

Foreign Direct Investment vs. National Security: lengthy period of liberalization?

This year, two high-profile transactions involving foreign investments in a Japanese airport and power company have stirred up controversy and reopened a national debate over the limitations on foreign direct investment for national security considerations.

Liberalization of Japanese Capital Markets

Over the last several years, the Japanese government has gradually liberalized Japanese capital markets and lifted legal restrictions on foreign investment. A number of former governmental entities or public corporations, such as Nippon Telegraph and Telephone Corporation (NTT), Japan Tobacco Inc. (JT), highway-related corporations and Japan Post Holdings Co., Ltd., have been privatized in turn during the last two decades. Some companies, such as NTT and JT, were publicly listed after privatization. Most of these companies are still regulated by specific laws, that require the government to hold at least one-third of their stock. Moreover, foreign ownership of NTT must remain less than one-third. Similarly, Japan's Radio Law and Broadcast Law limit foreign investment in broadcasters to less than 20%, and the Civil Aeronautics Act limits it in air carriers to less than one-third.

Otherwise, the government generally controls foreign investment based on the Foreign Exchange and Foreign Trade Act (Forex Act). The Forex Act was amended in 1991 to replace a prior notification requirement with an after-the-fact notification requirement for most inward direct investment. Prior notification is now required only in certain restricted sectors that are classified as being related to "national security," including weapons, aerospace, nuclear energy, agriculture, fisheries, mining, electric utilities, communication and passenger transportation. Although the Forex Act provides a scrutiny process by the government based on national security concerns for foreign investment in these restricted sectors,

administrative approval has generally been granted without problems in connection with proposed investment projects.

Increasing Security Concerns

While the general trend over the last several years has been one of liberalization, recent events seem to have provoked a reconsideration of the appropriate level of de-regulation of foreign investment. The Radio Law and Broadcast Law had until recently regulated only direct foreign investment, but in 2005 new regulations were introduced with respect to indirect investment through Japanese companies. These regulations were imposed after a Japanese internet service company, livedoor Co., Ltd., acquired a large stake in a radio broadcaster, Nippon Broadcasting System, Inc., with funds raised through the issuance of about 80 billion yen of moving strike convertible bonds to Lehman Brothers.

Japan had not reviewed the inward investment regulations under the Forex Act since the 1991 amendment. However, last year the government amended the Forex Act, saying that the regulations may not be sufficiently in line with the changed security environment surrounding Japan and trends in international investment activity. The government has now expanded the scope of the inward investment regulations to include not only industries directly related to defense, but also industries making general-use products which have a high probability of being diverted to use in weapons of mass-destruction among other things.

Airport Controversy

Early this year, the Japanese Ministry of Land, Infrastructure, Transport and Tourism announced an intention to submit to the Diet a bill that would limit foreign share ownership in the operating companies of Japan's major airports for national security reasons. The restriction would require foreign ownership to be less than one-third, which created strong

opposition from some cabinet members and lawmakers in Japan.

The Transport Ministry's move drew a great deal of public attention because of its timing. According to public securities reports filed last year, it was revealed that from July until October last year an Australia-based Macquarie Group fund had acquired a little less than 20% of the shares of Japan Airport Terminal Co. Ltd. (JAT), which owns the terminal buildings of Haneda Airport (Tokyo's major domestic airport), thereby becoming a top shareholder of JAT. The Transport Ministry, however, insisted that the proposed bill was drafted not because Macquarie had acquired a large shareholding in one of Japan's main airport companies, and that the Ministry had begun discussion of foreign ownership regulations before that from a national security perspective.

JAT was established in 1953 accepting private-sector funds from the beginning and went public in 1990. While JAT owns and manages Haneda's terminal buildings, Haneda's runways and other airport facilities are owned and managed by the Japanese government.

On the other hand, Narita International Airport Corporation (NIAC), an operating company for Narita Airport (Tokyo's major international airport), was a public corporation in the past and was privatized in 2004. NIAC manages all the airport facilities including Narita's runways and terminal buildings, and all of its shares are still held by the government. NIAC is scheduled to be publicly listed next year, by selling off government-owned shares in stages.

In this manner, a clear difference can be recognized between the current situation of these two major airport corporations. With regard to JAT, the imposition of new regulations limiting foreign ownership at this stage would seem to be an after-the-fact rule change that would undermine regulatory predictability.

In February, after massive criticism, the

Is Japanese protectionism on the rise after a

government decided against submitting the foreign ownership restriction bill to the Diet at this time. However, the Transport Ministry did not give up on ultimately enacting legislation in this regard and set up an advisory panel to reconsider the regulations. The regulations which discriminate foreign investment did not gain the experts' support at the panel and in early October, the Ministry has finally decided to abandon its plan to restrict foreign ownership and commence studies toward regulations that do not discriminate between Japanese and foreign investors.

Battle over TCI's Investment in J-Power

Around the same time of the airport controversy, there was a separate battle occurring with respect to foreign investment in one of the jewels of Japan's energy sector. The Children's Investment Master Fund (TCI), a UK-based fund, holds a 9.9% stake in one of Japanese main electric utility companies, Electric Power Development Co. Ltd., known as J-Power, as its largest shareholder.

J-Power was established as a government affiliated company to remedy power shortages in Japan after WWII. In 2004, J-Power went public by selling off all government-owned shares and was fully privatized. J-Power operates 67 power stations and has a construction plan for a nuclear power station in Oma City in Japan. The Oma Power Station is planned to operate using plutonium extracted from spent nuclear fuel, which is a landmark and symbolic plan for Japan's nuclear policy.

Under the Forex Act, prior notification to the government must be made before a foreign investor acquires 10% or more of the stock of a Japanese listed company that is engaged in restricted industries as described above, including electric utilities. TCI intended to increase its shareholding to 20% and submitted prior notification to the Ministry of Economy, Trade and Industry

(METI) in January this year. After four months of a scrutiny process, METI ordered TCI to discontinue further acquisition of J-Power's shares based on the Forex Act. METI said that TCI's acquisition of J-Power's shares had the possibility to disturb the maintenance of public order, and the decision was reached to avoid any negative impact on the stable supply of electric power or the construction plan for nuclear power plants. In this case, the government conveyed their negative position to such potential acquisition from the very beginning, and never changed their position throughout the scrutiny process.

This is the first time that the Japanese government has ordered to discontinue a proposed inward foreign investment under the Forex Act. Just before the issuance of the order, J-Power was given approval from METI to install the nuclear reactor for the Oma Plant. Although TCI strongly condemned the government decision, it announced in July that it had decided not to pursue an appeal or a judicial process.

Overseas Movement

Japan's recent reconsideration of foreign investment is not unique. The so-called Exon-Florio Act in the US is well known as being a tough foreign investment regulation. Last year President Bush signed legislation amending the interagency process for reviewing foreign acquisitions of US corporate entities, including widening the scope of reviews and investigations with regard to critical infrastructure and foreign government-controlled transactions. Such reform was prompted by controversies in the US that erupted over some recent transactions, including the proposed acquisition of certain US ports by Dubai Ports World, a UAE government-controlled entity, and of Unocal Corp., a US large oil company, by China National Offshore Oil Corporation, a Chinese government-controlled entity. When the Japanese government recently amended inward

investment regulations under the Forex Act for the first time in 16 years, it seems highly likely that they strongly recognized and were influenced by such similar movement in the US.

Future Outlook

It is hard to predict what impact the current crisis in world credit markets will have on the debate over foreign investment. Until recently, there was a lot of discussion throughout the world as to whether large sovereign wealth funds constitute a threat to other countries. However, in the current financial environment, those funds may now appear less of a threat and more as a good source of much-needed capital.

Following the J-Power controversy, it is not entirely clear what type of proposed investment could provoke a negative response from the Japanese government. While the government took a hard-line approach to TCI, the government has also been desperate to show the world how indispensable foreign investment is for Japan and how attractive the Japanese market is. Obviously, in order for the government to be successful in making that case, it will be essential for the Japanese regulatory system to be seen as transparent, predictable and impartial.

MORI HAMADA & MATSUMOTO

Author profile
Hiroko Yotsumoto
Attorney-at-law of Mori Hamada & Matsumoto
Corporate, M&A and Government Relations

Read law at University of Tokyo and received a master's degree at Harvard University (Master of Public Policy). She was involved in drafting legislation as a deputy director of the Science and Technology Agency of the Prime Minister's Office and is an expert member of the Nuclear Safety Commission of Japan.

Marunouchi Kitaguchi Building, 1-6-5
Marunouchi Chiyoda-ku, Tokyo 100-8222 Japan
Tel: +81 3 5220 1813
Fax: +81 3 5220 1713
Email: hiroko.yotsumoto@mhmjapan.com