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Investment screening is new normal but business interests can still be protected

Many countries have become wary of foreign investments on account of security concerns. This has implications for Singapore firms and investors.

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There was a time, not very long ago, when most nations were chasing foreign direct investments (FDIs) and throwing open their doors to investors. But national security concerns and supply chain disruptions have changed the picture dramatically, and many countries no longer automatically welcome foreign investors without first considering the implications for security and economic resilience.

These considerations are pertinent for Singapore, too, and our firms and investors will have to adapt to the new regulatory environment when they consider venturing abroad.

In the past few years, several countries have introduced or strengthened measures to subject investments in strategically important companies to greater scrutiny. Among them are open economies that have always been welcoming of investments, but now see a need for further safeguards to balance national security and economic interests.

The European Union Screening Regulation enacted in 2019 encouraged member states to adopt and renew FDI regimes to shield EU businesses from foreign takeovers that could pose a risk to security. As at April 2023, 24 out of 27 EU member states had FDI regimes, while about 90 per cent of Organisation for Economic Co-operation and Development (OECD) countries have regulations to screen investments.

While investment screening may be a necessary reality in the post-pandemic world, countries must take care to sustain a conducive business environment while protecting their national security. Firms and investors, on their part, will need to factor in time for investment screening and be prepared to address any regulatory concerns that may arise.

THE NEED FOR INVESTMENT SCREENING

Investment screening itself is not new. Governments in the United States, Europe, Asia and South-east Asia already had, for many years, powers to restrict foreign investments in sectors deemed to be critical or sensitive. For example, China's Foreign Investment Law places restrictions on investment into sectors such as nuclear power plants, film production and genetic treatments. Vietnam's Law of Investment prohibits or requires approval for foreign investments in sectors such as rice export and mineral mining. Within the OECD, 60 per cent of member countries had investment screening regulations as early as a decade ago. Globally, sectors commonly regulated include energy, public utilities, banking and telecommunication services.

The Covid-19 pandemic underscored the need to protect critical supply chains and essential sectors. Governments scrambled to procure medical protective equipment, ventilators and vaccines, while some also restricted the export of food and other resources in the face of domestic shortfalls. Disruptions to trade arising from port closures and other supply chain snarls further compounded policy-induced bottlenecks.

In addition, governments were concerned about undesired foreign acquisitions of companies in financial distress brought about by the pandemic. As a result, there was enhanced scrutiny of FDIs in countries such as Spain, France, Germany, Italy, Australia and India, while Canada extended timelines for national security reviews in 2020-2021. While investment screening thresholds were temporarily lowered in France and Australia in response to the pandemic, recent amendments to FDI regimes in most countries are permanent.

Meanwhile, geopolitical tensions have stoked national security concerns. There is fear that investments in strategic companies may be motivated not just by commercial interests, but also geopolitical objectives. Besides gaining access to critical technologies and resources, foreign acquirers may seek to exercise influence by economic means, leading to concerns over foreign interference, particularly when the acquiring firms are state-owned or controlled. Furthermore, governments have a strong interest in protecting technologies and data seen as critical to their societies.

The result is that across the world, trade policy and national security have become increasingly intertwined.

NEW MEASURES AND EXPANDED SCOPE

Among the jurisdictions that have recently broadened and enhanced FDI review mechanisms are 15 OECD countries including the US, United Kingdom, France, Germany and Italy. These jurisdictions have taken measures such as expanding the scope of investment screening to cover more sectors deemed important to national security, lowering thresholds requiring notification of investment, lengthening review periods as well as stiffening penalties for non-compliance.

The Netherlands most recently enacted new laws to screen investments in sensitive infrastructure and technologies, while Switzerland is considering its own investment screening regime amid concerns that this could make it less attractive to businesses. Even Ireland, a leading global technology hub, is planning to pass a new "Screening of Third Country Transactions Bill" that will screen investments in a wide variety of technologies including artificial intelligence, robotics and semiconductors.

Governments are also undertaking detailed reviews of investments and are becoming more inclined to intervene in transactions, whether by blocking them entirely or imposing remedies. The acquisition of NKT Photonics, a Denmark-based fibre laser manufacturer, by Japanese company Hamamatsu Photonics was rejected under Denmark's Investment Screening Act. A German acquisition of UK telecommunications company Truphone was cleared under the UK's National Security Investment Act (NSIA), but with the requirement of a government-approved security chief and security auditor.

In many Western countries, Russian and Chinese investors have come under increased scrutiny due to the Ukraine war and big power rivalry. However, Western governments have also stepped up screening of transactions involving "friendly" countries, such as intra-EU transactions. The UK and Netherlands screen not just investments by foreigners, but also those by their own citizens.

POTENTIAL IMPACT ON INVESTMENT AND BUSINESS

While serving a necessary purpose, investment screening may add friction to cross-border investment at a time when countries are looking to rebuild after the pandemic. Beyond the few investments that are blocked by regulators, there may also be other transactions that are abandoned due to the difficulty – perceived or otherwise – of obtaining regulators' go-ahead.

FDI regimes can also place a burden on investors and potential targets. FDI reviews for national security are often triggered at considerably lower thresholds than merger and acquisition regimes focusing on market concentration. Even relatively small transactions involving limited governance and control rights have come under scrutiny.

This more stringent regulatory environment means that Singapore firms planning to make acquisitions overseas should take steps to manage and mitigate the risks from investment screening. Before undertaking a transaction, they should carefully consider the possibility of being flagged for national security or public interest risks.

In some jurisdictions, the thresholds for notification may be subjective. What constitutes a national security risk that would trigger a review is often not clearly defined. For instance, France takes a case-by-case approach in deciding whether an activity is subject to review, which depends on what is deemed sensitive at the time of a transaction.

All this places a burden on investors who have to put in extra effort in terms of due diligence and preparation for FDI filings, as well as set aside time for government reviews and regulatory decisions. There are also costs of mitigating the risk of triggering government intervention. Some investors may face conditions that limit their ability to place members on boards or restrict their access to information.

Investors who fall foul of reporting obligations or fail to follow through with remedies may be subject to criminal or civil penalties. Fines for non-compliance may be pegged to the value of the transaction (in France and Spain) or a percentage of the controlling entity's worldwide revenue (in UK). The aim is to make the penalty commensurate with the financial means of the investor and to serve as an effective deterrent.

Differences in regulatory requirements across FDI regimes and the overlapping mandates of multiple agencies within the same jurisdiction may all make for a less predictable environment for FDI.

Start-ups may be particularly affected as they are highly dependent on timely access to funding. Venture capital firms may face uncertainty arising from mandatory notifications at each round of investment, and differing regulatory treatment across instruments such as options and convertible debt.

WHAT REGULATORS AND FIRMS CAN DO

Even if investment screening regulation is deemed necessary, it is important to protect the legitimate interests of companies and investors while balancing the interests of the public.

Business costs can be reduced by ensuring that investment screening departments are well staffed with the appropriate expertise to enable timely reviews and fair outcomes. More frequent communication between regulatory case managers and firms also helps.

Greater transparency on trigger events for reviews as well as the outcome of reviews will also help. Also, certain categories of investors such as private equity and portfolio investors could be exempted from notification. Australia, for instance, allows investors to apply for exemption certificates, which serve as upfront approval for lower-risk investments. Jurisdictions such as France and the UK also provide investors with informal confidential guidance prior to notification. Meanwhile, Australia, China, Japan and the UK offer avenues to appeal against regulators' decisions.

This more stringent regulatory environment means that Singapore firms planning to make acquisitions overseas should take steps to manage and mitigate the risks from investment screening. Before undertaking a transaction, they should carefully consider the possibility of being flagged for national security or public interest risks. It is important to take into account how a regulator may view an investor's or target's global operations, relationships and investment portfolio. Investors should also consider the political sensitivity of the deal and, if necessary, spell out how the proposed transaction would align with the host nation's security and economic objectives.

Investment screening is emerging as a vital policy tool that many countries have adopted. While this will increase compliance costs for investors, it need not deter them, provided the regulations are well designed and implemented. Ultimately, investments can thrive only in a safe and secure environment, which requires that national security concerns be appropriately addressed.

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