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THE CASE FOR A EUROPEAN SYSTEM MONITORING FOREIGN INVESTMENT IN DEFENCE AND SECURITY

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1. Introduction

1.1. *Factual background*

The European Union as a proponent of open frontiers does not control or otherwise restrict capital movements stemming from third countries. The open external frontiers are a guarantee of public welfare and in line with the free movement of capital enshrined in the EC Treaty. However, there are cases where this openness may well be seen as implying risks. The need to further explore the question of secure investment arises in particular in connection with the European defence and security industry. There is no mechanism at the European level that would in any way restrict, control or monitor the acquisition of participations in the European defence industry by third country operators or investors.

The case for the adoption of a common European system monitoring direct investment from third countries ("foreign direct investment" or FDI) in European defence and security-related industries is therefore worth discussion. Such a common regime would harmonize the national control schemes which exist in this field in some Member States but which fragment the investment market. Harmonization of those rules would ensure that investments from third countries which may impact the so-called "European defence technological and industrial base" (EDTIB) – the industrial "backbone" of the security of the European Union – are treated in the same manner. Common rules would thus improve the conditions of intra- and extra-Community investment while at the same time more efficiently combating FDI-related threats to public security and security of supply.

Several attempts have recently been made by third countries to increase their influence over strategic European businesses in the defence, security and energy sectors. Huge foreign State funds raise the fear that certain investments may reflect political strategies rather than financial considera-

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tions.[1] Such a development requires consideration of what the political and legislative response should be.

Moreover, as the experience in other liberalized sectors shows, the progressive creation of an internal market for defence and security-related products within the Union will further increase the attractiveness of the European market to foreign investors. While this is a welcome development and beneficial for the European economy, the European Union should not lack the legal instruments necessary to intervene in those cases where direct investments may threaten security, autonomy or security of supply within the European Union. The investment control applied *inter alia* in the United States shows how serious potential risks to national security are taken elsewhere.

The EU Commission's first reactions to the abovementioned developments have been to lay down in its third energy package of 19 September 2007[2] that, without prejudice to the international obligations of the Community, European energy transmission systems shall not be controlled by persons from third countries. An agreement concluded with one or several third countries to which the Community is a party may however allow for derogation.[3] The proposal of a total ban on foreign control concerns an activity which has the character of a natural monopoly. Obviously, for security-related industries which compete on global markets and need domestic and foreign capital, such a ban would be unsuitable. In their case, it is rather a screening procedure based on the principle of minimum intervention which is required. Rightly the Commission mentioned already in 2003 the need to avoid the sale of the defence-related industries and their reduction "to the status of sub-supplier".[4]

However, no blueprint has yet been envisaged as to how such a common investment control could legally be put in place by the European Union, and how and by whom it should be implemented. Below, the legal background and the various existing national control systems are presented and on this basis the possible legal basis, scope and modalities of a common system as well as the options for its implementation are discussed.

partner of Kemmler Rapp Boehlke, Brussels. Both are founding members of the European Security Forum, Brussels. The views presented here are personal.

1. See section 2.1. below.

2. Proposals of 19 Sept. 2007 for a Directive amending Directive 2003/54/EC concerning common rules for the internal market in electricity, COM(2007)528, and for a Directive amending Directive 2003/55/EC concerning common rules for the internal market in gas, COM(2007)529.

3. See Schmidt-Preuß, "Energieversorgung als Aufgabe der Außenpolitik? Rechtliche Aspekte", (2007) *Recht der Energiewirtschaft*, 281–287.

4. See Commission Communication on "European defence – Industrial and market issues", COM(2003)113, p.11.

1.2. *Legal background*

From a legal perspective, the question arises as to whether the provisions of the EC Treaty provide the basis for the adoption of common rules in this field or whether, because of the relative weight of the security objective within the objectives pursued, the provisions of the EU Treaty on CFSP govern the subject matter.

The EC Treaty contains rules on the internal market comprising "an area without frontiers in which the free movement of goods, persons, services and capital is ensured" (Art. 14(2)). The Commission intends taking them as the basis for the creation of an internal market for defence equipment (EDEM).[5] The EU Treaty for its part contains rules on the Common Foreign and Security Policy (CFSP). On their basis the European Council adopted in 2003 the European Security Strategy[6] ("ESS"). The ESS sets out the Union's responsibilities with regard to European and global security. To achieve these goals, the European Council envisages the need for "more resources for defence and more effective use of resources", recognizing that the systematic use of "pooled and shared assets" will "reduce duplications, overheads and, in the medium-term, increase capabilities."[7]

The European Parliament adopted a resolution "on the implementation of the ESS" in November 2006.[8] It emphasized the need to move ahead on the basis of both the CFSP and the EC rules, in order to achieve:

– an independent European defence industry and an autonomous industrial base providing the necessary defence capabilities, and

– "internal market rules for defence-related products which are adapted to the specificities of this sector".

It claimed furthermore that the rules required for the creation of a European defence equipment market should "give full effect to the principle of reciprocity in trade relations".[9]

5. See Commission Communication on the results of the consultation launched by the Green Paper on Defence Procurement and on the future Commission initiatives, COM(2005)626. See also *Defence procurement in the EU, the current debate*, Report of an EUISS Task Force, rapporteur Burkard Schmitt, May 2005, pp. 16–26.

6. See website <www.consilium.europa.eu>; *A secure Europe in a better world – The European Security Strategy*, European Council, Brussels, 12 Dec. 2003. Revised version of the Presidency Conclusions of the Brussels European Council of 12 and 13 Dec. 2003, Doc. 5381/04 of 5 Feb. 2004.

7. ESS, ibid., p. 13.

8. EP Resolution "on the implementation of the ESS in the context of the ESDP" of 16 Nov. 2006, O.J. 2006, C 314 E/01, p. 334 et seq.

9. Ibid., para 50.

The Parliament also noted that "the derogation provided for in Article 296 of the EC Treaty leaves intact the duty of the Community institutions to legislate on the development of the internal market for defence-related equipment and services, provided such legislation protects the essential security interests of the Member States and of the EU" and claimed "that a high level of protection needs to be achieved".[10]

Common rules on investment control for FDI in the European defence and security-related industries would contribute to both the functioning internal defence and security market and the reliability of the European defence and technology base ("EDTIB").

2. National investment supervision rules

Several but not all Member States have enacted national investment monitoring rules for their defence and security sectors, which apply to EU investments from third countries and from other Member States. Their application erects barriers to the free movement of capital both within the European Union and in relation to third countries which, in principle, and in the absence of justification, infringe the fundamental rules on the free movement of capital laid down in Article 56 EC.

Some Member States without such national legislation rely instead on so-called golden shares, i.e. shares to which special rights are attached which aim at protecting defence or security-related industries. There is ample case law of the ECJ on golden shares[11] demonstrating that it is only under narrow conditions that State measures restricting intra-Community investment can comply with the free movement of capital and the freedom of establishment. In particular, the Member State concerned must be able to rely on an overriding general interest justifying the restriction and moreover show the proportionality of the measure.

With respect to defence and security-related industries, Article 296 EC permits Member States a derogation on the basis of their "essential security interests". Barriers to fundamental freedoms are therefore not incompatible with the EC rules on the free movement of capital and the freedom of establishment in Articles 56 and 43 EC where the conditions of this provision

10. Ibid., para 48.

11. Case C-112/05, *Commission* v. *Germany*, judgment of 23 Oct. 2007, nyr; Joined cases C-282 & 283/04, *Commission* v. *Netherlands*, [2006] ECR I-9141; Case C-98/01, *Commission* v. *United Kingdom*, [2003] ECR I-4641; Case C-463/00, *Commission* v. *Spain*, [2003] ECR I-4581; Case C-503/99, *Commission* v. *Belgium*, [2002] ECR I-4809; Case C-367/98, *Commission* v. *Portugal*, [2002] ECR I-4731, para 47.

are met. Accordingly, barriers resulting from the application of the national investment monitoring rules (including golden shares) may be justified by the security interests referred to in Article 296 EC for as long as the national rules have not been harmonized at the EU level.

It cannot be expected that national rules provide effective protection in an internal market. Investors can easily circumvent national systems by acquiring defence companies in a Member State without controls and subsequently extend their operations to other Member States. The risk is particularly obvious in the case of groups with companies in various Member States.

An overview of certain national investment control schemes will prepare the ground for debate on common rules and how they could be shaped.

2.1. *Germany*

The German Foreign Trade Act[12] read together with the Foreign Trade Regulation[13] forms the legal basis for the control of foreign investments in the national defence and security sectors. Under this Act, "legal transactions and acts in foreign trade and payments may be restricted … in order to guarantee the vital security interests of the Federal Republic of Germany" (Art. 7). Targeted foreign investors are not only non-residents but also resident companies in which non-residents hold a 25 percent stake or more. The restrictions apply to investments aimed at the acquisition of either control or substantial influence upon German military, security equipment and technology companies. This legislation is designed to secure the country's vital and strategic security interests, its ability to cooperate in security and defence matters, and the security of supply for its armed forces. [14]

The substantive test to be applied by the administration is "whether the political and security interests of the Federal Republic of Germany or the military security precautions would be endangered as a result of the purchase" (Art. 7 para 2(5) of the Act).

Any acquisition resulting in the granting of more than 25 percent of the voting rights in a company must be notified[15] to the Federal Ministry of Economics. The Ministry may within one month prohibit the transaction, failing which it is considered legal (Section 52(1) Foreign Trade Regulation).

12. BGBl (Federal Law Gazette) I-1386, 2006, as amended on 18 Dec. 2006, BGBl I-245, 7462, 2006.
13. BGBl (Federal Law Gazette) I-1934, 1993.
14. Bundestag Printed Matter 15/2363 of 15 Jan. 2004, para 5.
15. Foreign Trade Order 13/2004 of 27 Aug. 2004.

Currently, the German Government plans to extend its screening system well beyond the defence and security sector.[16] Foreign investments (also including investments by a German resident in which a non-resident has a participation of more than 25 percent) in any German company which could affect public security or public order may become subject to a clearing procedure. As it stands, the bill does not further specify the substantive test. There may be no duty to notify but transactions without clearance may have to be wound up within a certain time limit. The proposal particularly targets large foreign investment funds, which are State owned and capable of being used as vehicles for political objectives. The underlying policy objective aims at ensuring the reciprocity of investments and at a more effective protection of strategic German undertakings from investors likely to threaten German public interests. Germany relies on Article 58 EC to justify legislation of this kind and points *inter alia* to the US CFIUS system.[17]

2.2. *France*

The French Monetary and Financial Code (Code monétaire et financier) submits investment in the defence sector to similar supervision and prior authorization. Article L. 151–2 specifies that any "foreign exchange transactions, capital movements and settlements" and "[t]he establishment and disposal of foreign investments in France" are subject to "declaration, prior authorization or inspection" by the Minister for Economics, Finance and Industry to "defend the national interest". Such investment is concerned if it is made in an activity in France

> "which, even if only occasionally, concerns the exercise of public authority, or … is likely to affect public order, public health, public safety, or national defence, or is being, or has been, made in research into, or production or trading of, arms, munitions, or explosive powders or substances intended for military purposes or military equipment".[18]

The Order implementing the Code[19] specifies that foreign investments require prior authorization if the investor purchases 33.33 percent or more of the shares of a French company. The Minister can block any relevant transac-

16. *Frankfurter Allgemeine Zeitung* of 31 Oct. 2007, p. 13.
17. Ibid.
18. Art. L. 151–3, Monetary and Financial Code, see Official Journal of 2 Aug. 2003 and 10 Dec. 2004; Order 2000-1223 of 14 Dec. 2000, Off. Journal of 16 Dec. 2000.
19. Order 2005-1739 of 30 Dec. 2006 "*réglementant les relations financières avec l'étranger et portant application de l'article L. 151–3 du code monétaire et financier*", Off. Journal of 31 Dec. 2005; rectification in Off. Journal of 4 Jan. 2006.

tion, impose conditions or require an investor to restore the *status quo* at his own expense.[20]

It is worth noting that under both the German and French foreign trade rules it is the Minister for the Economy not the Defence Minister who is in charge of investment monitoring. This attribution of powers suggests that the policies applied in enforcing the legislation concerned, despite overtly protecting national security interests, are predominantly economic in nature.

2.3. *United Kingdom*

The UK is one of the Member States lacking specific rules on the control of FDI in the defence and security sectors but which nevertheless operates screening on public interest grounds.

The Enterprise Act 2002, which came into force on 1 May 2004, regulates all issues concerning mergers and acquisitions. The Secretary of State for Defence, John Reid, explained in a Defence White Paper[21] how the UK handles foreign investment in British defence operators. The White Paper states that "the Government has a range of instruments to regulate acquisitions and mergers to ensure fair markets and security of supply."[22]

The Enterprise Act 2002, which provides the abovementioned "instruments", charges the Office for Fair Trading (OFT),[23] in cooperation with the European Commission, with taking decisions in its capacity as an independent competition authority. The Defence White Paper specifies that the OFT may take action to intervene in foreign defence investments when "the annual turnover of the enterprise being merged/acquired is greater than £70 million, or if the merger/acquisition will result in a share of any given market or markets of 25 percent or more."[24]

The Act empowers the Secretary of State for Trade and Industry to intervene in planned foreign defence investment on public interest grounds, including national security.[25] Such intervention takes the form of obtaining "undertakings from acquiring companies on retaining defence capabilities in the UK."[26]

20. See Order 2005-1739, Chapter I, Art. 2, ss. 1 and 3.
21. Published Dec. 2005 within the UK "Defence Industrial Strategy" www.mod.uk/NR/rdonlyres/F530ED6C-F80C-4F24-8438-0B587CC4BF4D/0/industrial_strategy_wp_cm6697.pdf..
22. UK Defence White Paper, p. 36.
23. Enterprise Act 2002, Part 1, ss. 1–11.
24. UK Defence White Paper, p. 36.
25. See Sections 42, 54, 56, 59 et seq., 139 et seq. of the UK Enterprise Act.
26. UK Defence White Paper, p. 36.

In addition, and like other EU governments, the UK Government holds golden shares in several major British military firms in order to protect vital defence industrial capabilities.[27] "Golden shares" are priority shares or similar instruments entitling the holders to veto other shareholder actions, which can be used to prevent foreign investors from acquiring control of sensitive companies. As such, golden shares have generally been disapproved of by the ECJ as constituting measures capable of obstructing the free movement of capital.[28] However, in the area of defence and security their use can be preserved to the extent justified by Article 296 EC.

2.4. *USA*

The present analysis would be incomplete without consideration of the system currently in force in the USA. The US applies a broad spectrum of rules restricting foreign investment in the defence and other strategic sectors, and in infrastructure. The main instrument is the Foreign Investment and National Security Act, which has only recently been further tightened.[29] It requires the US President through the Commission on Foreign Investments (CFIUS) to review and if necessary suspend or prohibit foreign acquisitions of US businesses that raise national security concerns (Sections 2 and 6). CFIUS is a multi-agency Committee composed of the Secretaries of the Treasury, Homeland Security, Commerce, Defence, State, Energy, Labor, National Intelligence and the Attorney General (Section 3).

CFIUS is required to conduct an investigation and take the necessary action if a covered transaction "threatens to impair national security". This may in particular be the case if the transaction is foreign government-controlled or would result in control of national critical infrastructure by a foreign person (Section 2). Security-related effects on US critical technologies are further factors to be considered (Section 4).

The industries concerned are not predefined. The security impact is relevant for the scope of the law. The notion of "national security" includes "homeland security" and accordingly the law extends to the acquisition of control of any US critical infrastructure by a foreign person (Section 2). In practice, the investigations concern predominantly the defence industry, but they extend also to the telecommunications, transportation and energy sectors. "Covered transactions" are any merger, acquisition, or takeover by or

27. Apparently *inter alia* in BAE Systems plc (BAE) and Rolls-Royce plc.
28. Cf. *supra* note 11.
29. See US H.R. 556: Foreign Investment and National Security Act, as amended by Law 110-49 of 26 July 2007.

with any foreign person that could result in foreign control of any person engaged in interstate commerce in the US (Section 2).

Notification is not mandatory but a transaction, which has not been cleared, may be annulled. The CFIUS Committee and the investor may negotiate mitigation agreements designed to eliminate the threat to national security (Section 5). The investigation procedure is secret and of limited duration.

The European Commission refers to further restrictive US rules in its 2006 Report on "US Barriers to Trade and Investment".[30] Of particular relevance here, the Report lists a large number of import and procurement restrictions applying to the defence and security sectors. The US rules are moreover characterized by exemptions favouring specific nations with bilateral agreements.[31]

Given that the US is the world's largest defence market and the EU Member States' principal partner in defence procurement, the CFIUS system has an impact on the European Union. US firms do not tend to regard the fragmented European market as being of particular importance in their overall strategies, but a number of such firms have nonetheless made substantial investments in purchasing controlling or influential stakes in European defence undertakings. Such investments enable US firms to secure access to European defence procurement, obtain technology and know-how, and are currently only regulated by national rules, if at all.

In contrast, European firms confronted with the current CIFIUS system have made relatively few inroads into that market. Also, collaborative efforts between European and US defence contractors have often lacked reciprocity in market and technological access.[32]

3. International trade law

Measures as discussed here would normally be adopted and applied "without prejudice" to existing international obligations. This proviso has also been

30. See Commission (DG Trade) report "U.S. barriers to trade and investment Report for 2006", Feb. 2006.

31. See e.g. list of countries exempted from the restrictions of the Buy American Act and the Balance of Payment Program in US defence acquisition from foreign sources, Part 225 Subpart 872-1 Defence Federal Acquisition Regulation Supplement, <www.acq.osd.mil/dpap/dars/dfars/html/current/225_8>.

32. Note e.g. obstacles presented by the US International Traffic in Arms Regulations ("ITAR") in giving European companies access to US technologies within the scope of the Joint Strike Fighter project.

used by the Commission in its recent proposal on European energy transmission systems, intended to prevent their control by third countries.[33]

It is nevertheless of interest to shed some light on whether the adoption of common rules restricting the free movement of capital between EU and non-EU countries for the defence and security sector would be impeded by international trade law.

The main international trade agreements to which the European Union and all Member States are contracting parties are GATT, the Agreement on Government Procurement (GPA) and the Agreement on Trade-Related Investment Measures (TRIMs).

The GATT applies only with respect to measures concerning trade in goods and is thus inapplicable to the present context. The "security exception" laid down in Article XXI GATT is nevertheless of interest. It effectively provides a waiver of the obligations entered into under the GATT,[34] disapplying the agreement from any action taken by a contracting member 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".

The 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. Article XXIII paragraph 1 provides for an exception which broadly reflects the exemption already noted in the GATT, i.e. for any measure a signatory State "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". In sum, the GPA does not apply to investments and moreover contains a broad exception for national security interests.

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 in-

33. See above Section 1.1.

34. Hahn in Callies and Ruffert (Eds.), *EUV/EGV*, Art. 133 EC para 159; Schloemann and Ohlhoff, "'Constitutionalization' and dispute settlement in the WTO: National security as an issue of competence", 93 AJIL (1999), 424–451.

corporates by reference all exceptions laid down in GATT 1994 and therefore offers the same derogations as noted above.

In conclusion, investments in the defence and security-related sectors appear not to be subject to liberalization at the level of international law. The general stance taken by the existing agreements further indicates that were such liberalization steps taken, they would be subject to derogations phrased in terms similar to those noted above. Accordingly, international rules would not at this stage restrict the freedom of the European Union to install a common monitoring scheme for non-EU investments in defence and security-related industries.

4. Does the EC Treaty provide a basis for a common investment monitoring system?

4.1. *Applicability of the EC Treaty*

As already mentioned, it needs to be determined whether the subject matter of monitoring investments in defence and security-related industries established within the European Union is a matter covered by the provisions on the free movement of capital and the freedom of establishment of the EC Treaty or by the provisions of the Common Foreign and Security Policy in Title V of the EU Treaty. This delimitation of the spheres of competence of the European institutions under the first and second pillars is governed by Article 47 TEU. Moreover, the distribution of powers between the Union and the Member States is relevant, and in this matter is governed by the security exception in Article 296 EC.

4.1.1. *A matter for internal market rules rather than CFSP*

Pursuant to Article 47 TEU, "nothing in this [EU] Treaty shall affect the Treaties establishing the EC…". In other words, the EU Treaty leaves fully intact the competences granted to the European institutions under the EC Treaty. As Advocate General Mengozzi noted recently, the function of Article 47 TEU is to protect the competences conferred by the provisions of the EC Treaty against any encroachment by acts claimed to fall within the scope of Titles V or VI of the EU Treaty.[35] As he rightly stressed, Article 47 TEU aims to keep watertight, so to speak, the primacy of Community action under the EC Treaty over actions undertaken on the basis of Title V and/or Title VI of the EU

35. Opinion of A.G. Mengozzi of 19 Sept. 2007, Case C-91/05, *Commission* v. *Council* (*ECOWAS*), pending.

Treaty, so that if an action *could* be undertaken on the basis of the EC Treaty, it *must* be undertaken by virtue of that Treaty.[36]

In the present case, action could, and accordingly should, be undertaken on the basis of the rules of the EC Treaty because this Treaty covers the subject matter at issue and provides the necessary competence.[37] In this regard the following considerations apply.

The measures discussed here aim in the first place at the better functioning of the internal capital market. If Member States apply different schemes restricting foreign investments in the defence and security-related industries these investments may be deflected and the capital market distorted.

The fact that rules extending their effects to third countries are at stake does not prevent reliance on the internal market rules. The *ERTA* doctrine may be recalled here, according to which internal competences under the EC Treaty may at the same time provide powers to act externally.[38]

Moreover, Article 57(2) EC expressly enables the Council to "adopt measures on the movement of capital to or from third countries involving direct investment". The adoption of measures to restrict direct investments from third countries is therefore part of the internal market competences which the provisions of the EC Treaty confer on the Community (Art. 14(2) EC).

This view is confirmed by the fact that the measures at issue would also aim at increasing the competitiveness of the European defence technological and industrial base. Article 157 EC expressly grants the powers to enhance the competitiveness of the European industry. They may be used "through the policies and activities it pursues under other provisions of this Treaty", i.e. also through the internal market policy under consideration.

The fact that the common rules should also create additional safeguards, i.e. increase public security, ensure the autonomy of the EDTB and enhance the security of supply,[39] is insufficient to bring the intended measures under the banner of the CFSP. The EC Treaty has its own notion of public security, as can be seen for instance in Articles 30, 46, 55, 58 and 296 EC, and allows the pursuit of this general interest in the context of harmonization measures aimed at improving the conditions for the functioning of the internal market,[40]

36. Ibid., para 116. See also recent cases such as Case C-440/05, *Commission* v. *Council*, judgment of 23 Oct. 2007, nyr, and earlier Case C-176/03, *Commission* v. *Council*, [2005] ECR I-7879, in relation to the first and third pillars.

37. In the alternative, see Section 5 below.

38. Case 22/70, *Commission* v. *Council*, [1971] ECR 263, paras 16–29. See Oppermann, *Europarecht*, 3rd ed. (Beck, 2005), section 30 para 19.

39. See Case 72/83, *Campus Oil and Others*, [1984] ECR 2727, para 34.

40. Case C-491/01, *British American Tobacco (Investments) and Imperial Tobacco*, [2002] ECR I-11453 para 75.

as is the case here. Article 47 TEU therefore requires the action discussed to be undertaken on the basis of the EC Treaty.

4.1.2. *A competence of the Union rather than of the Member States*

The question remains whether the Member States could rely on Article 296 EC in order to contest the powers of the European institutions in relation to foreign defence investments. Under this Article, "any Member State may take such measures as it considers necessary for the protection of the essential interests of its security which are connected with the production of or trade in arms, munitions and war material."

The Commission clarified the interpretation of this provision in an interpretative Communication.[41] Referring to the case law of the ECJ, the Commission held that the aim of the provision is "to ensure that the derogation remains an exception limited to cases where Member States have no other choice than to protect their security interests nationally."[42] Indeed, the ECJ itself has ruled that derogations such as Article 296 "deal with exceptional and clearly defined cases".[43]

The derogation is thus confined to exceptions on a case-by-case basis and for this very reason cannot prevent the adoption of legislative measures which are by definition general in scope. This is also the view of the Commission in its recent proposals on defence procurement and intra-Community transfer, intended to bring the national defence equipment markets closer together.[44]

Accordingly, Article 296 EC does not entitle the Member States to contest the powers of the Union as they apply in the present context. Nor could the principle of subsidiarity laid down in Article 5(2) EC be relied upon by the Member States. Under this principle, the Community acts only if the objectives of the proposed action cannot be sufficiently achieved by the Member States and can, by reason of the scale or the effects of the proposed action, be better achieved by the Community. In this respect, it is sufficient to recall that a common instrument can provide a more efficient protection than national

41. Interpretative Communication on the application of Art. 296 EC in the field of defence procurement, COM(2006)779.

42. Ibid., p. 5.

43. See Case C-414/97, *Commission* v. *Spain*, [1999] ECR I-5585, para 22; Case C-273/97, *Sirdar*, [1999] ECR I-7403; Kielmansegg, *Die Verteidigungspolitik der Europäischen Union* (Stuttgart, Boorberg, 2005), p. 187; von der Groeben and Schwarze (Eds.), *EU-/EG-Vertrag* (Nomos, Baden-Baden, 2003), Art. 296 EC para 2 et seq.

44. See Commission Proposals for Directives of the EP and the Council of 5 Dec. 2007 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, based on Arts. 47(2), 55 and 95 EC, and on simplifying terms and conditions of transfers of defence-related products within the Community, based on Art. 95 EC.

legislation or golden shares. Although it remains the responsibility of each Member State to protect the defence and security-related industries operating under their jurisdiction, it is crucial for the security of the Union to ensure that one or more Member States are not made vulnerable by weaknesses or lower security standards in other Member States. Moreover, uniform substantial and procedural rules for FDI screening will result in gains in efficiency, coherency and legal security while also underscoring the weight, which needs to be given to applying the reciprocity principle in this field.

4.2. *Applicability of the internal market rules*

4.2.1. *Legal basis may be Articles 57(2) and 47(2) EC*

The free movement of capital laid down in Articles 56 to 60 EC is one of the four fundamental freedoms enshrined in the EC Treaty. Under Article 56(1) EC, "all restrictions on the movement of capital between Member States and between Member States and third countries shall be prohibited". It is a peculiarity of the free movement of capital that it extends to movements between the EU and third countries and therefore prohibits, as a rule, restrictions on the movement of capital between the EU and third countries.

Under Article 57(2) EC, first sentence, the Council is however entitled to restrict the free movement of capital in relation to transactions to or from third countries, and this particularly with respect to "direct investment". It lays down that: "Whilst endeavouring to achieve the objective of free movement of capital between Member States and third countries to the greatest extent possible and without prejudice to the other chapters of this Treaty, the Council may, acting by a qualified majority on a proposal from the Commission, adopt measures on the movement of capital to or from third countries involving direct investment…"

The common measure would genuinely have as its object the improvement of the conditions for the functioning of the internal market. It would be directed at eliminating those barriers to the free movement of capital between the Member States, which at this stage result from the application of existing national schemes (e.g. in Germany and France) to third country investors. The fact that some Member States have such legislation and others do not maintains a market fragmentation, which is deplorable. A "no" in a controlling State can easily be circumvented through the open door of another Member State.

Furthermore, the barriers which at this stage apply within the Union to investments from other Member States would be further reduced if the substantive criteria to be applied to investments from other Member States were to be harmonized. Scrutiny exclusively in the light of the national security interest is in fact an outdated and counterproductive perspective.

The ECJ rightly held[45] that a directive which genuinely has as its object the improvement of the conditions for the functioning of the internal market can be adopted on the basis of the internal market rules (Art. 95 EC), even where another objective was a decisive factor involved in harmonization: "…it is no bar that the protection of public health was a decisive factor in the choices involved in the harmonizing measures which it defines".

This case law confirms that reliance on the internal market rules, in particular Article 57(2) EC as the legal basis is valid even though, in addition to the internal market objectives, the objective of increasing public security will also be a decisive factor involved in harmonization.

Let us add that the Treaty rules relating to the free movement of capital, Article 56 et seq. EC, appear to be more specific to our subject than the rules on the freedom of establishment, Articles 43 et seq. EC, even though they often overlap.[46] For present purposes it is decisive that the rules on the free movement of capital apply also in the relationship "between Member States and third countries", whereas the rules on the freedom of establishment are limited to "nationals from other Member States" and accordingly do not extend to investors from third countries. Moreover, in its case law on "golden shares" concerning the assessment of restrictions on direct investment, the Court gives preference to the applicability of the rules on free movement of capital over those on freedom of establishment, holding that where an infringement of Article 56(1) EC has been established, there is no need for a separate examination of the measure at issue in the light of the Treaty rules concerning freedom of establishment.[47]

4.2.2. *Harmonization of security interests*

In order to prevent the applicability of the defence and security derogation in Article 296 EC, the common measure would have to cover all the risks for the essential security interests of the Member States within the meaning of Article 296 that may be associated with third country investments in the European defence and security sector. Such risks may result from a variety

45. *British American Tobacco (Investments) and Imperial Tobacco*, cited *supra* note 40, para 75.

46. This overlap has been dealt with by the Court in particular in taxation cases, such as Joined Cases C-374 & 446/04, *Test Claimants in the FII Group Litigation* [2006] ECR I-11673, or Case C-157/05, *Holböck* v. *Finanzamt Salzburg-Land*, judgment of 24 May 2007, nyr.

47. See e.g. Cases C-282/04 and C-283/04, *Commission* v. *Netherlands*, [2006] ECR I-9141 para 43; Case C-463/00, *Commission* v. *Spain*, [2003] ECR I-4581, para 86, and *supra* note 11.

of factors, including the absence of reciprocity in the access to the respective markets, circumstances related to the investor (State funds are conceived to imply particular risks), a threat to the security of supply, the need to protect a given technology or other circumstances.

If the common measure is able to attain this objective and accordingly affords an adequate degree of protection of the public security objective, Member States no longer have any valid reason to rely on their national security interests. The common measure would address the relevant risks while and at the same time facilitating the free movement of capital. With respect to security matters outside the CFSP there is no stringent legal reason why the security interests referred to in Article 296 EC should not also be amenable to harmonization, as is for instance health protection.[48]

4.3. *Procedural requirements for a common system*

Article 57(2) EC provides in its first sentence that the Council may adopt the necessary measures acting by a qualified majority on a proposal from the Commission, but lays down in its second sentence that unanimity is required where the measures taken constitute a "step back" in Community law as regards the liberalization of the movement of capital to or from third countries. Common investment monitoring rules would not appear to constitute such a "step back" given that investments in the sectors at issue have not, at least not expressly, been subject to liberalization of the free movement of capital, neither within the Union, nor to/from third countries. Article 296 EC and the comparable derogations prevailing in international trade agreements[49] have prevented such liberalization.

Article 57(2) EC does not specify the role of the European Parliament in the legislative decision-making process, though today the Parliament is, as a rule, consulted. Pursuant to Article 192(2) EC the Parliament also has the option to request the Commission to exercise its right of initiative for an act "required for the purpose of implementing this Treaty". The Commission for its part is bound, as a rule, to comply with the Parliament's request.[50]

4.4. *Modalities of a common system*

The purpose of the common rules would be the harmonization of the existing national control schemes. Accordingly, no additional burdens need be im-

48. Case 376/98, *Germany* v. *European Parliament and Council*, [2000] ECR I-8419; and *British American Tobacco (Investments) and Imperial Tobacco*, cited *supra* note 40, para 75.
49. See Section 3 above.
50. Haag in von der Groeben and Schwarze, op. cit. *supra* note 43, Art. 192 para 18.

posed on investors. The modalities should ensure that the investment screening entails a minimum intervention, thus obeying proportionality.

4.4.1. *The scope of the measures*

The system should aim at protecting the defence and security-related industries and service providers established in the Union. It could also include other sensitive or strategic industries as required, e.g. belonging to the so-called critical European infrastructure[51] such as essential networks. As mentioned, energy transmission systems are already the subject of a Commission proposal.[52]

As indicated, capital transactions involving investments from third countries could be focused on in the first place. The national control of defence investments might at this stage remain in place insofar as it applies to investments from other Member States. However, in order to avoid any discrimination, the substantive criteria applied to investors from other Member States have to be aligned to those applying to third country investors. Moreover, national legislation cannot continue to protect national security interests exclusively.

4.4.2. *The transactions concerned*

Only those transactions that entail the control of the target company or grant a significant degree of influence upon the target company should be considered to fall under the common rules. The influence could be measured in terms of the percentage of shares or voting rights acquired in the target company, as in the existing French or German systems. Transactions concerning companies with reduced turnover or operations could be exempted from the common screening system and remain subject to national rules where they exist.

Proper safeguards would have to be laid down to ensure compliance with the regime. An obligation to notify the defined transactions is not indispensable. It may suffice to define the period of time within which transactions that have not undergone clearing have to be wound up.

4.4.3. *The substantive criteria*

Notifiable transactions could be subject to authorization for public security reasons. The substantive criteria or "test" to be applied could be modelled on

51. Proposal for a Directive of the Council on the identification and designation of European Critical Infrastructure and the assessment of the need to improve their protection, COM(2006)787.

52. See *supra* note 2.

existing national legislation, also taking the Merger Regulation into account.[53] They could provide that third country investments which may significantly affect the public security of the Union or of Member States shall be incompatible with the common market and therefore prohibited. The test could be further refined by referring to certain defined situations which suggest that an investment may have such a significant effect, e.g. where military secrets, security precautions or the security of supply with regard to certain security equipment are threatened by the intended transaction.

The existence of restrictive rules or discretionary practices in the third country in question is an issue inextricably entwined in the overall question of security. The substantive test could therefore take reciprocity into account.[54] Security could be conceived as being affected in those cases where the reciprocity of the market access for a comparable EU investment cannot be demonstrated. An agreement on reciprocity with the third country concerned would provide the basis for a derogation.

4.4.4. *The authority in charge of applying the common system*

In theory, progress in terms of market integration and security could already be made if all Member States adopted and applied monitoring schemes based on similar criteria. However, this approach would entail high administrative burdens for the Member States and investors alike and would moreover entail the risk of diverging decisions even in cases concerning the same investor.

In practice, therefore, a significant advantage over existing national investment control schemes could only be achieved if the common rules are implemented and applied by a single authority. It goes without saying that in the area of defence and security the implementing authority would have to act and operate in concert with the Member States. To that effect, the system should define the way in which the Member States concerned would participate in the decision-making process.

A central administration would moreover increase the legal clarity and transparency in favour of investors while at the same time providing the "one-stop-shop" which reduces red tape to a minimum.

The question of the nature of the central authority will be particularly delicate. The assignment of the administration of the common rules to a central

53. See Reg. 139/2004, O.J. 2004, L 24/1. Under Art. 2(3) a concentration which would significantly impede effective competition, in the common market or in a substantial part of it, shall be declared incompatible with the common market.

54. See EP Resolution of 16 Nov. 2006 on the implementation of the ESS in the context of the ESDP, O.J. 2006, C 314 E/01, para 50. On the question of reciprocity more generally, see Wils, "The concept of reciprocity in EEC law: An exploration into these realms", 28 CML Rev. (1991), 245–274.

authority like the EDA would fit particularly well with the EDA's task of strengthening the European defence industrial and technological base, but the legal framework of this Agency, based on the CFSP, would have to be adapted accordingly.

Whatever the solution opted for, the relevant authority should be empowered to take measures binding on the parties, in a procedure based on fairness, transparency, flexibility and minimum intervention, and subject to judicial review.

4.4.5. *The conclusion of mitigating agreements*

Any disadvantages of the common rules in terms of their restrictive character and effect could be reduced if they were accompanied by a mechanism allowing the conclusion of agreements designed to render a contestable investment compatible with the common market. The French system allows the minister in charge to impose conditions aimed at securing the compatibility of a transaction with the national interest.[55] Under the Merger Control Regulation, the Commission may clear a merger under certain conditions provided commitments have been offered by the parties pursuant to Articles 6(1)(b), Article 7(3) or Article 8(2), second subparagraph. Under the Antitrust Regulation 1/2003, Article 9, the commitments offered by the parties may enable the Commission to conclude that there are no longer grounds for action. The US system provides a further example of how such a mechanism can be integrated in an investment control scheme.[56]

5. Alternative approaches under the EU Treaty?

The following observations are designed to demonstrate that the CFSP Chapter of the EU Treaty, even assuming it were to apply, *quod non*, would not provide convincing alternative solutions.

5.1. *CFSP Rules*

Title V EU Treaty contains in Articles 11 to 28 a number of specific provisions inviting the Union to define and implement a common policy, the objectives of which shall be, *inter alia*, to safeguard the independence and integrity of the Union and to "strengthen the security of the Union in all ways" (Art. 11(1) EU, first and second indents). "Security" in this context

55. See Section 2.2 above.
56. See Section 2.4. above.

means external or international security rather than the public security of the Member States (or the Union) referred to in the EC Treaty.[57] Pursuant to Articles 14 and 15 TEU, the Council may implement the CFSP by adopting Joint Actions or Common Positions. However, for present purposes it should be stressed that neither one may form the basis of common legislation in the field of CFSP.

Pursuant to the Lisbon Treaty, assuming it enters into force, the CSFP chapter of the EU Treaty will be amended.[58] Article 11 as amended will provide that the Union's competence in matters of common foreign and security policy shall cover all areas of foreign policy and all questions relating to the Union's security, including the progressive framing of a common defence policy that could lead to a common defence. The common foreign and security policy shall be defined and implemented by the European Council and the Council acting unanimously. Article 11 will expressly exclude the adoption of legislative acts.[59] Article 23 in its amended form[60] will likewise exclude the adoption of legislative acts.

It is safe therefore to conclude from these remarks that the EU Treaty cannot at present and also in the near future will not be able to serve as the legal basis for common legislation aimed at securing the European defence industrial and technological base.

5.2. *Articles 60 and 301 EC?*

The EC Treaty contains in Articles 301 and 60 two provisions where Common Positions or Joint Actions authorize action under the EC Treaty related to emergency situations. It is however doubtful whether this inter-policy cooperation can be extended to other situations such as the one envisaged here.

Article 301 EC is an example of a cooperative tie between the Council acting in accordance with the CFSP and the Commission acting in accordance with EC trade policy. It permits the imposition of trade embargos on third countries where they are provided for by a Common Position or Joint Action and required as a "necessary urgent measure". Article 60 EC extends this coordinated approach to the field of capital movement. "In the cases envisaged in Article 301", the Council may for serious political reasons adopt the necessary urgent measures on the movement of capital and on payments as regards

57. See e.g. heading to Title V TEU "Provisions on a CFSP" and Art. 11(1) EU referring to the objective "to preserve peace and strengthen international security".
58. Chapter V will become Chapter II TEU "Specific provisions on the CFSP".
59. See Lisbon Treaty, point 27 amending Art. 11 EU.
60. See Lisbon Treaty, point 34 amending Art. 23 EU to become Art. 17.

the third countries concerned, i.e. restrict investments from third countries for reasons related to CFSP.

The CFI interpreted in *Ahmed Ali Yusuf* [61] the above provisions extensively so as to allow sanctions to be imposed not only on Member States but under certain conditions also on persons.[62] However, the ruling does not contain elements suggesting that the coordinated approach can be extended to the establishment of an enduring legal system for capital movement such as that here under discussion.

5.3. *A Code of conduct?*

By Joint Action adopted in 2004 the Council of the EU established the European Defence Agency, an "intergovernmental agency in the field of defence capabilities development, research, acquisition and armaments".[63] EDA is thus a body governed by the rules on CFSP. It has been given four main functions: strengthening the European DTIB and creating a competitive European defence equipment market, developing defence capabilities in the field of crisis management, promoting and enhancing armaments cooperation, and enhancing the effectiveness of European defence research and technology.[64]

In November 2005, Defence Ministers approved the Code of Conduct for defence procurement to cover defence equipment contracts to which Article 296 EC applies. This intergovernmental regime is now effectively applied by 22 out of the 26 participating Member States.[65]

In theory, the Council could also adopt a joint action aimed at the establishment of a code of conduct for the monitoring of FDI in European defence operators and assign its administration to a central authority, such as the EDA. The code would form an intergovernmental, voluntary and non-binding regime and apply to Member States prepared to sign and cooperate. It could provide some guidance on how to react to FDI in defence operators in the subscribing Member States, and the conditions under which these investments could be viewed as endangering the essential security interests of the Member States and of the Union. As a matter of course, the EDA acting on the basis of an intergovernmental, voluntary and non-binding regime

61. See Case T-306/01, *Ahmed Ali Yusuf & Al Barakaat Foundation* v. *Council and Commission*, [2005] ECR II-3533; appeal pending in Case C-415/05.

62. Ibid., para 160.

63. Joint Action 2004/551/CFSP of 12 July 2004, O.J. 2004, L 245/17, first recital.

64. Art. 5.3 of the Joint Action. For details, see <www.eda.europa.eu>; and Kielmansegg, op. cit. *supra* note 43, p. 174 et seq.

65. See <www.eda.europa.eu>.

would not be in a position to adopt decisions binding on the Member States let alone on the foreign investors concerned.

This option would therefore not provide an appropriate solution to the problem of FDI in the defence and security sector. Nor would it promote market integration. The most important objective, i.e. of replacing the divergent national systems by one common system, could not be attained given that a voluntary non-binding system would not offer equivalent guarantees for the security interests of the Member States.

6. Result

European homeland security requires more attention to foreign investments in strategic European industries. The recent Commission proposal focused on the energy transmission networks confirms this view. The Commission and the Member States should examine the situation in more detail in order to find an adequate response at the European level. A proper assessment of the real risks implied in foreign control of strategic European industries is necessary, as is an in-depth analysis of the knotty legal situation tentatively addressed above. The *status quo* where some Member States apply protective rules and others maintain open frontiers is unsatisfactory, and the longer the European institutions remain in the back seat, the more they invite Member States to seek their own solutions. This state of affairs fragments the European market and is all the more inadequate as only action at the European level can attain the degree of security, transparency and legal certainty required in the field of capital movements targeting the defence and security sector.