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Foreign Direct Investment: Striking the Right Balance

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Many countries around the world, including the United States, have long-standing safeguards against takeovers by foreign investors in strategic sectors, such as defense, utilities, and transportation. However, the walls inhibiting foreign investment on the basis of national security are growing taller in many jurisdictions.

Controls against foreign direct investment are starting to apply beyond the takeover context, often triggered by lower levels of foreign investment than before—at 10 percent or even 1 percent of a company's shares. Many carry significant penalties for noncompliance. In addition, because of the COVID-19 crisis, countries such as Germany, France, and Spain have extended their controls beyond traditional sectors to the healthcare and biotech sectors.

Governments around the globe have a legitimate interest in protecting national security and the public health of their citizens. But foreign direct investment laws are often drafted so broadly that regulated funds and their managers are getting swept up, though they are neither activist investors intending to change the strategic direction of a company, nor do they intend to take over a company. It is in governments' interest to strike a better balance in their rules, so that they can protect national security while still allowing beneficial investments that help their countries' companies and industries grow. Providing exclusions or safe harbors to global regulated funds and their managers would help achieve this objective.

Regulated funds publicly offered to investors in jurisdictions worldwide now manage [US\\$68.6 trillion in total net assets](#). They provide growth to capital markets around the world, helping companies grow and prosper. Foreign investments make up a significant portion of regulated funds' investments—an estimated 22 percent of assets under management (AUM) of US-registered investment companies^[1] is invested outside the United States, and an estimated 70 percent of AUM of UCITS is invested outside the European Union.^[2] Asset managers of these funds invest on behalf of investors to fulfill the stated investment objectives of their funds with no intention to control or secure board seats of their portfolio companies for themselves.

Yet, in their attempt to protect sensitive industries, many governments do not recognize that investment funds and their managers differ from state-sponsored or activist shareholders. For example, in January, Australia implemented major reforms to its foreign investment review framework, including the introduction of new national security powers that require the screening of investments that may raise national security concerns and grant the government the authority to "call in" for review actions that were not otherwise notified. Under the law, foreign investors that want to acquire an interest—typically 10 percent or more—in a "national security business" must notify the government of their plans and await approval. Noncompliance carries heavy costs: criminal penalties of up to 10 years in prison and civil penalties of up to AUS\$525,000,000.

The law in Australia is wide-ranging. It covers state-sponsored or activist shareholders, as intended. But it also covers regulated funds and their managers. By subjecting regulated funds and their managers to the law's requirements in the same manner as state-sponsored or activist shareholders, Australia runs the risk of diminishing its attractiveness as a market to beneficial overseas investors when such investors could play an important role in recovering from the COVID-19 crisis.

It would be more beneficial to countries' overall economic well-being and national security if governments recognized that asset managers to regulated funds are not seeking to control the companies in which their funds invest. Rather, these managers are buying securities on behalf of investors to fulfill a regulated fund's investment mandate, whether as a European growth fund or a technology fund, for example. To help preserve and encourage foreign investments that do not threaten national security, countries

could exclude, or provide safe harbors to, certain investors—such as regulated funds—subject to compliance with certain conditions.

Some countries have already chosen this type of approach. Japan's recently implemented foreign direct investment controls exempt certain regulated foreign financial institutions, including asset management companies and registered investment companies, provided they comply with certain conditions, such as not becoming directors or corporate auditors of the target company.

In a world that is more interconnected than ever, it is important to fend off foreign threats to strategic industries—but not at the expense of constricting productive foreign investments. It is in every nation's interest to make the distinction between the two in their foreign direct investment laws. The health of their economies may depend on it.

[1] Data include mutual funds, money market funds, and exchange-traded funds, and exclude closed-end funds, UITs, variable annuities, and fund holdings not classified as equity or fixed-income securities (e.g., cash). Data are based on ICI calculations of Morningstar data.

[2] Data include UCITS funds and UCITS exchange-traded funds, and exclude fund holdings not classified as equity or fixed-income securities (e.g., cash). Data are based on ICI calculations of Morningstar data.

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