HERBERT SMITH FREEHILLS KRAMER

# NAVIGATING FOREIGN DIRECT INVESTMENT REGULATION: DEFENCE

# Control of foreign investment in the Defence sector

Foreign Direct Investment (FDI) regulation is an area of increasing activity and enforcement worldwide. Notwithstanding the potential benefits of inward investment, sensitivities can arise from geopolitical considerations, especially given heightened international tensions, and from concerns around ownership and control of strategic industrial capabilities and the desire to keep these 'onshore'. Globally, FDI regimes have tended towards broadening scope, with the result that it is not just outright acquisitions but also minority investments that can be affected, even where the interests acquired do not confer control over the target business or its assets. Similarly, the range of industries within the scope of these regimes can be extensive.

Many FDI regimes impose requirements on parties to seek prior approval from a FDI agency before carrying out certain transactions. Even where it is lawful for parties to complete a transaction without first obtaining consent from the FDI agency, that authority will frequently have powers to review transactions after the fact, and impose remedies that may ultimately include forcing acquirers to divest their newly acquired businesses. In some other cases, countries do not maintain FDI screening regimes in this traditional sense, but instead regulate FDI via "negative list" arrangements that limit or prohibit foreign ownership, or impose other regulatory requirements on foreign ownership.

FDI regimes are typically applied as an additional layer of regulation on top of other rules such as merger control, export control and "change of control" provisions for government contractors. Moreover, especially in significant cross-border investments, it is quite possible for multiple FDI regimes to apply to a single transaction. With this in mind, conducting a multi-jurisdictional FDI analysis is now an essential part of any M&A or investment due diligence exercise.

### Common features of FDI regimes

- FDI regimes typically apply to **specified classes of investments** – increasingly these are not limited to controlling interests but can capture minority investments even where they do not confer control over the target business or its assets.
- Often there are **no turnover or other thresholds** for the FDI rules to be engaged.
- **Mandatory notification obligations** may apply and clearance may be required before transactions can complete.
- Some regimes **prohibit or restrict** all foreign investment in specified industries.
- Decision-making can be far more **politically-driven and secretive** than in other regulatory processes such as merger control. Outcomes can therefore be harder to predict and more difficult to explain.

## FDI and Defence

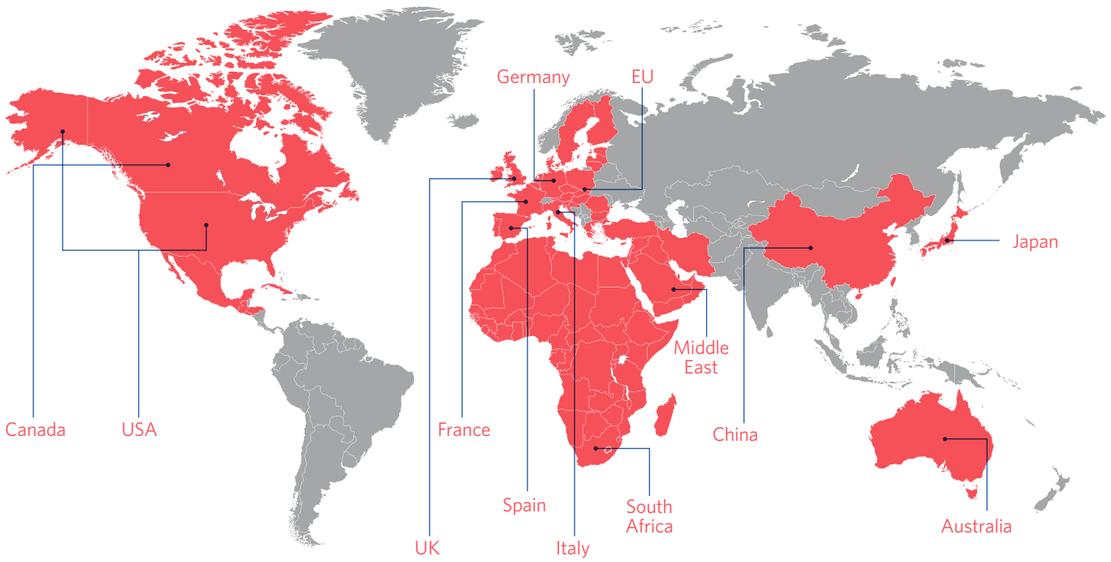
Defence, and the related military and dual-use sectors, encompasses activities that support defensive and national security capabilities, such as the manufacture of weapons and defensive systems, supporting personnel, operations, cyber operations, and development of related technologies. While some of these activities may be defence-specific, others have applications in both the military and civilian spheres.

FDI controls are commonly perceived as being principally concerned with the protection of national security interests. Although the concept of national security has been stretched well beyond the starting point of many FDI regimes when first introduced, defence, military and dual-use activities continue to be subject frequently to foreign investment controls. It is not difficult to see how transactions that impact in these areas could be viewed as concerning from a national security perspective, whether that stems from perceived risks to the supply chain for military hardware, ownership of a country's strategic defence assets and keeping key capabilities located within its territory, third party access to sensitive and emerging technologies, data or know-how, impacts on future development efforts, involvement of foreign state actors, or an investor's own vulnerability to influence or interference from malign actors. Indeed, there could be any number of other security concerns that might not be apparent to the public, and the potential list of threats and challenges continually changes.

In the current climate of rising international tensions, multiple states are committing to higher spending on defence and related activities. The prospect of such spending generating business for private sector suppliers may well be a factor in driving future transactions and investments in this sector. Such investment may in itself be a necessary component of achieving national security objectives, as well as providing jobs and skills, contributing to R&D, and generating economic output through manufacturing and exports. Any of these factors might be viewed as beneficial from a wider "national interest" perspective, adding further complication to any assessment of transactions in these sectors.

Perhaps understandably, given the importance of these activities to national security, FDI regimes often capture a broad scope of activities and impose comparatively low thresholds for requiring transactions to be reviewed. In the UK, for example, a transaction might be within the mandatory notification regime simply because the target is a sub-contractor in a supply chain that ultimately provides services to the Ministry of Defence, provided that the service in question can be said to be provided or used for defence or national security purposes. Some other jurisdictions impose maximum ownership limits, or even prohibit foreign direct investment in defence altogether.

# World Map




## EUROPE

UK

Under the National Security and Investment Act (**NSIA**) a mandatory and suspensory notification obligation applies to certain transactions involving a target entity that carries out activities in the UK of a specified description in one or more of the 17 specified sectors (certain transactions that do not trigger mandatory notifications can still be reviewed at the authority's discretion).

The specified sector for "Defence" is broadly framed, covering research, development, production, creation or application of goods or services which are used or provided for defence or national security purposes, provided that the target entity either is a direct government contractor or a sub-contractor for government contracts, or holds or may come into possession of classified information. Government guidance clarifies that this covers providers of services that do not have a clear "military" application, such as cleaning or catering services provided at defence facilities.

The "Military and Dual-use" specified sector covers goods, software and technology that can be used for military purposes, or for both civil and military applications. Dual-use items in particular can be very broad and include not just complete systems but also raw materials or components, or even systems used in the production or development of military goods. Although the range of activities is broad, mandatory filing requirements only apply to certain categories of goods or technology that are subject to export controls.

There have been multiple examples of deals where measures have been ordered to prevent harm to national security in the defence, military and dual-use sectors. Remedies imposed have included requirements to maintain continuity of supply for Ministry of Defence programmes, prevent third party access to sensitive IP, expertise and information, and maintain domestic supply of products and services in support of UK defence programmes and platforms.



EU

The Regulation for the screening of FDI into the EU on security and public order grounds became fully operational on 11 October 2020 (**EU FDI Regulation**). The EU FDI Regulation does not establish FDI screening at EU level but creates a framework for pan-EU cooperation on FDI screening.

Member States must notify the Commission and other Member States of any FDI in their territory undergoing screening.

The Commission may request information on FDI likely to affect security or public order of another Member State or a project or programme of EU interest.

Common criteria and standards are set for national FDI mechanisms if maintained or adopted, but there is currently no obligation to adopt new FDI screening mechanisms.

The EU FDI Regulation sets out a non-exhaustive list of sensitive sectors and other relevant factors that may be taken into account to determine whether FDI poses a risk to security or public order. This includes the potential impact of the investment on critical infrastructure, critical technologies, and dual-use items, particularly where the investment is relevant to the defence sector.

A proposal for a new EU FDI Regulation has recently been introduced that, once adopted, will result in a more comprehensive framework at EU level, including mandatory FDI screening mechanisms for all EU Member States.

France

France has an active FDI regime that imposes mandatory filing requirements. FDI clearance, when required, must be obtained prior to closing.

Pre-completion approval is required from the French Minister for the Economy (*ministre chargé de l'Economie*) for foreign investments occurring in sensitive or strategic sectors where either: (i) a foreign investor acquires control of a French corporate entity or a branch of a foreign entity registered in France; (ii) a foreign investor acquires all or part of a business division (*branche d'activité*) operated by a French corporate entity; or (iii) a non-EU/EEA investor crosses, directly or indirectly, alone or in concert, the threshold of 25% of the voting rights of a French corporateentity (or 10% of the voting rights of a French listed entity).

The sensitive or strategic sectors which trigger the requirement to obtain FDI approval include in particular:

**a.** inherently sensitive businesses that fall within the defence and security sectors, including *inter alia* activities relating to weapons, ammunition and explosives, dual-use goods and technologies, activities conducted by entities holding national defence secrets, cryptology, activities related to technologies or equipment used for interception of communications;

**b.** business activities that may, depending on their characteristics, fall within the scope of screening because they relate to essential infrastructure, goods and/or services for carrying out certain strategic activities, such as the integrity, security and continuity of energy and water, transportation networks and services, public health, food safety and space operations; and

**c.** R&D activities that relate to specific critical technologies (eg, cybersecurity, artificial intelligence, semiconductors, quantum technologies) and to dual-use goods and technologies, when intended to be used in the sectors mentioned in (a) and (b).

Defence sector activities (including military/dual-use), will usually fall under one or more of the sensitive or strategic activities referred to above. These sectors are in any case interpreted widely and anyone contemplating investing in these sectors or adjacent sectors should assume that prior FDI clearance will be required (provided the above-mentioned conditions are met).

While prohibitions are not frequent in France, there have been two notable cases in the defence sector:

- Photonis/Teledyne (2020/2021): Teledyne, a US-based company, sought to acquire Photonis, a French manufacturer specialising in night vision systems. In December 2020, the French Minister for the Economy announced his refusal to authorise the transaction. Although conditions were later proposed to allow the acquisition (including the establishment of an internal oversight committee with government representation, equity participation by the French public investment bank, and a requirement to provide a 7% annual return on investment over eight years), they were considered excessively stringent. As a result, Teledyne withdrew from the deal.
- Velan/Flowserve (2023): Flowserve Corporation, a US-based company, attempted to acquire Velan SAS and Segault, French subsidiaries of the Canadian company Velan. These entities supply valves for nuclear submarines and nuclear power plants. Due to national security concerns, the French Ministry for the Economy refused to approve the acquisition. Subsequently, in March 2025, Velan sold the subsidiaries to Framatome, a French company operating in the nuclear industry.

Germany

Germany has an active FDI regime that imposes mandatory filing requirements. The regime is suspensory ie clearance must be obtained pre-closing. Pre-closing approval is required from the Federal Ministry for Economic Affairs and Energy (the "Ministry").

The FDI regime is engaged by acquisitions of either:

**a.** (i) 25% (direct or indirect control) of the voting rights in a German company by a non-EU/EFTA company (in which case the Ministry is entitled to call-in the transaction for review); (ii) 10% if the target company operates in certain sectors (eg certain critical infrastructure) - in which case a mandatory filing is triggered; or (iii) 20% in certain other sectors, including specific dual-use goods, in which case a mandatory filing is triggered; or

**b.** as regards military products, acquisitions of 10% (direct or indirect) of voting rights in a German company by a non-German investor.

Our experience is that the German government is currently particularly cautious with regards to the screening of transactions in the defence sector. The Ministry will analyse very thoroughly whether a defence-related transaction might affect public order or security and will require an issue-free investor and sensitive case management in these transactions.

New investment screening legislation is expected to be adopted in Germany. in the short term. This is likely to introduce further protections against foreign investment from non-trustworthy states, particularly in the critical infrastructure and defence sectors.

Italy

Italy has an active FDI regime that imposes mandatory filing requirements. The regime is suspensory ie clearance must be obtained pre-closing. Pre-closing approval is required from the Presidency of the Council of Ministers.

Notifications are required for transactions relating to the defence sector: in particular, activities that are deemed strategic for national security. The defence sector is certainly under particularly close scrutiny currently, as are transactions affecting targets whose activities relate to dual-use products and activities that may have some relevance to national security. In fact most prohibition decisions and decisions imposing conditions relate to these sectors.



Spain

Spain has an active FDI regime that covers the defence sector (defined as activities affecting the industrial capabilities and areas of knowledge necessary to provide the equipment, systems and services that give the Armed Forces the necessary military capabilities, as well as those intended for the production -understood as design and manufacture- maintenance, or trade of defence material in general).

A suspensory FDI screening mechanism applies to any investment of 5% or more in any Spanish company in the defence sector, or any lower percentage that allows the investor to become part, directly or indirectly, of its management body. Authorisation decisions are made by the Council of Ministers.

Investments between 5% and 10% are exempt from authorisation provided that the investor notifies certain governmental agencies, and undertakes not to use, exercise or transfer to third parties its voting rights, or to form part of any management bodies of the listed company.

Foreign investments in activities related to the manufacture, trade, or distribution of weapons, ammunition, pyrotechnic articles, and explosives for civilian use and other material for the State police forces are also subject to authorisation.

In addition to the defence-specific regime, investment may also be subject to the general FDI regime provided that either a foreign investor acquires a shareholding interest of 10% or more in any Spanish company or, as a result of any transaction, a foreign investor acquires effective control of a Spanish company; **and either**

**a.** the investment is made in a restricted sector (which includes critical and dual-use technologies, and technologies developed under programmes and projects of particular interest to Spain, including defence); or

**b.** the foreign investor:

- **i.** is directly or indirectly controlled by the government (including state bodies or the armed forces) of a third country; or
- **ii.** has made investments or has taken part in sectors that affect public safety, public policy or public health in another EU Member State; or
- **iii.** there is a risk that the foreign investor conducts illegal activities affecting public safety, public policy or public health.

As a general rule, authorisation procedures related to the defence sector tend to involve longer processing times and more extensive documentation requirements than other filings.

Similarly, while it is rare for conditions to be included in FDI authorisations in the general regime, in relation to the defence sector this rule is reversed, and it is common for conditions to be included, with the Government benefitting from a wide margin of discretion.

## MIDDLE EAST

Middle East

FDI in the Middle East is relatively nascent, and the majority of jurisdictions do not have FDI regimes requiring pre-notification and clearance. Across the Gulf Cooperation Council, defence and military-related sectors (including activities involving dual-use goods or technologies) are typically regarded as strategic and sensitive even where not explicitly referenced in FDI legislation and, in practice, foreign involvement in such sectors often requires prior approval from the relevant ministry, such as the relevant Ministry of Defence.

Some jurisdictions, such as Kuwait and Oman, have a 'negative list' which prohibits foreign ownership in certain sectors. In Kuwait, the 'negative list' includes defence, which is therefore explicitly closed to FDI; whilst in Oman the list does not specifically refer to the defence sector.

In the Kingdom of Bahrain, a formal 'negative list' is not maintained, but rather a 'positive list' approach is generally followed, with the legislation listing the sectors where activities can only be undertaken by Bahraini nationals and otherwise are open to foreign investment, although the listed sectors do not include defence.

In Qatar, foreign ownership is prohibited in certain sectors. There are no explicit references to the defence sector but the Qatar Ministry of Commerce and Industry's list of business activities specifically prohibits foreign ownership of defence-related activities (eg tailoring of army and military clothes, repairing of weapons and ammunition, trading in security equipment and trading in military apparatuses and accessories).

In the UAE, foreign investments in UAE companies are restricted in some strategic industries and prohibited in industries such as security and defence.

In Saudi Arabia, a new investment law applicable to all investors came into effect in February 2025. The new law does not include a 'negative list', but provides that ministerial approval will be needed before a foreign investor can undertake any 'excluded activities'. A list of excluded activities has not yet been published.

## AFRICA

Africa (excluding South Africa)

The African continent is increasingly seeking to develop its own military hardware production capabilities. However, funding remains a significant constraint and many African states may turn to FDI and public-private partnerships as a potential solution.

Most African countries do not have specific FDI regimes. Instead, they may regulate and monitor foreign investment through other means, such as through exchange control regulations and treasury approvals. In some cases, FDI regulation is more nebulous – regulation is carried out by way of broad policy considerations conveyed to investors through informal discussions with government or through licensing requirements imposed on an ad hoc basis at the time of the investment.

Many African countries also regulate foreign investment by ensuring that such investment is carried out in a responsible manner and for the benefit of the country (eg linking it to a social responsibility requirement to local communities or local industry).

Competition law regulations may include public interest considerations which may bring transactions involving the defence sector into the scope of review.

South Africa

While there is currently no separate foreign direct investment authority in South Africa, the South African Competition Commission (**SACC**) reviews mergers that meet prescribed financial thresholds. Foreign investors will, through this process, often be required by the SACC and/or Department of Trade, Industry and Competition to provide commitments that are responsive to the SACC's public interest mandate, notably in respect of local ownership, employment and procurement.

Aside from the merger notification process, there is no general obligation to notify acquisitions in South African companies by foreign investors, or the establishment of new South African companies by foreign investors.

However, a sector-specific code applicable to the defence sector has been issued within the broader framework of the broad-based Black Economic Empowerment Act. This code sets compliance targets for local procurement of defence materials and technologies and ownership by black South Africans (among other things). While compliance with the code is not mandatory, the extent of compliance is taken into account (and is a requirement for state-owned enterprises to consider) when procuring goods or services or entering into other business relationships with private firms.



## AMERICAS

Canada

Canada has an active FDI regime. All acquisitions of control of Canadian businesses by non-Canadians are subject to reporting and review under the Investment Canada Act.

Investments are screened to consider potential effects on Canada's defence capabilities and interests, including but not limited to the defence industrial base and defence establishments.

Defence-related investments of concern include those that enable the transfer of sensitive technology or know-how; relate to critical minerals and critical mineral supply chains; and/or involve SOE investors.

- Guidelines enumerate a list of "sensitive technologies" the transfer of which could cause injury to Canada's national security and defence through: Canadian or allied military degradation or enhancement of adversarial military capability; and Canadian or allied intelligence degradation or enhancement of adversarial intelligence capability.
- Canada has stringent rules on investments in critical minerals businesses, in part because of "the role critical minerals play at the very core of advanced industrial and defence policies."
- Investments by adversarial state-actors have long been a focus of Canadian national security reviews, with most blocked or conditioned investments relating to investors from China or Russia.

USA

The USA has an active FDI regime (**CFIUS**), which includes a mandatory filing component.

While CFIUS jurisdiction is sector agnostic, foreign investment in the US defence sector continues to draw significant CFIUS scrutiny.

CFIUS mandatory filings may be required in transactions where, among other scenarios, the (direct or indirect) target US business deals in certain export controlled "critical technologies." Defence transactions in particular can trigger a mandatory CFIUS filing where the US target deals in defence articles, technical data and services regulated under the International Traffic in Arms Regulations. In addition, foreign investment into US defence as well as other companies involved in dual-use technologies can require a filing to the extent those items are included on the Commerce Control List in the Export Administration Regulations and are subject to certain US export control designations.

The US Government has identified, among other national security priorities, the need for a resilient defence supply chain that can reliably and securely produce and provide defence-related products, technologies and services to meet current and future needs. Identified FDI risks in respect of the US defence industrial base include the transfer of US intellectual property, offshoring of US domestic production and the availability of source materials (eg specialised metals, alloys, rare earth materials, etc.) critical to weapons systems. Any CFIUS review of a foreign defence sector transaction can be expected to probe these and related issues.

Even in the absence of mandatory CFIUS filing obligations, there is a very active CFIUS investigation and call-in regime that is not sector specific, and CFIUS has broad discretion to investigate and call-in for review transactions in the defence sector (or any other) where CFIUS believes the transaction may present US national security concerns.

## ASIA-PACIFIC

Australia

Australia's FDI regime (**FIRB**) has an enhanced level of mandatory notification for direct and indirect foreign investments in 'national security businesses' and in entities which conduct such businesses. While the concept of national security in this context is very broad, and extends to a range of identified 'critical infrastructure' assets, it expressly includes a range of defence and intelligence matters.

In particular, a 'national security business' includes:

- development, manufacture or supply of 'critical goods' or 'critical technology' that are, or are intended to be, for a military or intelligence use by; and
- provision of 'critical services' to,

  Australian defence or intelligence personnel, the defence force of another country, or a foreign intelligence agency.

What is 'critical' is not defined in the regulations, although there is published government guidance. In summary the relevant goods, technology or services must be 'vital to advancing or enhancing Australia's national security and could be detrimental to Australia's national security if not available or if misused'. It does not include businesses that provide goods, technologies and services that are generic or widely available for a range of inputs.

A business will also have 'national security business' status if it if stores, collects or has access to various specified types of data. This includes information with a security classification of 'protected' or higher (or equivalent), or personal information of Australian defence or intelligence personnel which if accessed could compromise Australia's national security.

There is a similar regime in relation to direct or indirect investments in defence premises and other 'national security land'.

National security status has a number of implications for foreign investors. In particular, the notifiable investment level is generally 10% (less if there is influence or control, or other arrangements with the target) and there is a zero financial threshold. Further, offshore acquisitions of securities in entities with downstream Australian 'national security' interests can be subject to mandatory notification in Australia.

China

Foreign investment in the military or defence sector in China is not explicitly banned or restricted under China's FDI Negative List. However, enterprises must obtain industry-specific permits and special confidentiality qualifications to operate in these sectors. Under these regimes, foreign investors are generally subject to investment restrictions – typically, foreign investors are either not permitted to invest in the relevant enterprises or, in certain cases, may only indirectly (and not directly) invest below a 20% shareholding in the relevant enterprises and are not permitted to obtain control.

Additionally, mandatory notification applies in certain sectors under the National Security Review measures – namely those related to military and military support industries that concern national defence and security, as well as non-military industries important to national security. Mandatory filing requirements arise where foreign investors wish to invest in military and military support industries that concern national defence and security, or to invest adjacent to any military facilities. There is no monetary or shareholding threshold applying to such investment.

China also has a regime that regulates the import and export of dual-use items and technologies. Under the regime, permits are required for import and export of any dual-use items and technologies listed in a dual-use items and technologies catalogue issued (and updated from time to time) by the Chinese government.

Japan

Japan has an active and relatively broad FDI regime. The regime is generally mandatory and suspensory in respect of FDI relating to certain "core sectors", including national security (weapons, aircraft, nuclear energy, products related to space development, products convertible to military use, and cyber security). Clearance can be required, among other circumstances, prior to the acquisition of more than 1% of shares of a publicly listed Japanese corporation or any investment in an unlisted Japanese corporation.

The authorities tend to tighten their reviews on acquisitions of shares in a corporation which is engaged in any of the "core sectors".

A reform is being considered to further tighten the rules for foreign investors that have an obligation to cooperate with foreign governments in collecting information related to Japan's national security.

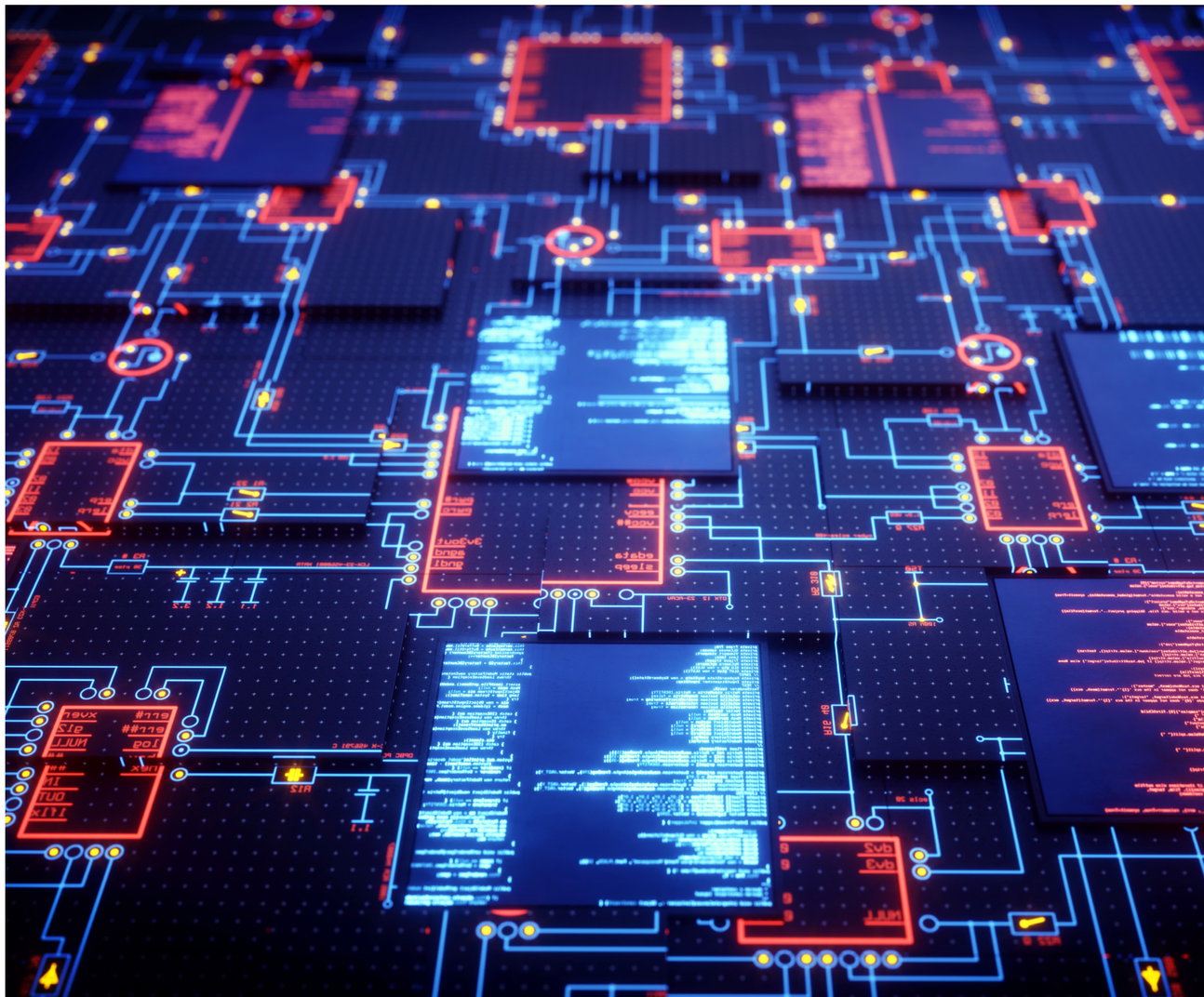


# Outlook for the future

In a world where traditional certainties no longer hold, defence and security organisations face increasingly complex challenges. Technological innovation remains essential to maintaining a strategic advantage, with cyber security playing a more critical role than ever.

Continuing global developments seem likely not only to drive increases in defence spending but to encourage a focus on topics such as the reliability of supply chains, procurement strategies and self-sufficiency, including through domestic R&D, manufacturing and procurement. Transactions that touch on these areas seem likely to face heightened scrutiny and an increased risk of FDI regimes being used as a way to protect national security interests.

FDI regimes will need to balance the interests of national defence in the context of broader industrial strategy interests, including the need to promote investment in the defence, military and dual-use sectors, both as a way to promote national security and as a way to drive growth, jobs and exports.



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