



**THE BEGIN-SADAT CENTER FOR STRATEGIC STUDIES**

# **Foreign Investment in Israel's Strategic Industries**

Efraim Chalamish



**Mideast Security and Policy Studies No. 136**

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**BAR-ILAN UNIVERSITY**  
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Efraim Chalamish

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# Foreign Investment in Israel's Strategic Industries

*Efraim Chalamish*

## EXECUTIVE SUMMARY

The changing map of foreign investment in Israel demands a new balance between market access and investment review. The Israeli government has not yet communicated to the global investment community its vision for foreign investment in Israel, especially in the banking, insurance, commodities and defense markets. This vision is crucial so that multinational companies can make informed investment decisions. Current ambiguities in this regard leads to policy inconsistency, resulting in the fact that many potential foreign buyers avoid penetrating the Israeli market altogether.

Israel needs new legislation that would establish an interdisciplinary, comprehensive and consistent review mechanism for foreign investment, especially in relation to sensitive and strategic assets. Israel also needs a better and more consistent integration of national security considerations in its foreign investment and economic review processes.

A more qualified workforce familiar with the investment-security nexus, a better integration of economic thinking into the national security establishment, and a stronger and more structured participation of the National Security Council in investment decisions – are all important steps towards a more effective review process of foreign investment in Israel.

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# Foreign Investment in Israel's Strategic Industries

*Efraim Chalamish*

## INTRODUCTION

### *The State of the Israeli Economy and Foreign Investment*

Over the last couple of years, an increasingly large number of Israeli companies have been sold to both private and state-linked foreign companies. The profile of the buyers has changed overtime. If historically most foreign investors in the Israeli market were Americans, now there is a growing interest from Chinese companies and the Chinese government, among other new economic players, driven by a supportive official Israeli policy and global economic trends.

This development in the sphere of mergers and acquisitions (M&A) in Israel has triggered mixed feelings. For many commercial actors, the influx of foreign investment has usefully introduced new sources of financing, liquidity, and connections to the global economy. On the other hand, in the general public and among certain political groups, negative feelings towards foreign investors have developed, as takeovers are perceived as a threat to Israel's economic stability and to its national security interests. Recent transactions, such as the foreign acquisitions of the Israeli giant conglomerates Tnuva Food Industries and Israel Chemicals, have amplified this tension.

The enhanced M&A activity should be understood in the broader context of foreign investment in Israel. Foreign direct investment (FDI) is one of the leading economic engines of the Israeli market, strengthening its economic

and strategic position in the world. Israel has transformed itself from a developing to a developed market within a very short period of time, building one of the world's largest research & development hubs and becoming a global leader in technology export. Israel's clear market-based and open-borders economic policies have supported these developments.

According to the United Nations Conference on Trade and Development (UNCTAD),<sup>1</sup> Israel received \$6.7 billion in FDI in 2014 and \$11.56 billion in 2015.<sup>2</sup> However, it is important to note that 2014 figure was 46% lower than the \$11.8 billion Israel received in 2013. This drop was significantly larger than the 16% drop in global FDI in 2014 to 1.23 trillion dollars. (Statistics for 2016 are not yet available).

While Israel has been an increasingly attractive foreign investment target in recent years, it remains a relatively centralized economy, especially in industries such as banking and insurance, and most of all – defense. Strategic investment by foreign investors in Israel plays an important part in securing the country's economic resilience. FDI helps Israeli companies penetrate new markets and enhance local know how by introducing new technologies to the Israeli market. It also improves wage growth and fosters economic growth.<sup>3</sup>

Thus, populist sentiment against foreign ownership is often unjustified, and Israel is not the only case where this holds true. Many American politicians were wary of the Japanese penetration into the US market in the 1980s, though most of the Japanese investment in the US at that time – such as investments in the real estate market – did not threaten US economic sovereignty or its national security.

Nevertheless, nations often impose rules that limit foreign investment, for both economic and security reasons. Economic considerations may include, among other, protecting infant industries, saving local jobs and fostering economic growth, and maintaining leadership in dominant industries. Security considerations may include, for example, access to critical infrastructure and capability to meet long-term requirements for sources of energy and other critical resources and materials.

While countries approach the need to identify strategic industries differently, there is a constant challenge to differentiate between

economic and national security factors, and to identify genuine strategic concerns without political influence. Economic protectionism is often supported by inaccurate security considerations. National security risks and protecting national strategic assets, which should be carefully and thoughtfully defined, are serious considerations that call for a responsible, consistent, and cohesive policy.

However, unlike other developed markets, Israel lacks a transparent intra-governmental process that consistently examines certain investments. Strategic industries or strategic assets are not well defined in legislation. Therefore, references to strategic assets, including in this study, are inconsistent.

In point of fact, over-regulation and intervention by multiple Israeli agencies can and have made the investment process complicated, costly, and uncertain. Consequently, some attractive Israeli assets have been avoided by foreign investors, due to what they perceive as a risky political and economic environment. In addition, the price paid by foreign investors for Israeli assets or companies has often been overvalued or miscalculated. This makes certain Israeli industries less competitive over the long term, and as a result, some significant foreign investors avoid Israel, preferring instead other, more affordable, markets.

One of the purposes of this study is identification of the various risks in the Israeli market, exploring potential response models and suggesting comprehensive solutions, especially regarding differentiation between economic risks and opportunities, on the one hand, and security risks, on the other. These distinctions are necessary if Israel is to develop a comprehensive and consistent regulatory and policy approach to FDI.

By way of doing so, this study will identify key emerging trends in FDI in Israel, the nature of the investors, and the target industries. It will then address opportunities for the Israeli market and potential threats to its economic interests and national security. It will examine the current state of policy to foreign investment in Israel, and how appropriate policies and regulatory tools can find the right balance between open borders and economic growth on one hand, and protecting Israel's strategic needs on the other – while taking into account other competitive models from around the world.

## TRENDS IN FOREIGN INVESTMENT IN ISRAEL

### *The Rise of Chinese Companies in Israel*

For several decades, the US, the leading capital exporter of the world, was the main foreign player in the Israeli market. The US market in general, and Silicon Valley in particular, is the source for the majority of technology investments and venture capital financing. The close diplomatic and military relations between the two countries, and several regulatory tools, such as the US-Israel Free Trade Agreement from 1986, have increased American foreign investments in the Israeli market.

Yet, this trend is changing. In recent years, there has been a dramatic increase in Chinese financing of Israeli start-ups and of venture capital funds in the Israeli market. Chinese investors find Israeli innovation groundbreaking and inspiring. Many of them would like to transfer unique Israeli intellectual property to China and commercialize it. Additionally, Chinese funds and individuals are gradually more interested in direct private equity investments in Israel in order to take advantage of Israeli companies' Asian expansion strategy.

This is a significant change. In many respects, the Israeli technology ecosystem was designed by Western executives and investors, and it targeted Western challenges and markets. In order to supply countries like China with its tech solutions, Israel needs to prioritize China as the "go-to" market on all levels – government, research and development, and the investment community.

Indeed, rising Chinese investment in Israel is driven not only by grassroots initiatives, but is also strategically supported by both the Israeli and Chinese governments. The two governments perceive cross-border technology investments as a tool to improve their bilateral diplomatic relations. A constructive bilateral dialogue has taken place between Jerusalem and Beijing, with a three-year plan approved by the Israeli government in May 2014, together with a number of government supported programs initiated between 2014 and 2015. Consequently, the Israeli government set several commercial goals,<sup>4</sup> including the significant increase of mutual investments and joint projects, doubling

Israeli exports to China within five years, and tripling the number of Chinese visitors to Israel in five years. Continuous Israel-China official dialogue, and intra-governmental committees established by the Israeli government, aim to drive cross-border investments significantly.

The numbers speak for themselves. In 2014, 12 Israeli venture capital funds (VCs) raised \$914 million – a 6-year high (according to a report conducted by IVC Research, the leading research arm of Israel's venture capital community, and KPMG, a global accounting firm). Several of these funds targeted Chinese investors. For instance, JVP, a leading Israeli fund, had an overall target of \$180 million, about 40% of which was targeted by Chinese “limited partners,” who were not involved in the management of the funds. The number of Israeli funds raised with Chinese investors went up from one in 2012 to seven in 2014. In 2016, the vast majority of Israeli VCs had at least one Chinese investor in their financing round, according to IVC.

Some of the new Chinese tech investments are led by Beijing's leading tech players. Alibaba, the country's largest e-commerce platform, first entered the Israeli market in July 2014 with \$6 million investment in Visualead. Similarly, SAIF Partners, China's leading venture capital fund, had its first investment in Israel in December 2014 in Supersonic, an Israeli corporation in the mobile monetization and marketing sector.

The rise of Chinese investments in the Israeli market has been dramatic. According to the National Economic Council at the Prime Minister's Office, there were over 70 transactions involving Chinese investments in the Israeli market in 2014. Chinese direct investments in Israel grew from \$458 million in 2013 to \$989 in 2014. In 2015, Chinese direct investment in Israel grew to more than a billion dollar, according to the Rhodium Group.<sup>5</sup> We saw a continuation of this trend in 2015, and according to IVC (Israel's leading source of comprehensive information on Israel's high-tech industry), almost \$500 million was invested in Israeli tech by Chinese investors in 2015. Altogether, since 2012, thirty new Chinese investors have entered the Israeli market and reached around 80 Israeli companies and 11 Israeli VC funds, according to IVC Research.

Chinese investments in foreign markets are also influenced by the government's five-year strategic plan,<sup>6</sup> which reflects its most important

economic priorities and goals. And, indeed, judging by the industries they focus on, Chinese transactions in Israel tend to focus on high-tech and biomed, as part of Beijing's new vision to move from low-cost manufacturing to R&D in emerging technologies. Additionally, Chinese investments also target traditional industries, such as food and farming, if they involve potential significant technological leapfrogging for their economy. Israel's internal economic structures fit well with the new Chinese five-year plan model. (The Israeli government does not track and release official numbers of Chinese investments in non-tech sectors as a percentage of total FDI flows, but there are efforts to produce such information accurately).

An overview of sizeable transactions in 2011-16 shows groundbreaking acquisitions in various industries. ChemChina's acquisition of Makhteshim Agan (\$2.4 billion) in the chemicals industry; Fosun's purchasing of Alma Lasers (\$240 million), a manufacturer for the aesthetic and surgical markets in the medical industry; Bright Food's takeover of Tnuva (\$960 million) in the food space; and XIO's acquisition of Lumenis, a world leader manufacturer of medical laser equipment. Some of these transactions involve governmental long-term national interests, while others are purely commercial and driven by markets.

Since Israel's goal is to leverage these investments to create a closer cooperation between the two economies, the regulatory regime should support such a cooperative model while protecting Israel's national interests as defined by its leadership. But it remains to be seen how the new Chinese investments will reshape the Israeli economic landscape. The fact that many Chinese investors, including private corporations, have a strong connection to the Beijing government already implies the latter's greater involvement in the investment process, which makes the regulatory and integration process more complex.

The changing map of foreign investment in Israel, and the rising shift from West to East, call for a new balance between market access and investment review, taking into account several new elements, such as cultural divide, governmental involvement, and bilateral or regional strategic and economic relations that are different by nature. Moreover, in addition to the new profile of investors in Israel, the target industries for foreign investment or

acquisition have themselves changed. Old industries are disappearing and new industries have come to life and are flourishing. Thus, for example, several natural gas discoveries in recent years have created a vibrant regional, perhaps even global, energy industry. The current Israeli energy market comprises several energy ventures that are constantly looking for foreign investment. Israel's new Electricity Law provides the framework for the increase of Independent Power Producers (or IPP) from less than 0.5 % to 20% of Israel's installed generating capacity.<sup>7</sup> Investment in the energy sector involves strategic assets, critical infrastructure, access to essential commodities, and sizable financial support. As such, it makes the energy sector perhaps more vulnerable to external economic and security threats than other industries in Israel.

Another example is development of water technologies, an area where Israel is a world leader. Unlimited access to water infrastructure, especially in times of war and emergency, is a critical part of Israel's national security apparatus. Currently, Israel's largest desalination project, developed by IDE Technologies, is jointly and equally owned by two Israeli large public companies, ICL – Israel Chemical Ltd., a global minerals and specialty chemicals company, and the Delek Group, one of Israel's largest holding companies. CCCC, a Chinese state-owned company, placed a bid to acquire IDE Technologies in 2016 for \$650 million, which was rejected. However, future transactions may still be relevant.

Overall, foreign investors are looking into new and innovative Israeli industries that may introduce them to essential technologies and lucrative sources of income, but may expose the Israeli government to various economic and security risks. Israel's policy should consider both the identity of the investors and the nature of the target industry or particular company and product.

### ***Contributions of Foreign Investment***

Israel's basic current approach – that its market should be open to foreign investment – should not be taken for granted. A global overview shows that some countries are more protectionist than others when it comes to foreign investment, even in industries that are traditionally more open to foreign investment. In fact, Israel itself has been more protectionist in the past.

Israel has come a long way from being an agriculture-oriented, socialist country to a diverse, open economy.<sup>8</sup> Israel's integration into the global economy is its biggest success story, and penetration of foreign companies and the rise of foreign direct investment in Israel are important components of this.<sup>9</sup> It is worthwhile reminding ourselves of the myriad ways in which foreign investment improves the economy:

- **Supporting Export.** Israeli affiliates of foreign companies increase domestic export by either shipping products from Israel back to their parent foreign companies or using Israel as a global commercial hub as part of their global supply chain. Exports lead to economic growth and a growing demand for output from local sources.
- **Increasing Employment.** Investments by foreign companies, especially in the manufacturing sector, lead to a higher employment in the local market and create many new high-paying jobs. As often these jobs need to be supported by other functions, according to industry estimates, each manufacturing job leads to two to five additional supporting jobs in the Israeli economy.<sup>10</sup>
- **Higher Wages.** Research shows that foreign investment increases wage levels in respective industries and the market as a whole.<sup>11</sup> This is a critical benefit in developed markets, such as the US and Israel, where in absolute terms wages have been stagnant for a long time and costs of living have been rising – which are among the reasons for income inequality, poverty, and significant political pressure on policy makers to act. The social unrest in Israel in 2011 is a direct result of these recent economic developments. One of the consequences of this pressure is the ongoing debate in Israel and around the world on the adequate minimum wage. Israel's minimum wage rose in 2016 to 4,825 shekels (around \$1,225) and rose again on January 1, 2017, to 5,000 shekels (around \$1,270).
- **Promoting Research and Development (R&D).** Many of the Israeli affiliates of foreign companies are mainly R&D centers, taking advantage of the country's cutting hedge technologies, quality of human capital, strong academic-industry nexus, and a culture and an ecosystem of innovation. The economy ministry's "Invest in Israel" unit counts more than 270 foreign-owned R&D centers in Israel. Foreign acquirers

often keep their research capabilities in Israel while outsourcing manufacturing to foreign markets. The economic and strategic advantages of R&D activities are unparalleled. They foster economic growth, introduce innovative products, and support significant numbers of high-paying jobs. In the Israeli context, the rising foreign investment in R&D centers gives Israel a competitive advantage on defense matters, as it provides Israeli security and defense companies with the necessary financial resources for advanced R&D projects.

- **Bilateral and Regional Economic and Strategic Relations.** Foreign investment tends to bring together economic interests from the countries involved in a particular transaction. Spillover effects may lead to other follow up and new transactions in the future. Also, industries with national interest often involved the sovereign governments themselves, a fact that calls for deeper bilateral relations. Additionally, when it comes to a very sizeable transaction, especially if it is the first foreign investment in a given industry or from a new market, the acquisition can be a game-changer and help to establish new diplomatic or economic relations. ChemChina's acquisition of Makhteshim Agan,<sup>12</sup> a global leader in the chemicals industry, had this effect on China-Israel bilateral commercial relations. It opened the door to several subsequent China-Israel cross-border transactions, and built the necessary trust and experience among advisors, such as lawyers and accountants, who tend to work on similar transactions.

### ***“Strategic Assets” and “Strategic Industries”***

Several countries with similar security tensions have approached this issue by dividing commercial assets and industries into different categories based on their strategic importance to the economy and national security.

Assets or industries which are defined as “strategic,” according to this model, require extra scrutiny of potential foreign investors or become unavailable for foreign investment. The extra scrutiny may lead to the question what kinds of “national security” risks are relevant to the “strategic” industry or asset. Generally, in those markets, “strategic assets” and “strategic industries” with a high level of vulnerability get more attention in the national security debate.

As mentioned, “strategic assets and industries” are ill-defined in the Israeli regulatory framework, which makes it difficult for both policy makers and private actors to implement an effective investment review mechanism. While looking at the “strategic” element of financial legislation from a comparative perspective, nations around the world have developed various approaches to regulation of foreign investment. These models often reflect the different constitutional structures and roles of national security in the economy. Most of them were developed following the terrorist attacks of September 11, 2001:

- **The first approach** involves the adoption of legislation that screens and blocks foreign investment transactions based on the *profile of the buyer*. In the French context, it would be the rules about state-linked companies’ acquisition of French companies.<sup>13</sup>
- **The second approach** is *case-based analysis* of proposed transactions by a special governmental body, comprising representatives from all relevant ministries, which can either look at the economic benefit of the transaction or national security risks. Such review mechanism exists in several leading Western democracies, such as the US, Canada, and Germany.<sup>14</sup> Even if one would adopt this approach, identifying national security risks does not necessarily mean that the proposed transaction should be blocked. The US experience shows that aggressive and effective mitigating agreements could allow many foreign transactions in the Israeli market. Mitigating measures can include, for example, a separation between business units based on their economic or national security impact; separate boards for different parts of the company to make sure that the risky part of the company has local nationals on its board; periodic review by the government of the operations of the target company to assure compliance with the national security review process; and involving governmental officials in certain key corporate decisions such as change of control and sales to foreign sovereign entities.
- **The third approach** includes adoption of legislation that limits foreign investment in *specific industries/assets* (traditionally energy, telecommunications, transportation, informational technology, defense and space, and other regulated industries). Russia, for

example, has a specific law that lists “strategic industries” and blocks access to foreign investors.<sup>15</sup>

Israeli legislation does include discriminatory elements against foreign sovereign buyers (first approach) and rules about specific limitations on investment in specific assets or industries (third approach). These limitations are driven by both economic rationale and strategic factors. However, Israel has not adopted a review mechanism that makes decisions on a case-by-case basis, according to well-defined and publicized parameters. Such a mechanism could bring the clarity and consistency to the process that so many foreign investors are looking for. This would add to the current FDI regulatory framework in Israel. Indeed, clarity and consistency take the flexibility from the government's decision-making process and its ability to adjust investment rules based on the identity of the buyer and the profile of the asset, taking into account national security concerns. Yet, any proposed mechanism can include checks and balances to make sure that clear consistent rules are supplemented by some executive discretion when necessary and appropriate, led by senior government officials.

In light of the open nature of the Israeli economy and the various benefits of the above-mentioned foreign investment, it is not surprising that historically the Israeli government has not dealt with strategic industries or assets in a systematic and interdisciplinary way. The Israeli parliament has avoided legislation that provides investors with clear rules about the strategic importance of Israel's industries and its consequences.

The approach has been driven by two vectors. First, case-by-case legislation has been adopted that prevents foreign investors from investing in particular markets or companies due to national security and other related public policy concerns resulting from the identity of the foreign buyer or the profile of the asset/industry. Such fragmented legislation covers, for example, the telecom, media, and aviation industries. The national security establishment provides input to the legislative process that identifies the threats based on their own internal analysis only. Secondly, national security exceptions in general corporate laws have allowed the Israeli government to protect its interest in the private sector.

One example of the first type of legislation is Israel's 1982 Communication Law, which covers the telecommunications industry as a whole, including phone, mobile services, satellite, broadcasting, etc. By imposing restrictions on ownership of broadcast licenses, the law explicitly blocks foreign investment in cases where the investor is a foreign government<sup>16</sup> or when the investment poses a *national security risk*.<sup>17</sup> A foreign government is allowed to own up to 10% of the license by indirect ownership only.<sup>18</sup> This legislation presents two different concepts of foreign investment review. On one hand, the Communication Law does not define what a "national security" risk is, and thus gives the designated minister broad discretion to examine the potential risks of a proposed investment and decide how to respond to the license application. The text does not include the parameters that need to be factored in by the government during the national security review process, which provides the government with great latitude.

On the other hand, the law does not allow any foreign government under any circumstances to invest and gain control of a broadcasting license. The assumption underlying such legislation is that access to a media platform provides such a government a critical ability to have a political impact, which becomes a threat during times of emergency. This limitation on foreign ownership does not make an important distinction between a sovereign central government and a quasi-private commercial entity owned or controlled by a foreign government. One of the most exciting developments in recent years in the global economy is the development of sovereign legal entities that are active in private markets and serve commercial purposes.<sup>19</sup> They are motivated more by financial returns and business goals and less by political forces, and they provide critical liquidity to global capital markets. Research shows that most of these entities operate and invest similarly to other institutional investors.<sup>20</sup> Indeed, there are commercial entities that execute sovereign policy and serve as a long-arm of the government. Yet, a blanket sovereign restriction on ownership in the communication sector prevents such quasi-entities from entering the market, fostering competition, and improving pricing.

The Israeli government may want to consider a policy change that would allow such entities to invest in order to create a competitive environment that does not present serious security threats.

Some of the references to national security concerns, as mentioned, are exceptions or additions to general corporate or securities laws. Defense Corporations Law (Protection of National Security Interests) - 2005 and Government Companies Law are leading examples. The Defense Corporations (Protection of National Security Interests) Law gives the Prime Minister, the Minister of Defense, and the Minister of Industry the power to designate “defense corporations” and “security interests.” An entity can be designated as a “defense corporation” if the corporation, including via its subcontractors or suppliers, deals with defense know-how or equipment that is used or intended to be used by Israel's defense forces. Thus, an organization that targets non-defense markets exclusively cannot be designated as a “defense corporation.” However, if the activity of the corporation is of “substantial defense significance,” the status of the corporation could change.

This designation has wide implications. The named ministers can issue orders if they conclude that Israel's national security “is liable to be harmed” as a result of potential acquisition or having a control of the company, venture/merger with another entity, or transfer of knowledge. In fact, one cannot transfer control of a defense corporation without prior approval from the Minister of Defense. This mechanism gives the Israeli government the ability to designate a commercial company as a corporation of “substantial defense significance” and block a potential takeover of that company by a foreign entity, claiming national security risks. Here, as in the Communication Law, the legislation does not provide the factors that need to be taken into account as part of the “national security” or “substantial defense significance” definitions. This ambiguity leads to policy inconsistency, as some defense companies are up for sale to local and foreign investors while others are excluded, and many potential foreign buyers would prefer to avoid penetrating the Israeli market altogether.

The recent controversy between the Israeli government and the high-tech community surrounding Israel's policy regarding limitations on exporting cyber technologies shows the complexity of prioritizing and regulating strategic industries. The Prime Minister's office, together with the Ministry of Defense and other ministries, has promoted an order<sup>21</sup> that would impose restrictions on, and increase the level of review of, the export of cyber technologies in the civil market. The industry that has been developing cyber

civil technologies based on prior defense experience has been placing a lot of pressure to withdraw this proposal.<sup>22</sup> While the Prime Minister's office has been driven by protection of sensitive technologies and the resilience of its National Cyber Bureau,<sup>23</sup> the tech industry has been more concerned about its competitiveness in global markets. Eventually, the Prime Minister withdrew his proposal,<sup>24</sup> while keeping exports of defense technologies and dual-use products under the supervision and approval process of the Ministry of Defense and establishing a new unit within the Ministry of the Economy to support the civil cyber industry while monitoring its potential national security risks, when applicable.

The Government Companies Law, which governs Israel's state-owned corporations, on the other hand, describes the interests that the Prime Minister and the Finance Minister should take into account when identifying "vital interests" as part of a privatization process of a state-owned corporation covered by this legislation. Among the factors or concerns the government should look at are: assuring the continuity of activities essential for national security or for Israel's foreign relations; assuring the continuous orderly supply of essential public services; maintaining the company's character as an Israeli company (e.g. center of business in Israel); supervising the control, exploitation and development of mineral deposits or natural resources; and making sure that all or some of the officers of the company and holders of other positions are Israeli citizens and residents for reasons of national security. Maintaining the company's character as an Israeli company imports a more economic rationale to a rather security-oriented list of factors.

This list gives us a better sense of what Israel considers "vital interests," at least when it comes to government companies and their privatization process, and this analysis can be exported to other policy areas, such as strategic industries and their review more generally.

The importance of the Government Companies Law should not be underestimated. This legislation is broader than laws covering specific industries or even defense companies. Moreover, the number of state-owned companies in Israel, 67, is still among the highest in OECD countries,<sup>25</sup> in light of Israel's historical shift from a centralized economy to a market-base economy. According to a recent OECD report on state-

owned companies, they are highly concentrated in strategic sectors on which large parts of the private sector depend, and half of state-owned companies by value operate in the network industries (telecom, electricity and gas, transportation and postal services).<sup>26</sup> Some state-owned companies are commercial by nature and have been in the process of privatization for couple of years, while others are non-commercial, mixed, or undergoing structural changes.

Interestingly enough, the above-mentioned factors include both traditional national-security and commercial considerations. Thus, for example, securing the Israeli essence of the company by keeping most of the company's operations in Israel is designed to secure the country's economic viability, which practically adds national economic resilience to the strategic assets protected by this legislation. Israeli officials have insisted over the years that any proposed foreign acquisitions of large employers in Israel's periphery, such as Teva and ICL, would not lead to corporate relocation to foreign markets. Similarly, access to natural resources, not necessarily only in times of emergency, can be perceived as protection of national economic interests in order to secure competitive pricing and unlimited quantities of the resource for local markets. Some would argue that inclusion of commercial interests in such legislation can open the door for protectionism and dilution of the concept of "national security." This concern is real. Nevertheless, Israel is not alone; countries like Canada have also included economic interests in their national security review, especially when it comes to state-owned companies.<sup>27</sup>

According to this analysis, the Israeli approach to the review process of foreign investment includes both traditional national security concerns and economic considerations, such as job creation in Israel and access to valuable natural resources. It also imposes investment restrictions based on the identity of the investor (such as sovereign governments) or the nature of the acquired business and its national security implications (such as media and broadcasting). However, it is important to note that while certain laws do refer to "strategic assets" or "national interests," or include the factors to be considered as part of the national security review of such assets or interests, the reality is that this is a fragmented and inconsistent process. Foreign investors who are interested in looking

at the Israeli economy across different sectors and industries will find it difficult to accurately assess Israel's policy towards foreign investment in ill-defined strategic assets, such as commodities and railroad infrastructure, and how Israel addresses national security concerns. This challenge may affect their assessment of the time of review process, its costs, and likelihood of effective results.

Israel's struggle with "strategic assets" or "strategic industries" should be understood in the broader context of the role of economic analysis in defense decision-making process in Israel. The relatively limited role of economic thinking in the national security apparatus and its institutions, including the National Security Council and the Israeli Parliament's Foreign Affairs and Defense Committee,<sup>28</sup> makes it harder for the national security establishment to provide policymakers and legislators with a comprehensive approach. Conversations with National Security Council senior officials indicate limited funding and personnel for the National Security Council's economic analysis work. Similarly, policymakers and legislators in the investment space do not always have the right tools to properly integrate national security concerns into financial legislation.

### ***The Future of Foreign Investment in Israel***

The effectiveness of any policy change and future foreign investment regulation in Israel will be measured in light of the state of the economy, the macroeconomic environment, and the nature of the national security threats to Israel. While the slowdown in China,<sup>29</sup> volatility in emerging markets such as Turkey, and slow recovery of European and US markets may take their toll on the Israeli export-driven economy,<sup>30</sup> the Israeli market currently shows economic and political resilience and a strong growth potential, especially in cutting edge and emerging technologies and associated investments.

In June 2016 alone, according to IVC, Israeli startups have raised over \$561 million in capital, across almost all sectors and subsectors.<sup>31</sup> Silicon Valley, on the other hand, has experienced a slowdown, especially with respect to "unicorns," disruptive start-ups with more than \$1 billion valuation. More generally, recent numbers are very positive. According to IVC, Israeli high-tech exits hit \$9.02 billion in 2015, up 16% from

2014; VC-backed exits reached \$4.98 billion, the highest in 10 years; and merger and acquisitions deals below \$1 billion is the strongest in 10 years at \$7.2 billion. Hence, the interest in Israel as a target market for foreign investment will continue to grow, though the profile of the new investors has been changing. In 2016, Israeli companies have raised significant funding from strategic companies such as Qualcomm, Sony, Volkswagen, MGM, and Alibaba. While there has recently been some slowdown in trade activity in Israel in light of global economic trends, the country's exports are well diversified geographically and across different industries,<sup>32</sup> which has reduced the slowdown's impact on Israel's economic activity. In fact, the Israeli economy is expected to grow 3.25% yearly in 2017-18, according to recent OECD forecasts.<sup>33</sup>

The macroeconomic environment and fiscal policies support this growth story. Improving the economic environment also includes tax cuts, low inflation rates, lower commodity prices, and governmental policies that promote competition and lower consumer pricing. Yet some factors impose challenges for the industrial, export-oriented, sector. The strong currency has made the Israeli market less competitive in global markets, though the policies of the Trump administration may strengthen the US dollar and weaken the Israeli shekel moving forward. Additionally, anti-business political climate has deterred many potential foreign investors in recent years. The long and fierce dispute between the Israeli government and energy companies in the oil and gas sector is one of the leading examples, which still has an impact on market perception and business opportunities.<sup>34</sup> Additionally, despite the various attempts to reduce red tape and bureaucracy, Israel still suffers from overregulation according to international rankings,<sup>35</sup> and regulatory uncertainty has been a market barrier in many industries.

Investments in the Israeli technology sector are expected to grow in areas with unique capabilities, such as financial technology (FinTech), advertising technology (AdTech), and cyber security. Some of these fields, such as advertising technology, are important for commercial innovation. Others are tied to Israel's essential infrastructure. FinTech and cyber security, for example, have direct bearing on the resilience of Israel's critical financial, banking, and government infrastructures.

In fact, Israel has created an effective ecosystem in cyberspace, becoming a world leader. In 2014, a new advanced technologies park was established in the southern city of Beersheba, which ties the park's resident companies with the Israel Defense Forces (IDF) technology campus. This project already has been successful in attracting foreign investments from global companies.

Finally, it is important to note that, fortunately, Israel's significant internal and external security challenges have had only limited impact on the strength and growth of its economy, which has proven resilient with continued growth.<sup>36</sup>

## **INVESTMENT REVIEW AND POLICY IMPLICATIONS**

### ***New Legislation on Foreign Investment***

Over the years, investment legislation has been more concerned about trade in sensitive technologies and strategic assets than in foreign investment in Israel's national assets. Very little regulatory work has been done to develop a comprehensive approach to foreign investment.

With regard to foreign investment in military and defense technology, Israel would be well advised to adopt a system similar to the US government's CFIUS review process, which regulates takeovers and investments by sovereign foreign entities and government.<sup>37</sup> There could be a similar Israeli intra-ministerial process, with two levels of review.

The review process needs to be transparent. It does not have to define "strategic assets" or "strategic industries," but it has to provide investors with information about the review process and factors that have been considered for approval or rejection. Since the goal of such review is to provide existing and future investors with clarity, predictability, and consistency, it is important to share with the public what are the factors underlying any decision. Foreign investors will take into account these factors when contemplating future investments in the target market, avoiding investments that may threaten national interests. It would also provide credibility to the investment review process as a whole.

In order to do it, the government can provide seasonal reports on the main factors and recent trends to be considered, while keeping information about specific transactions confidential. Under the US model, Congress publishes an annual report with statistics about transactions, reviews, approvals, rejections, and approvals upon conditions.<sup>38</sup> The report also refers to trends and industries in order to better understand the government's position with respect to risks associated with specific industries. Not disclosing the details of specific reviewed transactions in the annual report and other similar documents minimizes any potential national security risks.

Any proposal to establish such a committee should take into account potential concrete risks to Israel's strategic interests, which can be factors that should be included in any comprehensive review mechanism of foreign investment transactions in the future. The US legislation includes a non-exclusive list of factors that impact the evaluation of security and economic threats resulting from a foreign investment.<sup>39</sup> These factors are designed to secure America's defense and strategic advantage in global markets, as well as access to the nation's strategic assets and commodities in time of peace and war. Most of these factors can be applied in Israel, especially in light of the recent growth in its energy and cyber industries. Moreover, the factors included in the above-mentioned Israel's Government Companies Law can guide the legislative process and be integrated into a new comprehensive investment review process. These factors might include:

- **Capability to meet long-term requirements for energy sources and other critical resources (coal, natural gas, etc.).** Foreign investments in the energy and commodities sector can lead to high levels of exports, under-production for the Israeli market, or re-allocation of resources, so consequently the Israeli market cannot meet its long-term needs. This factor is particularly important when there is no existing specific legislation that addresses this concern. The Israeli government, for example, has addressed it specifically in the natural gas market when created an export limit by legislation.
- **Israel's critical infrastructure (the national grid, access to port facilities and airports).** The Israeli economy has transformed itself in recent years and has gone through privatization of state-owned

companies and national assets. Any review process of foreign investment should take into account the protection and resilience of Israel's critical infrastructure.

- **Main energy assets**, such as natural gas transmission pipelines (Tamar's pipeline and on-shore pipelines to factories and other natural gas users). Any access to the pipeline networks in times of peace and war can threaten the access to and the resilience and credibility of the energy market. Investment review process in midstream energy companies should look carefully at the exposure of the pipeline networks to foreign control.
- **Israel's domestic production** needed to meet national defense requirements (including, for example, the availability of human capital, products, technology and materials). The IDF and Israel's defense sector depend on the reliability of commercial third parties. Some of these entities are critical to meet national defense requirements.
- **International technological leadership with impact on national security.** Defining certain sectors, such as IT infrastructure, as strategic, raises the issue of technological leadership. Foreign investment review process should examine that.
- **Critical technologies** (such as cyber security national initiatives), taking into account diversion of technologies under the current Israeli export control regime. The Israeli government controls its critical technologies via the Israeli export control regime. Foreign investment in critical technologies should be aligned with the interests of this regime.
- **Israel's current and future sales of military goods, equipment, and technology to other foreign countries.** The advanced defense sector is one of Israel's leading industries. Foreign investments in companies in this sector should not interfere with the strategy and execution of this process.
- **Israel's bilateral diplomatic and military relations**, in light of potential political influence by foreign state-owned corporations

(including areas like media and communication). Investments by foreign state-owned entities can lead to attempts to use commercial interests to influence Israeli diplomacy and foreign relations. While recent research shows that sovereign wealth funds generally tend to invest in a commercial manner, leaving politics aside, certain countries and industries tend to involve more foreign diplomatic and military influence.

Some countries, such as Canada, are integrating “economic benefits” tests into the review process of a proposed transaction (jobs creation, economic growth, export markets, domestic consumption and access to goods and services, etc.).<sup>40</sup> Often, the Israeli media does not differentiate between traditional “national security” threats and “economic benefits,” and criticizes the government for moving forward with specific transactions, without taking into account certain economic threats, such as losing research and manufacturing centers to other markets, or threatening the edge of leading industries. While foreign investment’s “economic benefits” have long-term impact on Israel’s strength and resilience, transactions that pose risks to local employment and goods do not necessarily change Israel’s strategic positioning. Using economic analysis as a pretext to reject or impose restrictions on a proposed transaction due to national security concerns without any regulatory grounds can send serious negative signals to local and global markets and suggest that Israel is not open for business and the government is not pro-foreign investment, with serious long-term economic consequences for growth and jobs creation. The “economic benefits” analysis should be a reflection of the government’s economic policy, and can cautiously be (but does not have to be) part of a policy reform and the intra-ministerial review process.

In fact, the new US administration may go this direction as part of its protectionist economic approach, and will likely reform its investment review process to include economic factors. Congress has recently asked the Government Accountability Office to review the effectiveness of the current CFIUS review process of foreign investment in America.<sup>41</sup> This request was politically bipartisan, driven by the frustration of both Democrats and Republicans with recent trends in foreign investment in the US market. Early indications of a potential reform of the foreign investment review process show that future legislation may add economic

considerations and requirements, such as a “net benefit” or economic security test; a reciprocity test (e.g., are the same industries in China open to US investors?); greater authority for national security agencies on economic matters; expanded jurisdiction to include and review Greenfield investments (i.e., building operations or constructions from the ground up directly instead of purchasing an existing entity); limitations on FDI or ownership in certain sectors or industries; and limitations on foreign sovereign wealth funds and state-owned enterprises.<sup>42</sup>

It is too early to judge how Congress may change the CFIUS review process or how the Trump Administration would implement it, but clearly the new government may use the investment review mechanism to implement trade-related policies, such as limitations on Chinese investments in protected sectors like agribusiness and manufacturing.

Australia has very recently moved in a similar direction following a wave of Chinese investments in its territory. It established a Critical Infrastructure Center within the Attorney General’s Office, meant to identify and register critical national assets with national security concerns. It is currently reviewing the foreign investment review process executed by the Foreign Investment Review Board.<sup>43</sup> While originally the Australian government was concerned about water, energy, and ports, the current review process may broaden the process and introduce new considerations. Among recent blocked transactions are the proposed Chinese takeovers of an Australian electricity company, a large Australian landholder, and a port facility that is close to a US Marine base.

In Israel, adoption of any systematic, comprehensive, and consistent investment review process should be supplemented by flexible executive power that can respond to any threats to national security and other interests. Investments should be reviewed on the senior ministerial level, and the appropriate government authority should have the ultimate say.

A sample of recent concluded or proposed takeovers of Israeli companies by foreign investors shows the importance of adopting a new comprehensive approach to foreign investment and especially investment in projects that relate to national security. The proposed policy reforms could have

resolved some of these takeovers' difficulties. For instance, in 2013, ICL, a global Israeli manufacturer of products based on unique minerals for agriculture, food and engineered materials, discussed a merger with Potash, a Canadian company and the world's largest potash producer.<sup>44</sup> Once the merger talks became public, Yair Lapid, the Israeli Finance Minister at the time, announced he would not support the transaction.<sup>45</sup> His approval was necessary since ICL was a state-owned corporation before being privatized, and the Israeli government kept a "Golden Share" that allows it to accept or reject a change of control of the corporation.

Lapid was mainly reacting to pressure from the media and public, claiming that selling such an important national corporation and national natural resources to a Canadian conglomerate would have a devastating effect on the Israeli economy. ICL has been the largest employer in the Negev, a region in Israel's South that historically has suffered from lack of employment opportunities, sluggish economic growth, and high levels of poverty. ICL's tax payments also contribute significantly to the national budget. The Minister's announcement, without a thorough analysis at first, had a significant negative impact on the stock of the target company and its valuation.

Eventually, the Ministry of Finance rejected the deal based on its own analysis despite support from the Prime Minister's Office.<sup>46</sup> In 2015, the Israeli media reported that an internal report by the CFO of the ministry led to such a determination.<sup>47</sup> The report, according to the press, listed the following as reasons for rejection: approval of acquisition would lead to a limited decision-making in Israel with respect to daily corporate decisions; losing its competitive advantage vis-a-vis its Jordanian competitor; failure of the acquisition in contributing to Israel's economic growth and ICL's profitability; influence exerted by foreign policy and political considerations on the relationship between the Israeli government and ICL; and ambiguity around Potash's tax obligations in Israel post-merger. This report also referred to the fact that Canada itself rejected a proposed takeover of Potash by the Australian market leader BHP Billiton, proposing some conditions in case the Israeli government did eventually approve the deal. These included assuring Potash's tax payments to the government, honoring ICL's prior commitment to invest in a new 3.5 billion NIS

project in Israel, establishing a committee on taxation of Dead Sea's natural resources, and making sure that Potash would not sell itself to a government and/or entity that is hostile to Israel. Only this last factor is directly connected to national security considerations.

This internal ad hoc and insular review process allowed Israel's finance minister in the ICL case to make irresponsible or uninformed statements. The finance ministry's internal analysis did not include other parts of the government in an intra-ministerial way, and its internal report did not differentiate between traditional national security concerns, which should have required an input from the security establishment, and economic and financial resilience concerns. A comprehensive and transparent analysis might have led to different results.

The Israeli insurance industry has also experienced similar trends. Companies like Clal Insurance and Phoenix Insurance have been looking for new foreign investors following a decline in profits and tighter regulation. The nature of the insurance business has invited Chinese insurance, financial, and real estate groups to express their interest and negotiate with the companies and Israeli regulators. Limitations on credit and local investments in China due to oversupply in recent years force many Chinese individuals and investors to deploy capital abroad, especially as long-term patient investors in developed markets. Since many potential American investors are subject to strict capital requirements and other regulations, Israeli companies find potential Chinese investors easier to deal with.

Yet, the Israeli government is concerned about the identity of the buyers, particularly since many of the proposed buyers are tied to the Chinese government or raise questions about the source of funding and its legality, issues that are critical to an industry with a wider systematic impact on local and global financial markets. Insurance companies in Israel are managed conservatively, and many of them serve as the main provider of liquidity to public markets and safety net to Israeli workers in retirement. While these are not strategic concerns by nature, they raise the importance of the nationality of the acquirer and its credibility to the fundamentals of the financial and pension markets in Israel.

The review process of the Chinese investment groups that have expressed their interest in Israeli insurance companies has been focused on insurance regulation, capital requirements, and the “fitness” to control an insurance company. In order to sell a controlling stake of an Israeli insurance company, the Israel Insurance Superintendent must give the individual investor a permit to control an Israeli insurance company,<sup>48</sup> based on financial fundamentals, corporate governance reputation, and “fit and proper” analysis (similar to a directors’ qualification). Criminal background, for example, would be under the last category. This review process does not formally engage other ministries. Historically, the Insurance Superintendent has not publicly disclosed considerations behind the final decisions reached. The current Insurance Superintendent has rejected several attempts by Chinese companies to inject capital into these Israeli insurance companies, and has referred to various risks such as insufficient capitalization and reputational and security risks associated with the identity of the Chinese individuals who maintain control of the investment vehicles. Some of these risks, in fact, have already materialized.

The Chinese mega investment group Fuson was in advanced acquisition negotiations with the Phoenix Insurance Company in 2015.<sup>49</sup> The Israeli Insurance Superintendent tentatively provided the necessary approval. However, after the chairman and founder of Fuson disappeared for a few days in late 2015, rumors surfaced of a criminal corruption investigation by the Chinese authorities. Consequently, the Israeli government suspended the approval process and the Israeli company and Fosun had to withdraw the deal.<sup>50</sup> Beijing has revamped its efforts in recent years to prosecute government officials and corporate executives for corruption in order to deal with civil disobedience more broadly. Some of these cases have national security components as well since the acquirer involves ties to the Chinese military or other parts of the security establishment. Insurance in general has limited defense use, but it provides a deep access to national critical data bases and impacts broadly the financial system. This saga forced Phoenix to pursue several other bidders, many of whom were Chinese. Fujian Yango Group, a Chinese holding company, signed an agreement to acquire the Phoenix Insurance Company in 2016 for 1.95 billion shekels, but the Israeli government has not yet approved the transaction. Similarly, the Israeli Insurance Superintendent rejected several applications by Chinese investors to acquire Clal Insurance,<sup>51</sup> and no final transaction is in sight.

There are general perceptions about lack of good corporate governance in Chinese organizations and over-intervention of the Chinese government in the operations of Chinese public and private corporations in China and abroad. However, these perceptions alone cannot serve as a justification to reject a proposed transaction. In general, ownership of an insurance company does not grant access to a unique IP portfolio or a national security asset, but rather serves as a financial investment and a source of liquidity. Indeed, corruption and other criminal allegations may pose a serious threat to Israel's financial markets and even its national security due to the systemic importance of insurance to the market and society more generally. Yet, every decision must be tied to a thorough and structured review process and concrete risks that cannot be mitigated by an agreement between the Chinese buyer and the Israeli company. Such an agreement may include, for example, a commitment to have Israeli citizens serve on the new corporate board.

The review process of an acquisition of an insurance company in Israel is done separately within the finance ministry. Transforming the process into a broader intra-ministerial review, including a systematic and comprehensive inclusion of a "*national security*" review by the security establishment and its relevant ministries, can signal predictability, consistency, and transparency to the market. The current decision-making process, which is centralized and unpredictable, may deter many important potential investors, including Chinese, from entering the Israeli market. Such a dysfunctional review process may lead to long-term negative economic consequences, such as lack of liquidity, limited competition, distorted pricing, and slow economic growth. Hence, this paper's investment review proposals have a significant importance for the insurance industry as well.

Makhteshim-Agan, another market leader in Israel in the commodities industry, was sold to ChemChina in 2011.<sup>52</sup> This transaction was one of the first acquisitions of leading Israeli multinational corporations by a Chinese investor. While several politicians and commentators raised concerns about the impact of the sale on employment and economic growth in the south of Israel, the transaction was approved relatively quickly and national security considerations had not played a significant role in the approval process by the ministry of finance and the Prime Minister's office. The company (now known as ADAMA Agriculture Solutions) is a leading manufacturer

and distributor of branded off-patent crop protection products including herbicides, insecticides and fungicide. While both ADAMA and ICL transactions raise concerns about economic resilience and future effects on national budget, ADAMA involves manufacturing with no defense use, which may have made a difference in this case.

## CONCLUSION

### *An Industry-Based Approach*

These case studies emphasize the importance of a systematic review of an industry as a whole, in addition to specific buyers and sellers. The necessity to analyze a whole industry derives from the need to identify strategic assets and provide consistent and policy response to investors in particular industries. Our examples show that the Israeli government has not yet communicated to the external investment community what its vision for foreign investments in Israel is in the insurance and commodities markets, among other industries. This vision is crucial for many multinational companies when they compare various target markets and attempt to make informed investment decisions, which are often costly and time-consuming.

In addition to a more comprehensive and intra-ministerial foreign investment review process, and an industry-based approach, Israel also needs a better and more consistent integration of national security considerations in its foreign investment and economic review processes. This requires a better understanding of markets and economic factors within the national security apparatus.

Thus, for example, in recent years, there have been efforts to reform national security councils globally to better address new threats and conduct a more inclusive national security analysis that includes, among other things, economic and business factors. Within the Israeli context, the National Security Council Law – 2008, which establishes the Israeli council, does provide for the National Security Council's participation in defense budget analysis and discussion. However, the current legislation marginalizes any reference to economic analysis of threats, foreign investment, and potential strategic responses. By contrast, the US National Security Act of 1947 (as amended)<sup>53</sup> refers specifically to such broader strategic analysis.<sup>54</sup> Again,

Israeli capabilities in the economic arena are currently limited. Israel should develop a better understanding of, among other things, the volatility of emerging markets (such as Turkey), the strong appreciation of the US dollar, the growth of the Chinese currency in a slowing economy, and their effect on political and military instability in the Middle East as well as foreign investment trends in various industries.

The adoption of a formal intra-ministerial review process of foreign investment by the Israeli government could integrate such an interdisciplinary national security approach into its practices. In general, Israel's State Comptroller showed in his 2012 report on the implementation of Israel's National Security Council Law – 2008 that Israel's National Security Council does not fulfill its mission to provide a neutral and integrated, "second opinion" national security analysis.<sup>55</sup> This conclusion has a dramatic effect on commercial issues, such as review of any proposed military budget and foreign investment in the Israeli economy.

In addition, many Israeli defense institutions should adopt an institutional-cultural shift towards a more diverse and inclusive approach to defense analysis. Such an approach would encourage and embrace new perspectives, such as taking into account economic and business factors in areas where it was previously less common. The profile of the personnel in many institutions shapes the national security process. Currently, the national security establishment promotes a revolving-door approach, where most of its leaders go back and forth between defense institutions and private markets. Israel's defense institutions should create a more diverse pool of employees, including business executives, economists, and diplomacy experts, for a diverse decision-making process and a better and more effective risk-management system. The national security leadership itself should take the lead in initiating and implementing these changes. A more qualified workforce familiar with the investment-security nexus, a better integration of economic thinking into the national security establishment, and a stronger and more structured participation of the National Security Council in investment decisions are all important steps towards a more effective review process of foreign investment in Israel. Together with the various proposed investment reforms that have been discussed in this paper, Israel should be better prepared for its new, exciting, and safe economic future.

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- 55 For a complete Hebrew version of the Report, see <http://www.mevaker.gov.il/he/Reports/Pages/114.aspx?AspxAutoDetectCookieSupport=1>.

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