FOREIGN INVESTMENT SCREENING SYSTEMS AFFECTING COMPANIES

— MANY COUNTRIES IMPOSING FOREIGN INVESTMENT RESTRICTIONS —

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SUMMARY

- Many countries have been adopting or enacting foreign investment screening systems, and this trend is expected to continue. Japanese companies therefore must understand how each system works and how to respond if they are unfairly targeted by such regulations.
- In New Zealand, such a system was temporarily adopted due to the COVID-19 pandemic, and subsequently became permanent. While New Zealand and other countries are wary of investment by Chinese companies, there are concerns that investment by Japanese companies will also become restricted because these screening systems target all foreign capital.
- In the EU, there is a draft regulation that would target foreign-capital companies subsidized by their own country's government whenever they plan to acquire an EU company. Although it is designed to curb investment by Chinese companies, this proposal needs to be watched closely, as it could affect Japanese companies' investment in the EU.

In recent years, there has been a noticeable increase in the adoption and enhancement of regulations on foreign capital investment. These often arise based on the concept of expanding national security to include supply chains. The vulnerability of many national supply chains has become clear in the COVID-19 pandemic, and with the rise of China as an economic superpower. For example, in August 2021, the United States expanded restrictions prohibiting US nationals from investing in certain Chinese companies[1]. The ban prevents investment in 59 Chinese companies. These include not only those performing development for the country's military, but also airlines and communications companies such as Huawei. Meanwhile, some new regulations in recent years are targeting all foreign-capital companies. As will be explained in more detail below, there are concerns that resulting review of investment by Japanese companies could restrict the size of their investments and the types of industries concerned.

1. INVESTMENT SCREENING SYSTEMS ADOPTED AND ENHANCED TO COPE WITH THE PANDEMIC AND THE RISE OF CHINA

The investment activities of foreign companies are generally subject to various government regulations. In particular, every country has regulations directly related to national security. These prevent foreign investment in the mass media and weapon manufacturing. However, there is no universal definition of national security when it comes to foreign investment, making it possible for any country to adopt broad interpretations of the concept and apply their laws accordingly, depending on the circumstances.

The main type of this regulation has an investment screening system that sets standards for approval of foreign

[1] "Executive Order on Addressing the Threat from Securities Investments that Finance Certain Companies of the People's Republic of China", June 3, 2021, US White House

investment. The system restricts or prohibits foreign investment in designated industries such as artificial intelligence (AI), robotics, semiconductors, aerospace, and biotechnology, etc. Any potential investment exceeding a threshold amount will be subject to national government examination. The purpose is to protect the country's domestic market, as well as its industries and businesses, as part of national security, by stopping any outflow of advanced technology that could result from foreign investment in key industries, and by preventing foreign companies from acquiring domestic companies larger than a certain size.[2]

At the outset of the pandemic, due to the initial drop in global stock prices, many countries were concerned about foreign companies buying up their domestic firms at a discount. Moreover, there was a global shortage of hygiene products and medical equipment, which raised concerns about domestic medical-related companies being acquired with foreign capital. There were also worries that strategic advanced technology could be obtained by the Chinese government through corporate acquisitions by Chinese state-owned enterprises that receive huge government subsidies.[3] Therefore, many countries have been trying to protect their own companies from foreign acquisition by adopting investment screening systems or enhancing them. In fact, according to an OECD survey conducted of 62 countries, such system adoptions and enhancements have been on the rise since 2016. In particular, the number of cases jumped from 12 in 2019 to 50 in 2020, and the number of cases in the first four months of 2021 alone reached 20.[4] (Table 1)

Table 1: Overview of Recently Adopted Investment Screening Systems and System Enhancements

France	In 2020, as a temporary pandemic measure, the threshold share of potential foreign ownership requiring examination in important industries, including biotechnology, was reduced from 25% to 10%.
Germany	In 2020, a system was adopted to examine corporate acquisitions that would result in foreign ownership of 10% or more in designated industries, such as advanced technology and core infrastructure. For acquisitions in other industries, potential ownership of 25% or more is also subject to examination.
Hungary	A new system was adopted in 2019 to review potential investments by non-EU companies in the electricity, water, natural gas, and telecommunications service industries (direct acquisitions and greenfield foreign direct investments).
USA	In 2020, the US expanded its system to examine foreign investment in terms of national security. It extended the scope of potential foreign acquisitions that can be blocked to include those in the areas of core infrastructure, strategic technology, and personal information handling.
Australia	In 2015, a system was adopted to examine potential acquisitions by foreign state-owned enterprises or by companies from specific countries. Such acquisitions can be blocked based on a review in terms of national interest and security. In 2020, a temporary pandemic measure was adopted that requires review of all potential acquisitions by foreign companies, regardless of the resulting ownership stake.

Sources: Prepared by MGSSI based on "Acquisition- and ownership-related policies to safeguard essential security interests: Current and emerging trends, observed designs, and policy practice in 62 economies" May 2020, OECD; and "Transparency, Predictability and Accountability for investment screening mechanisms", 27 May 2021, OECD

2 According to the "2021 Report on Compliance by Major Trading Partners with Trade Agreements" issued by Japan's Ministry of Economy, Trade and Industry, foreign investment by Japanese companies has been subject to review by investment screening systems. The examples provided include Toshiba's acquisition of Westinghouse in the United States in 2006. The Committee on Foreign Investment in the United States reviewed the deal and asked Toshiba to revise its acquisition plan. The report also looked at US government review of investment by Japan's Renesas Electronics in Intersil Corporation in 2017 and in IDT in 2018. The US investment screening system is also explained in the report.

3 For restrictions pertaining to China's industrial subsidies, see "The Impact of China's Industrial Subsidies on Companies and the Response of Japan, the United States, and the European Union " (issued in January 2021 by Mitsui & Co. Global Strategic Studies Institute). https://www.mitsui.com/mgssi/en/report/detail/__icsFiles/afieldfile/2021/02/19/2101c_matano_e.pdf

4 "Investment screening in times of COVID-19 and beyond", 7 July 2020, OECD; "Transparency, Predictability and Accountability for Investment Screening Mechanisms", 27 May 2021, OECD.
Also, according to information this author obtained from government insiders, due to the impact of the pandemic (although the trend started before the pandemic), even jurisdictions such as the EU, Australia and Canada, which have traditionally been focused on liberalized investment policies, are moving toward regulatory measures on foreign investment.

2. NEW ZEALAND'S INVESTMENT SCREENING SYSTEM

2.1 MEASURES TO PROTECT AGAINST CHINESE CAPITAL BECOME PERMANENT

Let's look at two investment screening system cases, starting with the one in New Zealand. This is a typical example of the recent investment screening trend. When a small country like New Zealand receives a major investment by a foreign company, it can have a substantial impact on domestic markets, industries and companies. It is especially true compared to a foreign investment of the same amount in a large economy such as Japan. This is the reasoning behind the active application of New Zealand's investment screening system, and it could set a precedent for other countries to follow.

The purpose of the country's investment screening system is to prevent foreign-owned companies from buying up domestic companies during the pandemic.[5] The system is based on the Overseas Investment (Urgent Measures) Amendment Bill[6] and the Overseas Investment Amendment Bill (No. 3)[7]. These revisions to the original Overseas Investment Act came into effect in June 2020. The system has two key points. The first is that when a foreign company invests in a New Zealand company, regardless of the investment amount, if the investment increases the foreign company's ownership to 25% or more, or if the foreign company's existing ownership is increased to 50% or more, the New Zealand government must be notified in advance. The second key point is that based on the notification, the government will investigate whether the investment could harm the national interest, and then decide whether to approve or conditionally approve the investment or not.[8]

New Zealand originally introduced this system as a temporary measure, but then repealed it a year later due to pandemic control and economic recovery in the country. Nevertheless, a new review system was adopted by amending the Overseas Investment Act. The new permanent system and the key points to note are outlined in Table 2. The trend toward reducing the threshold investment amount and expanding the types of applicable industries is not limited to New Zealand. Many other countries have also been adopting review systems or tightening the applicable requirements.

Table 2. Key Points Concerning New Zealand's Investment Screening System

(1) Any investments can be subject to the national interest test.
(2) Investments in core infrastructure such as ports and important industries including telecommunications are subject to the mandatory test, and investments by foreign government investors and their associates can also be tested.

Source: Prepared by MGSSI based on "Foreign Investment Policy and National Interest Guidance", June 2021, New Zealand Government

While the New Zealand government has not explicitly stated the reason behind the new system, it can easily be recognized as a measure to control investment from China. This assumption can be made based on the fact that under the system, investment by foreign government investors and their associates can be subject to the national interest test. (as shown in Table 2, item 2). These organizations can be interpreted as foreign state-owned enterprises, namely those in China with a lot of money to invest thanks to subsidies from the Chinese government. In other words, the intention is to limit investment from China even if the investment is not directed toward core infrastructure or strategic industries.

5 "Fact Sheet: Strengthening New Zealand's Overseas Investment Regime in Response to the COVID-19 Pandemic", 13 May 2020, New Zealand Government
6 "Overseas Investment (Urgent Measures) Amendment Bill", 14 May 2020, New Zealand Government
7 "Overseas Investment Amendment Bill (No. 3)", 24 May 2020, New Zealand Government
8 "Key Questions and Answers: COVID-19 Economic Response: Reform of the Overseas Investment Act", 13 May 2020, New Zealand Government

2.2 IMPACT ON JAPANESE COMPANIES AND THEIR RESPONSE UNDER THE CPTPP

Since this system targets not just Chinese companies but all foreign companies, investment by Japanese companies could be reviewed and sometimes denied. If a Japanese company were dissatisfied with such a ruling, it could take measures under the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP). If a member country were to violate the investment chapter of the CPTPP, under a provision in the chapter (the investor-state dispute settlement (ISDS) clause), the offending country could be sued by a company of another member country that suffered discrimination as a result of the violation. This can be done through international arbitration procedures, including those involving the International Centre for Settlement of Investment Disputes (ICSID). If the arbitration ruling is made in the claimant's favor, it can receive monetary or other compensation and reversal of the discriminatory treatment.[9] Japan has already signed many international investment and economic partnership agreements with ISDS clauses, and Japanese companies are entitled to take such measures against any member country that violates a relevant agreement.

If a Japanese company were to be prevented from making an investment by the New Zealand investment screening system, in order to obtain compensation using an ISDS clause, the claim will need to meet the following three criteria. (1) A New Zealand company would have been allowed to make the same investment. The investment chapter of the CPTPP states that member countries must legally treat investment by their own companies and those of other member countries equally (national treatment)[10]. Therefore, if a member country such as New Zealand prevents an investment by a company of another member country, it could be a violation of the CPTPP. (2) The Japanese company suffered a loss due to the investment denial by the screening system. This is necessary because ISDS clause compensation is determined according to the losses incurred. (3) The investment denial was not based on national security reasons. This is necessary because under the agreement, CPTPP members are permitted to apply regulations to protect their own national security.[11] Of these three criteria, the third one is most likely to become an issue. As already mentioned, it is easy for a country to expand its interpretation of national security and extend application of its rules. It is expected that the New Zealand government and a potential Japanese corporate claimant will have differing views on whether an applicable investment denial was based on national security.

3. EU INVESTMENT SCREENING SYSTEM

3.1 REGULATION PROPOSAL WITH A FOCUS ON CHINESE GOVERNMENT SUBSIDIES

The other investment screening system to be looked at here is the one being proposed for the EU. In May 2021, the EU announced a draft regulation[12] targeting foreign companies subsidized by their own governments that seek to acquire companies in the EU. With this regulation, the EU aims to address the potential harm of foreign

[9] TPP Article 9.19 to 9.29 Although Japan and New Zealand are also parties to the Regional Comprehensive Economic Partnership (RCEP), the agreement does not have an ISDS clause, therefore it is better for Japanese companies to use the CPTPP. While not related to an investment screening system, the Saluka arbitration case from the 2000s is an example of a company using an ISDS clause. The following citation is from the Outline of Investor-State Dispute Settlement (ISDS) Procedures issued by Japan's Ministry of Foreign Affairs in 2017. "The four former state-owned banks of the Czech Republic had large amounts of bad debt, and Saluka, a Dutch subsidiary of Nomura Securities, held a 46% stake in IPB, one of those state banks. The Czech government provided financial support including the investment of public funds to three of the banks, but not to IPB. Due to this lack of support, IPB's finances deteriorated further and it was eventually acquired by one of the other state-owned banks. Saluka took its case to the United Nations Commission on International Trade Law (UNCITRAL), claiming that a series of actions by the Czech government violated a Dutch-Czech investment agreement. In 2006, UNCITRAL found that the Czech government had violated the agreement and ordered the country to pay compensation of about 18.7 billion yen plus interest to Saluka."

[10] TPP Article 9.4

[11] TPP Article 29.2 (b)

[12] "Proposal for a REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL on foreign subsidies distorting the internal market", 5 May 2021, European Commission

investment on the security of member states[13]. The key points of the proposed EU system are shown in Table 3.

Table 3. Key Points Concerning the EU's Proposed Investment Screening

(1) Whenever a foreign company with a subsidy of 50 million euros or more plans to acquire an EU company with sales of 500 million euros or more in the EU market, it must submit the plan to the European Commission in advance.
(2) If the European Commission examines the plan and determines that the positive economic benefits of the acquisition would not outweigh the adverse effects caused by a foreign-owned oligopoly in the EU market, it can take measures such as blocking the acquisition.
(3) The European Commission may take the same measures in cases where it is a new or increased investment but the EU company's turnover does not meet the threshold in (1) above, as long as the criteria of (2) above are likely to be met.

Source: Prepared by MGSSI based on a European Commission press release, "Commission proposes new Regulation to address distortions caused by foreign subsidies in the Single Market", 5 May 2021

While not explicitly stated, it is clear the EU is proposing this regulation as a precaution against the possibility that investment from China could increase, and create oligopolies in this regional market. The "Commission Staff Working Document Impact Assessment"[14], which was released together with the draft regulation, points out that Chinese companies whose financial strength is supported by subsidies from their government have distorted the EU market through investment. In 2015, the , which is subsidized by the Chinese government, acquired Italy's Pirelli, the world's fifth-largest tire maker. The report
cites this as a negative example of a Chinese corporate oligopoly in the EU market.

3.2 IMPACT ON JAPANESE COMPANIES AND THEIR RESPONSE UNDER THE JAPAN-EU ECONOMIC PARTNERSHIP AGREEMENT

Since the proposed regulation is not aimed specifically at Chinese companies, it would also apply to investment in the EU by companies from other countries. Subsidies are generally understood as financial grants from governments to companies. The draft EU regulation states that foreign subsidies can take various forms such as interest-free loans from a government, unlimited government guarantees, and tax exemptions, etc.[15] Since a strict definition is avoided, we can infer an intention to apply a broad definition. If this proves to be true, it could be assumed for example, that the potential acquisition of an EU company by foreign company that has received a loan from a government-affiliated financial institution would be subject to the new regulation.

If this proposed regulation is adopted, and a planned corporate acquisition by a Japanese company were to be reviewed and denied, then the disadvantaged Japanese company could conceivably file a claim under the Japan-EU Economic Partnership Agreement (EPA), which guarantees national treatment. However, because the Japan-EU EPA does not have an ISDS clause, an international arbitration procedure may not be available. Moreover, the national treatment provisions may not apply to subsidized companies.[16] On the other hand, under the Japan-EU EPA, a joint committee with representatives from both signatories meets once a year, and it would possible to discuss the application of the agreement.[17] Therefore, a disadvantaged Japanese company could ask the Japanese government to inform the EU of its argument that a loan from a government-affiliated financial institution is not a subsidy, and demand that the investment denial be reversed.

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[13] "Questions and Answers: Proposal for new Regulation to address distortions caused by foreign subsidies in the Single Market", 5 May 2021, European Commission

[14] "Commission Staff Working Document Impact Assessment", 5 May 2021, European Commission

[15] TPP Article 9.4

[16] Japan-EU EPA Article 8.12

[17] Japan-EU EPA Article 22.1

4. OUTLOOK

In conclusion, it is clear that each country will continue to adopt investment screening systems or tighten ones already in place. Consequently, there could be more cases where foreign acquisitions by Japanese companies are denied or subject to conditions. It is therefore increasingly important to understand what kind of investment screening system is in place in the country of investment, and to pay attention to any restrictions on the investment amount and ownership ratio, or target industry, etc. as well as what measures a company can take if it is dissatisfied with the application of these systems.