Privatizing Investment Control: A Renaissance for Restricted Shares?

Since almost a decade now, the increased use of investment screening has become one of the most striking trends in cross-border mergers and acquisitions. The reinvigorated popularity of this policy tool of defensive economic statecraft evidences a shift in dominant ideology in capitals around the world. The previously prevalent worldview, that the forces of competition will eventually weed out a shareholder not motivated by profit maximization, is fast being replaced by an acute realization that the status quo cannot be maintained by simply turning a blind eye to security externalities.

Yet, with ever more extensive investment screening and the introduction of screening mechanisms of varying designs, governments risk burdening businesses, not just with red tape and compliance costs. National security threat analysis comes with legal uncertainty that is difficult or expensive to manage, let alone reduce. This calls for imagination as to how the policy aims of investment control can be achieved as economically efficient as possible.

As an alternative to the screening of foreign investments by a government authority, it is worth reconsidering a system of free and restricted shares. A creatively modified and updated system of restricted shares would turn companies themselves into the 'first line of defence' against geoeconomically problematic investments in a manner that, ideally, is economically more efficient and less disruptive to the capital allocation process than the current form of investment screening by public authority (only).

How did restricted shares work originally? To explain this, the case of the Swedish legislation as it existed (and evolved) between 1916 and 1991 is a useful illustration.[1] In 1829, Sweden introduced a law expressly restricting the acquisition of real estate by foreign subjects in a bid to control foreign influence over Swedish mineral resources. Since this restriction did not extend to acquisitions by Swedish limited-liability companies in foreign hands, such control was readily circumvented, with British and later German industrial interests continuing at a brisk pace to acquire significant mining assets in central and northern Sweden during the latter part of the nineteenth century. To remedy this situation, legislation was introduced in 1916 requiring government authorization of all real-estate acquisitions by foreign-controlled entities including Swedish limited-liability companies that did not have a 'restricted share clause' in their by-laws. Such a clause provided for two classes of shares: free and restricted, with 'foreign control subjects' being entitled to acquire only the latter. Companies choosing to introduce such a clause could acquire real estate freely but had to limit the share of voting rights of restricted shares to (originally) 20% of all voting rights in the company unless it obtained government authorization.[2]

The system certainly had its flaws. It was an instrument with little accuracy insofar as all foreign investors in a company were grouped together without distinction for their individual national-security risk profiles. Government authorization, likewise, was not about assessing the appropriateness of an *individual* investor's

1 The historical synopsis draws on *Statens offentliga utredningar (SOU 1992:13) Bundna aktier. Delbetänkande av Aktiebolagskommittén, Stockholm 1992* [Swedish Public Enquiries (SOU 1992:13) Restricted Shares. Interim Report by the Company Commission, Stockholm 1992], https://data.kb.se/datasets/2015/02/sou/1992/1992_13%28librisid_17112232%29.pdf.

2 Later, this was changed into a system of multiple ownership thresholds (of both capital and voting rights) triggering renewed government authorization to increase the proportion of foreign-controlled share capital or voting rights.

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acquisition, but rather about allowing a company to raise the overall proportion of restricted shares above the statutory threshold. Such a system may be acceptable for a smaller administrative apparatus without the resources to effectively screen and control individual foreign investments. That said, the legislation apparently did not prevent Sweden's transition from a largely agrarian economy to an export-driven, high-GDP economy during the decades from the 1910s and 1990s when the regime was operated.

So, what inspiration today can be drawn from this (and other) earlier experiences with foreign investment control? Arguably, today's investment screening laws rely exclusively on government oversight and intervention. By creating a 'fast lane' for companies that *choose* to have a 'restricted share clause', one could imagine an investment-screening free existence for such firms, greatly reducing the uncertainty and compliance cost for a section of the business community. Enforcement would be privatized and decentralized insofar as it would be in the economic self-interest of holders of 'free shares' to ensure that the restrictions on voting and capital applicable to holders of restricted shares were maintained in accordance with the law to avoid dilution of their own voting rights and capital shares, as well as to avoid investment screening and other sanctions.

At the same time, nuance could be built into such free and restricted share regime. For example, a company and/or foreign investor therein may be allowed to seek authorization to convert restricted shares into free ones – essentially by lifting or loosening the voting restrictions – if the *individual* foreign investment is cleared in a screening by the respective public authority. Better still would be to delegate to the company's management the initial due diligence of the relevant investor, as in a private placement, with a duty to notify the national investment-screening authority and certify the result of the due diligence. The authority could then act as a second line of defence and rely on the (domestic) company as its interlocutor. As a matter of course, in the EU, any such complementary private-public screening mechanism would of course have to comply in particular with the rules on free movement of capital and the CJEU's 'golden shares' jurisprudence. Also, limiting voting rights would not be permitted to prevent unwanted know-how transfer.

Would such an arrangement make investment screening more efficient and save taxpayers' money, while not compromising national security? The answer would likely depend on the prevalence and intensity of investment screening in the years to come. The higher the proportion of investments that are screened, the higher the likelihood that an investment will be screened, and, as a result, the higher the legal uncertainty that investments might be screened and perhaps blocked. This, in turn, leads to higher the aggregate compliance costs and greater government resources required to conduct investment screening. At some point, it will be necessary to explore ways to delegate and make the investment-control process leaner.

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