Foreign Direct Investment and National Security: Regulatory Challenges for the US and Japan

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As inward foreign direct investment (FDI) from emerging countries in both the United States and Japan increases, the two countries need to consider how to avoid protectionism while protecting national security. This requires further “fine-tuning” of FDI regulations by both Washington and Tokyo. Unlike trade rules under the World Trade Organization (WTO), there are no comprehensive agreements covering FDI. Rules on FDI have been formulated in multilateral and bilateral investment agreements rather than global ones.

The Organization for Economic Co-operation and Development (OECD) Code of Liberalisation of Capital Movements provides member countries such as the US and Japan a basis to regulate and restrict FDI under certain conditions. Article 3 of the Code allows member countries to restrict FDI when deemed necessary for (1) maintenance of public order or the protection of public health, morals and safety; (2) protection of essential security interests; and (3) fulfillment of obligations relating to international peace and security.

The FDI “State of Play” in the United States

In the United States, a law was enacted in 1988 for regulating FDI from the perspective of national security. It empowered the president to order divestment of proposed foreign takeovers presumed threatening to national security. The current Foreign Investment and National Security Act (FINSA) was enacted in 2007 following the amendment of the 1988 law. Under this system, the Committee on Foreign Investment in the United States (CFIUS) examines FDI without any limits on the scope of businesses and industries subject to examination. During the examination process, consultation is conducted on mitigating perceived threats to national security.

When initially enacted, it was assumed that FINSA would apply to proposed investments leading to the acquisition or control of U.S. military and defense related industries. However, after the terrorist attacks of September 11, 2001, homeland security came to be included in the scope of national security. More recently, the acquisition of food and agricultural chemicals industries has also been subject to extensive review. Importantly, the scope of potentially restricted areas of foreign direct investment has expanded under FINSA and CFIUS.

Thus far, presidential orders have been issued in a total of three cases. These consisted of the planned acquisition of an aircraft parts company by a Chinese state-related company in 1989, the planned acquisition of a wind turbine company by the US subsidiary of a Chinese company in 2012, and the planned acquisition of the US subsidiary of a German semiconductor manufacturer by a Chinese company in 2016. Based on these cases, the evidence is that Chinese FDI in the US receives particular scrutiny.

Although presidential orders cannot be referred to judicial review, the Chinese company in the 2012 case challenged the legality of the order. In the ensuing case, the United States Court of Appeals subsequently ruled that a foreign investor has the right to access any unclassified information that forms the basis of the President’s decision and should be given an opportunity for rebuttal. This ruling indicates the emphasis on due process of law or the transparency of the
regulation despite the wide discretion on the part of the president. The case was later settled between the parties.

The FDI “State of Play” in Japan

In Japan, FDI currently makes up about 5 percent of the total GDP. This is only one-sixth the level of the US and low by international comparison. In light of this fact, in 2013, the Japanese government set a goal of achieving 35 trillion yen (approximately USD 300 billion at the current exchange rate) of FDI by 2020 — or a doubling of the 2012 level. To achieve this goal, the government is making various improvements in the investment environment under the slogan of “Invest Japan.” However, given the current global security climate, it is also necessary to create regulations that will enable Japan to respond effectively to FDI that threatens its national security.

Japan regulates FDI through the Foreign Exchange and Foreign Trade Control Act (FEFTA) of 1949. After the Japan-U.S. Structural Impediments Initiative, the restrictions on FDI took their current form with the 1992 and 2007 amendments of the FEFTA. In Article 27, in principle, FDI is subject to an ex-post notification, while prior notification is required in cases involving designated businesses corresponding to the categories set forth by Article 3 of the OECD Code. This conforms to the fact that FDI is free in principle. Businesses that are connected with national security are subject to prior notification. Such businesses include the manufacturing of weapons, aircraft, and commodities with a high probability of being converted to military use, as well as manufacturing related to space development.

In the case of prior notification, implementation of investment plans is prohibited for a period of 30 days from the date of filing. During this period of suspension, investment plans are examined by the Minister of Finance, as well as the minister who has jurisdiction over pertinent business. If it is determined in the course of this examination that the proposed FDI is problematic, the ministers may recommend and later even order changes to the content of the investment, or the discontinuation thereof.

A discontinuation order has been issued in only one case when a British investment fund filed prior notification for increasing its holdings of shares of Electric Power Development Co., Ltd. (J-Power) in 2008. The Minister of Finance and the Minister of the Economy, Trade and Industry, after examining the notification, judged that the proposed increase in the distribution of retained earnings to shareholders would prevent J-Power from implementing its capital investment plans for nuclear power plants. This proposal was deemed to pose a threat to the maintenance of public order under the FEFTA. However, as the case related to energy policies, it can be said that the essential nature of the investment plan related to national security in a broader sense.

The Expansion of Chinese FDI Poses Challenges to US and Japan FDI Regulations

Japan and the United States are beginning to face the expansion of Chinese FDI. Both countries are considering how to therefore strengthen their FDI regulations. One legal loophole in Japan’s FEFTA compared to the US system is that it does not require prior notification of transactions concerning unlisted stocks between foreign investors. There is no necessity in distinguishing listed and unlisted stocks from the perspective of national security. Therefore, prior notification and the review process under the FEFTA should cover such transactions to avoid potential national security risks to Japan.

At the same time, Japan should establish a system for consultation with foreign investors leading to agreements on the mitigation of perceived threats to national security, and the monitoring of the implementation of investment plans. For foreign investors, transparency and predictability of regulations under the FEFTA and access to necessary guidance from ministries and agencies with jurisdiction would certainly serve as positive factors in investment decision-making.

In order to protect national security while pursuing the goals of economic growth and trade expansion, regulations of the US and Japan over FDI will need to be made both stronger and more transparent. This would require more extensive consultation with other OECD member countries to recognize regulatory coherence pertaining to national security beyond protectionism.