would have to be unanimous, see Article 31 TEU.

#### *c) Objective*

The Option would be seeking a common approach of the Member States concerning non-EU defence investments.

### *5.5.2 Function and modalities*

The function of the Council Decision would be to take the intergovernmental route towards national information exchange and consultation rules or even at review systems for non-EU investments.

[210] Council of the EU. (2008) Council Common Position 2008/944/CFSP of 8 December 2008 defining common rules governing control of exports of military technology and equipment. *OJ* L 335:99-103.

The modalities could be as follows:

- **Consultation between Member States concerned:** the Council could limit itself to recommending Member States the adoption of rules on the need for consultation among those Member States which are directly or indirectly concerned by a proposed acquisition. Further details as to the modalities of national rules on information exchange and consultation have been discussed in connection with Option 1 at point 5.1.2 above.

- **National screening mechanisms:** The Council decision could furthermore recommend to Member States the adoption of national rules on a screening mechanism and the creation of national authorities implementing these rules. Further details as to the modalities of national screening rules and the organisation have been discussed in connection with Options 2 at point 5.2.2 and 5.2.3 above.

#### *5.5.3 Scope and organisation*

This decision taken by the Council would be legally binding for the Member States. Article 29 TEU states that "*Member States shall ensure that their national policies conform to the Union positions*". The obligation so created for the Member States would however not be subject to judicial control by the CJEU. Pursuant to Article 24(1)2 TEU the Court of Justice of the European Union shall not have jurisdiction with respect to the CFSP provisions.

The Decision would not have direct effect for investors and other parties. Not would it deal with the internal dimension of FDI. In fact the rules on the CFSP concern the external action of the Union.

#### *5.5.4 Rationale*

The Council Decision may lead to national legislation. However, the normal enforcement mechanisms for EU law and the principles of supremacy and direct effect do not apply in the context of CFSP.

#### *5.5.5 Complementary EU instruments for the internal dimension*

They would be those already discussed with respect to Options 1 and 2.

Option 5 on a CFSP Council Decision can be summarised as follows:

| Notification | Consultation | Review | Decision-making |
|---|---|---|---|
| May cause adoption of national legislation on decentralised ex ante notification to national authorities | Consultation and information exchange within Network of MS under auspices of the Council (EDA?) | *Sub-Option: May cause very loosely harmonised set of rules for review by national authorities* | By national authorities |

## 5.6 Option 6: EDA Code of Conduct on notification and consultation or on review of non-EU and EU investments

This Option would consist of a politically but not legally binding Code of Conduct (CoC) managed by the EDA. The Code would be established by the Member States. It would provide common guiding principles and call upon Member States to adopt, in line with those principles, national rules

- Regarding non-EU defence investments: either for information exchange and mutual consultation or for review;
- Regarding EU defence investments: either on a gradual phasing out of national controls of EU investments or on a transitory information exchange and consultation system for EU investments.

### *5.6.1 Legal basis and objective*

The EDA is a European agency foreseen in the TEU, see the new Article 45 TEU. According to paragraph (1)(e) of this Article, it forms part of EDA's tasks to "*implement any useful measure for strengthening the industrial and technological base of the defence sector*". Soon a Council decision will be adopted under this Article concerning the EDA.

A Code of Conduct would be a politically binding agreement under which Member States agree to abide by certain principles and criteria when controlling non-EU defence investments and regarding intra-EU investments.

Such a CoC would meet the condition of Article 45(1)(e) TEU and constitute a "useful measure for strengthening the industrial and technological base of the European defence sector" for the following reasons:

- The CoC would have an impact upon the European defence industry if it were to encourage the adoption by the participating Member States of national legislation on the introduction of national screening mechanisms concerning non-EU investments. Such legislation would, if adopted by participating Member States, enable the phasing out of the EU internal controls and indirectly the consolidation of the defence market.

- The CoC would also be useful for the European defence industry if it were to provide a platform within the EDA for information and consultation between the subscribing Member States (sMS) as to the legal treatment of non-EU investments. The national decisions might become more coherent and the control more effective. The phasing out of the EU internal controls may be facilitated.

- Finally such cooperation would implement the declaration on strengthening the capabilities in the French Presidency conclusions of December 2008.[211] In that it would allow a limited exchange of information between subscribing Member States concerned by non-EU investment.

The objective of the CoC would be to reach a common understanding between the Member States participating in the EDA as to the legal treatment of foreign defence investments. EDA initiatives have been drivers of regulatory changes in the past.

### *5.6.2 Function and modalities*

The function of the CoC would be to use the intergovernmental route if Options 1 to 4 on legislative measure do not find the necessary support. In comparison to the Council Decision discussed as Option 5 the CoC would be politically but not legally binding.

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[211] See Conclusions of the Council of the European Union. Declaration on Strengthening Capabilities, Brussels 11 December. *In fine*: "*Non-European investments in strategic defence enterprises can in certain cases have an impact on defence security or supply security. In this regard, Member States will exchange information when they deem it appropriate to do so*."

As to the possible modalities, the following considerations apply:

With regards to non-EU investments, the CoC would either encourage the creation of national control mechanisms or mechanisms for information and consultation, or combine both, as follows:

- **National rules on information exchange and consultation concerning non-EU investments:** The CoC could also encourage the Member States to adopt rules on the exchange of information and consultations among those Member Stats which are directly or indirectly concerned by a proposed acquisition, e.g. in case of common projects, supply chains, or groups of companies (for details see Option 1 at point 5.1.2). A special Network to that effect should however not be created.

- **National review mechanisms concerning non-EU investments:** The Code could encourage the Member States to adopt legislation on a national control mechanism of non-EU defence investments. It could moreover coordinate the views of the participating Member States with respect to certain essential modalities of such control, such as strategic defence assets, non-EU investors, and assessment criteria (for details see Option 2 at point 5.2.2 above).

It would be preferable to have the CoC address both the information exchange and the control mechanism in order to contribute to coherent national decisions.

#### *5.6.3 Scope and organisation*

The CoC would be open to all 26 EU Member States which presently participate in the EDA plus Norway. It would apply to Member States participating in the EDA and subscribing to the Code of Conduct.

As compared to the Council Decision discussed as Option 5 above the Code would be likely to be more flexible in its scope.

The Code would be managed and supervised by the EDA.

#### 5.6.4 Rationale

The rationale is a "soft" political approach of the legal treatment of non-EU investments. The Code would be aimed at a coordinated approach with a maximum of Member States managed by a European defence institution in a situation where other measures of the Union would not find the necessary support. Given the non binding nature the adoption of national rules cannot be enforced.

#### 5.6.5 Complementary EU instrument for the internal dimension

The complementary Option here could be nothing else but further rules in the Code of Conduct of the EDA addressing the treatment of defence investments from other Member States as well, as follows:

##### a) Objective

Under Option 5 concerning a Council Decision pursuant to Article 29 TEU we submitted that the Council could not, or at least as a rule would not, address the internal dimension. This issue is controversial with regard to the EDA. In fact Articles 43(3) and 45(1)(e) TEU defining the EDA's tasks refer also to the EDTIB. Pursuant to these provisions contributing to "implementing measures needed to strengthen the EDTIB" makes part of the tasks of the EDA.

The objective of a CoC concerning EU investments would be to encourage consultation with the aim of the gradual phasing out of the national control measures.

##### b) Function and modalities

The function of the CoC is to address the legal treatment of EU investments. As to the possible modalities the following considerations apply:

**Consultation:** the CoC could encourage measures designed to create a consultation mechanism concerning EU investments. Participation should be limited to representatives of the Governments. The participation of industry representatives may be objectionable given that their participation might favour concerted practices within the meaning of Article 101 TFEU.

**Gradual phasing out of national controls of EU investments:** the EDA Code of Conduct should encourage those participating Member States which apply national controls of EU investments or apply measures of equivalent effect to phase out these national controls and measures. The CoC would thus be aimed at facilitating and accelerating the process of phasing out the national controls of EU defence investments. Adoption of binding legislation concerning non-EU investments (Options 1-4) would support the phasing out process.

### *c) Scope and organisation*

Application of the EU internal rules of the Code would be open to all 26 EU Member States which presently participate in the EDA plus Norway.

### *d) Rationale*

The rationale is to try and prepare the phasing out of the national control rules concerning EU investments.

Option 6 – an EDA Code of Conduct – can be summarised as follows:

| Notification | Consultation | Review | Decision-making |
|---|---|---|---|
| Might cause national rules on decentralised ex ante notification to national authorities | Might cause consultation & limited information exchange mechanism between representatives of the MS | *Sub-Option: Might cause very loosely harmonised set of rules for review by national authorities* | By national authorities |

## 6 ON MEASURES REGARDING STATE OWNERSHIP

This Chapter concerns the question whether State ownership of defence assets as a method to control FDI from other Member States can be given a "European dimension".

Elaborating special Options concerning political measures challenging the existence of public ownership would go beyond the purview of this study. Issues of State ownership do not only concern the defence but also other industries and these issues have been subject to complex and wide ranging debates in the past, without leading to a consensus.

State ownership means here the case where a Member State[212] owns a controlling share in a defence company and may make use of the rights attached to them in order to control the access of potential new shareholders. State ownership of defence assets may also take the form of a corporation with a public status.

State ownership and special rights within the EU have in common that they impact on the participation of investors from other Member States in strategic defence assets. Where the State is the controlling owner of defence assets or the holder of a special right, it may acquire defence operators in private ownership in the other Member States, whereas the private operators may not have similar access to companies in public ownership. The acquisition remains at the discretion of the Member State who controls the target company or holds a special right. Therefore these measures may constitute obstacles to a further integration of the national defence markets, hamper the emergence of a functioning European defence market and delay the consolidation of this sector.

A major difference between State ownership and special rights lies in the legal assessment under the rules of the Treaties. State measures attaching particular rights to a share, which exceed the rights conferred by this specific shareholding under normal company law may be incompatible with the rules on the freedom of establishment and of capital movement (Articles 49 and 63 TFEU). Whether they comply or not, remains to be decided on a case-by-case basis (see Chapter 7 below).[213]

The case of State ownership is different. State ownership of companies or assets may *de facto* likewise have restrictive effects upon other investors, but the same may also be said of private ownership of companies.

European Union law fully respects property rights. Public ownership benefits in the same way as private ownership from the guarantees, which are laid down by the Treaties with respect to property rights, i.e. the right to property enshrined in the Charter of Fundamental Rights (which applies to EU institutions and bodies, as well as to Member

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[212] The subject of public investors from non-EU countries is different and has been addressed under 5.2.2 above.

[213] See ECJ case-law concerning "golden shares" already quoted above.

States when implementing EU law) and recognised by the case-law of the CJEU. Under these rules the *existence* of the property right is fully protected whereas the *exercise* of property rights, whether public or private, may well be subject to restrictions.

Public ownership is in addition subject to Article 345 TFEU according to which the Treaties shall in no way prejudice the rules in Member States governing the system of property ownership. According to the case law of the CJEU, although the system of property ownership continues to be a matter for each Member State under this provision, Article 345 TFEU does not have the effect of exempting such a system from the fundamental rules of the Treaty.[214]

Finally, as Article 106 TFEU shows, the Treaty is neutral in relation to the existence and the creation of public enterprises. The rules of the Treaties apply in the same way to the private and the public sector. Given the Treaty is neutral, and given Article 345 TFEU, secondary legislation cannot differentiate between the private and the public sector so as to discriminate against the latter.

It has to be admitted therefore that neither the *existence* nor the *creation* of public enterprises can be affected by EU action. This applies to all sectors including the defence sector.

Accordingly there is very little room, if any, for intervention for the Commission on the issue of State ownership.

[214] See e.g. Judgments of 23 February 2003, C-452/01, *Ospelt* [2003] ECR I-9743, paragraph 24; 1 June 1999, C-302/97, *Konle* [1999] ECR I-3099, paragraph 38; and of 6 November 1984, *Fearon*, C-182/83, ECR [1984] p. 3677, paragraph 7.

# 7 ON MEASURES REGARDING SPECIAL RIGHTS

According to existing case law of the CJEU special rights retained by Member States in strategic companies may be in conflict with the Treaty rules on the free movement of capital.[215]

## 7.1 Case-law of the Court on strategic assets exists

In Case C-503/99 of 4 June 2002 *Commission versus Belgium* the Court was confronted with a case concerning strategic assets. Subject of the case was a Royal Decree of 1994, which vested in the Belgian State a special right in the Belgian gas supplier Distrigaz. The special right concerned "strategic assets", i.e. the gas infrastructure for the domestic conveyance and storage of gas. The right was to the effect that any transfer, use as security or change in the company's strategic assets must in advance be notified to the minister, and that the minister could oppose and ex post annul any transfer that affects the national interest in a secure energy supply.

The Court admitted that Member States may in pursuit of overriding reasons in the general interest recognised by the Court be entitled to retain influence in companies which provide certain "services in the public interest" or "strategic services". Safeguarding of energy supplies in the case of an energy crisis was legitimate in this sense.

The Court concluded that the Belgian special right legislation was justified by the objective of "*guaranteeing energy supplies in the event of an energy crisis*" provided a certain number of conditions were met.

- The special rights must be necessary on grounds of public policy, public security or similar reasons in the general interest
- The exercise of the special right must be subject to precise and objective criteria

[215] See CJEU in cases C-463/00 *Commission v Kingdom of Spain*; C-98/01 *Commission v United Kingdom* and C-367/98 *Commission v Portugal*.

- The proportionality and a proper procedure have to be respected
- An effective control by the courts must be granted.

The Court added that Member States may rely on reasons in the general interest only for so long as there are no Community measures harmonising them. The following conclusions might be drawn from this case law:

- Special rights designed to cope with the necessity of safeguarding strategic defence assets are Treaty compatible only under certain defined conditions, in particular the application of precise and objective criteria, a justification on grounds of security interests, proportionality, a correct procedure, transparency, and possibility of an appeal.
- The Member States may no longer rely on reasons justifying special rights such as security reasons if harmonisation measures cover their security interests.

No case-law of the CJEU is as yet available concerning the specific subject here, i.e. the exercise of special rights in defence companies.

### 7.2 Interpretative Communication could provide guidance

The Interpretative Communication discussed with regard to Option 2 (see 5.2.5 above) could set out the general principles concerning the interpretation of Article 346 TFEU. These principles would also be relevant for the question of the Treaty compatibility of special rights in defence companies. Therefore the Communication would provide guidance as to the application of the Treaty rules on the free movement of capital to special rights in defence companies in those cases where Article 346 TFEU is relied upon in order to justify the right.

### 7.3 Further monitoring of special rights is required

As mentioned, case-law on special rights related to defence companies does as yet not exist. The Commission could through an Interpretative Communication on the application of Article 346 regarding the control of strategic assets contribute to further legal clarification.

Moreover, some EU Governments have entered into contractual arrangements with other shareholders in order to cope with the necessity of protecting certain strategic defence assets from foreign control. These arrangements render the access of a foreign investor to a company more difficult but there is as yet no case-law of the CJEU clarifying under what conditions contractual measures of this kind can amount to State measures within the meaning of the Treaty rules on the free movement of capital.

Therefore the Commission will have to continue monitoring the use of special rights and contractual or other arrangements that could have the effect of impeding EU investments in strategic defence assets.

# C EVALUATION OF THE OPTIONS FOR INVESTMENT CONTROL

In this Chapter we will evaluate the Options for EU level action that we introduced in the previous Chapter. To this end we will first outline the criteria we use to examine the Options in a Balanced Scorecard. The card will then be applied to evaluate each of the Options we presented.

## 8 CRITERIA FOR THE EVALUATION OF THE OPTIONS

There are a number of different considerations that guide the choice of the appropriateness of an Option. These considerations include legal feasibility, efficiency, political feasibility and technical challenges. Thus, the evaluation of the Options requires what we will call a *balanced scorecard approach*. The balanced scorecard uses a multi-dimensional approach to make an assessment of the advantages and disadvantages of each Option.

### 8.1 Legal feasibility looks at legal basis and its viability

The criterion of legal feasibility addresses the question of to what extent the Treaty allows for the adoption of the suggested measures. For each Option we have outlined the legal basis on which it might be adopted. We have already explained in the Options the legal questions which arise in connection with some of them.

We will therefore come back only to those legal questions which either may have an impact upon the possible choice of an Option or have particular importance for the political debate of an Option.

### 8.2 Efficiency assesses to what extent an Option remedies current problems

Under “efficiency” we will examine to what extent each Option constitutes a remedy for the five problems identified above which characterise the current patch work situation: the fragmentation of the market for defence investments; the lack of transparency in the

area of defence investment activities, in particular for potential investors; the lack of consultations among the competent authorities of the MS and in particular the consequences of the security of supply, the security risk resulting from “Trojan horse”-investments; and last but not least the risk resulting from non-EU investments for the security of the Member States as well as for the security, independence and integrity of the European Union, in particular in terms of security of supply. In case of the EU legislation we will take into account the value added of such a solution.

We will assess to what extent an Option addresses the common management of investment control. We will examine questions such as: How far should the Europeanisation go – should there be a single control procedure, should there be one set of harmonised rules, or should there only be a looser cooperation? Which authority should take the decision on an investment? The answer to these questions depends to a large extent on the appropriateness of an Option with regard to the abovementioned problems, i.e. whether they can put an end to the market fragmentation and the lack of transparency and consultations while at the same time properly addressing the risks that may be linked to certain investments, in particular inward investments or “Trojan horse”-investments.

In this context we will also consider to what extent an Option adequately addresses the changed environment that will be created by the transposition of the Procurement and Transfer Directives. As pointed out above, it can be expected that within two years from now a new legal framework will be effectively applied and the Options have to provide effective solutions within this changed setting.

We will further examine the means that the different Options provide for an informational and consultative cooperation among EU Member States. Information and consultation would allow Member States to take account of the security interests of other Member States or to become aware of the different risks implied by a transaction in the view of other States. This would also allow addressing the security interests of the EU as a whole.

### 8.3 Political feasibility investigates political challenges

Under this criterion we will consider the steps and procedures that have to be taken into account for an Option to gain support for it to pass into legislation and then be implemented. The views of Member States are referred to here both with respect to their views of what would be seen as extension of Union or Commission competence but also because of their views about its implications for transatlantic relationships. The views of the European Parliament are taken into account as much as possible and equally, the views of industry are considered.

We will point to potential issues and open questions that can be expected to be raised should the particular Option be pursued. These questions will need to be addressed at an early stage of the implementation with the specific stakeholders.

### 8.4 Technical challenges examines issues of implementation

We will also examine the technical challenges that the implementation of the Option is likely to face and point to issues that need to be clarified and addressed in the process of an implementation. We will also assess the regulatory burden at EU and at national levels. For example we will ask question such as can the existing national rules and practices remain unchanged or have they to be changed? Will some Member States have to modify their investment control legislation? We will also examine the implications in terms of administrative burden for investors.

# 9 EVALUATION OF THE SIX INDIVIDUAL OPTIONS

## 9.1 Evaluating Option 1: Directive creating notification & consultation obligations for non-EU investments

We recall that this Option consists of a Directive limited to harmonising the national rules on the notification of non-EU investments and on consultations between Member States.

The Directive jointly with national legislation would oblige non-EU investors to notify certain acquisitions of strategic defence assets. To that effect, the Directive would have to define those transactions, which are subject to notification. This requires harmonisation of certain basic definitions, e.g. of the notion of defence enterprises concerned, of non-EU investors, and of the notification threshold. Disregard of the obligation to notify should be subject to sanctions.

There would be no common rules for the review of investments, neither with regard to non-EU investments, nor to investments from other EU countries.

The Member States would have to transpose the rules of the Directive into their internal law.

### *9.1.1 Legal feasibility*

The Option would be legally feasible on the basis of Article 64(2) TFEU, which applies only to third country investments.

As argued above, the introduction of an EU wide notification system for investors from third countries would not, in legal terms, amount to a restriction in trade between Member States and third countries. It represents a mere procedural requirement which is confined to one and the same Member State, corresponds to the notification requirement practiced by Member States under national investment control legislation and (where the

transaction has a Community dimension) by the Commission under the EMCR and increases the transparency of the movement of capital between third countries and the Union.[216] The notification does not fall under Article 346, as the notification is still confined within one and the same Member State, and does, hence, not impinge on the essential security interests of the Member States. The publication of the notification would not require the divulgation of sensitive information.

The obligation to exchange information about the intended transaction and to consult with other Member States could lead to the invocation of Article 346 (1) (a) TFEU whenever a MS relies on the derogation claiming e.g. the sensitive nature of certain information. In this respect the Directive presents a certain legal challenge.

If e.g. the reviewing Member State refuses the exchange of information required by the Directive relying on the sensitive nature of all or parts of the information the consultation of the other Member States concerned would become less effective.

However, Member States concerned which would not be given the occasion of being heard or would not have received the information required for a proper consultation would have the possibility to act either themselves under Article 259 TFEU or to signal problems with other MS' compliance with EU law to the Commission, leaving up to the latter to take action under Article 258 TFEU as appropriate. It would then be for the CJEU to address the legal questions so raised such as the possible scope left by the Directive for reliance upon Article 346 (1) (a) TFEU.

Altogether, the overlap is not such as to question the functioning and the effectiveness of the Directive as a whole. The reviewing Member States could in particular not establish that their essential security interests are hurt by the mere fact that they have to delay the decision by a certain period of time in order to consult the other Member States.

[216] For details regarding the practicality of Option 1 see the discussion above under 5.1.2.

### *9.1.2 Efficiency*

The Option would provide a solution to part of the issues of the current situation only, in particular to the negative consequences of a lack of consultation among EU Member States about the risks or merits of a particular transaction in view of the security interests of the Union as a whole or of other EU countries that are also concerned by the proposed acquisition. Such an improvement of the present situation would be welcomed by a clear majority of Government and industry stakeholders. As an expert from industry stated, "Some kind of consultation/notification amongst MS would make sense because this is lacking at the moment."[217]

Business risks for non-EU investors may be reduced in view of the fact that a consultation between all MS concerned might lead to more appropriate remedies or mitigation requirements. Investors can be sure that a review decision of one Member State will be taken only after a consultation with all other MS concerned, which is not necessarily the case in the current situation.[218] As mentioned above, we would suggest a time-limit for Member States to comment on an intended transaction, combined with a stand-still obligation for the Member State of the target company until such a delay for comments has expired.

The Directive would increase the present degree of transparency for investors and Governments. In comparison to the existing national review procedures all third country investors would know *that* they have to notify an investment in strategic defence assets – and *what* such an asset is. However, the Directive would not improve transparency as to the concrete review rules and procedures applied. For Governments the Directive would imply that they would have a better picture regarding the potential consequences of an investment for their security of supply. Even if their opinion should not be heeded after a consultation a Government could draw its own conclusions and act in a better informed position.

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[217] This opinion is also reflected in the aforementioned fact that LoI countries have concerned themselves with creating such an information and consultation mechanism, albeit without implementing it so far, and in the abovementioned Declaration on Capabilities.

[218] For details regarding the consultation under Option 1 see the discussion above under 5.1.2 (i).

The notification would form the basis for collecting important background information about the state of defence investment activities in the EU. Collecting such information on a standardised basis would place the Member States and the Commission into a better position to monitor the development over time and to assess the appropriateness or even necessity of an EU wide instrument providing for a mandatory review procedure. Obligation to notify and information exchange on notified transactions would thus provide the basis for potential future regulatory steps. It would also be the foundation for introducing all EU Member States to the issue of controlling strategic European defence assets.

Option 1 is by its very nature preparatory and incomplete in that it does not address the security deficit of the Union nor contribute to the phasing out of the national review procedures. Neither market fragmentation nor "Trojan-horse" investments are properly addressed. A major weakness lies with the fact that if the Member State where the target company is based, following notification and consultation, cannot (given that no regime is in place) or does not want to take a decision in spite of concerns expressed by other Member States, the security issues are not solved. However, even if the Member State where the target company is based goes ahead with a decision that does take into account the concerns raised by other Member States, the latter are through the information and consultation in a better position to judge the consequences of a transaction for their security and can act accordingly.

Member States are not prevented by this Directive from relying on the main argument capable of justifying existing national controls, i.e. the "Trojan horse"-justification – a point which has been raised by Government stakeholders in France and Germany. Consequently, this Option does not solve the issue of the fragmentation of the capital market. The various existing review and control legislations would remain in place and Member States could use the absence of investment controls at EU level as a justification to maintain their national measures restricting investments from other Member States. Implications of this kind are however acceptable in view of the fact that Option 1 should be considered as a measure of a limited duration and guided by an approach in stages.

Option 1 presents advantages in terms of efficiency over the EDA CoC discussed below. Only Option 1 would consist of legally binding rules on notification, information exchange and consultation, subject to enforcement and legal review by the CJEU. The

Directive would have supremacy and may, under the conditions identified by the CJEU, also produce direct effect. The legal certainty so created is all the more important as security concerns are being addressed. Moreover, Option 1 could at a later stage be followed up by a second step of harmonisation, to include common rules on investment review (Option 2) or to create a single review mechanism (Option 3). While such a possibility exists in principle also after an implementation of Option 6, the adoption of a Code of Conduct would make a second step of harmonisation more challenging, as no independent institution could control the effectiveness of the Code and Governments could point to an existing solution, independent of how successful the latter works.

### *9.1.3 Political feasibility*

The Option might politically be easier to accept by Governments than a Regulation or a Directive harmonising the national rules on the mandatory review of foreign defence investments. It would not take issue with the decision of the Member States as to whether or not there should be a control of foreign defence investments. A further sign that such an Option might be acceptable is the fact that a certain information exchange and consultation mechanism has been elaborated by the LoI6. Moreover, the French Presidency Conclusion in 2008 recommended such a mechanism with respect to non-EU investors.[219] In addition, the consulted members of the European Parliament considered such a Directive as an appropriate first step for the harmonisation of investment controls among EU countries.

One of the concerns Government and industrial stakeholders raised was related to the potential need to involve intelligence community in the information exchange and consultation. Stakeholders would have to be assured that any information exchange should be subject to the condition that in accordance with Article 346 TFEU Member States are not obliged to supply information the disclosure of which would be contrary to the essential interests of their security.

[219] See Conclusions of the Council of the European Union. Declaration on Strengthening Capabilities, Brussels 11 December.

The national investment control legislation would need to be harmonised with regard to a notification procedure. A notification requirement exists in all EU countries with investment control legislation but the UK. Government and industry stakeholders have expressed concerns about an obligation to notify an intended investment, as this might negatively affect markets, if a Government that has been informally contacted about the merits of an investment is to share that information with other European Member States. The crucial question seems to be, at what point in the notification process Governments will have to inform and consult their EU partners whereas the principle that a notification has to be made is less controversial.

Some stakeholders from Governments and industry have an issue with any Commission involvement in this specific matter, which is partly a reflection of a perceived "regulatory over-burden presently emanating from Brussels". Let us stress therefore that the Commission has no special role to play in the implementation of this Option; the responsibility for notification and consultation lies with solely the Member States. Moreover, also the time when the initiative is launched is of essence. While these stakeholders might prefer Option 6 over Option 1, there is also a view among many stakeholders that unless the Commission takes action, little is going to happen in any other forum, as the involvement of the Commission secures a degree of dynamism and sustained initiative that might otherwise not occur.

#### *9.1.4 Technical challenges*

The implementation of this Option would require the adoption of a Directive at EU level. While all Member States may be informed about a proposed transaction, only MS which are concerned by a notified transaction would have to be consulted by the reviewing MS.

The Option requires the definition of several complex notions such as "European enterprises", "strategic defence assets", "non-EU investor", "Member States concerned". Moreover, it is necessary to establish the threshold that triggers the notification obligation

and the procedures for the notification. Finally, the Directive would need to spell out the rules for the information exchange and consultation mechanism.[220]

The implementation of this Option would benefit from a systematic analysis of the strength and weaknesses of the Security of Supply Implementing Arrangement agreed by the LoI6. As pointed out above industrial and Government stakeholders from different countries provided us with different presentations not only about the state of play of the Implementing Arrangement but also about the reasons for the fact that its application has stalled. A systematic examination of the obstacles to the implementation of the agreement would help to draw valuable lessons for carrying out this Option.

Under the Directive third country investors would be required to multiple filing of their intended transaction. This additional administrative burden would, however, be rather small, as the obligation to notify laid down in the Directive would not represent a significant additional burden compared to the status quo. It would in essence just mirror the obligation to notify which applies since many years to investors under the EMCR and extends to all defence equipment/technologies, strategic or not, within the scope of Article 346 TFEU or not, provided only the conditions of a Community dimension are met. Moreover, the administrative burden on investors would be the same as in the present situation in the countries with national investment control legislation. Only in those countries where such legislation does not exist would the administrative burden be slightly increased as compared to the status quo. Multiple filing implies normally the risk of contradictory decisions by the various Member States concerned; however, consultation among Member States would minimise this risk.

Finally, in face of the concern raised by many stakeholders that this Option would relate only to the external dimension and might therefore have negative repercussions for transatlantic relations, the implementation should include some form of communication to the U.S. industry and Government, as well as other NATO partners as to the goal of the measures. They are aimed as a preparatory means to create a more consolidated defence market within the EU rather than at discriminating against U.S. investors.

[220] For details see the discussion above under 5.1.2.

European industry stakeholders regard the U.S. CFIUS and FOCI control processes as a fact of business life if operating in the United States. They are anxious that this Option would be seen as an attempt to create Fortress Europe and would not wish to see it lead to retaliation of any kind by the United States (Government or Congress) that would make acquiring and operating defence businesses in the United States more difficult than it is today.

#### *9.1.5 Evaluating the Policy Communication*

We suggested above that the Directive could be accompanied by a Policy Communication on the control of strategic European defence assets and on possible ways forward with regard to the external and the internal dimension of control. The main purpose would be to provide guidance to stakeholders but also to ensure alignment within the Commission.

Guidance is all the more required as the Directive envisaged as Option 1 would constitute an initial step within the process of Europeanization of FDI control in that it would be limited in scope to a mere information exchange and consultation at the level of the Member States. Accordingly the Directive would in no way address the important subject of the control of defence investments, whether they come from third countries or from other Member States. The Communication would address this gap and thus constitute an appropriate corollary of the Directive.

##### *a) Legal feasibility*

The Communication is legally feasible.

##### *b) Efficiency*

A Policy Communication could be used by the Commission for different purposes and, hence, at different moments. We discussed it as a complementary measure to Option 1. It could equally be used to structure the public debate, to build momentum and to prepare the ground for action by the Commission.

The Communication would provide a useful basis for a coordinated approach in the EU, providing a shared vocabulary, addressing all relevant stakeholders, not least all EU

governments – also those countries with a small or no defence industries – as well as the EU and national parliaments.

A close coordination inside the Commission, especially with DGs MARKT and COMP is crucial for the success of any measure, especially those including legislative action.

### *c) Political feasibility*

Such a Communication would be a useful step, not least because several Government stakeholders expressed an explicit interest in greater transparency with respect to national controls of defence investments.

Also internally such a Communication would ensure that all Commissioners are on board and committed to the implementation of these measures that touch upon the core of national interests.[221]

### *d) Technical challenges*

A Policy Communication on the control of strategic European defence assets and on option for EU level action would be prepared by the Commission. It would require an inter-service coordination among the different DGs concerned. The relevant committees of the European Parliament and the Council should be kept informed.

[221] The importance of this effect was underlined to us by a former Commissioner.

Table 9.1: Summary of the evaluation of Option 1 (without Policy Communication)

| **Summary of the evaluation of Option 1: Directive creating notification & consultation obligations for non-EU investments** | |
|---|---|
| **Legal feasibility** | Legally feasible on the basis of Article 64(2) TFEU to adopt Directive for the free movement of capital between the Union and third countries<br>Notification by non-EU investors represents no restriction on the movement of capital and does not overlap with Art. 346 for similar reasons<br>Consultation and limited information exchange could trigger invocation of Art. 346, which would be rather difficult to justify and not undermine the Directive as a whole |
| **Efficiency** | A common set of rules on notification requirements (e.g. the type of investment, the strategic assets targeted etc) would facilitate notification and increase transparency for investors<br>Information exchange and consultation can improve the quality of the measures, i.e. lead to more appropriate remedies or mitigation requirements, increase the coherence of national decisions concerning the same transaction and accordingly reduce the business risks<br>Investors and Governments would benefit from more coherent decisions of the different national authorities<br>Governments could better assess the risks for their security of supply (even if their opinion is not heeded after a consultation)<br>More experience as to the state and development of EU defence investment activities can be gained<br>Option 1 is by its very nature preparatory and incomplete in that it does not address the security deficit of the Union nor contribute to the phasing out of the national review procedures and thereby bringing market fragmentation and its negative consequences to an end or remedy security of supply and “Trojan-horse” investment concerns<br>In comparison to Option 6 (Code of Conduct), Option 1 would consist of legally binding rules on notification, information exchange and consultation, subject to enforcement and legal review by the CJEU |

| Summary of the evaluation of Option 1: Directive creating notification & consultation obligations for non-EU investments | |
|---|---|
| **Political feasibility** | Interest in information and consultation has been shown by a majority of Government and industry stakeholders<br>Consulted MEPs considered such a Directive as an appropriate first step for the harmonisation of investment controls among EU countries<br>While some stakeholders are hesitant to an involvement of the Commission in these matters, others have pointed out that unless the Commission takes action, little is going to happen in any other forum, be it the EDA (Option 6) or the Council (Option 5)<br>Government and industrial stakeholders would have to be reassured that the information and consultation obligation is without prejudice to their rights under Art. 346.1 (a) under the condition that they take the security interests of the other MS and of the Union into account |
| **Technical challenges** | National authorities would have to be designated to monitor the notification obligation<br>Burden of multiple filing for third country investors is only mildly increased, as obligation exists today under EMCR and national legislation.<br>Definition of several complex notions such as “European enterprises”, “strategic defence assets”, “non-EU investor” required |

## 9.2 Evaluating Option 2: Directive harmonising the review of non-EU investments & Interpretative Communication

This Option consists of a Directive harmonizing national rules concerning not only the notification but also the review of investments from non-EU countries, as well as information exchange and consultations between Member States. The Member States would have to transpose the rules of the Directive into their internal law and designate or create competent authorities, which would be responsible of the implementation of the national legislation. The national rules so adopted would have to be made binding on third country investors.

The Directive would be limited to the external dimension. It should therefore be complemented by an Interpretative Communication on the interpretation in particular of Article 346 TFEU. An Interpretative Communication would be the appropriate instrument to clarify the legal appraisal of EU investments in strategic EU defence assets while at the same time facilitating possible infringement proceedings in this area.

We will evaluate the two parts of this Option separately, first the Directive and then the Interpretative Communication.

### *9.2.1 Legal feasibility*

A Directive would be legally feasible on the basis of the rules on the free movement of capital. In our discussion of this Option at point 5.2 above we showed in particular

- That Article 40(2) TEU does not prevent legislation in this field
- That EU wide rules on a review procedure do not amount to restricting trade in investments with third countries in a manner contrary to Article 63 et seq. TFEU nor to a "step backwards in liberalisation" within the meaning of Article 64(3) TFEU
- That the Directive may proceed to harmonisation in the interest of the functioning of the internal market and also address security concerns (see the notions of essential security interests in Article 346 and public security interests in Article 65(1)(b) TFEU).

We think that the Directive would not constitute such a step backwards if only for the reason that already the existence of Article 346 and the indicators of its heterogeneous, nontransparent and disproportionate invocation imply that in the field of defence investments no full liberalisation has as yet taken place.[222] One can reasonably expect that the capital movement between the Union and third countries would reach a degree of freedom that would be higher than under the status quo if the risks for the security of Member States linked to FDI were appropriately covered by common objective and transparent rules rather than by the divergent national rules and non-transparent practices prevailing in this area at this stage.

The fact that the Directive would facilitate trade in defence investments between the Union and third countries (as well as indirectly also within the Union) and increase transparency and predictability in this field contributes to the justification of such a Directive.

As already mentioned above under Option 1, the notification does not fall under Article 346, as it is still confined within one and the same Member State, and does, hence, not impinge on the essential security interests of the Member States. The publication of the notification would not require the divulgation of sensitive information.

The obligation for information exchange and consultation might lead some Member States to invoke Article 346 and not to follow this obligation. However, the Directive would cover some of the risks for the security of Member States linked to FDI by providing common objective and transparent rules. Consequently, Member States would have less reason to rely on Article 346.

In order to address the risk the Directive could provide for rules echoing the dialogue procedure between the Commission and the Member States concerned in accordance with Article 348 TFEU.

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[222] For a more detailed discussion of this issues see 5.2.1 (d).

### 9.2.2 Efficiency

This Option would address the major deficiencies of the current situation, though in a less "perfect" manner than the Regulation discussed further below. The Directive would create an EU wide market for corporate control of defence companies for third country investors. This market would operate on the basis of harmonised as opposed to a single set of rules, as Member States may vary in the way they transpose the Directive.

Option 2 would improve the transparency for investors and Governments regarding investment policy, review procedure and mitigation requirements due to the harmonisation of existing and newly adopted legislation. The existence of a harmonised set of rules would simplify the conditions under which third country investors take their investment decisions, as they would face a harmonised set of rules.

As discussed above, Governments could take recourse to Article 346 TFEU, potentially undermining the Directive. However, this risk should not be overestimated as the Directive would also serve the interests of the Member States in greater security of supply and transparency. Moreover, the Commission, enjoying a wide margin of discretion, might determine on a case-by-case basis whether Article 348 TFEU applies or whether infringement proceedings might be an appropriate remedy.

The present Directive would indirectly contribute to a consolidation of the European defence industry driven by European firms. In as much as the creation of EU wide harmonised rules concerning non-EU investments would provide an effective protection from security risks that may be linked to them the Directive lays at the same time the basis for the reduction of national barriers concerning EU investments: it reduces the possibility for the Member States to rely on Article 346 TFEU in order to justify the control of investments from other Member States. In fact, let us recall that certain Member States tend to justify the control of investments from other Member States arguing that they cannot rely on the "security" of an investment from other Member State because in the absence of a review mechanism in all Member States they may in reality be "Trojan horse"-investments, i.e. investments possibly stemming from outside the EU and therefore justifying control measures. If this "pretext" can no longer be used Member States will have one reason less to invoke Article 346 TFEU in order to justify that investments from other Member States threaten their essential security interests.

Moreover, EU investors planning an acquisition of a defence company in another Member State would not be directly concerned by the Directive but may well rely on the Treaty in order to contest national restrictions such as national review mechanisms. In an environment in which the Procurement and Transfer Directives are applied, Option 2 would thus provide an important complementary measure, one that represents a clear advantage in comparison to a Directive limited to rules for notification, information and consultation (Option 1).

However, compared to Option 3 – a Regulation on investment review – the Directive envisaged as Option 2 might not be strong enough to prevent that extending the review mechanisms from now 6 to the 27 MS risks generating incoherent national decisions re the same transaction and conflicts with the EMCR. This is specifically relevant in light of the fact that all Member States have high interest in receiving foreign investments.

#### *9.2.3 Political feasibility*

The present Option constitutes an intermediate solution between a Directive limited to common rules on notification, information and consultation and a Regulation for a single review procedure, to be discussed further below.

At the moment, our stakeholder consultation suggests that the political inclination towards harmonised rules for the review of foreign investments seems to be rather small. Having said this, the attitude might change over time, especially if MS and industry get the chance to collect experience in cooperating in one way or another on defence investment controls within the EU. The political reservations outlined above regarding information sharing and consultation, the potential involvement of the intelligence community and the involvement of the Commission apply to this Option in a similar manner or even more strongly than under Option 1.

More than in the case of Option 1, stakeholders from Government and industry object to the present Option 2, due to concerns about the impact of such a Directive on transatlantic relations and the signal that it would send out of a “Fortress Europe”. European defence companies having invested in the United States or wish to proceed with investments in the United States are likely to oppose action that might render such investments more difficult. A strong reaction may come from the executive and Congress

in the United States (it should be recalled though that the United States have a strict and complex investment control legislation, see the country report).

Some stakeholders from industry and Government might raise objections to this Option on the ground that it would discriminate against third country investors or some of them. The objection may be based on the fact that not all investments in strategic defence assets but only transactions of non-EU investors will have to be notified. In essence, such criticism would be aimed at ensuring mutual market access in relation to countries like the United States or Canada. The answer to this argument can only be that an EU defence market without internal frontiers cannot be created without a minimum of common rules.

Moreover, stakeholders from Government say there are not many investment transactions with a European dimension at present. This statement was also made to challenge the necessity for EU level action, given the "high administrative cost" it would imply. On the other hand, if there are not many cases, then Governments have little reason to worry about a negative impact of EU level action on the investment activity. Hence, even while at present Government and industry stakeholders have been very reserved when faced with the idea of harmonisation in this field the Directive cannot be qualified as politically unfeasible in the long run. It may present a way forward in the future after first experience with harmonisation in the area of defence investment control has been made.

MEPs who have been consulted on this Option have expressed their favour for an EU level review mechanism. While they supported a Regulation suggested as Option 3, they were sceptical as to whether it would be feasible to even implement Option 2 at this point in time.

#### *9.2.4 Technical challenges*

The implementation of this Option would require the adoption of a Directive at EU level and the establishment of a Consultative Committee or special Network of Member States representatives. The latter could also be the forum in which the MS concerned by a transaction could interact with each other.

Member States would have to transpose the Directive i.e. to adopt new legislation or change existing legislation. This would imply quite an administrative effort, which might be difficult to justify given that a number of Member States are not home to many

strategic defence assets. The effort would be "heavier" than that related to the Directive above, which is limited to notification and consultation and does not include a review mechanism.

Multiple filing, i.e. notification to all Member States concerned will be required where proposed acquisitions concern groups of companies with affiliates in different Member States. If notification and review procedure were to be centralised in the country hosting the parent company, the efficiency of the Directive risks being threatened. In fact it can reasonably be expected that the Member States hosting the affiliates would not hesitate to rely on Article 346 TFEU in order to block the proposed take-over of the national affiliates. In other words the Directive could not function properly if notification and review were centralised in the country of the parent company. As mentioned above for Option 1, the burden of multiple filing is not unacceptable; all the more so as investors cope with it under the status quo in countries with investment control legislation, as well as in connection with the Merger Control Regulation for mergers with EU dimension. As already stated above, multiple filing implies the risk of contradictory national decisions; however, the Committee would mitigate this risk.

A Directive would involve the definition of the complex categories such as the assessment criteria or the notion of public investors. Option 2 requires in addition to Option 1 to establish notions of how to treat public investors, which could draw on the Commission's Communication on Sovereign wealth funds.[223] Moreover, it would be necessary to develop assessment criteria and rules for their application by national authorities, as well as procedures to arrive at justified decisions and rules for their publication and appeal of decisions; the Directive would also have to spell out the rules for the information exchange and consultation mechanism.[224]

[223] European Commission A Common European Approach to Sovereign Wealth Funds. COM(2008)115 final. For a more extensive discussion on public investors see 5.2.2 (c).

[224] For details see the discussion above under 5.2.2.

#### 9.2.5 Evaluating the Interpretative Communication and infringement procedures

The Directive could be accompanied by measures addressing the internal dimension, i.e. EU investments. Article 63 TFEU prohibits any restrictions on such investments, and this prohibition is directly applicable to EU investors and target companies. The present Option therefore consists (only) of a Communication from the Commission on the interpretation of Article 346 TFEU in the field of defence investments from other Member States (EU investments). It will clarify the Treaty rules and may prepare the ground for proceedings of the Commission pursuant to Articles 258-260 TFEU against Member States where the control of investors from other Member States exceeds the limits in particular of Articles 346 and 65 TFEU. The objective is to facilitate the abolition and phasing out of any controls for EU investments.

***e) Legal feasibility***

The Communication is legally feasible.

***f) Efficiency***

An Interpretative Communication would in general be a preparatory step towards the phasing out of the internal defence investment controls but and in particular to the improvement of transparency for investors. It would provide guidance on the interpretation of Article 346 TFEU in relation to the Treaty provisions, which prohibit any restriction on investments from other Member States. This would be helpful for investors, defence firms, as well as national authorities.

The Communication would increase the legal security, facilitate legal proceedings and encourage European investors to contest national control measures in the national courts. Such proceedings may be referred to the CJEU and would in that case be similarly effective to institutional infringement proceedings.

***g) Political feasibility***

An Interpretative Communication from the Commission would be seen by most stakeholders as an appropriate step by the Commission. Some Government stakeholders would even welcome such a Communication as it would improve the transparency for Member States how they ought to go about investment controls within the rules of the

Treaty. In as much as such a step would contribute to the application of a more "equal standard" by all Governments across Europe it would also be well received by some industrial stakeholders.

Infringement procedures in this area are highly contested but provide the necessary "backing" threat for any action by the Commission.

### *h) Technical challenges*

An Interpretative Communication on the application of the TFEU in the area of defence investment control would be prepared by the Commission. It would require an inter-service coordination among the different DGs concerned. The relevant committees of the European Parliament and the Council should be kept informed.

Table 9.2: Summary of the evaluation of Option 2 (excluding the Interpretative Communication)

| **Summary of the evaluation of Option 2:** Directive concerning national review of certain non-EU defence investments in strategic EU defence assets | |
|---|---|
| **Legal feasibility** | Legally feasible on the basis of Article 64(2) TFEU to adopt Directive for the free movement of capital between the Union and third countries<br><br>Notification by non-EU investors represents no restriction on the movement of capital as it is still confined within one and the same Member State and limited to increasing transparency; it does not overlap with Art. 346 for similar reasons<br><br>Consultation and limited information exchange could trigger limited overlap with Art. 346; recourse would, however, not undermine the Directive as a whole and moreover be subject to proceedings under Art. 258-260 TFEU<br><br>Review obligation would in our view not imply a step backwards in liberalisation because Article 346 TFEU prevented liberalisation<br><br>Review obligation would create overlap with Article 346 TFEU<br><br>The ordinary legislative procedure applies (unless "step backwards in liberalisation"; Article 64(3) TFEU would then require unanimity in the Council and only consultation of the EP) |
| **Efficiency** | The security of supply of the MS and of the Union would be increased; the supply chain could broaden, the integration of the defence market would increase and the European defence industry would gain<br><br>Option 2 would improve the transparency for investors and Governments regarding investment policy, review procedure and mitigation requirements due to the harmonisation of existing and newly adopted legislation<br><br>The possible recourse to Article 346 TFEU might undermine the Directive but this is not sure because the Directive would also serve the interests of the Member States in greater security of supply and transparency<br><br>The present Directive would indirectly contribute to a consolidation of the European defence industry driven by European firms. In as much as the creation of EU wide harmonised rules concerning non-EU investments would provide an effective protection from security risks that may be linked to them the Directive lays at the same time the basis for the reduction of national barriers concerning EU investments: it reduces the possibility for the Member States to rely on Article 346 TFEU in order to justify the control of investments from other Member States. This presents an advantage compared to Option 1 |

| **Summary of the evaluation of Option 2:** Directive concerning national review of certain non-EU defence investments in strategic EU defence assets | |
|---|---|
| **Political feasibility** | Currently, Government and industrial stakeholders show a rather small inclination towards harmonised rules for the review of foreign investments<br><br>Stakeholders from Government and industry object, due to concerns about the impact of Option 2 on transatlantic relations and the signal that it would send out of a "Fortress Europe"<br><br>Even while at present Government and industry stakeholders have been very reserved when faced with the idea of harmonisation in this field the Directive cannot be qualified as politically unfeasible in the long run. It may present a way forward in the future after first experience with harmonisation in the area of defence investment control has been made. |
| **Technical challenges** | National authorities would have to create legislation and organise review even in countries with little if any defence industry which means a heavy administrative burden<br><br>The high interest of all Member States in foreign investments implies risks with respect to the uniform application of the Directive. Compared to Option 3 – a Regulation on investment review – Option 2 with its consultation obligation might not be strong enough to prevent that extending the review mechanisms (from now 6) to the 27 MS risks generating incoherent national decisions and conflicts with the EMCR re the same transaction<br><br>Multiple filing only mildly increases administrative burden on non-EU investors, as the obligation exists already today under EMCR and national defence investment control legislation. Only the countries where such legislation does not exist would have to create an obligation to notify investments. However, multiple filing implies normally the risk of contradictory decisions by the various Member States concerned. The Committee/Network of representatives of the Member States would be there to minimise this risk.<br><br>Definition of several complex notions such as "European enterprises", "strategic defence assets", "non-EU investor", "Member States concerned" is required. In addition to Option 1 need to establish notions of how to treat public investors, of the assessment criteria and rules for their application by national authorities, as well as procedures to arrive at justified decisions and rules for their publication and appeal of decisions |

## 9.3 Evaluating Option 3: Regulation on a common review of non-EU investments & Interpretative Communication

This Option consists of a Regulation establishing a single common procedure for notifying and reviewing certain direct investments from non-EU countries in strategic defence assets of EU countries. Only one notification would be required even where the target company has affiliates in several Member States. The EU Member States concerned would participate in the joint decision making on an investment; the Member State of the parent company could have a veto right.

Controls of EU investments are as a rule prohibited by the Treaty. An Interpretative Communication should be adopted in order to clarify the legal situation with regard to these investments. It would also facilitate possible infringement proceedings.

### *9.3.1 Legal feasibility*

As outlined above the Regulation could be based on the rules on the free movement of capital or the rules on the Common Commercial Policy or, alternatively on both of these legal foundations. Council and Parliament would act in accordance with the ordinary legislative procedure. The Regulation is legally feasible.

### *9.3.2 Efficiency*

This Option provides a solution that goes furthest in addressing appropriately the problems of the current patchwork situation. While it would be the most efficient solution in terms of security, market integration, consolidation, cost effectiveness and administrative burden, it appears politically rather unfeasible at this stage, also because an agreement on and the implementation of its modalities would be challenging.

The Regulation is the Option that entails the lowest administrative burden and the lowest implementation costs for third country investors and Governments given that Member States need not adopt legislations and that investors benefit from a one-stop shop.

It would create a legally binding and easily enforceable review system for the EU as a whole for the notification and review of third country investments. The existence of one set of rules and its uniform application would ensure a clear and consistent EU defence

investment policy in relation to the world. Together with the suggested measures for the internal dimension the Regulation would make it more difficult for MS to rely on Article 346 with regard to EU investments. A Regulation would also appropriately address these issues in the changed legal environment created by the transposition of the Procurement and Transfer Directives.

The Option would also create a maximum of transparency with regard to policy towards foreign ownership, the review process and mitigation requirements.[225] Process-transparency would increase due to the fact that only one set of rules would be applied, that there would be one entry-point for notifications and review and one set of rules for appeal and publication. A high level of transparency would also be reached by the requirement to publish the main lines of any decision or of any remedies or mitigation measures accepted to avoid a decision. Transparency would increase the predictability for investors and the wider public and facilitate the judicial review by competitors.

This Option would also provide comprehensive data as to how many cases occur, how they are handled, and what the results of the reviews and appeals are. On the basis of this information the Regulation could be easily updated if the need arises.

Moreover, the Regulation would ensure that Member States concerned by a proposed acquisition would have to inform and to consult each other.

### *9.3.3 Political feasibility*

The main challenges associated with this Option are of a political nature and make the adoption of such a Regulation improbable at this stage.

While some stakeholders – especially from industry – admit after some deliberation that a Regulation would represent a "clean and clear" Option, a stark majority of stakeholders from industry and Government were opposed to a single EU review system. Only a minority of stakeholders was open to contemplate such an Option at all, mainly on

[225] This statement assumes that a number of political and technical challenges have been successfully solved. See the discussion below under 9.3.3 and 9.3.4 respectively.

grounds of reduced market fragmentation, increased transparency and protection of countries without investment controls.

Several stakeholders question the legitimacy of the Commission, the Parliament or a European agency to regulate investments in defence industrial assets arguing that the "EU does not invest in the defence industry". Other stakeholder take issue with this view, as they consider research funding through the Framework Programme as a way of the EU to strengthen the defence-related industry.

While in principle the Option would also create a maximum of transparency, it assumes that a common view on defence investments from third countries, in particular from the United States, can be forged among EU countries. Our analysis has shown that the EU case study countries espouse very different attitudes on this subject.[226] Moreover, the decision-making at EU level is by most stakeholders expected to become even more subject of a political struggle than it is currently at national level, where the Ministries of Economic and Defence have to reach an agreement. With a Regulation a European dimension would be added – the goal of it – but the decision might actually become less transparent: "Common decision making would not be black and white but rather a process of negotiation", as one stakeholder from industry put it.

As with the previous Option, one major issue relates to the perception of such a Regulation from outside the EU. This concerns the openness of the EU towards defence investments in general and towards its transatlantic partners in particular. Given the Commission's efforts to liberalise markets a Regulation replacing six different national legislations by one single set of rules applying to 27 Member States and beyond can also be perceived as a contribution to the transparency of the investment conditions to be welcomed by investors. While some stakeholders associate the Regulation with the Merger Regulation, the main concern for industrial stakeholders was different: "From an industry point of view, our concern is not investment but a lack of investment. The more that we make investments difficult the more it becomes the responsibility of the MS to make the investment and they are not doing that!"

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[226] For details see the discussion above under 3.6.1.

Though a Regulation would in fact remove the existing patchwork situation vis-à-vis non-EU investors and reduce the overall administrative burden this Option might in some quarters, not least by the EU's transatlantic partners, be interpreted as "yet another move" towards a "fortress Europe", no matter what the positive effects for non-EU investors might be. To counter that impression would present a challenge of this Option. However, the fact that the strict and complex U.S. legislation is in some countries perceived as an obstacle to investments while in others not, points to the importance of shaping the perceptions of stakeholders and partners in this matter.

#### *9.3.4 Technical challenges*

Next to the political challenges associated with this Option there are also some formidable practical hurdles to overcome.

The implementation of this Option would require the establishment of a special Network of representatives of the Member States (or of a Committee) which would participate in the decision making process.

Moreover, we suggested giving a veto right to the Member State most directly concerned, i.e. the Member State hosting the company or the parent company of a group targeted by a proposed and notified acquisition. This veto right implies the risk of blocking the procedure. Therefore we suggested including into the Directive provisions which mirror and possibly detail the dialogue procedure Commission/Member State concerned laid down in Article 348 TFEU.

More than in the other Options, where national Governments would remain involved in the controls to a far greater extent than in this Option, a single investment control regime would actually imply less of an administrative and regulatory burden for investors, since *several* national control systems would be replaced by a *single* EU Regulation. However, a Regulation might be perceived within and especially outside the EU as an additional "strap" rather than a replacement of existing "red-tape" in EU countries.

The decision-making process would require Member States to share certain information on the proposed acquisition; however, as specified above, elements of information that are essential to safeguard national essential security interests need not be disclosed. The subject of information exchange and secrecy of information will be controversial in

practice. In comparison to the review under the EMCR Option 3 requires the sharing of classified Government (not commercial) information, which gives rise to different problems and is subject to different legal regimes and more stringent restrictions. Let us recall that the information acquired by the Commission pursuant to the EMCR – which may contain business secrets – must not be used for purposes other than the relevant investigation (see Article 17 EMCR). This provides a first protection but will be insufficient for the purposes of the present Regulation. The Regulation should therefore address the technically complex and politically sensitive issue of ensuring effective protection of national classified information released by a Member State. In order to do so, the Regulation could either contain specific rules on this matter or make reference to a distinct applicable regime.

Moreover, the modalities of the "cooperation" between Member States and Commission or Agency can be expected to be controversial.

The Commission or the European Agency to be created would have to acquire sufficient new know how in order to be in a position to act as the responsible public body in this field.[227] This is a new challenge to be met. This challenge is, however, not limited to the Regulation here discussed. As mentioned, the Commission will henceforth have to take the objectives to safeguard the security, independence and integrity of the Union into account whenever carrying out its responsibilities under external EU policies and actions. It will have to develop the expertise required to accomplish this task.

[227] For a discussion of different possibilities regarding the choice of institution see 5.3.3 a above.

Table 9.3: Summary of the evaluation of Option 3 (excluding the Interpretative Communication)

| **Summary of the evaluation of Option 3: A Regulation on a common review of non-EU defence investments in strategic EU defence assets** | |
|---|---|
| **Legal feasibility** | The Regulation concerning the free movement of capital between the Union and third countries could be adopted on the basis of Article 64(2) TFEU (unless Article 64(3) would be held to apply; in that case Article 207(2) TFEU could be used instead)<br>It could be adopted under Article 207(2) TFEU as a framework CCP Regulation<br>It could be based on both these legal bases given that in both these cases the ordinary legislative procedure applies |
| **Efficiency** | The Regulation would contribute to an EU wide protection from security risks linked to non-EU investments, contribute to the phasing out of national security checks, and allow, together with the ECMR, a coherent review of the effects of concentrations involving non-EU investors on security and competition.<br>The security of supply of the MS and of the Union as a whole would be ensured in an efficient and effective comprehensive manner, the supply chain could broaden, thereby contributing to the consolidation of the defence industry and the further integration of the defence market<br>Recourse to Article 346 TFEU is possible but the Regulation would also serve the interests of the Member States in greater security of supply, transparency and coherence. Moreover, the participation of the Member States in a Committee or Network (which should include MoD), as well as the specific dialogue procedure laid down in Article 348 TFEU could mitigate both the effects of the veto right given to the MS most concerned and conflicts arising from Article 346 TFEU<br>Filing only to the Commission would reduce the burden on investors to a minimum; the single framework would facilitate notification, increase predictability and transparency<br>The procedure would have to be synchronised with that of the EMCR |

| **Summary of the evaluation of Option 3: A Regulation on a common review of non-EU defence investments in strategic EU defence assets** | |
|---|---|
| **Political feasibility** | A stark majority of stakeholders from industry and Government were opposed to a single EU review system with only a minority being open to contemplate such an Option at all<br><br>Several stakeholders question the legitimacy of the Commission, the Parliament or a European agency to regulate investments in defence industrial assets arguing that the "EU does not invest in the defence industry"<br><br>Creation of transparency is based on assumption that a common view on defence investments form third countries, in particular from the United States, can be forged among EU countries, which is currently not the case, as our analysis has shown. Moreover, the decision-making at EU level is by most stakeholders expected to become even more subject of a political struggle than it is currently at national level, reducing transparency<br><br>Despite removal of administrative burden, risk of "Fortress Europe"-perception is voiced among stakeholders who fear backslash in markets of third countries<br><br>However ensuring security of supply is key to making Member States fully accept inter-dependence and thereby to bringing about integration and broadening of the supply chain, and a properly functioning EDEM |
| **Technical challenges** | Many controversies have to be settled to implement this Option, for example<br><br>Responsibility for review – the Commission or an Agency to be created – the dialogue procedure under Article 348 TFEU together with the general interest in a coherent assessment of security *and* competition considerations constitute strong arguments in favour of choosing the Commission<br><br>Decision-making process would require Member States to share certain information on the proposed acquisition; however, as specified above, elements of information that are essential to safeguard national essential security interests need not be disclosed<br><br>Modalities of the "cooperation" between Member States and Commission or Agency e.g. how to involve all the relevant players from departments of economy, defence, interior<br><br>The Commission or the European Agency to be created would have to acquire sufficient new know how in order to be in a position to act as the responsible public body in this field |

## 9.4 Evaluating Option 4: Enhanced cooperation enacting Option 1, 2 or 3

It will be recalled that this Option consists of enhanced cooperation between at least 9 Member States who would put in place between them one of the abovementioned legislative Options 1, 2 or 3 concerning the control of investments from third countries in strategic European defence assets. For example, only those MS with significant defence industry such as the LoI6, the Netherlands, Greece, Poland, Finland, or others could start enhanced cooperation. This form of cooperation would remain open for other EU Member States to join at a later stage.

Below we will evaluate only those parts of the Option that are specific to the modus of enhanced cooperation, while all the strengths and weaknesses identified for Options 1 to 3 have to be born in mind.

### *9.4.1 Legal feasibility*

As outlined, Article 20 TEU read together with Articles 326 to 334 TFEU and Article 329 TFEU would provide the legal basis of an enhanced cooperation concerning foreign defence investments. Initiative for legislation would have to come from the Commission.

The Council would need to authorise enhanced cooperation, which would subsequently have to be open to other MS.

The main drawback from a legal point of view of this Option is that enhanced cooperation works only “as a last resort”. One of the pre-conditions is in fact that the aforementioned Options 1 – 3 have been “attempted” but could not materialise within a reasonable period of time at the level of the Union. This condition may be difficult to meet or at least it may be very time consuming to provide evidence thereof.

### *9.4.2 Efficiency*

Assuming that certain Member States start with a fully-fledged EU instrument the cooperation could have satisfactory results only for the participating Member States. In the absence of a comprehensive EU wide instrument the security risks run by the Member

States that do not participate would not be covered. Consequently, market fragmentation of the EU as a whole and nontransparency would persist.

In this context it should be stressed, again, that any measure using enhanced cooperation is clearly a "second best" solution only.

#### *9.4.3 Political feasibility*

Politically speaking, this Option might provide an occasion for those Member States with significant strategic defence assets to engage in cooperation in a limited circle. One would expect that the interest in establishing some form of cooperation on the control of defence assets within a smaller circle would make an agreement on the right approach to non-EU investments easier than among 27 EU Member States. However, in our discussions with Government stakeholders and MEPs a political interest in such a solution has not been expressed.

The Member of European Parliament we consulted for the study regarded this Option as a clearly inferior solution. They specifically pointed out that it would increase fragmentation and nontransparency for investors.

#### *9.4.4 Technical challenges*

It should be noted that currently there is a lack of experience of how to devise, implement and manage enhanced cooperation. If pursued this Option would present a journey into widely unchartered territory, possibly leading to a larger debate of the institutions to be involved at EU level and how the procedures should be set up.

Table 9.4: Summary of the evaluation of Option 4

| | |
|---|---|
| **Summary of the evaluation of Option 4:** Enhanced cooperation of at least 9 Member States who would put in place between them one of t abovementioned legislative Options 1, 2 or 3 | |
| **Legal feasibility** | Article 329 TFEU would provide the legal basis of enhanced cooperation concerning foreign defence investments<br>The authorisation to proceed with enhanced cooperation requires a decision of the Council<br>The Council must establish that the objective of the cooperation cannot be attained within a reasonable period on a uniform basis by the Union as a whole; this condition may be difficult to meet or at least it may be very time consuming to provide evidence thereof<br>The cooperation would have to be open to other MS |
| **Efficiency** | The added value of the Options as to security of supply etc would be limited to the cooperating MS but market fragmentation of the EU as a whole and nontransparency would persist<br>Both these problems are the more pressing, if one assumes that the number of assets deemed to be of strategic importance for the European defence industry spreads in the future, due to the effects of the Procurement and Transfer Directives |
| **Political feasibility** | Government stakeholders and MEPs did not express political interest in such a solution |
| **Technical challenges** | It would require one or more MS to actively pursue such a cooperation, which is rather improbable<br>Currently there is a lack of experience of how to devise, implement and manage enhanced cooperation<br>Further challenges depending on the Option chosen – for details see the discussions of Option 1, 2 or 3 respectively |

## 9.5 Evaluating Option 5: CFSP Council Decision on review of non-EU investments & Interpretative Communication

This Option consists of a Council decision defining the approach of the Union to non-EU defence investments and inviting the Member States to introduce national mechanisms to that effect. The Option could merely refer to the obligation of investors to notify their transactions and of Member States to engage in information exchange and consultation - or extend also to the review of investments.

### *9.5.1 Legal feasibility*

The Option would be based on an intergovernmental approach in accordance with the rules of the TEU on the CFSP, Articles 23 et seq. TEU.

There is as yet no case-law on Article 40 TEU as modified by the Lisbon Treaty in relation to its predecessor Article 47 of the former TEU[228]. In its "ECOWAS" ruling from May 2008 the Court of Justice annulled a CSFP decision of the Council arguing that it should have been adopted under the "Community method".[229] This ruling provided the first interpretation of Article 47 of the former TEU with regard to the delineation of the competences of the Council and the Commission within the CFSP on the one hand and the former EC Treaty on the other hand and strengthened the "Community method in the development of the EU external action".[230] The Lisbon Treaty has further complicated the applicable legal framework. Whereas the first paragraph of Article 40 TEU continues to protect the "*acquis*" under the TFEU, the (new) second paragraph of Article 40 TEU now also protects the CFSP "*acquis*". This makes it very difficult to predict whether the ECOWAS reasoning may be upheld in the future and how the Court would rule on a similar case today.

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[228] This Article 47 aimed, in accordance with the fifth indent of Article 2 EU and the first paragraph of Article 3 EU, to maintain and build on the *acquis communautaire*. This objective is no longer mentioned in the Treaties.

[229] CJEU of 20 May 2008, Case C-91/05 *Commission v Council.*

[230] Hillion, C. and R.A. Wessel. (2009) Competence distribution in EU external relations after ECOWAS: Clarification or continued fuzziness? *Common Market Law Review* 46:551-86.

In light of these considerations a CFSP Option may be legally feasible.

### 9.5.2 Efficiency

This Option would take the intergovernmental route towards national information exchange and review systems for non-EU investments providing a solution to part of the issues of the current situation only, in particular to the negative consequences of a lack of consultation among MS. To the extent that similar national rules are adopted investors would benefit from an improved quality of the review of their investments by different national authorities and Governments could better assess the risks for their security of supply.

A Council Decision adopted under Article 29 TEU would lead to national legislation. However, not all Member States may fulfil their obligation to adopt legislation. The normal enforcement mechanisms for EU law (judicial control by the CJEU) and the principles of supremacy and direct effect do not apply in the context of the CFSP.

In comparison to a Code of Conduct of the EDA, two differences are worth mentioning:

- A Council Decision would extend to all 27 EU Member States (including Denmark) and not only to the 26 participating Member States of the EDA. Given that potentially all EU Member States could adopt rules for the review of defence FDI a Council Decision offered in the long term the possibilities to reduce the fragmentation of the market for corporate control, to improve the transparency for investors, to address the risks for security of supply and those associated with “Trojan horse”-investments.

- The Council structure might find it easier than the EDA to bring together the concerns of the different Departments of Government involved in the information exchange and consultation including Ministries of Economy and Defence.

### 9.5.3 Political feasibility

Having grown accustomed to cooperation on defence and defence industrial matters within the EDA, Stakeholders from Government and industry were not impressed by the possibility to start cooperating on industry and market issues within the Council structure. They gave preference to a mechanism of the EDA. A Council structure was perceived as

more cumbersome and less transparent, which would make access, especially for industrial stakeholders more difficult than a mechanism of the EDA.

The MEPs we consulted regarded this Option as a clearly inferior solution, as it would increase fragmentation and opacity.

#### *9.5.4 Technical challenges*

The Council would need to define a structure that could function as a forum for the information exchange and consultation among Member States. It might delegate this role to the EDA, which has already some responsibility and experience in dealing with related topics. In this case the association of Denmark to the work of the EDA would need to be addressed, as "Denmark does not participate in the elaboration and the implementation of decisions and actions of the Union which have defence implications".[231]

[231] Denmark and the Treaty on European Union. (1992) Denmark and the Treaty on European Union,. *Official Journal* 0001.

Table 9.5: Summary of the evaluation of Option 5

| **Summary of the evaluation of Option 5: CFSP Decision of the Council defining the approach of the Union to non-EU defence investments and inviting the Member States to introduce national mechanisms to that effect** | |
|---|---|
| **Legal feasibility** | Option 5 may be legally feasible. It would be based on an intergovernmental approach in accordance with the CFSP rules – Articles 23 et seq. TEU Article 25 (b) ii TEU and/or 29 TEU would provide the legal basis<br>Article 40 TEU is even more complex than the predecessor norm ex-Article 47 TEU and would probably not stand in the way<br>A precedent is the Common Position 2008/944/CFSP of the Council of 8 December 2008 defining common rules governing control of exports of military technology and equipment<br>The Council would have to act unanimously, see Article 31 TEU |
| **Efficiency** | Option 5 would take the intergovernmental route towards national information exchange and review systems for non-EU investments tackling part of the problems of the current situation only, particularly consequence of lack of consultation.<br>The Decision would be binding upon the MS but the adoption of national rules by the MS would not be subject to judicial control by the CJEU, see Article 24(1)2 TEU.<br>In comparison to an EDA Code of Conduct a Council Decision would extend to all 27 EU Member States (including Denmark) and not only to the 26 participating Member States of the EDA.<br>The Council structure might find it easier than the EDA to bring together the concerns of the different Departments of Government involved in the information exchange and consultation |
| **Political feasibility** | Though Government and industrial stakeholders admitted that a CSFP decision presented one form to cooperate on the issues of defence investment controls they would give preference to a mechanism involving the EDA<br>Consulted MEPs regarded this Option as a clearly inferior solution, as it would increase fragmentation and nontransparency |
| **Technical challenges** | Delegation to EDA would be possible, which has already some responsibility and experience in dealing with related topics. In this case the association of Denmark to the work of the EDA would need to be addressed. |

## 9.6 Evaluating Option 6: EDA Code of Conduct on notification, consultation or on review of non-EU and EU investments

Option 6 would consist of a politically but not legally binding CoC managed by the EDA. The Code would be established by the Member States. It would provide common guiding principles and encourage Member States to adopt, in line with those principles, national rules

- Regarding non-EU defence investments: either for information exchange and mutual consultation or for their review and
- Regarding EU investments: either on a gradual phasing out of national controls of EU investments or on a transitory information exchange system for EU investments.

While we will focus in our evaluation on a Code for information exchange and mutual consultation to allow for a straight comparison with Option 1 (a Directive with the same function) we will at times also comment on other versions of this Option.

### *9.6.1 Legal feasibility*

This Option may be legally feasible pursuant to Article 40 TEU.

Pursuant to Article 45(1)(e) TEU the EDA is entitled to contribute to implementing useful measures for strengthening the European defence industry. This provision entitles the EDA to contribute by a CoC to strengthening the European defence industry. Such a CoC would require an initiative on the part of the EDA or the High Representative, Head of the Agency, as well as a decision of the EDA Steering Board.

### *9.6.2 Efficiency*

A Code of Conduct on information exchange and consultation would provide a solution to part of the issues of the current situation only, in particular to the negative consequences of a lack of consultation among subscribing Member States about the risks or merits of a particular transaction in view of the security interests of the Union as a whole or of other EU countries that are also concerned by the proposed acquisition. Such

an improvement of the present situation would be welcomed by a clear majority of Government and industry stakeholders.

This Option would – like Option 1 – provide a set of rules on notification requirements (e.g. the type of investment, the strategic assets targeted etc) that would facilitate notification, information exchange and consultation. To the extent that similar rules are adopted investors would benefit from an improved quality of the review, i.e. more appropriate remedies or mitigation requirements increase the coherence of national decisions concerning the same transaction and accordingly reduce business risks. Governments could better assess the risks for their security of supply (even if their opinion is not heeded) after a consultation.

However, compared to Option 1, a Code on information exchange and mutual consultation would have several shortcomings:

(a) Denmark does not participate in the activities of the EDA. Hence, the Code would not extend to the entire Union. The Members States participating in the EDA are not bound to subscribe to the CoC and those who would not subscribe would not abide by it. That implies that the information exchange and consultation would always be limited to subscribing Member States.

(b) Even if all countries with significant defence industrial assets would subscribe to the Code, it has to be doubted that the existing significant differences of national legislation would be changed and that the national rules to be adopted would not differ from each other given that under a CoC subscribing MS are at liberty as to the transposition of the rules.

(c) The CoC though binding on sMS, would not be subject to judicial review by the ECJ, and it would not have supremacy over national law nor direct effect. This constellation would make it more difficult to ensure a dynamic in which investors, other Member States and the Commission could contribute to a more transparent application of national investment control legislation. The fact that the LoI Security of Supply Implementing Arrangement has not been put into practice despite a decision by the six Governments raises doubts as to the effectiveness of a Code to be followed by 26 participating MS. It remains open to what extent the EDA's

instrument of "peer pressure" could provide an effective solution to such a problem.[232]

In face of these points the extent to which transparency improves for investors will be rather limited, and definitely more limited than under Option 1.

The EDA would provide for the possibility to collect information on defence investment activities and gain experience concerning their legal treatment, which might prepare the ground for a later establishment of a common legislative review system. However, as mentioned above, while such a possibility exists in principle the adoption of a Code of Conduct would render, from a political standpoint, the case for a second and more advanced step of harmonisation more challenging to make.

A Code of Conduct on the review of investments in strategic defence assets (comparable in content to Option 2 – a Directive – and Option 3 – a Regulation) would by its very nature not be the instrument appropriate to bring the market fragmentation to an end and to remedy concerns about security of supply and "Trojan-horse" investment. For the aforementioned reasons (a) and (b) security of supply concerns could only be remedied among subscribing MS but not among all EU countries. This would, again, raise serious doubts whether participating Member States would under these circumstances agree to address the treatment of defence investments from other Member States, aiming at the gradual phasing out of the national control measures and thereby at overcoming the current fragmentation of the market.

In comparison to Option 1 an EDA Code of Conduct would provide – also a way to address the treatment of defence investments from other Member States, aiming at the gradual phasing out of the national control measures. However, in face of the fact that fragmentation and the associated issues of security of supply can hardly be overcome with the Code, it has to be doubted whether participating Member States would ever agree to go ahead with an abolition of existing EU investment controls.

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[232] We wish to note that the study team did not systematically investigate the reasons for the stalling of the LoI Security of Supply Implementing Arrangement.

### 9.6.3 Political feasibility

On the other hand, the CoC is the Option characterised by a high degree of political feasibility.

A large number of stakeholders expressed that if an EU dimension has to be given to the control of defence investments, then this should come under the oversight of the EDA. Governments underlined the ample flexibility as to the design of the Code and the national rules and the close control regarding the information and consultation, as well as application of national legislation, which does not necessarily have good implications for transparency for investors.

This reaction may be due to the fact that the CoC has several forerunners that serve as a model for MS to pursue this route. It ranges from the EDA CoC on Defence Procurement to the EU Code of Conduct on Arms Exports under the auspice of the Council. While it might be too early to judge the effect of the former, there are some clear signs that the latter Code – now a Common Position – has changed the arms export policy of EU countries. While one recent study found little evidence for an increased harmonisation of the export controls of EU Member States,[233] the Code is said to have not only increased transparency and parliamentary scrutiny[234] but also to have had a normative impact due to the information exchange and consultation among Member States[235].

The Option is also viewed positively because for many stakeholders it is conceived as an extension of the LoI Security of Supply Implementing Arrangement to further EU countries. As one Government official put it "Already through the LoI there are arrangements for transnational companies and those could be adapted specifically for the purpose to control FDI in strategic defence assets. This would be a natural thing for the

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[233] Bromley, M. and Brzoska, M. (2008) Towards a common, restrictive EU arms export policy? The impact of the EU Code of Conduct on major conventional arms exports. *European Foreign Affairs Review* 13:333-56.

[234] Bauer, Sybille. (2003) The EU Code of Conduct on Arms Exports - Enhancing the accountability of arms exports policies? *European Security* 12:129-47.

[235] Bromley, Mark. (2008) 10 years down the track – the EU Code of Conduct on Arms Exports. *European Security Review* 39:1-5.

EDA to do." Again, it should be noted that cooperation on investment controls in the LoI process has run into serious difficulties.

However, as mentioned above there is a view among many stakeholders that unless the Commission takes action, little is going to happen (neither in the EDA – Options 6 or the Council Option 5). There are indications that some Governments pay increased attention to the topic of State control of defence investments in reaction to the present study. They might take up the matter and address it. While such initiative and interest should be welcomed and encouraged, the involvement of the Commission secures a degree of dynamism and sustained initiative, as well as consideration of economic and single market issues in a highly political context that might otherwise be much less thought about.

The MEPs we consulted on this Option were rather hesitant to endorse it. They pointed to the lack of a legal enforcement mechanism and of an effective remedy to the main problems at stake. Moreover, they did not consider Option 6 to be conducive to further harmonisation efforts in the future.

#### *9.6.4 Technical challenges*

At EU level the implementation of this Option would require the adoption of an EDA Code Conduct on notification/information/consultation or also on review, which would require the agreement and active support if not the initiative of the largest armaments producing countries.

The administrative burden for Member States would depend on whether the Code refers only to notification etc. or extends to the review procedure. As in Options 1 and 2 EU Member States that do not have legislation would need to designate an authority (Ministry or Agency) responsible for the notifications, information and consultation (and review) and to adopt legislation obliging all non-EU investors to notify their transactions.

However, in comparison to the Directives of Options 1 and 2 it would be left at the discretion of Member States whether or not to adopt legislation. Moreover, the Member States would have more leeway as to how they design and apply the legislation.

Table 9.6: Summary of the evaluation of Option 6

| **Summary of the evaluation of Option 6: EDA Code of Conduct on notification, consultation or on review of non-EU and EU investments** | |
|---|---|
| **Legal feasibility** | This Option may be legally feasible pursuant to Article 40 TEU<br>The EDA is subject to the authority of the Council<br>Under Article 45(1)(b) TEU it may contribute to implementing useful measures to strengthen the European defence industry. |
| **Political feasibility** | High acceptance among stakeholders from industry and Government:<br>• Ample flexibility as to the design of the Code and the national rules<br>• Possibility for governments to exercise close control regarding the information and consultation, as well as the application of national legislation<br>Consulted MEPs were hesitant to endorse this course of action given that it lacks a legal enforcement mechanism, does not remedy the main problems at stake and is not considered as conducive to further harmonisation efforts in the future |
| **Technical challenges** | Adoption of an EDA Code Conduct on notification/information/consultation or also on review, which would require the agreement and active support if not the initiative of the largest armaments producing countries.<br>As in Options 1 and 2 EU Member States that do not have legislation would need to designate a responsible authority and to adopt legislation obliging all non-EU investors to notify their transactions<br>Compared to Options 1 and 2 MS would have more leeway as to whether or not to adopt and implement legislation |

| Summary of the evaluation of Option 6: EDA Code of Conduct on notification, consultation or on review of non-EU and EU investments | |
|---|---|
| **Efficiency** | Code would provide a set of rules on notification requirements (e.g. the type of investment, the strategic assets targeted etc) that would facilitate notification, information exchange and consultation.<br><br>Information exchange and consultation can improve the quality of the measures, i.e. lead to more appropriate remedies or mitigation requirements, increase the coherence of national decisions concerning the same transaction and accordingly reduce the business risks.<br><br>To the extent that similar rules are adopted investors and Governments would benefit from more coherent decisions of the different national authorities. Governments could better assess the risks for their security of supply.<br><br>However, compared to Option 1, a Code on information exchange and mutual consultation would have several shortcomings:<br><br>(a) Denmark does not participate in the activities of the EDA. Hence a Code would not extend to the entire Union;<br><br>(b) Risk of (continued) significant differences among national legislation;<br><br>(c) The CoC though binding on subscribing Member States, would not be subject to judicial review by the ECJ, and it would not have supremacy over national law nor direct effect.<br><br>For all three reasons a Code would be less effective than Option 1<br><br>An EDA Code of Conduct would provide – in comparison to Option 1 – also a way to address the treatment of defence investments from other MS, aiming at the gradual phasing out of the national control measures. However, in face of continued market fragmentation and the associated issues of security of supply, it has to be doubted whether subscribing Member States would ever agree to go ahead with abolishing the internal EU investment controls.<br><br>A Code would provide for the possibility to collect information on defence investment activities, which might prepare the ground for a common legislative review system. However, such a step might become more challenging, as no independent institution could control the effectiveness of the Code and Governments could point to an existing solution, independent of how successful the latter works.<br><br>A Code of Conduct is by its very nature not the instrument appropriate to bring the market fragmentation to an end and to remedy concerns about security of supply and "Trojan-horse" investment, which Options 2 and 3 would provide to different extent. Hence, it has to be doubted whether participating MS would ever agree to go ahead with action on the internal dimension of EU investment controls. |

## Table 9.7(a): Comparative Summary of the Evaluation of Options (here Options 1 to 3) – RECOMMENDED Option in GREY

| | Option 1: Directive on Notification/Consultation | Option 2: Directive on Not./Cons. & Review | Option 3: Regulation on Not./Cons. & Review |
|---|---|---|---|
| **Main features** | • Notification: Ex ante notification to national authorities mandatory<br>• Consultation and (limited) exchange of information between MS concerned by a proposed acquisition<br>• Review according to national rules<br>• Decision-making by national authorities | • Mandatory ex ante notification of non-EU investments to national authorities<br>• Consultation and (limited) exchange of information within the Network of MS chaired by Commission<br>• Harmonised set of rules for review of non-EU investments by national authorities<br>• Decision by national authorities after consultation of Committee or Network | • Mandatory ex ante notification to EU body<br>• Consultation and limited information exchange within EU Network or Committee<br>• Single set of rules for review by EU body<br>• EU body decides with input and eventually veto right from MS concerned |
| **Legal feasibility** | • Art. 64(2) TFEU to adopt Directive for the free movement of capital between the Union and third countries<br>• Consultation and (limited) information exchange could trigger invocation of Art. 346 TFEU, which would be difficult to justify and not undermine the Directive as a whole | • Art. 64(2) TFEU<br>• The ordinary legislative procedure applies (unless "step backwards in liberalisation"; Art. 64(3) TFEU would then require unanimity in the Council and only consultation of the EP) | 3 possibilities for adoption of a Regulation:<br>• Art. 64(2) TFEU (unless Art.64(3) would be held to apply; in that case Art. 207(2) TFEU could be used instead)<br>• Art.207(2) TFEU, a framework CCP Reg.<br>• Both these legal bases |
| **Political feasibility** | • Interest in information and consultation has been shown by a majority of Government and industry stakeholders<br>• Consulted MEPs considered such a Directive as an appropriate first step<br>• While some stakeholders are hesitant to an involvement of the Commission, others have pointed out that unless the Commission takes action, little is going to happen in any other forum, i.e. EDA (Option 6) or the Council (Option 5) | • Government and industrial stakeholders show a rather small inclination towards harmonised rules for the review of foreign investments<br>• Stakeholders from Government and industry object, due to concerns about the impact on transatlantic relations and the signal that it would send out of a "Fortress Europe"<br>• However, the Directive cannot be qualified as politically unfeasible in the long run. It may present a way forward once experience with harmonisation in this area (e.g. on the basis of Option 1) has been made. | • Majority of stakeholders from industry and Government were opposed with only a minority being open to this Option<br>• Some stakeholders question legitimacy of EU to regulate investments arguing that "EU does not invest in the defence industry".<br>• Requires common view in EU on the appropriate treatment of defence investments from third countries (esp. U.S.), which as yet does not exist |

**Table 9.7(a): Comparative Summary of the Evaluation of Options (here Options 1 to 3) – RECOMMENDED Option in GREY**

| | Option 1: Directive on notification/Consultation | Option 2: Directive on Not./Cons. & Review | Option 3: Regulation on Not./Cons. & Review |
|---|---|---|---|
| **Political feasibility (cont.)** | • Government and industrial stakeholders would have to be reassured that the information and consultation obligation is without prejudice to their rights under Art. 346.1(a) under the condition that they take the security interests of the other MS and of the Union into account | | • Decision-making at EU level is expected to be "even more political" and less transparent than at national level<br>• Risk of "Fortress Europe"-perception and backslash in markets of third countries<br>• However security of supply requires MS to accept inter-dependence, integration and broadening of the supply chain, and a properly functioning EDEM |
| **Technical challenges** | • National authorities would have to be designated to monitor the notification & consultation obligation; considerable admin. burden for MS without existing legislation and even more for MS without defence industry<br>• Burden of multiple filing for third country investors is only mildly increased, as obligation exists today under EMCR and national competition/investment control legislation.<br>• Definition of several complex notions such as "European enterprises", "strategic defence assets", "non-EU investor" required | • Need for legislation and review in all MS (incl. those without industry concerned)<br>• Multiple filing only mildly increases the pre-existing administrative burden of non-EU investors.<br>• Reduction of contradictory decisions by MS through Committee/Network chaired by Commission<br>• Need to agree on additional notions compared to Option 1 e.g. how to treat public investors, define efficient assessment criteria etc. | • Decision on the EU body in charge of implementing the review (Commission or an Agency to be created)<br>• Decision-making process would require MS concerned to share certain information on a proposed acquisition; reliance on Article 346 TFEU in order to protect sensitive information risks undermining the Reg. (but see efficiency)<br>• Modalities of the "cooperation" between MS and Commission/Agency are a legal challenge; e.g. how to involve all relevant bodies, how to synchronise with EMCR & how to grant the MS most concerned a veto right while ensuring the functioning of the Reg. (suggestion: dialogue procedure Art. 348 TFEU)<br>• Commission or Agency in charge would have to acquire new know how in accordance with Art. 21(2) (3) TEU |

**Table 9.7(a): Comparative Summary of the Evaluation of Options (here Options 1 to 3) – RECOMMENDED Option in GREY**

| | Option 1: Directive on notification/Consultation | Option 2: Directive on Not./Cons. & Review | Option 3: Regulation on Not./Cons. & Review |
|---|---|---|---|
| **Efficiency** | • Increased transparency for investors and governments<br>• Improvement of quality of review, e.g. more appropriate remedies, increased coherence of national decisions would reduce business risks<br>• Investors and Governments would benefit from more coherent decisions of the different national authorities<br>• Possibility to collect information for a common legislative review system<br>• Option 1 is preparatory and incomplete, as security deficit of the Union and internal dimension are not addressed<br>• Compared to EDA Code of Conduct Option 1 would be legally binding and subject to supremacy, enforcement & legal review by the CJEU | • Increase of security of supply of MS and Union as a whole<br>• Improvement of transparency and predictability for investors and Governments due to harmonised rules on national review mechanism<br>• Recourse to Art. 346 TFEU might undermine the Directive but this is not sure because the Directive would also serve the interests of MS in greater security of supply and transparency<br>• Directive would contribute to the phasing out of the existing national controls of EU defence investments<br>• It would indirectly contribute to consolidation of the European defence industry driven by European firms<br>• However, interest of MS in FDI implies risks regarding uniform application of the common rules, (as comp. to Opt. 3) & of conflict with EMCR | • Reg. would contribute to EU wide protection from security risks linked to non-EU investments; security of supply would be ensured in an efficient, effective & comprehensive manner<br>• Reg. would ensure, together with the ECMR, a coherent review of effects of concentrations involving non-EU investors on security and competition,<br>• Reg. would prepare and allow the phasing out of the existing national controls of EU defence investments<br>• Recourse to Art. 346 TFEU possible but Regulation would also serve interests of MS re security of supply, transparency, coherence; participation of MS in Committee or Network and dialogue procedure (Art.348TFEU) would mitigate the conflicts<br>• Filing to the Commission only would reduce burden on investors to minimum, increasing predictability and transparency |

## Table 9.7(b): Comparative Summary of the Evaluation of Options (here Options 4 to 6)

| | Option 4: Enhanced cooperation: Opt. 1-3 | Option 5: CSFP decision | Option 6: EDA Code of Conduct |
|---|---|---|---|
| **Main features** | • Specific features depend on which of the Options 1 to 3 is pursued under enhanced cooperation | • May cause adoption of national legislation on decentralised ex ante notification to national authorities<br>• Consultation and information exchange within Network of MS under auspices of the Council (EDA?)<br>• *Sub-Option: May cause very loosely harmonised set of rules for review by national authorities*<br>• Decisions taken by national authorities | • Might cause national rules on decentralised ex ante notification to national authorities<br>• Might cause consultation & limited information exchange mechanism between representatives of the MS<br>• *Sub-Option: Might cause very loosely harmonised set of rules for review by national authorities*<br>• Decisions taken by national authorities |
| **Legal feasibility** | • Art. 329 TFEU; Council authorisation after it has been established that the objective of the cooperation cannot be attained within a reasonable period on a uniform basis by the Union as a whole;<br>• This condition may be difficult to meet or at least it may be very time consuming to provide evidence thereof<br>• Cooperation must be open to other MS | • May be legally feasible, based on an intergovernmental approach – Art. 23 et seq. and Art. 25 (b) ii and/or 29 TEU<br>• Art. 40 TEU would probably not stand in the way<br>• Precedent: Common Position 2008/944/ CFSP re control of exports of military technology and equipment<br>• Need for unanimity see Art. 31 TEU | • Feasible pursuant to Art. 40 TEU<br>• Art. 45(1)(b) TEU: EDA may contribute to implementing useful measures to strengthen EU defence industry |
| **Political feasibility** | • Government stakeholders and MEPs did not express political interest in such a solution. | • Government and industrial stakeholders gave preference to a mechanism involving the EDA over a CSFP decision.<br>• Consulted MEPs regarded this Option as a clearly inferior solution, as it would increase fragmentation and opacity. | • High acceptance among stakeholders from industry and Government<br>• Consulted MEPs were hesitant to endorse this Option given the lack (a) of a legal enforcement mechanism; (b) a solution to main problems; (c) a preparation of further harmonisation in the future. |

## Table 9.7(b): Comparative Summary of the Evaluation of Options (here Options 4 to 6)

| | Option 4: Enhanced cooperation: Opt. 1-3 | Option 5: CSFP decision | Option 6: EDA Code of Conduct |
|---|---|---|---|
| **Technical challenges** | • In addition to the practical challenges specific to the abovementioned three Options enhanced cooperation would in practice require the initiative of one or more MS (in addition to that of the Commission)<br>• Currently, there is a lack of experience of how to devise, implement and manage enhanced cooperation | • Council would need to designate a structure to function as a forum for the information exchange and consultation.<br>• MS without legislation would have to designate a responsible authority and to adopt legislation.<br>• Delegation to EDA would be possible but association of Denmark to the work of the EDA would need to be addressed. | • Code requires support of largest armaments producing countries.<br>• pMS without legislation would need to designate a responsible authority and to adopt legislation obliging all non-EU investors to notify their transactions.<br>• Compared to Options 1 and 2 pMS would have more leeway as to whether or not to adopt legislation and its application. |
| **Efficiency** | • The added value of the Option chosen for enhanced cooperation among Options 1, 2 or 3 as to security of supply etc would be limited to the cooperating MS but market fragmentation of the EU as a whole and nontransparency would persist.<br>• Both these problems are the more pressing, if one assumes that the number of assets deemed to be of strategic importance for the European defence industry will grow in the future, due to the effects of the Procurement and Transfer Directives. | • Option would take the intergovernmental route towards national information exchange and review systems for non-EU investments providing a solution to part of the issues of the current situation only, in particular to the negative consequences of a lack of consultation among MS.<br>• To the extent that similar rules are adopted investors would benefit from an improved quality of the review.<br>• Governments could better assess the risks for their security of supply.<br>• The Decision would be binding upon the MS but the adoption of national rules by the MS would not be subject to judicial control by the CJEU. The normal enforcement mechanisms for EU law and the EU principles of supremacy and direct effect would thus not apply to the national rules to be created. | • A Code on info exchange & consultation would only solve part of the issues of the current situation: negative consequences of a lack of consultation among sMS.<br>• To the extent that similar rules are adopted investors would benefit from an improved quality of the review.<br>• Governments could better assess the risks for their security of supply.<br>• Compared to Option 1 Code would not extend to the entire Union, risk differences among national legislation and, though binding on sMS, would neither be subject to judicial review by the ECJ nor have direct effect and supremacy over national law.<br>• Compared to Option 1 Code would allow addressing internal dimension of control. However, given market fragmentation and security of supply issues the willingness of sMS to proceed has to be doubted. |

**Table 9.7(b): Comparative Summary of the Evaluation of Options (here Options 4 to 6)**

| | Option 4: Enhanced cooperation: Opt. 1-3 | Option 5: CSFP decision | Option 6: EDA Code of Conduct |
|---|---|---|---|
| **Efficiency (cont.)** | | • In comparison to an EDA CoC Option 5 would extend to all 27 EU MS (incl. Denmark) and not only to the 26 participating (and potentially even less subscribing) Member States of the EDA.<br>• The Council structure might find it easier than the EDA to bring together the concerns of the different Departments of Government involved in the information exchange and consultation. | • Possibility to collect information for a common legislative review system; but this step might become more challenging, as no independent institution could control the effectiveness of the Code; Governments could point to an existing solution, independent of effectiveness. |

# D CONCLUSION AND RECOMMENDATION

## 10 CONCLUSION

The Commission defined three main tasks for the present study on State control of strategic defence assets: First, the study team was asked to provide a detailed overview and an assessment of the main national policies and practices used with regard to the control of strategic defence assets. Second, the study team was tasked to identify potential measures to introduce a European dimension to the review of foreign investment in EU countries; and finally we were requested to recommend possible actions at EU level.

As for the first task, we started from the fact that Governments apply an array of means to oversee the defence industry and to shape the expectations of investors. The understanding of "State control" underlying this study included not only investment control legislation but also Government ownership and special rights attached to shares of strategic defence companies as possible means of oversight. We have assessed these different instruments of control in nine in-depth case studies in the six LoI countries, the Netherlands, Poland and the United States and have conducted a survey in the 21 non-case study countries of the EU.

In conclusion we can say that all three means of control are used by Governments to oversee strategic defence assets.

- Four case study countries (France, Italy, Spain and Poland) and a significant number of non-case study countries use State ownership as a means of control. In addition the French Government makes use of contractual arrangements with key shareholders.

- Special rights are still used in four EU countries that is Finland, France, Italy and the UK. The use of special rights has been subject to rulings by the Court of Justice. Hence, in recent years Governments have adjusted their special rights and complemented them by entering into contractual arrangements with defence companies.

- Only six out of 27 EU countries have dedicated investment control legislation (Finland, France, Germany, Spain, Sweden and the UK). The legislation shows significant similarities regarding purpose, responsible authority, use of mitigation clauses and right to appeal. However, considerable differences persist with regard to the activities and the type of investors falling under the legislation, the assessment criteria and the publication of the results of the review process or the appeal decision.

Given that Article 63 et seq. TFEU guarantee the free movement of capital within the EU and in relation to third countries, the application of national investment control legislation requires Member States to justify this control on grounds of essential security interests referred to in Article 346 TFEU or of public security interests under Article 65 TFEU. In other words, by pointing to their security interests they can, under certain conditions, derogate from the Treaty and impose investment controls.

The study team did not find any particular cases where Member States made excessive use of Article 346. Addressing this issue would have been beyond the purview of this study and was hampered by the fact that information, which would allow for an assessment, is not publicly available. Nevertheless, we have found several indicators pointing to a possible lack of transparency and proportionality and to a degree of heterogeneity that would warrant harmonisation.[236]

- We have noted that, with the exception of the UK, Governments do not publicise either the opening of a case nor the final decision. This means that they do not (need to) explicitly invoke Article 346 for the control of an intended transaction. Thus it remains unclear under what exact conditions these Member States deem it necessary to control an investment and when not. It has to be doubted that such a *nontransparent* practice is compatible with a proper exercise of the retained rights under Article 346 TEU.

[236] As to harmonisation and Article 346 TFEU see also 4.3 above.

- Moreover, the systematic controls of intra-EU investments in certain Member States on the basis of criteria which are in essence the same as those applied to non-EU investments can be disproportionate.

- Our analysis shows that national legislation on the control of FDI varies considerably as to the types of assets that are to be scrutinised. Differing legislation and practice of the application of that Article would imply that, to the extent that Member States rely on Article 346, they are likely to do so in a *heterogeneous* manner. The wide range of the number of cases per year in which Governments chose to formally open an investigation provides further evidence for this line of reasoning. This number varies from country to country, ranging from 2-3 cases in Germany and the UK, even less in Sweden and Finland, to 15 to 40 cases per year in France.[237]

Given the lack of transparency and proportionality and moreover the degree of heterogeneity in the application of Article 346, it can be reasonably assumed that there is room to legislate. Recourse to Article 346 is reduced if the security concerns that motivate such recourse are properly addressed by harmonisation.

In assessing the current situation, the study team identified a number of negative consequences for the consolidation of the European defence industry. Though it can be assumed that there are hardly any strategic defence assets outside some form of State control, the fact that 21 countries do not have investment control legislation and that the existing legislation in six countries differs significantly, has at least the following five undesirable implications:

- A fragmentation of the market for corporate control of defence companies;

- Risks for the security of supply

- A lack of transparency with regard to the general policy towards foreign investments, the review process and about mitigation requirements;

[237] See Table 2.5.

- A lack of consultation of EU Member States that are likewise concerned by a national review decision;
- Risks associated with "Trojan horse"-investment to allow to undesirable companies from 3rd countries access to EU.

In our engagement with stakeholders we found that there is no agreement as to

- what the problem is;
- how significant it is;
- how it should be most adequately addressed and
- by whom it should be addressed.

There is, however, a notion that the current situation is not perfect, especially with regard to transparency of the existing legislation and its application in the case study countries.

Regarding the second task of the project, we identified a number of potential actions that would introduce a European dimension in the control of defence assets, in particular the review of foreign investment in EU countries. After briefly discussing the limitations that the Commission faces with regard to measures on State ownership and special rights, we outlined possible actions at EU level for investment control. Herein we distinguished six Options for the external and discussed appropriate complementary measures as for the internal dimension of investment control, considering the different legal bases for action on both dimensions.

Both dimensions are interlinked in that Member States can justifiably claim to maintain national investment control legislation for security reasons for so long as no legislation exists at EU level with regard to third country investments. They, hence, require the maintenance of individual national investment control mechanisms not only for the control of investments from non-EU but also from EU countries (risks of security of supply and those associated with "Trojan horse"-investments). In other words, national investment control mechanisms can only effectively be limited by EU action, if an investment control concerning the external dimension is in place.

All the different Options were evaluated on the basis of our analysis and an extensive consultation of stakeholder from Member States and at EU level. To this end we have engaged with representatives from Governments and industry, in particular with industry associations, not least ASD, individual companies, as well as several Members of the European Parliament.[238]

As for the third task – towards a European approach in the treatment of foreign investment in the European defence sector – the Commission requested the formulation of recommendations for a European approach, which will be outlined in the next chapter. We have formulated our recommendation following our own rigorous analysis of the subject matter and after extensive consultation with stakeholders.

[238] Appendix 4 in Volume 2 of this Report contains a list of all interviewed experts and consulted stakeholders.

# 11 RECOMMENDATION

The Commission has asked us to evaluate and to comment on different Options for a European dimension in the control of strategic assets and to recommend a course of action. In the previous part of the Report we have reviewed all potential Options. In this chapter we are going to outline the actions that should, in our opinion, be pursued at EU level.

## 11.1 On State ownership only limited measures are feasible

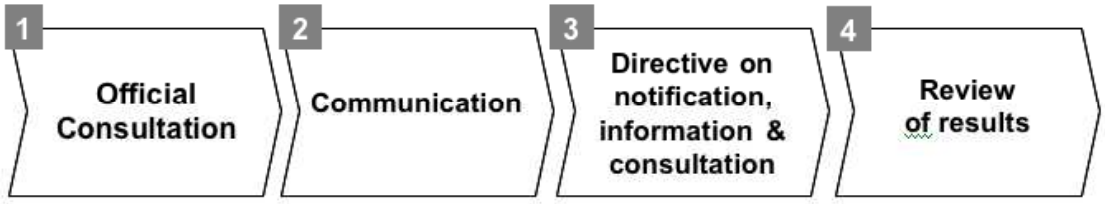
It will have to be accepted that legally speaking there is very little room, if any, for legislative EU measures on the issue of State ownership.

## 11.2 Keep scrutinizing the use of special rights

Regarding special rights we recommend that the Commission continues to monitor the use of special rights for the control of strategic defence assets. This concerns the creation of new golden shares as well as existing rights. As it can be anticipated that some Governments will privatise defence assets and might contemplate the introduction of special rights to exert some form of control in the future it is of importance that an Interpretative Communication on the application of Article 346 with regard to the control of strategic assets will also provide guidance as to the limits of special rights.

## 11.3 Harmonise national investment control legislation in a step-by-step approach

As for a European dimension in the treatment of foreign investment in the European defence sector we suggest that the Commission follows a step-by-step approach. At this point we suggest that it should consist of the following four stages:



We think that such an approach in stages rather than the immediate introduction of a particular Option is appropriate to the problem at hand. It is in particular four arguments that support a step-by-step approach.

- First, a clear majority of stakeholders have indicated that they are busy transposing the Procurement and Transfer Directives and working out the details of the implementation. Hence it might be advisable to await the first results of the full implementation of the two Directives and only then to take action on the issue of defence investment control.

- As pointed out above, a gradual approach, which allows stakeholders to first apply new EU legislation and gain practical experience and only then to complement it in a step-by-step manner, has also been successful in the liberalisation of other sectors such as energy, gas or telecommunications. Equally, the MEPs and a former Commissioner we consulted for this study advised such an approach to ensure the largest possible support for the measure.

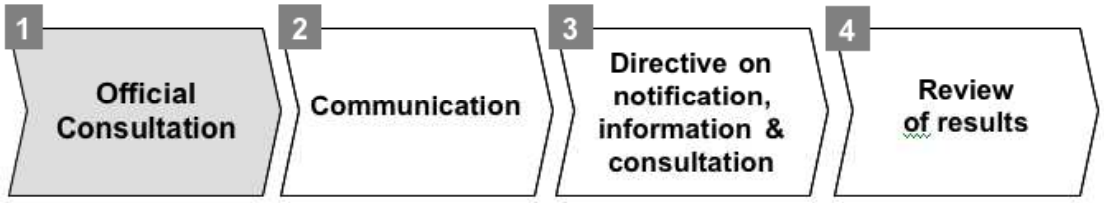
- In addition, our main conclusion is somewhat paradoxical: on the one hand, our analysis shows that there are a number of issues arising from the way the control of strategic defence assets in general and the control of defence investments are handled at the moment. Moreover, stakeholders from Government and industry concede that there are problematic consequences of the current practice. On the other hand, however, there is among stakeholders neither agreement as to the importance of these problems nor on how to deal with them and who should be involved in tackling them. In other words, although all the experts we talked to are aware of the drawbacks of the current situation they have in sum not reached yet a common understanding of the problem, its significance, and the remedies. This challenge is further compounded by the fact that nobody felt in the position to foresee the effects of the Procurement and Transfer Directives on the issue of defence investment controls.

- Finally, given the lack of a more clearly "distilled" understanding of the challenge most stakeholders – except the MEPs and several experts from industry – are extremely cautious of an involvement of the Commission into the subject matter. They hold that Governments, who procure defence equipment from companies in order to equip their armed forces, are better placed to assess to what extent an

investment would pose a threat to national security. However, such a reaction on behalf of the majority of stakeholders is not limited to this particular topic but can be observed in most subjects to which the Commission turns its attention. The initial reactions to the idea of action in the field of defence and security procurement is a case in point, which also shows that opinions can be altered, attitudes softened and standpoints shifted, as a more refined understanding of the problem at hand evolves. A similar change of perspective can be expected to grow over time in the present case too, were the different aspects of the topic are discussed in greater detail and on the basis of more information and facts that underline the growing interdependence of EU Member States in this area. Again, the Procurement and Transfer Directives might be anticipated to show some effects on the subject matter in the mid-term, thereby further "ripening" the idea for the need for EU level action.

After outlining the reasons for a step-by-step approach we will now turn to the individual stages.

#### *11.3.1 Stage One: Start a public consultation*




As a first step the Commission should launch an official consultation in the area of control of investments in strategic defence assets. This could take several forms such as seminars with different stakeholders or the publication of a Green Paper outlining an opinion of the Commission on the movement of capital and possible investment controls with regard to strategic defence assets. Stakeholders and the general public would be invited to comment on the content of the Green Paper and the possible Options for improving the cooperation between EU Member States on this issue.

It is understood that the Commission needs to prepare the ground before it can take any significant action. In particular it needs to make steps towards building consensus about the issues at stake and the benefits for EU level action.

Reasons:

- As mentioned above, there is still no consensus among stakeholders as to what the problem of defence investment control is from a European perspective and how it relates to other issues such as State control in general, security of supply or security of information.

- While we have pointed to facts that imply a nontransparent, heterogeneous and disproportionate use of Article 346 – a situation that would warrant harmonisation – currently, no precise judgement can be made as to the extent that Governments are excessively invoking Article 346 in the context of investment control, as most of the information is in most countries classified. Consequently, it is unknown how many investments in strategic defence assets are exactly made and how many of them have a European dimension (i.e. involve not only the EU target company but also subsidiaries in one or more other EU countries). Moreover, we have argued that the number of cases is likely to increase after a successful transposition of the Procurement and Internal Transfer Directives.

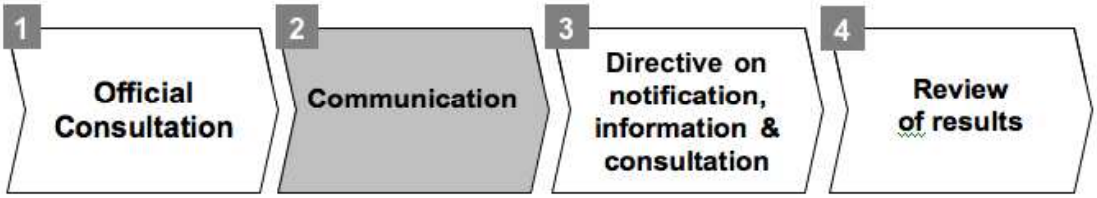
Objectives:

- To identify the extent to which Member States excessively use Article 346 in the area of investment controls and to obtain information for a clear picture about the defence investment activity in the EU, e.g. the type of companies, the contents, the number of cases per year, the number of subsidiaries located in other EU countries involved, the main investors. This information would provide a quantitative backup for the case for harmonisation.

- To stimulate discussion among all stakeholders attempting to build a consensus as to the definition of key concepts, the problem at stake and its significance and the merit of any EU level action in this field.

- To systematically address concerns of potential investors be they from EU or third countries. Some stakeholders raised the problem that any action by the Commission will almost certainly contribute to a perception of creating a “fortress Europe”. This issue should be addressed early on, in particular with regard to the EU’s transatlantic partners.

### *11.3.2 Stage Two: Issue a Communication*




As a second step we recommend that the Commission takes the initiative and publishes a Policy Communication regarding the control of strategic assets and suggesting possible ways ahead to develop a European dimension of control. Rather than interpreting the boundaries of Article 346 with regard to the internal dimension of investment control (Options 2 and 3) or regarding the appropriate use of special rights (Chapter 7), this Communication would present the issues at stake in its context, discuss options to address them and sketch the possibilities for a common way forward.

Reasons:

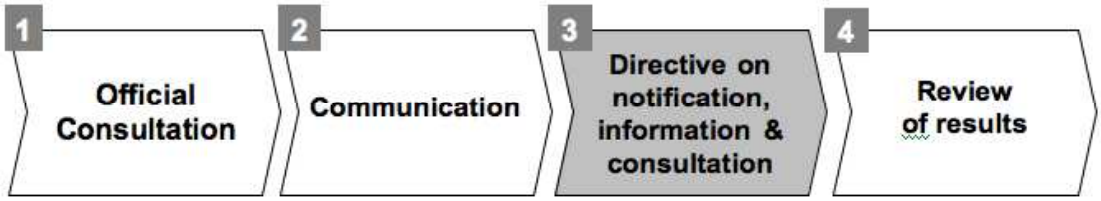
- The Communication could serve as a summary of the understandings reached during Stage One and propose a common understanding of the problem, provide a definition of key concepts and an analysis for tackling the topic at EU and national level.
- Some stakeholders already now expressed explicit interest in a clarification of the Treaty rules with regard to national controls of defence investments. It can be expected that the Official Consultation will point to further issues that will benefit from clarification.
- As mentioned above, such a Communication would also be useful to build commitment inside the Commission. Charting a course of action will clarify to all Commissioners the direction of the envisioned measures and their equity towards all Member States.[239] Moreover, close coordination inside the Commission, especially with DGs MARKT and COMP is crucial for the success of any measure, especially those including legislative action.

[239] This point was forcefully made to the study team by a former European Commissioner.

Objectives:

- to provide the ongoing discussion with a shared vocabulary and key concepts, especially regarding the internal and external dimension of the problem and their interdependence;
- to set out for Member States and all stakeholders what the Commission would consider as good practice in the field of the national review of investments, whether non-EU or EU investments, in European strategic defence assets;
- to underline that the Commission fully recognises and appreciates the particular character of the defence industry and the role that Governments and Parliaments play for it;
- to set out how it expects the Procurement and Transfer Directives to impact on industry and its relations to Governments;
- to outline the different options that are at the Union's disposal for the regulation of the subject matter and explain their added value for a European DTIB;
- to address the concerns of stakeholders regarding the transatlantic relationship.

#### *11.3.3 Stage Three: Adopt a Directive on the notification and consultation for non-EU investments*




If the Official Consultation has qualified and supported the assertion that Member States make nontransparent, disproportionate, heterogeneous and excessive use of Article 346 then we recommend that the Commission drafts a Directive on rules for notification and consultation regarding non-EU investments to be adopted by the Council and the Parliament. If there is a commonly perceived problem with regard to the control of FDI in strategic defence assets, the Commission should take legislative action.

Reasons:

- Only legislative action could lay the groundwork to possibly overcome in the future the negative consequences of the current situation, in particular the fragmentation of the market for corporate control and the opacity for investors but also the risks for security of supply of the Member States and the Union as a whole. A Directive on rules for notification and consultation regarding non-EU investments would present a first step towards a potential more comprehensive legislative solution at a later stage.

- Option 6 would present an alternative path at this stage, with the Commission not taking further action, leaving it to the initiative of the EDA (Code of Conduct) or to the Council (Council Decision based on Article 25 b ii or 29 TEU) to tackle the subject. While such a course of action might under certain conditions (e.g. strong disagreement of stakeholders to an involvement of the Commission) represent the only feasible way forward, let us repeat here the advantages that Option 1 offers over Option 6:

  1. In comparison to the Code of Conduct, Option 1 would consist of legally binding rules subject to enforcement and legal review by the CJEU;

  2. Since Denmark does not participate in the activities of the EDA, the Code would not extend to the entire Union as would Option 1; and due to the fact that subscription to the Code would be voluntary it runs the risk of not even covering all participating MS of the EDA;

  3. A Directive would be more effective in reducing the (continued) significant differences among national legislation;

  4. While many stakeholders are wary towards an involvement of the Commission in the subject matter, there is also a view among some stakeholders that unless the Commission takes action, also Options 6 or 5 are not going to be pursued. There are indications that some Governments are paying increased attention to the topic of State control of defence investments in reaction to the present study. They might take up the matter and address it in other forums. While such initiative and interest should be welcomed and encouraged, the involvement of the Commission secures a degree of dynamism and sustained initiative, as well as consideration of

economic and single market issues in a highly political context that might otherwise be much less thought about;

5. Similarly, the adoption of a Code of Conduct as a first step would make a second step of harmonisation at a later stage more challenging, as no independent institution could control the effectiveness of the Code and Governments could point to an existing solution, independent of how successful the latter works. Subscribing Member States might continue to apply the Code after legislation, thereby rendering the legislation less effective.

- At this stage Commission action needs to focus on the external dimension of investment control. The focus on the external dimension implies that investments from other Member States will not have to be notified and to be addressed commonly.

Objectives:

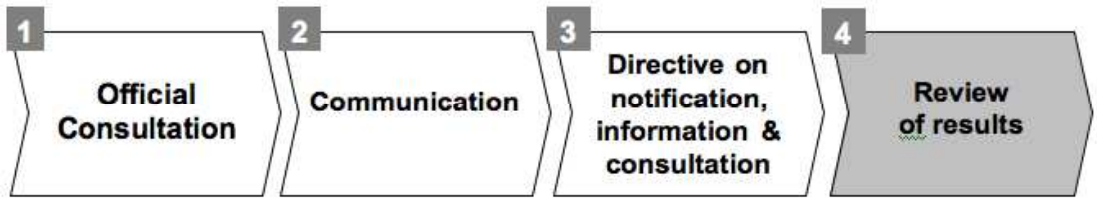
- To provide strong rules that MS have to implement for the creation of national legislation regulating the notification of third country defence investments, as well as the information exchange and consultation among Member States at EU level.

- To create the necessary mechanism for ensuring the notification, information exchange and consultation processes.

- To collect data on the defence number and character of investments in strategic defence assets of the EU originating in third countries.

- To eventually provide a common forum for information exchange and consultation so that stakeholders can collect experience with a European dimension of control, i.e. take into account the security interests of other countries and potentially address the question of a European security interest.

#### *11.3.4 Stage Four: Review the effects of the Directive*



We recommend that after a certain period, e.g. of three to five years, the Directive should be reviewed in order to assess its impact and the need to adapt the legislation. After a period in which stakeholders and the Commission will have had the chance to make firsthand experience with the notification and consultation mechanism the Commission could prepare a report on the results of the measures and the development of defence investment activities. On the basis of such an analysis the Commission could then envisage further action such as the revision of the Directive to include common rules for a review process.

The Directive on notification, information and consultation is limited to a cooperation of Member States in an *informational* manner i.e. the review of individual investments and the decision-making remain in the responsibility of Member States. A review would be beneficial in several respects.

Reasons:

- In order to overcome the fragmentation of the market for corporate control of defence firms and the nontransparency regarding policy, review process and mitigation requirements cooperation on the *management* of investment control among Member States would be required. The review of the Directive could show to what extent this kind of cooperation is indeed needed. In particular the review should assess

    - whether in order to enhance the security of supply of the Union and ensure a better integration of the defence market the review of FDI should no longer be limited to certain MS but be extended to the Union as a whole and

    - whether this should be done by means of a harmonised set of review rules to be applied by all MS on the basis of a Directive or whether it would be preferable to operate a single review mechanism on the basis of a Regulation.

- Some stakeholders, albeit a clear minority, have signalled during the course of this study that they would prefer single EU-wide investment review mechanism so as to create equal opportunities and conditions across the Union. A review of the Directive could assess stakeholder views on the desirability of such a single review mechanism.

Objectives:

To determine the merit of any further action such as the extension of the Directive to include also harmonised rules for the review of defence investments or the adoption of a Regulation on a single review mechanism.

# 12 COMMENT ON THE UNRECOMMENDED OPTIONS

After outlining our recommendation we wish to briefly comment on the reasons why we did not chose to endorse the other Options. Whilst all of them are legally feasible there are certain issues associated with them, which is why we do not recommend them.

- We did not recommend that the Commission would propose a Directive on the review of non-EU investments in combination with an Interpretative Communication (Option 2) largely due to the fact that stakeholders from Governments and industry would hardly accept such a move at this point in time. We acknowledge that this Option would – like a Regulation– address the problems of the current situation efficiently; however, stakeholders are not ready (yet) to support such a solution. As in case of a Regulation most stakeholders do not see the need for such a far-reaching mechanism and some seriously fear negative impacts for transatlantic relations.

- We would not recommend that the Commission proposes a Regulation on the review of non-EU investments in combination with an Interpretative Communication (Option 3) mainly because at this stage the former measure is politically not feasible. Neither Governments nor industry would now be willing and ready to accept such an extensive involvement of the Commission or any EU body and such an extensive form of cooperation, as joint decision-making would imply. Such a measure would also present considerable technical challenges as the EU would need to build up the capability for the assessment of transactions.

- We would not recommend that the Commission takes action under enhanced cooperation (Option 4), as this Option could only be pursued after all other Options have been tried but could not materialise within a reasonable period of time at the level of the Union. There are also political challenges with this Option as it could undermine the internal market and the attempt to establish a *Common* Security and Defence Policy. Moreover, market fragmentation in the EU as a whole would persist, as only a group of countries would have a harmonised or single set of rules, while the other would have no rules at all or maintain their national legislation.

- We would not recommend that action is pursued in form of a CFSP Council Decision regarding the national review of non-EU investments combined with an Interpretative Communication (Option 5), because the mechanism, though binding on Member States, would not be subject to judicial review by the ECJ, and it would not have supremacy over national law nor direct effect. A Council decision would be more inclusive than an EDA Code of Conduct but would, like the Code, only lead to loosely harmonised national rules.

- While Option 6 might under certain conditions e.g. strong disagreement of stakeholders to an involvement of the Commission the only feasible way forward, we would not recommend that in the current situation an EDA Code of Conduct on the review of or on notification, information exchange and consultation about defence investments is adopted: (a) Subscription to such a code would be voluntary, which is why the risks associated with non-EU investments and security of supply could not be efficiently addressed (compared to Options 2 and 3); the Code would also not include all EU MS in an information and consultation mechanism (as would Option 1); (b) The Code would not consist of legally binding rules subject to enforcement and legal review by the CJEU; (c) A Code would be less effective than a Directive in reducing the risk of (continued) significant differences among national legislation; (d) future harmonisation might be more challenging from a political point of view, as subscribing Member States might continue to apply the Code after legislation, thereby creating confusion and undermining legal certainty.

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