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The Emergence of National Security Considerations in Foreign Investment Regulation

KEY TAKEAWAYS

- While national security considerations when developing foreign investment regulation isn't new, it is becoming a greater consideration when assessing investment into sectors and companies that play a critical function to society or are of strategic importance to a country.
- Some countries have begun to specifically identify and delineate 'sensitive sectors' in the context of investment regulation.
- There are varying degrees of intervention countries have taken on this issue which demonstrates that there isn't a formulaic approach as a country's national priorities and risk appetite should guide policy development.
- Australia, Canada, Japan and Singapore have made policy decisions on how to balance the need to safeguard their national security while maintaining their attractiveness as an investment destination.
- As the international environment continues to become more complex, Sri Lanka will also have to contend with these issues and develop its own approach, while balancing its development and foreign capital attraction needs.

Disclaimer: This Note is based on work produced by a visiting researcher associated with CSF and is intended to support an in-person discussion. View expressed may not necessarily reflect those of CSF.

Foreign investment has long been key to supporting a nation's economic prosperity through access to international markets, technology and innovation. The risks arising from foreign investment, particularly national security, have increased due to a confluence of developments, including rapid technological advancement and changes to the international security environment. This has blurred the lines between economics and national security and prompted policymakers to think beyond an economic lens alone when developing foreign investment regulation.

Countries like Australia, the United States, Canada, Japan, the European Union, India and Singapore are strengthening their foreign investment policies to safeguard their national security. This note discusses the increasing prominence of national security when developing foreign investment policy, examines the different approaches that have been taken by Australia, Canada, Japan and Singapore and concludes by providing considerations for Sri Lanka to factor national security into foreign investment regulation.

As geopolitics increasingly influences the international economic environment, Sri Lanka needs to be front footed in balancing its economic and development objectives against its national security interests.

This note is not intended to advocate for protectionist policies. Countries prosper when they are open, dynamic, and have robust mechanisms to respond to external shocks. This note aims to raise awareness of the risks arising from foreign investment into sensitive sectors which require a nuanced approach that balances maintaining a country's investment attractiveness while safeguarding national security.

Why consider national security in foreign investment regulation?

Australian Treasurer, Dr Jim Chalmers, in his 2024 address to the Lowy Institute stated, "we recognise that in facing the most challenging strategic environment since World War II, economic resilience is an essential component of assuring our national security." Rising tensions in the Middle East, developments in Ukraine, increasing geostrategic competition in the Indo-Pacific and sluggish economic recovery post-COVID highlight the need for governments to be agile and alive to geo-political risks when developing economic policy.

Foreign investment is an example where governments are considering these international developments as it increasingly sits at the nexus of a country's economic and national security interests. While the free flow of capital should not be undermined, there is a growing need for safeguards to be in place to review proposals that run the risk of causing a loss of control over supply chains (e.g. agriculture), the sharing of sensitive information (e.g. health data), or impairment of critical infrastructure.

Australia's 2023 *Critical Infrastructure Resilience Strategy* defines critical infrastructure as "physical facilities, supply chains, information technologies and communication networks, which if destroyed, degraded or rendered unavailable for an extended period, would significantly impact the social or economic wellbeing of the nation or affect Australia's ability to conduct national defence and ensure national security".

Box 1: 'Sensitive Sectors'

Sensitive sectors refer to specific areas of the economy that are often subject to greater regulation and government oversight due to their importance and potential impact on national security, public welfare, or economic stability.

For example, telecommunications is crucial for national security and the efficient functioning of modern societies. It encompasses everything from internet service providers to mobile networks and satellite communication. Due to its importance, governments often impose strict regulations on who can operate within this sector and how data can be managed and shared.

If a foreign company wants to acquire a significant stake in a domestic telecommunications company, regulatory bodies will scrutinise the proposal. They would assess potential risks associated with foreign control over critical communication infrastructure, which could include the possibility of espionage or cyberattacks. Such scrutiny ensures that the sector remains secure and operates smoothly, safeguarding national interests.

These policies are not exclusively being introduced in advanced economies, with developing countries also looking to introduce their own foreign investment screening regimes. The recent update to the ASEAN-Australia-New Zealand Free Trade Agreement introduced a carve-out for screening regimes from dispute settlement provisions. This is outlined in

Chapter 18 (General Provisions and Exceptions) Article 6:

Article 6 - Screening Regime and Dispute Settlement

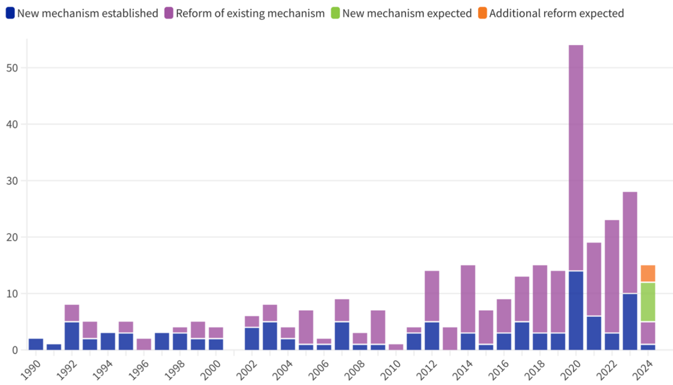
A decision by a competent authority, including a foreign investment authority, of a Party, on whether to approve or admit a foreign investment proposal, and the enforcement of any conditions or requirements that an approval or admission is subject to, shall not be subject to the dispute settlement provisions under Section B (Investment Disputes between a Party and an Investor) of Chapter 11 (Investment) or Chapter 20 (Consultations and Dispute Settlement).

As outlined at this link, there is a designation of a competent authority to all ASEAN countries, including, Cambodia and Myanmar and Laos, indicating that they may implement a foreign investment screening mechanism in the future.

2009 OECD Guidelines for Recipient Country Investment Policies relating to National Security

While there has been an increased conversation about national security with respect to foreign investment, it is not a new issue. In 2009, the OECD introduced *Guidelines for Recipient Country Investment Policies relating to National Security*. It recognised that safeguarding national security was an important part of investment policies in some countries but underscored the importance for countries to achieve their national security policy goals with minimal impact on investment flows to provide certainty to investors. However, a lot has changed since 2009 with many countries introducing foreign investment screening mechanisms or strengthening existing ones to respond to evolving national security concerns (see Figure 1).

Fig. 1: Introduction and reform of investment policies to safeguard national security interests in advanced and transition economies (1990-2024)



Source: OECD

A 2024 OECD Secretariat policy paper identified "long-term geopolitical and geo-economic changes triggering a surge of attention to security implications of certain foreign investments and international economic interaction more generally". These changes included, "increasing participation of State- guided investors pursuing their sponsors' strategic objectives, a decline of consensus on values and on rules for international economic interactions, transformational technological change, and concerns about the security of supply of essential products and services".

Overview of approaches taken in selected countries

Australia

Australia screens foreign investment above monetary thresholds set under the *Foreign Acquisitions and Takeovers Act* on a risk-based, case by case basis. Australia uses a 'negative test' – meaning there is a presumption that foreign investment proposals should proceed unless found to be contrary to the national interest. If it is determined that a proposed investment is contrary to the national interest, it will not be approved, or conditions will be applied to safeguard the national interest.

Factors that are considered when determining if a foreign investment proposal is in the national interest include; national security, competition, character of the investor, impact on the economy and community, and other Australian Government policies (including tax).

In 2021, Australia undertook reforms to enhance its national security which comprised of four elements:

- mandatory notification of proposed investments into the most sensitive sectors of the Australia economy, regardless of value;
- the ability for the Treasurer to "call-in" investments that were not otherwise subject to mandatory notification, but assessed as posing national security risks;
- the option for investors to voluntarily notify investments to avoid the risk of being called in; and
- a "last resort" power to enable the Treasurer, in rare circumstances subject to safeguards, to review and revise the approval of an investment where national security risks emerged that could not have been foreseen at the time of initial approval. This applies to investments made after 1 January 2021.

There are safeguards in place for the "last resort" power. The Treasurer conducts a review and considers advice from relevant government departments, then takes reasonable steps to negotiate in good faith with the foreign investor. The Treasurer will only use the "last resort" when they are satisfied that exercising the last resort power is reasonably necessary for purposes relating to eliminating or reducing the national security risk, and that the use of other options under the existing regulatory systems would not adequately reduce national security risk.

In May 2024, the government announced measures to give further clarity to foreign investors on sensitive assets and sectors which would require greater scrutiny while streamlining the screening process for known investors with a good compliance record making investments in non-sensitive sectors.

Canada

In 2021, Canada introduced reforms to the *Canada Investment Act* to include measures called the net benefit review and the national security review. The net benefit review allows government to review high value acquisitions of Canadian businesses valued above the relevant threshold by taking into consideration factors such as the impact on economic activity, competition, and compatibility with other government policies.

The national security review allows the federal government to conduct a national security review of any foreign investment, regardless of its value and whether it is subject to the mandatory filing requirements under the Act. The government relies on a variety of means to identify these investments, including referrals from security and intelligence agencies, news releases, media reports and commercial databases. These transactions are assessed for their applicability of the Act and potential for national security injury.

Since the introduction of the national

security review, the Canadian Government ordered the divestiture of three foreign investors from Canadian critical mineral companies in 2022 and the dissolution of two Canadian drone detection and wireless security businesses, Bluvec Technologies Inc. and Pegauni Technology Inc, in 2024.

Japan

In 2020, Japan amended its *Foreign Exchange and Foreign Trade Act* to require foreign investors to notify the government if they plan to acquire a stake of 1 percent or higher in 518 designated Japanese companies from 12 sectors including oil, railways, utilities, arms, space, nuclear power, aviation, telecoms and cybersecurity. This is a revision up from the original notification threshold of 10 percent.

The amendment included 'blanket exemptions' from notification requirements for foreign-supervised financial institutions if they planned to buy stocks for asset management purposes. Exemptions could also be obtained where foreign institutional investors did not plan to become board members, propose to transfer or dispose certain business activities, or access non-public information about investee companies' technology.

Sovereign wealth funds and pension funds were eligible for an exemption if they passed a screening process and signed an MoU with the Japanese government, however post-investment reports would still be required if they exceed the 1 percent threshold.

Foreign state-owned entities, except those that had been accredited by the Japanese government, were generally not entitled to these exemptions.

Singapore

Singapore is one of the latest countries to introduce foreign investment screening with the introduction of the *Significant Investment Review Act* (SIRA) in March 2024. The SIRA applies to domestic and foreign investors and establishes the Office of Significant Investments Review (OSIR), which administers and enforces the SIRA. The SIRA builds on Singapore's preexisting sector-specific laws such as the *Bank Act 1970* and Telecommunication Act 1999 which have approval requirements for investor acquisitions.

The SIRA allows the government to designate entities deemed to provide a "critical function to Singapore's national security interests," subjecting them to certain ownership and control restrictions. Section 18 of the Act requires investors to notify the government before acquiring a 5 percent stake, and Section 19 obliges investors obtaining a stake over 12 percent in these entities to receive prior approval. Existing investors with shares over 50 percent in these entities must also receive approval before divesting their stakes.

Under Section 27, the government must approve key personnel of designated entities like the chief executive and board members and can remove them at any time on national security grounds. The removal of the chief executive and board members is treated as a last resort if a mediation process fails. Section 29 empowers authorities to issue a "special administration order" where the government can effectively control the company during the period that the order is in force. Currently, the OSIR has designated nine entities in sectors including logistics, construction, marine engineering, defence, technology, and energy.

Under Section 32, the government can require any entity that has acted against Singapore's national security interests to transfer or divest equity interests and voting powers or to restrict disclosure of information to a particular person. Known as the "call-in" power, it applies to any company, designated or non-designated, that is based in Singapore. The government is limited to invoke this power to two years after a transaction is completed.

National security and international trade law

The enhanced national security measures taken by countries has raised questions about their compliance with international law including the General Agreement on Trade and Services (GATS) which addresses foreign investment in services as one of the four modes of supply of services. The provisions that are of particular concern are national treatment (i.e., a country does not differentiate treatment between domestic and foreign investors) and most favoured nation (i.e., a country does not differentiate treatment between foreign investors).

While many of these national security measures are relatively new and have yet to be legally tested, the General Exception and Security Exception under GATS gives countries the ability to take measures on the basis to "maintain public order" and protect "essential security interests" subject to certain conditions being met.

Countries have also adopted carve-outs in FTAs to protect their foreign investment screening regimes from dispute resolution and certain investment commitments (as seen in the AANZFTA example above).

Considerations for Sri Lanka when considering national security in foreign investment regulation

When reviewing Sri Lanka's foreign investment legislation, there is scope for greater consideration of national security. The *Strategic Development Projects Act 2013* defines a "Strategic Development Project" primarily through economic and social terms without balancing it against national security interests. It considers the provision of goods and services for public consumption, inflow of foreign exchange, employment opportunities and technological transformation. The *Board of Investment Act* (which was repealed by the introduction of the *Economic Transformation Act 2024*) considered the remit of the Board of Investment and did not refer to national security.

When considering the *Economic Transformation Act*, section 33(2) provides a legislative hook for Cabinet to introduce "new entry requirements or restrictions for foreign investments" if they are deemed necessary for "national security, public emergency, public safety and environmental protection".

Given the shifts in the international environment, Sri Lanka may want to consider using this provision to develop foreign investment regulation that balances economic and national security concerns. For example, Sri Lanka may want to consider the degree and concentration of foreign ownership and the type of foreign investor investing in critical infrastructure (such as telecommunications) and strategic industries (such as port development and logistics).

Key questions to consider

To support Sri Lankan policymakers' thinking on this issue, and based on the practices of the countries discussed above, Sri Lankan stakeholders can consider the following questions:

- How does Sri Lanka define its national security and more broadly, its national interest?
- What sectors and assets are of strategic value to Sri Lanka? Does this include critical infrastructure?
- Does foreign investment into these sectors and assets warrant scrutiny by the government?
- What considerations would be given to determine if the investment is in the national interest? Who will be part of that consultation process?
- If there are national security concerns, can they be managed by imposing reporting requirements or putting limitations on access and control of the business or asset?
- What sectors and assets are less sensitive and can benefit from limited or no screening? Can this can be determined through a consultation process across the relevant ministries and approved by Cabinet? Could this be defined through a monetary threshold?
- Should there be a "call in" mechanism to empower the government to order a review of foreign investment if there are national security concerns? If so, what safeguards are in place to make sure this is used in exceptional circumstances to give assurance to investors?

Participant Notes