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Global Trend of Tightening FDI Screening: A Race to Build Walls?

Tomoko Ishikawa (Nagoya University) · Thursday, August 27th, 2020 · Institute for Transnational Arbitration (ITA)

The years since 2017 have witnessed a global trend of tightening foreign direct investment (**FDI**) screening processes. Major economies, including the United States, Germany, France, the United Kingdom, and the European Union have moved towards stricter FDI rules. In all of these cases, security concerns and, in particular, the need to protect cutting-edge technologies against theft and prevent foreign control over strategic infrastructure assets, have been cited by governments to explain the policy shift.

Japan is no exception to this trend. In 2019, rules on investment screening under the Foreign Exchange and Foreign Trade Act (**FEFTA**), which sets out cross-sectoral regulations on inward FDI in Japan, were tightened only two years after their last amendment in 2017. Following the 2019 amendment foreign investments in "designated business sectors" are subject to tightened regulations. According to the list issued by the Japanese Ministry of Finance (updated as of 10 July 2020), the majority of Japanese-listed companies fell within "designated business sectors'. Notably, following the spread of COVID-19 and the intensifying race to develop vaccines and treatments, the scope of "core designated business sectors" (which are subject to the most extensive regulations) has expanded to include manufacturing industries for pharmaceuticals and highly controlled medical devices. In order to address the concern that the reform causes a chilling effect on inward foreign investment, the 2019 FEFTA amendment also introduces a system for exemption from the requirement of prior notification under certain conditions.

It is worth noting that behind the 2019 amendment was recognition of the need to keep pace with Europe and the United States' movements towards strengthening inward FDI screening that occurred in and after 2017. Specifically, the interim report of the Subcommittee on Security Export Control Policy explained the need for an immediate review of Japan's inward FDI management as follows:[1)]

> "*If the level of inward FDI management in Japan is lower than others [US and specific European countries] and thus Japan becomes a 'loophole' ¼ it would not only raise security concerns through the outflow of technology but also deter foreign companies from building business relationships with Japanese companies*".

While this may be a valid approach under the current rules of the World Trade Organization (**WTO**) and international investment agreements (**IIAs**) that draw on the concept of national (as opposed to international) security interests, it also suggests the risk exists that states will continue to introduce increasingly restrictive measures on the grounds of national security, which may cause a 'race to build walls'.

Tension between FDI screening measures and investment liberalisation commitments

Introducing stricter domestic measures on FDI screening creates tension between these measures and states' commitment to liberalise international investment under the General Agreement on Trade in Services (**GATS**) and IIAs which include such commitments (**Liberalisation Model IIAs**). While the possible inconsistency between tightened screening and liberalisation primarily concerns the pre-investment stage, whether the dispute may be brought to investor-state dispute settlement fora depends on the wording of the relevant IIA and the facts of the case.

For example, under the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (**CPTPP**), arbitrable investment disputes may exist in the following situations: where an attempted expansion (e.g. an additional acquisition of shares) of covered investments is blocked under the strengthened FDI screening rules, which results in the investor incurring loss or damage; and where pre-investment expenditures for the establishment or acquisition of investments qualify as a 'loss or damage by reason of, or arising out of' a breach of investment liberalisation obligations (Article 9.19(1)).[2)] Even when the dispute falls outside the scope of investment dispute settlement, a contracting party may dispute the interpretation and application of the IIA at state-state dispute settlement forums provided in the relevant IIA (e.g. inter-state arbitration and panel proceedings). In both state-state and investor-state disputes, several major legal issues arise concerning the consistency of the screening measure in question and investment liberalisation commitments.

Possible legal issues

Liberalisation Model IIAs typically seek to avoid conflicts between domestic restrictive measures and international liberalisation commitments by providing 'reservations' of non-conforming measures and exception clauses. An increasing number of IIAs, including the CPTPP, have adopted the "negative list approach" and identified non-conforming measures, business sectors, and activities (collectively, **Activities**) that need to be excluded from investment liberalisation obligations.

Even when the relevant non-conforming measures are listed, the contracting party may not adopt new or more restrictive measures than those identified in the list in the future if they are subject to so-called ratchet obligations. Under the ratchet obligations, an amendment to any non-conforming measure must not decrease the conformity of the measure with the relevant obligations as they existed immediately before the amendment. For example, Article 9.12 of the CPTPP provides that:

> "*Article 9.4 (National Treatment), Article 9.5 (Most-Favoured-Nation Treatment), Article 9.10 (Performance Requirements) and Article 9.11 (Senior Management and*

> *Boards of Directors) shall not apply to: (a) any existing non-conforming measure that is maintained by a Party … (c) an amendment to any non-conforming measure referred to in subparagraph (a), to the extent that the amendment does not decrease the conformity of the measure, as it existed immediately before the amendment" with these obligations.*"

Therefore, in the case of the FEFTA amendments, unless a more restrictive FDI screening measure introduced by the amended FEFTA falls within the category of non-conforming measures without ratchet obligations, it would *prima facie* amount to a violation of Japanese investment liberalisation obligations. As the scope of activities Japan reserves without ratchet obligations under its IIAs is highly limited,[3] tightened FDI screening will, in many cases, have to be justified by exception clauses, particularly security exception clauses.

Security Exception Clauses

All security exception clauses in Japan's Liberalisation Model IIAs have used "self-judging" wording concerning, *inter alia*, the question of whether a measure is necessary to protect essential security interests. For example, Article 29.2 of the CPTPP provides that:

> "*Nothing in this Agreement shall be construed to: (a) require a Party to furnish or allow access to any information the disclosure of which it determines to be contrary to its essential security interests; or (b) preclude a Party from applying measures that it considers necessary for the fulfilment of its obligations with respect to the maintenance or restoration of international peace or security, or the protection of its own essential security interests.*"

This is in contrast to the 'non-self-judging' wording of necessity exception clauses in other bilateral investment treaties (**BIT**) such as the US–Argentina BIT (Article XI), Mauritius–India BIT (Article 11(3)) and Germany-India BIT (Article 12) that have been discussed in investment arbitration cases.[4] Whether, and to what extent, self-judging security exception clauses allow substantive review by adjudicatory bodies is a matter of controversy. Outside the context of IIAs, the judgment of the International Court of Justice in *Certain Questions of Mutual Assistance in Criminal Matters*[5] and the WTO panel report in *Russia-Transit*[6] both support the approach that these clauses fall under the general obligation of a state to carry out its commitments in good faith (Article 26 of the Vienna Convention on the Law of Treaties), and that the good faith standard is subject to judicial review. However, what the good faith obligation actually requires remains unclear, and will need to be assessed on a case-by-case basis.

Need for an international cooperation mechanism

As noted above, the current international law framework, in which invoking the concept of national security is the only means for states to address newly emerging security threats, has the risk of

causing a “race to build walls”. The tension between tightened FDI screening and investment liberalisation commitments, thus heightened, may lead to state-state and investor-state disputes. This underscores the urgent need to establish an international mechanism of cooperation to address emerging and borderless security threats. Doing so is admittedly challenging given the highly political and inherently sensitive nature of security issues. Nevertheless, as the tension between economic globalisation and security will certainly increase rather than abate during and after the COVID-19 crisis, now is the time for initiatives to create a mechanism for dialogue and cooperation in political, business and academic communities.

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References

?1 Translation by author. The 2019 FEFTA amendment drew on the interim report.

?2 Walid Ben Hamida, 'The *Mihaly v. Sri Lanka* case: some thoughts relating to the status of pre-investment expenditures', in Todd Weiler (ed.) *International Investment Law and Arbitration: Leading Cases from the ICSID, NAFTA, Bilateral Treaties and Customary International Law* (2005) 47-76.

?3 Under the CPTPP, such activities are identified in Annex II.

?4 E.g. *LG&E Capital Corp, and LG&E International, Inc v Argentine Republic*, ICSID Case No. ARB/02/1, Award (25 July 2007); *CC/Devas (Mauritius) Ltd., Devas Employees Mauritius Private Ltd and Telecom Devas Mauritius Ltd v India*, PCA Case No. 2013-09, Award on Jurisdiction and Merits (25 July 2016); *Deutsche Telekom v. India*, PCA Case No. 2014-10, Interim Award (13 December 2017).

?5 ICJ, *Certain Questions of Mutual Assistance in Criminal Matters, Djibouti v France*, Judgment 4 June 2008, ICJ Rep 177.

?6 Panel Report, *Russia — Measures Concerning Traffic in Transit*, WT/DS/512, adopted 5 April 2019.

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