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**FORMAL AND INFORMAL
INVESTMENT BARRIERS
IN THE G-7 COUNTRIES:
THE COUNTRY CHAPTERS**

*Occasional Paper Number 1, Volume 1
May 1994*



Industry Canada Industrie Canada

**FORMAL AND INFORMAL
INVESTMENT BARRIERS
IN THE G-7 COUNTRIES:
THE COUNTRY CHAPTERS**

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*Occasional Paper Number 1, Volume 1
May 1994*

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We are grateful to Ed Safarian, Zulfi Sadeque, Ross S. Preston, Emmy Verdun, and the Canadian Investment Counsellors in our posts abroad for their comments on drafts of this paper. We also acknowledge Corinne Nolan for her technical assistance.

This paper has been prepared to encourage discussion and debate of impediments to direct investment. Comments would be appreciated.

The views expressed in these Occasional Papers do not necessarily reflect those of Industry Canada or of the federal government.

Details of the titles available in the Research Publications Program and how to obtain copies can be found at the end of this document.

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PREFACE

In this era of globalization, international investment serves as an integrating force among the world economies. Multinational enterprises (MNEs) have been the principal actors in the globalization process, primarily through their foreign direct investment (FDI) decisions. As a result, investment policies, particularly as they relate to foreign direct investment and the regulation of MNE activity, are of considerable interest and importance in an international policy context.

Some time ago, in light of the preceding trends and in response to the increasing interest in international investment and globalization, a study was undertaken at Industry Canada of the foreign investment regimes in the G-7 countries. That project has resulted in the production of two papers - *Occasional Paper No. 1, Volume 1 – Formal and Informal Investment Barriers in the G-7 Countries: The Country Chapters*; and *Occasional Paper No. 1, Volume 2 – Formal and Informal Investment Barriers in the G-7 Countries: Summary and Conclusions*. This paper, Volume 1, is a descriptive study of the investment regimes in each of the G-7 countries. It also contains an analysis of the effects on foreign investment of the establishment of EC 1992. Volume 2 is a synthesis of the country chapters. Its role is to draw out the major lessons of the analysis.

The project that led to these papers was born out of a strong interest in investment regimes, particularly in the context of globalization. It grew out of the belief that to date, much of the writing and argument on the subject of investment regimes has had a formal and legal orientation, but has been missing important elements related to less tangible formal and informal investment barriers which in practice can play significant roles in blocking the entry of foreign direct investment.

Starting from this viewpoint, it was first necessary to fully describe the international investment regimes in the G-7 countries before efforts were made to theorize about investment impediments and develop policy perspectives. In this paper we carefully describe investment regimes trying, above all, to focus on how they actually work, taking into account economic structures and institutions. As a result, it is virtually impossible to summarize all of the detailed

information which is provided. In each case, however, the approach taken to describe the international investment environment is similar.

Each chapter begins with a short **Introduction**, followed by a section on **Institutional Developments**, which outlines the recent changes in investment regimes in each country. That is followed by a section on **Recent Investment Patterns**, which examines the pattern of inward and outward direct investment stocks and flows, as well as the pattern of merger and acquisition activity in each G-7 country during the 1980s. This section is included so that the reader can develop a sense of the relative importance of foreign direct investment in each country. We do caution the reader against linking too strongly any differences in investment performance with differences in the characterizations of the international investment environment across the G-7 countries. No attempt has been made in this paper to empirically link the two.

Next, **Formal Barriers to Direct Investment** in each country are surveyed. This section focuses on traditional FDI barriers, including such legal and regulatory restrictions as foreign investment review requirements, antitrust provisions, and sectoral restrictions. In the case of each country, the institutional mechanisms that exist for applying the formal investment regulations are fully described. It appears from the descriptions that even though there has been significant liberalization of formal investment regulations in recent years, in most countries the machinery to block foreign investment remains in place should there be the political will to do so.

The primary objective of this project has been to broaden the examination of investment impediments to include barriers to foreign investment about which little has been written, such as the role of administrative procedures, institutions, and market models in deterring foreign investment. In the section entitled **Informal Barriers to Direct Investment**, a number of those informal barriers have been identified and described for each country. Included are share ownership restrictions, the size and depth of the stock market in each country, tactical barriers to investment in corporate articles of association, government and business linkages, commercial and financial linkages, and the role of state-controlled companies.

The size and functioning of the stock markets in the G-7 countries demonstrate an important point about informal investment

barriers generally and how they can be hidden. In terms of the number of firms listed on the largest stock exchanges, the United Kingdom has the most, followed by Japan, the United States, Canada, Germany, France, and Italy. On the basis of this quantitative evidence alone, it would appear that Japan is open to investment, with a large number of potential takeover targets trading on its stock exchange. In fact, though, the keiretsu business structures in Japan limit the extent to which shares are actually traded freely; so the economy is, in reality, relatively closed to foreign investment.

To demonstrate how investment barriers work and interact in practice, each country chapter contains a section which includes **Case Studies**, providing a number of concrete examples of investment impediments at work. The drawback with case studies, however, is that they cannot capture how both the formal and informal barriers operate successfully to preclude foreign investment entirely, thus creating no cases for review. Case studies can, however, effectively illustrate how many of the investment barriers do work, often in tandem. The case of Pirelli of Italy's attempt to take over the German firm Continental AG provides a good example of how restrictions on voting rights and the power of the banks in Germany succeeded in heading off a hostile takeover, while the case of the Hongkong Shanghai Bank attempting to take over the Royal Bank of Scotland demonstrates how antitrust provisions serve to deter foreign takeovers in the United Kingdom.

A short **Conclusion** then summarizes the findings for each country, and at the end of this volume is an Appendix entitled **The European Community: Influences on Foreign Direct Investment**. The Appendix reviews the impact of the establishment of the European Community on foreign direct investment in Europe. The study recognizes that a number of EC policy actions – liberalization of internal capital movements and efforts to control state aids – have provided for freer movement of international investment flows. However, EC merger and acquisition policy and key trade policy actions have imposed important influences on international capital movements. It is the area of trade policy where international concern most consistently arises with respect to EC actions. Since the second half of the 1980s, the EC has made significant use of various trade instruments, particularly rules of origin, local content and anti-dumping measures. A number of these actions have been seen by other countries as attempts to influence direct investment flows.

The identification and description of informal investment barriers are the unique contribution of the analysis of the investment regimes in each G-7 country. This volume demonstrates that the presence, or absence, of formal obstacles and barriers to foreign direct investment does not sufficiently reflect any openness to foreign direct investment. Efforts to characterize countries on that basis alone do not capture the full picture. In fact, investment asymmetry among G-7 countries appears to result more from differences in economic structures, corporate ownership patterns and linkages between various economic actors than it does from the presence of foreign investment review provisions and sectoral investment restrictions.

In an effort to explore the conclusions and lessons of the G-7 analysis to the fullest, the companion paper, Volume 2 entitled *Formal and Informal Investment Barriers in the G-7 Countries: Summary and Conclusions*, was prepared. That paper, which serves as a concluding chapter for the project, takes stock of the combined effects of formal and informal investment impediments in the G-7 countries and draws out the similarities and differences among the countries. The paper also points to the major international policy issues that become evident from a review of the investment regimes in each country. A summary of the major issues covered in the paper follows.

While investment-rule liberalization has been popular since the 1980s, the concluding paper suggests that there has really been little change in foreign investment accessibility. The reason is twofold. First, the liberalization of formal rules has not necessarily led to an increase in the transparency of investment regimes; second, informal investment barriers are now relatively more important because formal barriers have been eased, and globalization has heightened the significance of all impediments to investment. The conclusion that overall investment accessibility has changed little in recent years is true to a greater or lesser extent for every single G-7 country.

Another conclusion reached from the analysis in Volume 2 is that the G-7 countries can be divided into three groups. The United Kingdom, the United States, and Canada appear to have similar investment regimes, with few informal barriers and with formal investment regimes that are often considered relatively liberal but, are arguably, at least partially non-transparent. Examples of the operation of Exon-Florio in the United States and the antitrust provisions in the

United Kingdom tend to confirm this conclusion. Canada falls into this category because of its similar Anglo-Saxon traditions. In reality, Canada lies somewhere between the United States and the United Kingdom in this category and Italy and France in the next category, given its corporate concentration and the preponderance of family-owned firms, coupled with a foreign investment review process on the formal side.

Italy and France are similar in that family ownership acts as an effective informal investment barrier, while there is a general lack of transparency on the formal side stemming from the operation of the foreign investment review process in France and the antitrust process in Italy.

Finally, Germany and Japan's foreign investment regimes are characterized by financial-commercial linkages that effectively block foreign takeovers. This impediment stems from a different market model than is found in Anglo-Saxon countries. The rather extreme impenetrability of Japan, particularly to foreign direct investment, is evidence of the effectiveness of such informal investment barriers.

A number of international investment policy issues became evident through the comparative analysis of investment regimes in Volume 2. In particular, the paper echoes the calls of many international policy analysts for multilateral rules governing investment, just as there are multilateral rules governing trade. Increasingly, bilateral and regional trade deals are leading to regional investment discrimination. Further, the use of reciprocity to pry open foreign investment markets poses threats to a more comprehensive and coordinated liberalization of investment regimes. The paper highlights concerns raised by Sylvia Ostry and others that Canada, as a small country, can only lose out as the larger powers conclude such bilateral deals.

In addition, the analysis clearly points to the growing importance of domestic policies and institutions as determinants of investment accessibility and this suggests that as investment liberalization proceeds, new attention will have to be given to structural economic institutions and relationships. Changing the focus of negotiations on investment away from legal restrictions on foreign investment to issues like the role of market models and institutions in influencing the accessibility of foreign investment will not be easy.

Such informal barriers reflect cultural and historical differences among societies which will be difficult to address and reconcile.

At the same time, there is growing interest in the role of institutions and in the role of corporate governance in influencing overall economic growth and productivity. New theories of economic growth have elevated the significance of structural features of economies in determining performance and increasingly efforts are being made to analytically gauge to what extent there is a causal linkage. In this project, corporate governance issues (such as financial-commercial linkages, management board structures, and ownership concentration) were instrumental in conditioning the international investment environments in each of the G-7 countries. In particular, the financial-commercial linkages which characterize Japan (keiretsu structures) and Germany are significant, if not impenetrable, hurdles for potential foreign investors. At the same time, many have argued that these linkages are key to the strong economic performances of those countries. Thus there are important linkages between this project on barriers to investment in the G-7 and work that is now getting underway on the role of corporate decision making in economic performance.

There are also a number of policy issues which emerged in the conclusion to the G-7 project relating to policy harmonization and transparency. Some argue that in an era of globalized markets, domestic policies worldwide should converge to some norm so that MNEs face a level playing field, regardless of where they choose to invest. If, as argued, domestic policies and structures are increasingly to be examined in the international arena, then it will get more and more difficult to reconcile various countries' practices, many of which have always been seen in the domain of national law, with some international norm. As a result, working towards increased policy transparency appears to be a more realistic goal for international investment negotiations, and policy harmonization efforts should be directed at ensuring that policies with an international orientation are generally consistent and non-distorting across jurisdictions.

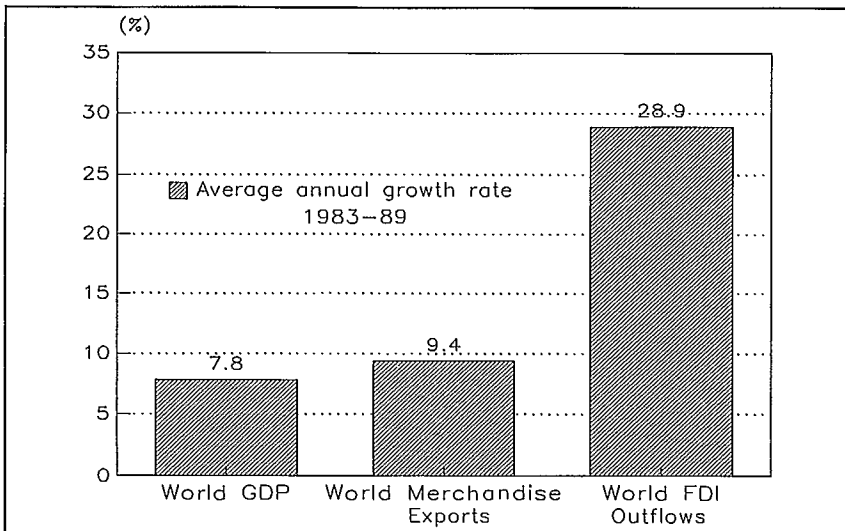
As a closing note, a caution to the reader is required. Both Volumes 1 and 2 have been written in a way that sets out an institutional framework for understanding formal and informal barriers to investment. In the absence of this framework, there is danger that readers will infer spurious links between differences in institutional

structures, which are clearly evident and differences in performance, which are also clearly evident. In addition, there are limits to the lessons that can be learned from comparisons among countries because each has unique characteristics which often reflect the particular social and individual preferences of that society.

INTRODUCTION

The purpose of this Working Paper is to examine barriers to foreign direct investment (FDI) in the seven largest industrialized countries (G-7) of the world. The paper surveys both the formal and informal obstacles to FDI in those economies. In all countries, formal controls have been liberalized over the past decade; however, the regulatory machinery needed to block FDI continues to exist in most countries. As the formal barriers to investment fell, the relative importance of informal barriers increased. The situation is similar to trade policy, where non-tariff barriers have become the focus of multilateral negotiations today after progress was made in the elimination of tariffs. These two phenomena – the liberalization of formal investment barriers and the emergence of informal ones – are the subject of this survey.

Chart I-1
Growth of World GDP, World Merchandise Exports,
and World Foreign Direct Investment Outflows, 1983-89

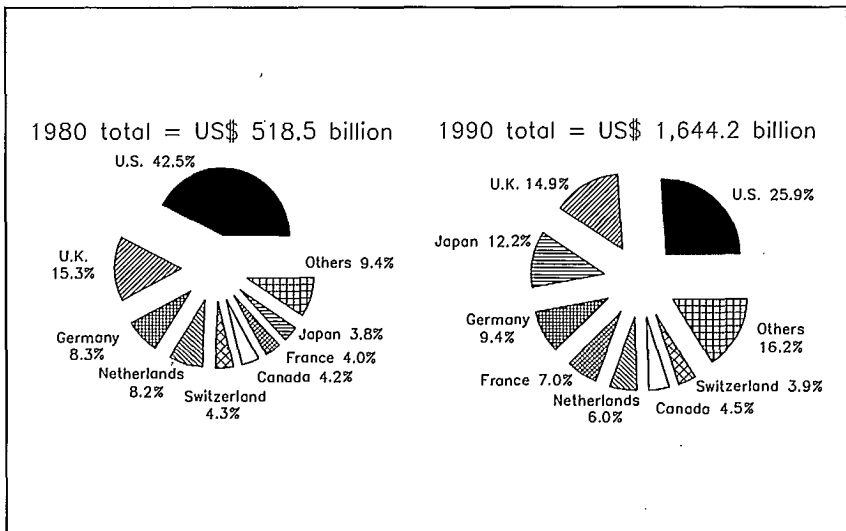


Source: United Nations Centre on Transnational Corporations (UNCTC), *World Investment Report 1991: The triad in foreign direct investment*, (New York: United Nations, 1991), p. 4.

Foreign investment has become an engine of growth for the world's economies in the last decade or so. Global direct investment activity grew by leaps and bounds. As Chart I-1 indicates, global FDI outflows from 1983 to 1989 rose at an average annual rate of almost 30% – about three times faster than the growth of world merchandise exports and four times faster than that of global output.

This explosion of FDI activity was accompanied by a marked realignment in the pattern of international direct investment. As a result of developments in the 1980s, there is a closer balance between inward and outward direct investment among the major host and home countries. The one important exception is Japan, whose outward direct investment in the 1980s consistently surpassed inward investment by a significant margin.

Chart I-2
Share of World Stock of Direct Investment Abroad,
by Major Country of Origin, 1980 and 1990



Source: Investment Canada compilations based on data from the U.S. Department of Commerce.

Chart I-2 illustrates the scope of the realignment. The United States, being the traditionally dominant source of international direct

investment, accounted for 40% of the world's outward direct investment stock in 1980. By the end of the decade, however, it owned just over a quarter of those assets. Other players – notably Japan, the United Kingdom, Germany, and more recently France – emerged as the major home countries of foreign direct investment. In the interim, the United States became a major host country to inward direct investment. The U.S. share of the global stock of inward direct investment rose sharply, from almost 17% in 1980 to about 25% in 1990.

This unprecedented rise in international direct investment activity in the 1980s was associated with a period of progressive liberalization of rules and procedures governing foreign investment in each of the G-7 countries. The removal of some of the regulatory barriers appears to have produced tangible benefits for many host governments as they compete for foreign investment in an era of global competition. By identifying the various informal obstacles to FDI in each country, this paper suggests that there is the potential to reap even more benefits.

At the outset, it is essential to clarify what is meant by "formal" and "informal" barriers. As is the case with the concept of "non-tariff" barriers, informal barriers to investment can take many forms and often lack transparency.

In this paper, formal investment barriers are defined as the set of controls on FDI explicitly introduced through legislation and government regulation. These policies typically concern the right of *establishment in key sectors*. In contrast, the informal barriers to investment are defined as an array of impediments to FDI in the host country that can arise from: administrative procedures and unpublished policies; structural rigidities in the market; and political, cultural, and social institutions that work to deflect FDI. These barriers mainly concern impediments to *transborder takeovers* rather than the establishment of new (greenfield) investments.¹

Given this very broad definition of informal barriers to investment, this paper could not be comprehensive. Certain barriers were omitted from discussion that could conceivably limit FDI.

¹ A. E. Safarian, *Governments and Multinationals: Policies in the Developed Countries*, British - North American Committee, Washington (December 1983), pp. 1-2.

These include: corporate tax structures, accounting practices, disclosure rules pertaining to a company's financial information, labour-management relations, and so on. All of these issues, particularly tax policy, warrant further work.

The remainder of this introduction describes the basic outline of each chapter. This is meant as a guide to the reader. Headings in each chapter are the same, but the broad nature of informal barriers to investment means that there can be considerable variation in the content of each country's chapter.

In general, each chapter of this Working Paper describes first the formal barriers to FDI, then the informal barriers. The introductory section in each case is followed by a review of the recent trends in FDI activity in the country being discussed. The next two sections contain accounts of the formal and informal FDI barriers that exist, consistent with the above definitions. This is then followed by a concluding section describing cases where government and business institutions have actually blocked FDI.

The formal section of each chapter begins with a discussion of the regulatory framework of FDI in the country being discussed. In some regimes, authorization for FDI may be required for all, or only certain, kinds of investment. In a few countries, authorization procedures are used as part of an active FDI policy; in others, they exist mainly for information and verification purposes.

Sectoral restrictions are also discussed at length in the section on formal barriers. In each G-7 country, certain sectors of the economy are closed (or restricted) to non-residents or established foreign-controlled firms. These formal barriers apply to a broad range of industries, including banking, insurance, broadcasting, communications, or air, land, and maritime transportation. These restrictions generally limit the foreign share of the capital of enterprises, or foreign investors' access to certain sectors and are often based on reciprocity² requirements.

Some of the sectoral restrictions find justification under the terms of the Capital Movements Code of the Organisation for

² "Reciprocity" pertains to a situation where the treatment of foreign investors depends on the treatment accorded to host-country investors in their respective countries of origin.

Economic Cooperation and Development (OECD). This Code calls for progressive liberalization of controls on inward investment by member countries; and it binds all members, including the G-7 countries. It allows for sectoral restrictions by means of "reservations" and "derogations" by each country. In addition, sectoral restrictions may be justified for other reasons, including maintenance of public order, the protection of so-called "national security interests", or the existence of public, private, or mixed monopolies.

The section on formal barriers also describes the rules and regulations defining antitrust policy in the G-7 countries, in particular those concerning cross-border mergers. In principle, merger policy in each regime is applied indiscriminately to both domestic and foreign firms; in practice, however, it is often a policy instrument through which differential treatment is accorded investors depending on their home country. This is particularly true for countries like Germany and the United Kingdom that have no formal regulatory bodies to oversee FDI activity. In addition, the sections on informal barriers discuss how antitrust policy has actually been discriminatory.

In the sections on informal barriers, the relative size of the stock markets in the G-7 countries is typically the first topic discussed. In some countries, a considerable number of domestic companies may not be listed on the stock exchanges. This is significant because it limits the scope for takeovers by all investors. Next, the discussion generally turns to ownership barriers to takeovers. In some regimes, even with relatively large, sophisticated stock markets, the ownership of listed companies tends to be concentrated in the hands of a small number of family groupings. The ownership pattern of publicly limited companies and related issues – such as cross-shareholdings – are discussed in terms of their potential to deter hostile takeover bids.

The sections on informal barriers also examine the provisions under company law that act as "tactical" barriers to contested takeovers. These include the ability of target firms to issue shares intended to weaken the relative importance of any shares held by potential acquirers. In addition, takeover obstacles can be erected through the complex structure of management boards. The chapters review how boards can be designed to make it difficult for potential acquirers to achieve full representation on them. Restrictions on voting rights and proxy voting schemes in the company laws are also

discussed. The general issue here is the extent to which commercial linkages and the corporate culture of each country act as impediments to foreign investment.

The sections on informal barriers to investment consider, too, the relative size of the public sector and the role played by state-controlled enterprises. Despite large-scale privatization in most G-7 countries, state enterprises continue to play a significant role. By definition, they exclude foreign interests from participating in economic activity. Moreover, foreign firms have generally only been allowed minority interests in firms that were privatized.

The sections on informal barriers also discuss administrative procedures related to foreign takeovers. These practices often have the consequence of controlling the way foreigners undertake direct investments. For example, some regimes use investment incentives, such as local-content rules and other forms of undertakings, as conditions for approving foreign investment proposals.

Each chapter concludes with case studies. The purpose of these sections is to describe how the formal and informal barriers interact in a regime. The cases demonstrate the ways in which the law, practices, and institutions actually work to prevent the establishment of foreign firms or block foreign takeover bids.

It has taken months to produce this Working Paper. Each chapter offers a lengthy description of the wide array of practices that can impede foreign direct investment. The addition of the concept of informal barriers to investment made the task even more difficult. Nevertheless, descriptions of the formal controls and obstacles to FDI, by country, do not sufficiently reflect the true degree of openness to FDI in each country. In no small measure, informal barriers to FDI can influence and determine the openness of different regimes to international direct investment. While there has been some progress in the liberalization of formal barriers to investment, the full story involves much more.

CHAPTER 1
FRANCE

FRANCE

Introduction

Relative to other European countries, France has traditionally displayed great sensitivity to foreign direct investment (FDI). French governments have often intervened to support domestic enterprises and to block foreign direct investment. More recently, however, the French government has singled out investment promotion as a key element of its economic policies. This has led to more liberal, albeit still selective, treatment of foreign investment. This shift in policy has occurred partly in order to redress the domestic capital shortages that developed in the early 1980s and partly because of pressures from other G-7 countries for a better balance between the growth of FDI in France and French direct investment abroad.

Institutional Developments

In 1939, the introduction of tough foreign exchange controls in France established the legal and administrative machinery to regulate foreign capital flows. While in the immediate postwar era French policy was relatively liberal in order to promote reconstruction, foreign direct investment was treated with ambivalence in France during the 1960s and 1970s. In this period, the positive aspects of foreign capital were typically weighed against the perceived disadvantages of a rise in foreign control of French industry. This combination of factors led to selective encouragement of foreign investment. There was widespread criticism of foreign firms – first U.S.-owned firms and more recently Japanese-owned firms – for establishing so-called screwdriver plants in France in order to gain access to the European Community (EC) market. Above all, there was the desire to maintain a national presence in a number of high-technology sectors.

In the late 1980s, the French government became concerned by the nation's relatively high unemployment rate and the worsening trade deficit. These problems had been aggravated by the cumulative effects of a persistently low level of investment activity in the first half of the 1980s. In addition, France's investment review policy appeared to encourage potential foreign investors to turn to other less interventionist host countries in the European Community. To address these problems, the government singled out export and

investment promotion as focal points of its economic policy. In fact, the Ministry of Finance announced publicly that it is "in our interest that foreign companies establish their activities in France, rather than in another EC country where their production would be another source of our trade imbalance. That is why the policy of welcoming job-creating foreign investment will be strengthened."³

Recent Investment Patterns

The stock of outward French direct investment at year-end 1990 was estimated at US\$ 114.8 billion, up from US\$ 20.8 billion in 1980 (representing an average annual growth of 18.6%). On the inward side, FDI stock in France grew from US\$ 21.1 billion in 1980 to US\$ 71.4 billion at year-end 1990, averaging 13% per year.⁴ As shown in Chart 1-1, the ratio of outward to inward direct investment stock was largely in balance during the first half of the 1980s. Thereafter, the relatively faster pace of outward direct investment contributed to a sharp rise in that ratio.

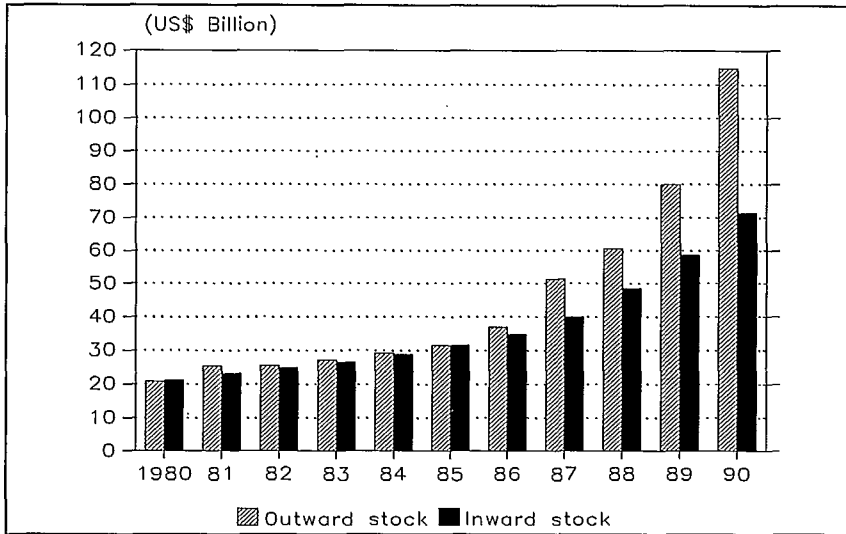
In recent years, French direct investment abroad has grown much more rapidly than incoming direct investment. Other industrialized countries raised concerns about this imbalance. In 1990, net outflows of French direct investment abroad totalled US\$ 35 billion – nearly 80% higher than the flows recorded in the previous year. In comparison, FDI inflows to France in 1990 went up 24% to US\$ 12.7 billion, representing 36% of the corresponding outward flows. France's outward and inward direct investment flows were generally in balance until 1985 when outward flows began to increase at a considerably faster pace than inward flows. Net outflows of direct investment soared from US\$ 2.2 billion in 1985 to US\$ 34.5 billion 1990, at a staggering average annual rate of 173%. The net FDI inflows into France during the same period grew from

³ *Business International: Business Europe*, "France Extends a Warmer Welcome to Foreign Investors", The Economist Intelligence Unit (U.K.) (February 20, 1990), pp.1-2.

⁴ French data on direct investment are released only on a balance-of-payments-flow basis by the Ministry of the Economy, Finance and Budget and the Bank of France. The above numbers reflect cumulative flows only, which are used as a proxy for the stock data. They have been estimated by the U.S. Department of Commerce. See John Rutter, *Recent Trends in International Direct Investment*, Washington: United States Department of Commerce, International Trade Administration (August 1992).

US\$ 2.6 billion to US\$ 12.7 billion, at an average annual growth of 137%.⁵

Chart 1-1
Stock of Inward and Outward Direct Investment in France, 1980-90



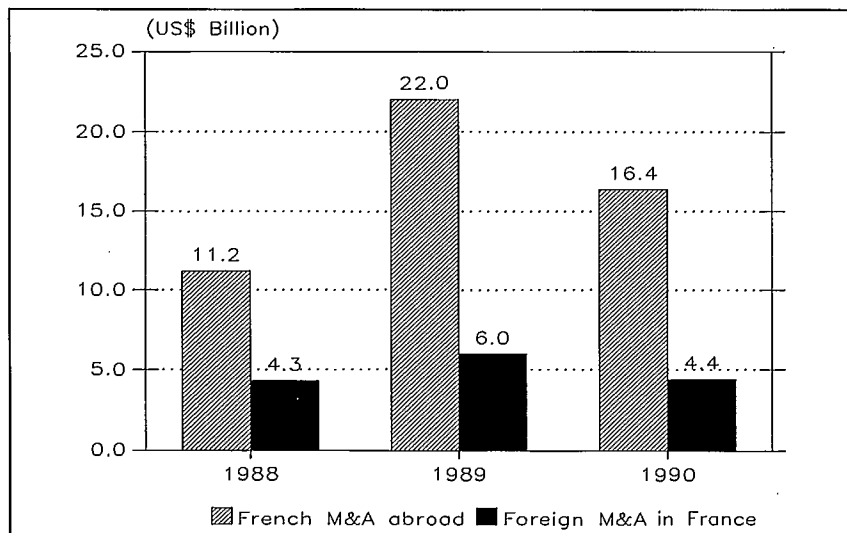
Source: Investment Canada compilation based on data from International Monetary Fund, *Balance of Payments Yearbook*; and U.S. Department of Commerce.

In the second half of the 1980s, merger and acquisition activity in France, as in most other European economies, rose sharply as a wave of industrial restructuring took place in anticipation of the 1992 European Free Market (hereafter referred to as Europe 1992). The pattern of French takeover activity reflects the same imbalance noted earlier between outward and inward direct investment flows. According to a KPMG report on international mergers and acquisitions, French takeovers of foreign companies in 1990 were valued at US\$ 16.4 billion (down from a record high of US\$ 22

⁵ International Monetary Fund, *Balance of International Payments*, 1991, and other issues. Note that the outflows and inflows of direct investment exclude reinvested earnings, the amount of which is not available from French official sources.

billion in the previous year);⁶ in contrast, acquisitions of French companies - at US\$ 4.4 billion - amounted to only a quarter of the French takeovers abroad during that year (see Chart 1-2).

Chart 1-2
Transborder Merger and Acquisition Activity in France, 1988-90



Source: KPMG DealWatch.

In 1988, the European Community accounted for 58% of the value of foreign acquisitions in France, while one-third of the purchases were made by firms based in North America. The average size of North American acquisitions, however, was three times as large as those of EC-based companies (US\$ 75 million versus US \$24 million). This reflects a greater preference by European companies to acquire and restructure small to medium-sized French companies, while North American firms have strategic interests in acquiring relatively large French multinationals. In Europe, France ranked behind the United Kingdom and West Germany as a target for foreign acquisitions in 1990.

⁶ The KPMG Report on International Mergers and Acquisitions, *Dealwatch 91*, Amsterdam: KPMG International M&A Network, p. 37.

Table 1-1
Foreign Ownership and Control in France

- ▶ The proportion of manufacturing enterprises under foreign control (where foreigners hold 20% or more of capital) increased from 6.7% in 1974 to 10.8% in 1986.
- ▶ In 1990, foreign-owned firms in France's manufacturing, mining and petroleum sectors accounted for 28.4% of assets, 28.4% of sales, 27.1% of value-added, and 23.7% of employment - up from their respective shares of 26.2%, 26.7%, 25.3%, and 21.1% in 1985¹.
- ▶ In 1975, the inward stock of foreign direct investment in France amounted to 1.5% of GDP in 1975. The ratio doubled to 3.1% by year-end 1985, and stood at 4.8% of GDP in 1989 - below the corresponding ratio for that of Canada, the U.K., the U.S., and Germany².
- ▶ Inward direct investment as a percentage of the gross private non-residential capital stock of France grew from roughly 1% in 1975 to 2.8% in 1989; the 1989 ratio of FDI to capital stock matched that of Germany but was less than that of the U.K., U.S., and Canada³.

¹ Data obtained from the Office of Trade and Economic Analysis, U.S. Department of Commerce

² Investment Canada compilations based on data from various sources

³ Ibid.

Despite the relatively slower pace of inward direct investment in France in the 1980s, there is a high level of foreign ownership in the economy. In fact, since the mid-1970s, foreign participation in France's manufacturing activity has grown steadily (see Table 1-1 for foreign ownership and control in France). Relative to other European countries, France has the highest share of foreign ownership in manufacturing in terms of both assets and employment.

Formal Barriers to Direct Investment

Since the mid-1980s, the French government has taken a variety of steps to relax foreign investment controls. With respect to FDI, the prior authorization rule applicable to all French investment abroad was rescinded in May 1986 and, at the same time, restrictions on real estate investment in France were removed. In 1988, greenfield investments by EC investors were exempted from prior notification and non-EC greenfield investments were exempted from

"declaration", in effect authorization. On January 1, 1990, France abolished all foreign exchange controls on French commercial transactions. This step was taken in response to the July 1990 deadline for liberalization of EC capital flows.⁷ Other reforms were directed mainly at expediting the screening and approval process with respect to foreign investment proposals.

The current approach is to review proposals on a case-by-case basis in light of national objectives. Investments that could potentially threaten a domestic producer are likely to encounter opposition from the government. Commitments on job creation, technology transfer, and increased export activity are sought and receive considerable weight in the foreign investment review process. Companies that provide technology and employment through new or "greenfield" investments in manufacturing facilities or research laboratories are highly favoured. For example, several Japanese investments in areas considered sensitive were recently approved in view of related decisions to set up R&D centres in France.⁸

Regulatory Framework

In France, control of foreign direct investment is implemented through a number of regulatory bodies that operate at various levels of the government. The major institutions that oversee FDI activity are illustrated in Chart 1-3. The Ministry of Economy, Finance and Budget (MEF) is the principal government department concerned with the overall supervision of foreign investment activity in France.⁹ The Treasury Department of the MEF screens and controls FDI in France, while the Competition Department is entrusted with overseeing antitrust policy. In addition to the Competition Department, the Competition Council is an independent consultative body that plays an advisory role to the Minister of the MEF in assessing the competitive impact of both domestic and foreign merger and

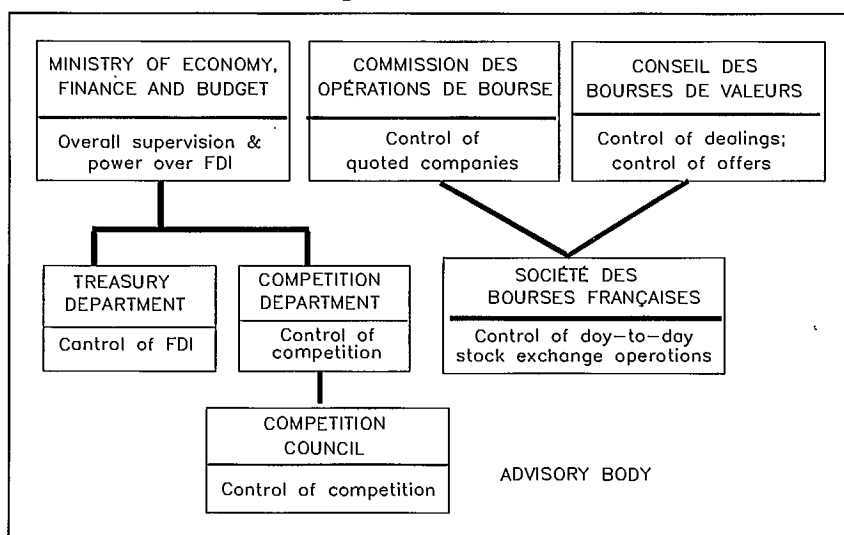
⁷ The Economist Intelligence Unit (U.K.), *IL&T* (France, July 1990), p. 12.

⁸ *Ibid*; p. 5.

⁹ In 1992, in an effort to step up promotion of foreign investment activity in France, the government announced the establishment of a pan-European network of "Invest in France" offices under the French Regional Development Agency DATAR. DATAR is a government agency specifically charged with the responsibility for supplying information to foreign investors.

acquisition activity in France. At the request of the MEF and subject to certain rules, the Council undertakes an investigation to assess the impact on competition of a proposed merger. Upon conclusion of its assessment, the Council submits a report to the MEF, which may or may not accept the Council recommendations.

Chart 1-3
Regulatory Framework for
Control of Foreign Direct Investment in France



Source: Investment Canada, based on information derived from various sources.

In addition to the MEF and the Competition Council, the *Commission des Opérations de Bourse* (COB), the *Conseil des Bourses de Valeurs* (CBV), and the *Sociétés des Bourses Françaises* (SBF) are agencies responsible for overseeing of the French securities market. The role of the COB is to ensure compliance with the provisions of French company law by public limited companies and to ensure that information is disclosed to shareholders during a takeover. The CBV is an independent, self-regulatory body composed largely of representatives of stock exchange members. It controls dealings on the stock exchanges in general and on tender offers and

trading procedures in particular.¹⁰ The SBF, which is responsible for day-to-day operations of the stock exchanges, and the CBV were established in 1988 to replace the *Chambre Syndicale des Agents de Change*.

In late 1989 and in early 1992, the French government introduced new legislation on FDI as part of an attempt to eliminate the more burdensome aspects of the old foreign investment regulations. It appeared that the discretionary character and the lack of transparency of the old system had contributed to deflecting a large number of potential foreign investments towards less interventionist host countries in the European Community.

The new laws enacted by decree on December 29, 1989, and January 15, 1990 (Decree No. 90-58) retained the distinction between investments emanating from the EC and those from outside the Community. The main thrust of these new regulations affect the approval procedure with respect to direct investments in existing enterprises by non-residents of the Community. While the time frame for approvals has speeded up, however, the government has retained ultimate control by making the new rules inapplicable to certain investments. These include those which may adversely affect "public order, public health, or security", as well as those which involve "production or trading of arms, munitions, and other military products". The French government applies these exemptions to all countries – from both within and beyond the European Community.

Foreign companies controlled by persons or entities of EC origin are exempt from prior authorization when acquiring a controlling interest in a French company. They are subject to only a prior notification requirement. This formality mainly serves the purpose of establishing the status of the foreign investor – i.e. whether the investor is a citizen of an EC member state or a corporate entity, the majority of whose capital and voting shares is held by EC

¹⁰ The CBV must notify the COB, the Treasury Department, and the Competition Department of the MEF as soon as an acquirer serves notice of a tender offer for the shares of a publicly traded company in France. The CBV reviews the principal terms of the offer and may require the acquirer to revise its offer. The COB is required to approve the draft prospectus. These responsibilities must be discharged subject to certain time limits.

investors.¹¹ The Minister of MEF has 15 days following notification to challenge the investor's status; otherwise, a failure on its part to act within this time frame constitutes a tacit approval of the investment. It is now possible for EC investors in France to obtain permanent recognition of their status and thereby avoid any notification requirements. A permanent EC status is granted to companies whose gross revenues exceeded one billion francs (US\$ 157 million) in the previous fiscal year and those who carried out real economic activity for the preceding three fiscal years.¹²

In late January 1992, France passed a new set of laws governing the acquisition of control of French companies by non-EC investors.¹³ The new laws go one step further in relaxing the thresholds concerning non-EC takeovers that were enacted in January 1990 (Decree No. 90-58). The relaxation was intended to benefit non-EC businesses, which no longer have to seek prior government approval to acquire French companies if the assets are worth less than Ffr 50 million (US\$ 9.2 million) and have annual sales of less than Ffr 500 million (US\$ 92 million). Previously, non-EC acquisitions valued at Ffr 10 million (US\$ 2 million) or more were subject to prior declaration (in effect authorization). Under the new rules, non-EC investors only need to notify the authorities of their acquisition plans (the new thresholds account for 90% of non-EC acquisitions in France).¹⁴ Once non-EC investors comply with the notification requirements, the authorities have 15 days - as against one month previously - to veto bids deemed to threaten public order, health or national defence interests. This approach puts EC and non-EC investors on the same footing.

¹¹ An EC investment is defined as one by EC residents and companies with headquarters in the Community, 50% of whose stock or voting rights are controlled directly or indirectly by individuals who are EC residents.

¹² IL&T France, *op. cit.*, p. 5.

¹³ As a rule of thumb, control is presumed to exist upon acquisition of 20% of the capital stock of a French company, but it may also be established by other means, such as contractual agreements or actual control of day-to-day management.

¹⁴ *Financial Times (U.K.)*, "France Loosens Investor Curbs", January 29, 1992.

Table 1-2
Legislative Regime Pertaining to Foreign Direct Investment in France

- ▶ **Foreign direct investment** in France covers the purchase, creation, or expansion of business in France and any acquisition by foreign residents of a "controlling interest" in a French company. Control is presumed to exist upon acquisition of 20% of a firm's capital or voting rights if the company is listed on the stock exchange, or 33.3% if the company is unlisted on the stock exchange.
- ▶ **EC investments** are subject to prior notification. The Minister of the MEF has 15 days following notification to verify the investor's status. If no action is taken, the investment is deemed approved. An EC investment is defined as one by EC residents and companies headquartered in the Community, 50% of whose stock or voting rights are controlled directly or indirectly by individuals who are EC residents.
- ▶ **Non-EC investments** that involve acquisition of control of a French company with assets valued at Ffr 50 million (US\$ 9.2 million) or more are subject to prior declaration (in effect, authorization). Once a declaration is made, the Minister of MEF has one month within which the acquisition must be granted or denied. If the one-month period expires without the Minister refusing the investment, the investment is deemed approved. Non-EC investments below Ffr 50 million are subject to notification, similar to any EC investment.
- ▶ **Exemptions:** The following activities are exempt from notification or declaration. In such cases a report has to be submitted within 20 days following the investment:
 - the establishment of new businesses or branches of existing businesses;
 - the expansion of an existing firm's activity;
 - an increase in a foreign investor's holding in a French corporation if the foreign investor already holds 66-2/3% of the capital or voting rights;
 - reorganizations (mergers, partial mergers, goodwill transfers, or leases of goodwill) within a foreign-controlled corporate group;
 - loans, advances, warranties, subsidies, waivers of debt, conversions of debt into equity, when granted to a French company by its foreign controllers;
 - the purchase of agricultural land (except for vineyard or wine-making operations) or of entities engaged in real estate activities other than the construction of buildings for sale or rent;
 - investments of under Ffr 10 million in small-scale manufacturing, the hotel industry, retail business, and other types of commercial services; and
 - investments in quarries and gravel pits.

Under the new laws, non-EC takeovers of French companies with assets of Ffr 50 million (US\$ 9.2 million) or more require prior authorization from the authorities. Authorization must be granted or denied by the authorities within one month of application; otherwise, the acquisition is deemed approved. As before, the takeover proposal may be rejected if it is found to affect adversely public order, health, or French defence interests.

Certain types of FDI activity are exempt from prior-notification and prior-authorization requirements. In some cases, however, follow-up reporting requirements exist. Transactions that have received an exemption from prior notification/authorization include: the establishment of new businesses or branches of existing businesses; the extension of business activities into areas unrelated to existing business; and an increase in a foreign investor's holding in a French corporation if that person or entity already holds at least two-thirds of the capital or voting rights. In addition, there are other exempt activities, such as acquisitions of agricultural land (except for vineyard or wine-making operations) or of entities engaged in real estate activities other than construction of buildings for sale or rent; investments of under Ffr 10 million (US\$ 2 million) in small-scale manufacturing, the hotel industry, retail business, and other types of commercial services; and investments in quarries and gravel pits. The legislative features of FDI control in France are summarized in Table 1-2.

Sectoral Restrictions on FDI

France has extensive restrictions on FDI activity in many sectors of its economy. A large number of these restrictions apply to sectors by virtue of France's limited reservation to the OECD Capital Movements Code. Other sectoral restrictions apply to industries in which all or some FDI activity is controlled by means of other impediments or as the result of the existence of public, private, or mixed monopolies. The various sectors restricted to FDI activity are illustrated in Table 1-3.

In many of these sectors, foreign direct investment is subject to strict reciprocity considerations that take into account the treatment of French investors in similar sectors abroad. For example, the principle of reciprocity may apply to investments in mining, the nuclear industry, the import of petroleum and refined products, publishing,

audiovisual services, brokerage, and tourism services. Non-EC investments in agriculture, banking and financial services, insurance, and travel services are permitted on a quid pro quo basis.¹⁵ What follows is a brief discussion of the form of FDI restrictions that exist in a few selected industries, as indicated in Table 1-3.¹⁶

Table 1-3
Impediments to Inward Investment
in All or Some FDI Activity in France, by Sector

Industry	Reservations to OECD Capital Movements Code	Other Impediments	Public, Private, or Mixed Monopolies
Banking	X	X	
Other financial services	X	X	
Auditing	X		
Insurance	X	X	
Broadcasting (Radio, TV, Cable)		X	
Press, publishing, and printing		X	X
Post, telephone, and communications			X
Audio visual works and film distribution	X	X	
Health and social security	X		
Land transport (including railways, buses, and road construction)	X	X	X
Air transport	X		X
Maritime transport	X		

¹⁵ U.S. Department of Treasury, *Survey of G-7 Laws and Regulations on FDI* (December 1988), section on Sectoral Restrictions, p. 4.

¹⁶ The following material borrows heavily from an OECD release entitled *Measures Affecting Direct Investment in OECD Member Countries*, Committee on Capital Movements and Invisible Transactions (Paris: March 1991), pp. 35-43.

Industry	Reservations to OECD Capital Movements Code	Other Impediments	Public, Private, or Mixed Monopolies
Petroleum	X	X	X
Agriculture and agriculture products	X	X	
Nuclear industries	X	X	X
Exploitation of water resources	X	X	
Energy production and public utilities			X
Armaments and explosives			X
Tourism and travel services	X	X	
Casinos		X	
Merchants and craftsmen		X	
Tobacco and matches			X
Public works and services			X
Legal profession and teaching	X		

Source: Organization for Economic Cooperation and Development, "Control and Impediments Affecting Inward Direct Investment in the OECD Countries" (Paris:1987).

Banking

In banking, the establishment of foreign branches and subsidiaries is subject to authorization of the Credit Establishment Committee (Comité des établissements de crédit). Foreign branches must maintain endowment capital at least equal to the minimum capital required for companies incorporated under French law. The establishment of foreign branches or subsidiaries of banks that originate from EC member countries will be subject to the Second EC Directive on Banking (89/646/EC) when it comes into force. Branches of non-EC banks in France will have the same rights accorded to banks from EC member countries; however, their

establishment will be subject to reciprocity provisions in the EC Banking Directive. The establishment of subsidiaries of non-EC banks will continue to be subject to the existing French banking laws.

Insurance

Insurance activities in France fall within the purview of the Insurance Directorate of the MEF. Establishment of branches by insurance companies not based in the EC requires a special concession that is accorded on a discretionary basis, taking into account reciprocity criteria and the requirements of the market. Consent can only be given for insurance activities that are also carried out by the company in its country of origin. Establishment of subsidiaries by insurance companies from a country that is not an EC member may be subject to reciprocity condition. Among other provisions, insurance brokerage can only be carried out by EC nationals or by nationals of a country that accords France reciprocity.

Cultural Activities

Among cultural activities restricted to FDI, **audiovisual communication enterprises** (private television, private local radio, and cable networks), with the exception of activities in the computer services sector, are subject to authorization or concession requirements, depending on the case. Public sector activities are covered by separate legislation.

In **publishing**, a corporate body with over 50% foreign ownership may not directly participate in the capital financing of more than one enterprise engaged in the publication (in French) of political and general information appearing at least once a month. Moreover, such participation is limited to less than 20% ownership of the direct or indirect capital or voting rights of the enterprise. Measures could be taken with respect to foreign language or foreign-based publications for reasons of morality and public security.

Audiovisual works concerning film production and distribution industries and the operation of cinemas may be authorized if the investors concerned come from countries with which France has signed international agreements that include a national assimilation or reciprocity clause.

Among other cultural activities with FDI restrictions, **travel and tourism** is subject to authorization (licences for commercial agencies and concessions for associations), which is granted to EC nationals as well as nationals of other countries on a reciprocal basis.

In **teaching**, private instruction must be declared. Foreigners may not hold directorate-level positions in private teaching establishments (primary schools or technical schools); in the case of secondary schools and private correspondence schools, foreigners must receive authorization.

Transportation

Authorization for activities in **air transport** are accorded only to enterprises fulfilling certain nationality requirements. At least 50% of the equity capital must be in the form of stocks or shares held by French nationals; the directors, associated owners, or operators must be French nationals. The state has sovereign responsibility over cabotage traffic¹⁷ in accordance with Article 7 of the Chicago Convention.

In **maritime transport**, a ship may fly the French flag and be registered in France provided that it is at least 50% French-owned or is completely owned by companies whose corporate headquarters are located in France.

Petroleum

The import of crude petroleum, petroleum by-products and residues, as well as refined products, is subject to authorization and may be subject to international agreements containing a national assimilation or reciprocity clause.

Mining & Minerals and Energy

Exploration (including petroleum exploration) of mines, quarries, and waterfalls must be authorized – an authorization that in some cases is exclusive. Exploitation is subject to concession or authorization, depending on the case. An establishment for the

¹⁷ In general, cabotage refers to the reservation accorded to a country to decide on matters relating to the operation of air maritime transport within its territory.

purpose of exploiting a hydrocarbon mine by a non-resident who is not an EC national must be in the form of a subsidiary. Foreign direct investment in these sectors may be subject to international agreements containing national assimilation or reciprocity clauses.

Among other strategic industries where FDI activity is restricted, the installation, operation, and use of **nuclear-energy**-related materials may be subject to authorization. Foreign direct investment may be subject to international agreements containing a national assimilation or reciprocity clause. The manufacture and trade of **armaments** is restricted to French nationals or companies in which over 50% of the capital is held by French nationals.

Agriculture

Non-EC investors must obtain prior authorization to set up an agriculture enterprise in France.

Casinos

The establishment of casinos is subject to authorization; the directors and employees must be French or EC nationals.

Other (Monopolies)

There is also a ban on foreign investment in publicly or privately operated (or mixed) monopolies that exist in such areas as tobacco, explosives, certain postal services, telecommunications, roads and waterways, inland waterways and ports, electricity, gas, atomic energy, rail transport, or public works and services.¹⁸ In certain high-technology sectors considered vital for France's economic development - including nuclear energy or computer and electronic components - the authorities have in the past required U.S. companies to reduce their shareholdings in order to make these industries less dependent on U.S. technology.¹⁹

Moreover, there are some other restrictions applied to foreign investments after establishment. These discriminatory restrictions

¹⁸ OECD, op.cit., pp. 38-42.

¹⁹ IL&T, op. cit., p. 6.

involve foreign access to government procurement of defence equipment (based on national security considerations) prohibition of non-French airlines from establishing ground-handling facilities, and limited access to French airline reservation systems.²⁰

Antitrust Framework and Merger Policy

The antitrust review of mergers in France is basically an administrative process largely controlled by the Minister of the MEF. The Minister's statutory mandate expressly requires that a trade-off be made between the competitive losses that arise as a result of a merger and the gains in efficiency, employment, research, or other criteria.²¹ Mergers and acquisitions strengthening France's industrial structure are looked upon favourably, while transactions whose anticompetitive effects exceed their economic and social benefits are likely to be blocked.

The Minister of the MEF has authority to refer a merger to the Competition Council. In order to qualify for a referral, the merger must be "of a type which would restrain competition, particularly through the creation or the reinforcement of a dominant market position in France or a substantial part of it".²² The merger review process is described in Table 1-4.

Unlike the laws of West Germany, the United States and other industrialized countries, the merger control laws of France do not require any pre-notification or compulsory prior approval of mergers. The law, however, provides for voluntary notification to the MEF of a merger that is proposed or that has been in effect for less than three months. Such voluntary notification provides investors with the advantage that the transaction will not be subsequently blocked by the government on antitrust grounds. To obtain a clearance, the acquiring company may file a notice with the MEF any time before, or within three months after, an acquisition. Lack of response within two months "is deemed tacit acceptance" unless the Minister extends the period for review to six months by referring the case to the

²⁰ U.S. Department of Treasury, *Survey of G-7 Laws*, op.cit.

²¹ Dominique Voillemot and Florence de Beughem, France, in *International Mergers: The Antitrust Process*, Sweet & Maxwell (1991), p. 307.

²² *Ibid.*, pp. 309-10.

Competition Council. If the transaction is referred to the Competition Council, the Minister must challenge the merger within six months or else the transaction is deemed authorized. These time limits, however, are not binding if an acquisition is not notified, in which case the Minister has the power to challenge and subsequently block the takeover after its completion.²³

Table 1-4
The Merger Review Process in France

- ▶ The MEF, after consultation with the Competition Council may challenge and prevent an acquisition that it considers to be anticompetitive or that exceeds certain thresholds, if the acquiror and the target:
 - together account for more than 25% of the turnover (revenues) in the French market for the products or services concerned or for substitutable products or services; or
 - monopolize a "substantial" part of the market; or
 - have a combined turnover in excess of Ffr 7 billion (US\$ 1.1 billion), provided that at least two of the companies involved have sales of at least Ffr 2 billion (US\$ 313 million).¹
- ▶ The Competition Council determines whether an acquisition referred to it by the MEF "will make a sufficient contribution to economic progress to compensate for the restraint of competition". There are, however, no statutory guidelines that indicate to the Council or the Minister how this determination is to be made.
- ▶ If an acquisition falls within the scope of the ordinance, the MEF, after the recommendation of the Competition Council, has the power to intervene at any time and may order divestiture if necessary, even if the transaction has been cleared by all other relevant authorities.
- ▶ The Minister, notwithstanding the recommendations of the Competition Council, has the authority to either approve or reject the merger/takeover. In fact, the Minister has on several occasions overruled the Council's recommendations and instead allowed mergers to proceed by seeking remedies ensuring that the economic and social benefits outweigh the anticompetitive effects of the acquisition.

¹ Kiernan, J.A.; Bedos, Jean-Luc; and d'Ornano, Antoine. "France" in International Financial Law Review, *The Regulations Governing Mergers and Acquisitions Across the European Community*, U.K.: Euromoney Publications (1989), p. 28.

²³ Ibid., p. 28.

Informal Barriers to Direct Investment

As in many other continental European countries, there are some significant informal barriers to FDI in France. They primarily concern obstacles to takeovers of domestic quoted companies. The barriers result from the absence of widespread ownership and control of listed companies, the relatively small number of targets on the stock exchanges, and various aspects of French company law that act as tactical barriers against contested acquisitions. In addition to these obstacles, foreign investors sometimes confront unusual delays in obtaining approval for takeover proposals from the MEF. The record clearly shows that on a number of occasions, the authorities have used their review powers to delay foreign takeover proposals in certain "strategic" sectors in order to enable a target or the government to arrange a "French solution". Last but not least, despite a privatization drive in the mid-1980s, France continues to have a relatively large public sector that bars foreign investment activity in many important industries where state-controlled monopolies operate.

Obstacles to Takeovers: The Ownership of Quoted Companies

The pattern of shareholdings of listed companies in France tends to impede the success of the Anglo-Saxon type of hostile takeover, which is more common in the United Kingdom, the United States, and in Canada. Shareholdings of publicly traded French companies are rarely as widespread as those of quoted companies in the United Kingdom and the United States. The vast majority of listed companies in France, organized as *Sociétés anonymes* (SA's), are in fact controlled by a relatively small group of shareholders. For example, many listed companies are wholly controlled subsidiaries of other listed companies. In effect, companies form a "cascade" ownership structure, sometimes of five or six tiers, which enables control to be exercised through master holding companies that own a majority of shares in a chain of subsidiaries. Furthermore, public companies listed on France's second market (*Second Marché*) in the stock exchange system need only float 10% of their shares to the public. The second market aims to serve the needs of small and

medium-sized closely held companies, often in the hands of families who do not wish to relinquish control.²⁴

According to a recent survey, it was estimated that family groups have controlling interests in 57% of the 200 largest public and private French industrial and commercial companies, excluding those controlled by the state. The percentage of family control is even higher among smaller companies. French banks are also believed to have a dominant stake in French industry, although it is less pervasive than in Germany. It is estimated that another 9% of the 200 largest private and public French companies are controlled by banks, insurance companies and other institutional investors, all of whom are often allies of management.²⁵

Among other dominant shareholders, the French government is estimated to own 15% to 20% of the French stock market by value. Despite the spate of privatizations carried out by the Chirac government between 1986 and the beginning of 1988, the authorities followed a policy of placing between 20% and 30% of the shares of state-owned companies that were privatized in the hands of "friendly companies". The purpose of this strategy was to ensure continued control of privatized enterprises by placing a *noyau dur* (or hardcore of shares) among companies allied with the government and by permitting those shares to be sold only to other members of the *noyau dur*.²⁶

Obstacles to Takeovers: The Size of the Stock Market

Notwithstanding the ownership barriers, the scope for foreign takeovers is also limited by the number and size of available targets on the French stock markets. In 1989, a total of 462 domestic companies were listed on the Paris stock exchange (the PSE - France's largest stock exchange), with a market capitalization value of US\$ 338 billion. Although the market capitalization of the PSE has

²⁴ Bryan de Caires and Debbie Fletter, eds., *The Montreal Exchange Guide to World Equity Markets 1990* (June 1990) p. 116.

²⁵ Kiernan, Bedos, and d'Ornano, "France", op.cit., pp.26-30.

²⁶ Coopers and Lybrand, *Study on the Barriers to Takeovers in the European Community*, prepared for the U.K. Department of Trade and Industry, June 1989; see pp. 13-14 of the Country Summary on France, Vol. II).

increased significantly in recent years, it remains relatively small in comparison to the London Stock Exchange - Europe's largest stock exchange. For example, domestic companies listed on the LSE in 1989 had a market capitalization of US\$ 814 billion - about two and a half times greater than the PSE.²⁷ Table 1-5 summarizes the various ownership barriers to takeovers in France.

Table 1-5
Takeover Obstacles: Ownership and Control of Listed Companies in France

The accessibility of French publicly traded companies through public takeovers by domestic and foreign acquirors is subject to constraints created by a number of financial market structural characteristics:

- ▶ Most publicly traded companies in France, which take the form of *Sociétés anonymes* (SA's), tend to be controlled by a relatively small group of shareholders. For example, family groups control 57% of the 200 largest public and private French industrial companies; another 9% of those companies are controlled by banks, insurance companies, and institutions.
- ▶ Despite a privatization drive in the mid-1980s, the public sector holds 15-20% of the French stock market by value; the government placed 20-30% of the shares of privatized companies in the hands of companies allied with the government, restricting their sales to only other members of the *noyau dur* (hardcore of shares held by friendly companies).
- ▶ The "*second marché*" on the stock exchange lists many small and medium-sized family-controlled companies; by law, only 10% of their shares can be floated to the public.
- ▶ Relatively few targets are available on the Paris Stock Exchange (PSE) - France's largest stock exchange. In 1988, the PSE listed only 462 domestic companies with a market capitalization of US\$ 388 billion, two-fifths that of the London Stock Exchange. The average size of companies based on market capitalization indicates that the PSE has a limited number of relatively large quoted companies.

The average size of listed companies on the PSE also suggests that relatively few large companies dominate stock market activity. Despite this structure, however, only a handful of French listed companies have in fact attained the size and stature of large

²⁷ International Federation of Stock Exchanges, *Activities and Statistics 1989 Report*, 1989, Tables 1 & 3.

international enterprises. For example, Elf Aquitaine, the largest company on the Paris Bourse in 1988, would not have ranked among the first 10 Japanese companies by market capitalization, and French companies are typically half the size of German enterprises.²⁸

Obstacles to Takeovers: Aspects of Articles of Association and Company Law

Aside from the ownership and market barriers to acquiring French companies, foreign investors also face numerous takeover obstacles that French firms are able to mount by virtue of invoking certain defences allowed under French company law or by legally incorporating certain antitakeover features in their Articles of Association. In this context, the allocation of voting rights (attached to company shares), which in effect determine control of listed companies, are often a serious impediment to the success of hostile takeovers. It should be noted that the use of voting rights and other defensive techniques by the target company can only be invoked prior to the launching of a tender offer for its shares; most defensive measures are no longer available to the target once the tender offer is launched.

In many French enterprises, voting rights are not directly proportional to the number of shares held by owners of the company. As an example, it is customary for many SA's to specify in the Articles of Association that shareholders who have held company shares for two to four years be assigned double votes. This practice ensures that shareholders of longer standing receive an increased control of the company. In effect, it is possible to concentrate control in a small percentage of the shares of the company. Moreover, non-EC shareholders may be excluded from the right to a double vote. As a highly popular antitakeover defence, the Articles of Association of major listed companies, such as Peugeot, Bénédictine, and LVMH, allow double votes to be assigned to shareholders of longer standing.²⁹

Another restriction on voting rights followed by some companies is the placement of a maximum limit on voting rights that

²⁸ Euromoney (Special Supplement), *Acquisitions in Europe*, May 1990, pp. 15-18.

²⁹ Ibid., p.15.

can be exercised by shareholders, irrespective of the number of shares held, thus partially blocking the voting power of a potential acquiror holding a large block of shares. This strategy is not widely used, however, since the cap must be imposed in a non-discriminatory way on all voting shares issued by the target. Firms like Pernod-Ricard, the beverage concern, have limited voting-share rights to 30% of the shares held. More recently, CGE, the French telecommunications and engineering giant, limited voting rights to a maximum of 8% of the company's capital, effectively ruling out a hostile takeover.³⁰

Under French company law, SA's are permitted to issue up to 25% of their capital as non-voting preferred shares, which receive priority dividends (*actions à dividende prioritaire sans droite de vote*). The SA's are also authorized to issue up to 25% of their capital as investment certificates (*certificats d'investissement*), which were introduced in 1983 as a way of encouraging private investment in French companies. Investment certificates are securities similar to common stock, except that they are issued without voting rights (*certificat de droit de vote*) to existing holders of the company's common stock. This technique allows the company to increase paid-in-capital without the corresponding dilution of existing voting rights.

In brief, the power of shareholders to elect and dismiss management at a general meeting may be skewed by the way voting rights – and thus control of the company – is determined. For example, under French company law, a majority of 50% or more of the voting rights is required to remove management. As a result, if voting rights are concentrated (e.g. by double voting rights) in the hands of a few shareholders allied with management – or even management themselves – then the power to elect or dismiss management becomes impossible. In such circumstances, obtaining management consent to contested takeovers has a limited chance of success.

As a means of entrenching management control, a few French companies have adopted the corporate structure of a *société en commandité par actions* (SCA). An SCA is a corporate entity having two types of partners: active ones, who have unlimited liability for

³⁰ *Business Europe: Business International*, "French Companies Choose Defensive Tactics, The Economist Intelligence Unit, op.cit., pp. 1-2.

the obligations of the SCA; and passive ones, who enjoy limited liability. Under its by-laws, the active partners may appoint managers for an indefinite term without a vote of the passive partners, thus ensuring that control remains in the hands of a particular group. Michelin and Casino are prominent examples of French companies that transformed themselves from stock companies (SA) to a limited partnerships (SCA) as a means of fending off unfriendly takeovers.

Some French companies are known to maintain a complicated web of cross-shareholdings in order to protect themselves from a contested takeover. For example, large blocks of shares are often held jointly by companies and their "friendly" investors, such as the company's bank (or a mutual fund managed by the bank) or even a major supplier or customer. By law, alliances formed through cross-shareholdings are permitted to a maximum of 10% (as in the case of Saint-Gobain and Compagnie Générale des Eaux). Some companies also issue stock warrants to allies and these can be converted to shares in the event of a hostile takeover bid.³¹

A number of companies have subsidiaries or controlled affiliates that own shares in the parent company – a practice known as "autocontrôle". Under company law, subsidiaries were able to own up to 10% of the shares of their parent. For example, subsidiaries of Paribas and CGE own blocks of shares of their respective parents. Subsidiary companies that adopted "autocontrôle" were, however, expressly prohibited from purchasing shares of their parents during a tender offer. The COB suspended the practice of "autocontrôle" in France in July 1991. As a result of this action, some analysts have speculated that cross-shareholdings between French banks and companies are likely to increase, since banks are expected to acquire a greater stake in companies that divest their interests in the parent companies.³²

In general, it is impossible to determine the ownership of listed companies, except to the extent that major stakes must be disclosed to the CBV. Most takeovers in France are preceded by at least limited open-market purchases; by law, the acquiror must notify the

³¹ Kiernan, Bedos, and d'Ornano, "France", op.cit., p. 32.

³² *Business International: Business Europe*, "Defensive Tactics", The Economist Intelligence Unit, op.cit., (July 10, 1989), pp. 1-2.

CBV of its stake acquisitions from open-market purchases within five trading days (and the target within 15 days) if it results in a shareholding crossing 5%, 10%, 20%, 33-1/3, or 50% thresholds.³³ Companies are allowed, however, to insert in their Articles of Association a reporting threshold as low as 0.5%. Some public limited companies have adopted quite low reporting thresholds (1-2%) for open-market purchases that require investors to notify the company as soon as they acquire a stake up to the threshold (e.g. Paribas, 0.5%; Saint-Gobain, 1%; Générale des Eaux, 2%; BSN, 1%; LVMH, 1%; and Lafarge-Coppée, 1%). This strategy is intended to work as an early warning system to detect the accumulation of stocks in potentially "unfriendly" hands.

The various features of French company law and the Articles of Association that tend to obstruct the success of hostile takeovers are summarized in Table 1-6.

The acquisition of French companies may be accomplished in several ways. The more popular and practical mode of acquisition involves either the purchase of a control block of shares, followed by an offer to buy out all minority shareholders on equivalent terms or by public tender offers for all (or the majority) of the outstanding shares. Although the number of public takeover bids in France has increased rapidly since the mid-1980s, they are relatively small in number compared with the public bids launched in the Anglo-Saxon countries. In 1988, for example, a total of 46 takeover bids, both agreed and contested, were made in France, compared with 191 in the United Kingdom. Of the 46 public tender offers launched that year, six were contested bids, of which only one involving French-owned companies was ultimately successful.³⁴

³³ Kiernan, Bedos and d'Ornano, "France", *op.cit.*, p.29.

³⁴ In 1988, France's Schneider made a contested tender offer for Télémécanique, a major manufacturer of mechanical and electrical equipment, which ultimately succeeded despite having been fought very aggressively and more openly than ever before in France.

Table 1-6
Takeover Obstacles:
Aspects of Company Law and Articles of Association in France

In France, as in most EC countries, various restrictions on voting rights specified under a Company's Articles of Association serve as an efficient tactical defence against hostile takeovers. The distribution of voting rights, and therefore control, may not be proportional to shareholdings. The voting-rights restrictions take various forms, for example:

- ▶ In the articles of SA's, double voting rights could be assigned to shareholders who have held shares for more than two years; in addition, non-EC shareholders could be excluded from the right to double vote. Publicly traded companies, such as Peugeot, Bénédictine, and LVMH grant double voting rights to shareholders of longer standing.
- ▶ Although rarely adopted in practice, voting rights could be subject to a maximum limit, regardless of the number of shares held. Pernot-Ricard, a major beverage manufacturer, has a 30% ceiling on voting rights, regardless of the number of shares held. Among other firms, CGE limits voting rights to 8% of the firms issued capital.
- ▶ SA's may issue up to 25% of their shares as non-voting rights, which receive priority dividends; similarly, SA's may also issue 25% of their capital as investment certificates. The voting rights associated with these certificates are issued separately to the existing ordinary shareholders. Not more than 50% of a company's capital can be issued as non-voting preference shares or investment certificates. With double voting rights, however, control can be concentrated in a small percentage of the company's shares.

Alliances to centralize control of a company's capital through cross participation and self-ownership via subsidiaries and affiliates is a takeover obstacle found among some companies in France. Under French company law:

- ▶ Companies are allowed to take cross-shareholding up to a legal limit of 10%, as in the case of Saint-Gobain and Compagnie Générale des Eaux.
- ▶ Until recently, subsidiaries or controlled affiliates could own up to 10% of the shares of their parents – a practice called "autocontrôle". Autocontrol as a defensive measure, however, has been considerably limited in scope since July 1991, when companies were prohibited from voting these shares. There is speculation that cross-shareholdings between banks and companies is likely to increase as a result.

(continued)

- ▶ In the Articles of Association, some companies have a low disclosure threshold concerning open-market purchases of shares in order to detect stake accumulation in potentially "unfriendly" hands. Paribas has a minimum reporting threshold of 0.5%; Saint-Gobain, 1%; BSN, 1%; and LVMH, 1%.
- ▶ New laws on the security and transparency of financial markets allow the target companies defensive capital increases to dilute the predators' shareholdings. Such defensive capital increases must be approved by a general shareholders' meeting. Capital increases must be open to all shareholders.

Public tender offers are expected to rise sharply in the future as a result of several factors. First, the French industrial and financial communities no longer view contested takeovers with the same suspicion as before. In principle, the authorities welcome the positive impact that tender offers may have on French business activity, as well as the corresponding benefits to shareholders. Second, since 1987 the government has introduced a series of reforms of the Paris stock exchange with a view to promoting Paris as a major international financial centre. These measures include the reorganization of the brokerage profession, the expansion of permissible activities by brokers, and the opening of their capital to outside investors.

In 1989, the French government passed new security laws with the fundamental objective of increasing the transparency of public takeovers, curbing abuses, and protecting French companies and minority shareholders. The takeover rules were set up to encourage open bids. Until then, French security laws made it possible to acquire effective control of a listed company by way of open-market purchases without any obligation to initiate a formal tender offer³⁵.

The most far-reaching element introduced in the 1989 takeover rules is the mandatory offer procedure. These procedures come into play when an acquiror (or several acquirors acting in concert) first acquires control of over one-third of the shares or voting rights of a

³⁵ Law No. 89-531 of August 2, 1989, relating to security and transparency within the financial markets, together with Titles 5 and 7 of the CBV General Regulations and Regulation 89-03 of the COB, established a new regime for tender offers.

French company, which are then traded either on the official market or the second market. The acquiror must then immediately inform the CBV and launch a tender offer for shares in the target that will result in the acquiror holding at least two-thirds of the target's voting securities. The acquiror's failure to do so would result in its losing the voting rights with respect to any share that it holds beyond the one-third threshold.

In March 1992, the government amended the 1989 takeover rules, making it mandatory for acquirors (or a group of acquirors acting in concert) to launch a 100% takeover bid once 33.3% of the shares of a company were acquired. The rules were amended in response to increasing complaints that they were unfair to minority shareholders, since they lost their influence and the value of their shares dropped once the acquirors purchased two-thirds of the capital.³⁶

Another important measure to increase transparency pertains to the tightening of threshold disclosure rules on equity held by shareholders. These thresholds (5%, 10%, 20%, 33-1/3%, 50%, or 66-2/3%), as noted earlier, must now be computed in terms of voting rights and not in terms of shares. In addition, the authorities have also introduced the concept of "concerted action" so as to include in the disclosure requirements all voting rights acquired by persons acting in concert.

The rules also permit target companies to use several defensive measures to protect themselves in hostile takeover situations. For example, the rules permit the board of directors of a company to initiate a capital increase after the launching of a hostile takeover in order to dilute the acquiror's shareholdings. Such defensive capital increases, however, must first be approved in advance by a general shareholders' meeting, and the authorization is valid for only one year. In addition, the capital increase cannot be limited to a specific investor (or a "white knight"³⁷), but should be open to all

³⁶ *Business International: Business Europe*, "France Modifies Takeover Rules", The Economist Intelligence Unit (U.K.), (March 27, 1992), p. 4.

³⁷ The term applies to a company making a counter-bid for another company that is the target of an unwanted (hostile) takeover. Often the second bid is an agreed and acceptable one for the target company, in contrast to the initial offer. Hence, the analogy of the white knight rescuing the damsel in distress.

shareholders without discrimination. The relatively strict requirements raise doubts as to the efficacy of the provision as a defensive measure.

Other Informal Barriers: Government/Business Linkages, State-Controlled Enterprises

Aside from using an arsenal of defensive weapons to fend off hostile takeovers, French companies may also seek, as a last resort, the help of the authorities to withhold or delay approval of a transaction in order to buy time to find a "French solution". In most cases, the solution has been to locate a "white knight" willing to top the hostile bidder. The authorities have in fact intervened on several occasions to delay takeover bids in "strategic" sectors (telecommunications, banking, and insurance) in order that a "French solution" may be found. Even when management agrees to the terms and conditions of a foreign-takeover offer, it is possible that the government might intervene to delay or prevent the success of the offer (see section entitled "Case Studies" later in this chapter).

Among other informal barriers, it could be argued that the French corporate culture is generally not conducive to contested takeovers. The importance of maintaining a stable shareholder base in the long-term interest of the firm is a strategic priority of many French companies, although this corporate goal is perhaps less pervasive than in Germany. The corporate view is that the shareholders' value should be maximized but not at the expense of jeopardizing the long-term stability and growth of the company. Despite this philosophy, more hostile takeover bids have succeeded in France relative to West Germany, where the long-term stability of companies rather than short-term profit maximization is also an important objective of management.³⁸

In France, the state has long played an important role in business through direct ownership of companies and through subsidies to ailing industrial sectors. State groups have intervened periodically to build up strategic stakes and to support the leading

³⁸ A discussion of the two opposing European corporate cultures (the United Kingdom and Germany) and their views on hostile takeovers can be found in the "Study on Obstacles to Takeover Bids in the European Community: Executive Summary" prepared by Booz-Allen Acquisition Services for the European Commission (December 1989), pp. 53-56.

companies' share prices. The role that state enterprises play in the French economy limits the participation of foreign firms.

State-owned enterprises account for about 30% of France's gross national product. By some estimates, as much as 15% to 20% of the equity of larger French quoted companies belong to nationalized shareholders.³⁹ In 1985, nationalized firms accounted for 47% of sales among large industrial companies (having more than 2,000 employees); the government controlled 90% of bank assets; and the state accounted for 21% of industrial employment and 52% of industrial investment (including that in the energy sector).⁴⁰

State enterprises loom heavily in many manufacturing industries. As of mid 1990, some of the major state-owned industrial companies, with their respective stakes, were: Renault (motor vehicles and trucks – 100% ownership, cut to 75% more recently); Aerospatiale (airplanes and missiles – about 75%); Elf-Aquitaine (petroleum – 53%); Thompson SA (electrical equipment – 94%); Thompson CSF (electrical equipment and defence electronics – 57%); Rhone-Poulenc (chemicals – 90%); Pechiney (aluminum – 92%); Usinor-Sacilor (steel – 100%); Roussel-Uclaf (pharmaceuticals – controlling minority); and Dassault-Breguet (aviation – controlling minority).

The size of the public sector was significantly reduced under the Chirac government's ambitious privatization program that lasted from 1986 to early 1988. These privatizations affected 65 major companies and banks (along with their respective subsidiaries) with a value of Ffr 20 billion (US\$ 33 billion), which significantly raised the market capitalization of the exchange.⁴¹ The large-scale privatizations reduced the number of public-sector firms by one-third and the public-sector work force by one-sixth. According to a survey, out of 15 French companies ranking in the top 100, seven were among the companies that featured in the government's privatization program from 1986 to 1988.⁴²

³⁹ *Financial Times* (U.K.), "The Break with French Tradition", January 17, 1990, p. 8.

⁴⁰ IL&T (France 1989), op. cit., pp. 4-5.

⁴¹ Coopers and Lybrand, op.cit. (June 1989), Vol. II (France), p. 11.

⁴² *Financial Times* (U.K.), "European 500", January 11, 1991, p. 15.

A direct benefit of the privatization program was a dramatic increase in the number of shareholders in France. According to some estimates, the privatizations between 1986 and 1987 added 6 million new shareholders to the stock exchange, bringing the total number of shareholders in France to 9.5 million at the completion of the program.⁴³

Following the general elections in 1988, President Mitterand halted the sales of assets instituted by the Chirac administration with his celebrated commitment to "neither nationalization nor privatization". More recently, however, the commitment to no privatizations, albeit a politically popular one, has proved to be impractical from the viewpoint of the government's budgetary situation.

Many of France's public-sector companies have undergone massive restructuring in order to face the competition of Europe 1992. In addition, many have also embarked on international acquisition strategies that have required a huge infusion of capital. As a result, the government has become more pragmatic on the question of partial privatization.⁴⁴ Among some recent examples, Sweden's Volvo group was allowed to bring in capital and to acquire a 25% stake in Renault. Similarly, Japan's electronic giant NEC, also invested capital for a minority stake in France's public enterprise, Bull (a computer manufacturer). The French authorities have in fact introduced a number of complex financing schemes whereby the capital requirements of the privatized industries can be raised. These include, among others, issuing "false" capital or participation certificates that carry no voting rights but whose yield may be linked to profits; swapping assets between nationalized companies and private companies; and floating subsidiaries on the stock exchange (such as Pechiney International).⁴⁵

⁴³ In comparison, there were 4.5 million shareholders in Germany and 8.5 million in Japan. See Bernard Buisson and Gide L. Nouel, *Acquisitions and Investment in France*, paper presented at the seminar on *Acquisitions and Investment in the New Europe: The Legal and Strategic Environment*, Toronto, May 30, 1990.

⁴⁴ The authorities issued a decree in April 1991 allowing for partial privatization. See *Financial Times* (U.K.), "Mitterand's Non to Ni-Ni", September 13, 1991, p. 17.

⁴⁵ IL&T (1989), op. cit.

Some recent privatizations have also been achieved by allowing cross-shareholdings between public enterprises. In July 1991, for example, two state-owned banks - Crédit Lyonnais and Banque Nationale de Paris (BNP) - took an equity position in two public-sector industrial companies - Usinor-Sacilor and Air France, respectively.⁴⁶ In each case, a company previously under 100% direct state ownership raised fresh capital from a financial institution. Similar transactions have taken place in the past two years. Crédit Lyonnais was allowed to acquire a stake in Rhone-Poulenc, the giant state-owned chemical group; and Assurance Générale de France, the state insurance enterprise, raised capital through selling part of its equity to the state-owned companies Total (oil) and Pechiney in 1990.⁴⁷

The French policy of increasing cross-shareholdings between state enterprises in order to raise fresh capital for the public sector is viewed as a much-needed financial innovation in light of the dwindling tax revenues that have resulted from economic slowdown. Despite claims made by the state-owned banks in the two recent deals that the transactions were undertaken for purely commercial reasons (in order to build up their industrial portfolios and to cement links with valued customers), others suspect that they may have amounted to nothing more than a covert state subsidy. The European Commission, and in particular its Competition Commissioner Sir Leon Brittan has been an ardent opponent of direct cash injection by the state into public-sector companies because of their competition-distorting aspects.⁴⁸ For foreign and domestic private investors in France, indirect bail-outs of state enterprises from cross-shareholdings in lieu of privatization restrict in practice the opportunities to participate in the French economy.

⁴⁶ *Financial Times* (U.K.), "Breakdown of Old Frontiers", July 23, 1991. Usinor-Sacilor sold a 20% stake to Crédit Lyonnais, while BNP acquired 5% to 10% of loss-making Air France.

⁴⁷ Ibid.

⁴⁸ *Financial Times* (U.K.), "A State Enmeshed in a Tangled Web", July 18, 1991.

Case Studies on FDI in France: A Brief Review

France has a long tradition of state intervention in the economy, and blocking takeovers is not uncommon. With respect to "greenfield" investments, the French laws enacted by decree in early 1990 exempt the establishment of new businesses and expansions from the requirement to file prior notice and to obtain approval. Notwithstanding these exemptions, France has strict local-content rules in consumer electronics and automobile manufacturing (80% local content for non-EC investors) that have proved to be a particularly effective deterrent to greenfield investments from Japan. Local-content requirements are one form of trade-related investment measures (TRIMs) that have trade distortionary effects. The use of local content, as well as other TRIMs, as performance requirements set by host governments is being currently debated in the Uruguay Round of Multilateral Talks.

The French government is particularly sensitive to so-called "screwdriver" factories that merely assemble imported components in order to avoid import restrictions on the finished products. In particular, French industrialists have argued for some time that Japanese investments can destroy, rather than create, jobs – with most value-added activity remaining in Japan. In 1989, a major greenfield investment by Japanese automaker Subaru fell through over French demands relating to local content. In fact, the Subaru case followed a more controversial one where the French government decided to include Nissan Bluebird cars imported from the Nissan plant in Sunderland, United Kingdom, in Nissan's French import quota – thereby treating them as Japanese exports – based on insufficient local content in the United Kingdom (70% as opposed to the 80% local content required by France).

While the Treasury Department has occasionally used its review powers to delay a takeover in order to enable the target or the government to find a "French solution", it has also used its powers to protect the interests of minority shareholders when existing regulations proved to be inadequate. For example, in 1987, the MEF intervened in Seagram (Canada)'s initial attempt to acquire French liquor company Martel by way of a private transaction with family

shareholders. The MEF forced an open bidding contest and approved the takeover only after Seagram agreed to make a full public offer.⁴⁹

France's Competition Council is increasingly scrutinizing the impact on competition from foreign and domestic mergers and acquisitions. Many experts believe, however, that the enforcement of antitrust laws has been less rigorous in France than in some other jurisdictions. From 1977 to March 1989, fewer than 12 acquisitions were referred to the Competition Council, and to date only two mergers have been blocked by the government on competition grounds.⁵⁰

Spontex/3M

As mentioned above, the Competition Council plays a purely advisory role in submitting its opinion to the Minister of the MEF with regard to the competitive impact of a particular merger. In fact, in one of the two acquisitions blocked on antitrust grounds, the Minister did not follow the Council's recommendation in favour of the acquisition of Spontex, a French subsidiary of sponge manufacturer Chargeur SA, by U.S.-owned 3M (Minnesota Mining and Manufacturing Company Ltd.) in 1989.

The Council had concluded that the acquisition would give 3M a dominant position in the relevant market but cleared the transaction on the grounds that it would improve the group's research and development capacity. The Minister of the MEF subsequently issued an order to block the transaction, because it was felt that 3M's post-acquisition share of three-quarters of the market for certain sponges, scouring cloths, and so on, would be too large and could block the entry of potential competitors into the French market for those products.⁵¹

⁴⁹ Buisson and Nouel (1990), op. cit., p. 5.

⁵⁰ Kiernan, Bedos, and d'Ornano, "France", op. cit., p. 28.

⁵¹ Competition Council Opinion, *3M Corporation and Spontex SA*, B.O.C.C.R.F. February 21, 1989.

It appears, however, that despite the ostensibly competitive grounds for blocking the transaction, the government may in fact have preferred a "French solution".⁵² In overruling the Competition Council's decision, the MEF paved the way for a French consortium to launch a bid for Spontex. In support of his Minister's decision, President Mitterand of France also expressed the need to preserve French industrial heritage from excessive foreign appropriation.

Cabot/Ashland

In 1984 the Competition Council recommended that the acquisition of Ashland France by Cabot-France SA – a subsidiary of Cabot Corporation USA – be blocked. At the time, Cabot Corporation was the largest producer of carbon-black for rubber production. The acquisition would have given Cabot France control of more than half the market for carbon black in France, including control of 30% of imports. The Minister of the MEF accepted the Council's view that the acquisition would restrict competition and prevent existing enterprises from restructuring themselves to compete more effectively against Cabot-Ashland.⁵³

The Minister's decision to block the takeover was later reversed, however, by the Conseil d'État on procedural grounds (the Administration apparently had in its possession an expert's report that had not been made available to the Competition Council or to the parties).

Saint Louis / Ferruzzi

In 1987, almost a year after it was established, the Competition Council faced its first major international merger case. Mr. Edouard Ballardur, then Minister of the MEF, requested the Competition Council to review the acquisition by Ferruzzi, the Italian food and agricultural industry group, of a 13.6% stake in Saint-Louis, France's second largest sugar producer. At the time, the Italian group was controlled by Mr. Raul Gardini, who already controlled Beghin-Say, France's second largest sugar manufacturer. The French authorities

⁵² Coopers and Lybrand (June 1989), op. cit., p. 43.

⁵³ Organization for Economic Cooperation and Development, *International Mergers and Competition Policy* (Paris:1988), p. 32.

were apparently concerned about the impact on market concentration since, between them, Ferruzzi and Saint-Louis controlled 75% of the French sugar market. The merger between the two firms was eventually unwound voluntarily in order to avoid an official ruling against the transaction.⁵⁴

Les Echos / Pearson PLC

There is evidence that the French government has intervened and resorted to dilatory tactics in an effort to find a "French solution" to a foreign takeover bid, even after a transaction received the support of the target's shareholders and management. In 1988, the U.K. publishing group Pearson PLC came to an agreement with the owners of the French newspaper *Les Echos* to purchase their company. Rupert Murdoch, an Australian-born U.S. citizen, owned 20.5% of Pearson. The MEF eventually blocked the deal on the grounds that Pearson was not an EC company. The MEF also expressed concern regarding the stability of Pearson after hearing rumours that it was also the subject of a takeover. Following objections to the ruling by owners and staff of *Les Echos*, the French government agreed to a revised bid that allowed Pearson to acquire two-thirds of *Les Echos* and delayed the purchase of the remaining one-third for a year.⁵⁵

The *Les Echos* case raises the question of what constitutes an EC investment. As the U.K. Department of Trade and Industry study notes, "there appears to be some confusion as to what level (between 10% and 50%) non-EC shareholding is viewed by the French government as affecting a company's own EC status."⁵⁶ The case reveals how the lack of transparency in French laws can provide the authorities with considerable discretion to review foreign takeover proposals.

⁵⁴ *Financial Times* (U.K.), "French Monopoly Policy Put to Test", November 25, 1987, p. 30.

⁵⁵ Coopers and Lybrand (June 1989), op. cit., p. 42.

⁵⁶ Ibid. pp.42.

The following are other foreign takeover proposals that were either blocked or withdrawn by the acquiror in recent times, based on a variety of reasons:

- ▶ In 1985, Italian investor Carlo de Benedetti attempted to acquire 36% of Valeo (a leading French car equipment manufacturer). The French government initially declined approval on "national security" grounds, citing that one of Valeo's affiliates was producing tank parts for the Defence Ministry, even though its sales to the Ministry only represented 2% of the firm's revenues. Subsequently, the French government limited Benedetti's shareholdings to 20%.⁵⁷
- ▶ In September 1988, the French government blocked the acquisition of Leroy, a French distributor of fine burgundy wine, by the Japanese-owned Takashimaya company. In this instance, the Minister of Agriculture cited that the wine belonged to a part of France's cultural heritage – presumably a reference to the reputable brand Romanée-Conti under the firm's control.⁵⁸
- ▶ In June 1990, the government refused to allow France's Rivaud bank to sell its 52.3% share of Pathé Cinéma, a French film theatre, to Pathé France Holding, an Italian holding owned by Italian financier Giancarlo Piretti a company that already owned 46.5% of Pathé Cinema. The sale, which would have given the Italian company full control, was ostensibly blocked by the French government because of the holding company's past financial dealings.
- ▶ In June 1990, the French government objected to the purchase of Chapelle Darby (the French paper producer) by Stora (the Swedish pulp and paper group) in conjunction with Kymmene of Finland, on the grounds that this would give Stora an excessive dominance of the magazine paper market. The Stora case would have been referred to the Competition Council, but the company withdrew its offer.

⁵⁷ Kiernan, Bedos, and d'Ornano, "France", op. cit., p. 27.

⁵⁸ Ibid., p. 28.

- In 1991, Prime Minister Edith Cresson suspended talks between state-owned computer manufacturer Bull and Japan's NEC over concerns that the Japanese multinational would gain control of one of France's important high-technology firms. The NEC wanted to swap its 15% stake in Bull HN, a subsidiary, for just under 5% in Groupe Bull itself, as part of a package intended to revive Bull's sagging profitability. The French authorities sought to clarify the actual intention behind the NEC proposal in order to assure itself that Bull would not eventually fall under Japanese control. With no alternative in sight, Prime Minister Cresson finally allowed the deal to go through, with assurance from Bull that it would not allow NEC to acquire control. In fact, the assurance was not necessary, as legislation limits private firms to minority stakes in French state-owned firms, with the condition that full government control be retained.

Conclusion

The French government promotes foreign investment as one element of its framework policies designed to address France's large trade deficit and unemployment problems. In this context, France has recently relaxed some of its formal barriers to foreign direct investment. In particular, French direct investment controls pertaining to EC investors have been significantly liberalized, while the review of investments originating from non-EC countries has been speeded up considerably.

Nevertheless, the current policies also provides the French government with the capacity to act in a restrictive manner. The new screening process, albeit more liberalized and explicit in principle, remains to be tested in practice; in the meantime, authorities continue to screen large investments on a case-by-case approach, weighing the pros and cons of each proposal. There continues to be room for discretion depending on the case. The government continues to act to protect "key sectors" from foreign takeovers, often by facilitating a "French solution". Moreover, the foreign investment regime is relatively thorough and active in following up investments and in ensuring that conditions attached to an investment are fulfilled.

A number of sectors remain closed to foreign investors through informal barriers to FDI. The limited number of publicly traded companies and a strong concentration of ownership and control in family-controlled companies create barriers for hostile takeovers. In addition, various features of company law and the company Articles of Association tend to entrench control in management and make hostile takeovers virtually impossible, as do the large public sectors with state-owned enterprises dominating activity. In this environment, the balance between France's inward and outward investment will likely remain an issue for other industrialized countries, especially since flows of French direct investment abroad have been twice as large as FDI flows into France since the mid-1980s.

CHAPTER 2

GERMANY

GERMANY

Introduction

Germany is among the most liberal and least regulated of the G-7 countries in its formal approach to foreign direct investment. An open-door policy dates back to the period of economic reconstruction after the Second World War. Germany is one of the few countries in the world that places no permanent currency or administrative controls on foreign investment of any sort. Despite this liberal tradition, there have been a number of interventions that prevented foreign takeovers over the years. Moreover, while few formal restrictions exist, there are some significant informal barriers that constrain foreign investment activity in Germany.

Institutional Developments

Economic reconstruction after the Second World War made foreign capital essential to the rebuilding of the country. Apart from a merger policy which is directed at all firms, there have been no authorization or screening requirements on FDI. The merger provisions of the German antitrust authority - the Federal Cartel Office - apply explicitly to cross-border transactions that affect domestic competition. Relative to other industrialized countries, few sectors have been closed by means of sectoral restrictions on FDI.

Despite the apparently liberal approach to foreign investment, barriers to FDI have existed for some time in Germany. Throughout the postwar period, a tradition of public ownership existed that limited entry to many private firms in a wide range of sectors. In 1972 and 1973, the authorities tightened restrictions on capital flows to thwart bouts of currency speculation that were considered to be undermining monetary policy. Substantial liberalization of capital movements occurred later in 1974 and in 1980. During the petroleum crisis in the mid-1970s, there was some concern that Middle East governments, with their new-found oil wealth, would come to dominate some of Germany's industrial sectors. Several firms, including Mannesman and Deutsche Bank, reacted to those developments by limiting shareholder voting rights in their company Articles in order to prevent the transfer of control into unfriendly hands. The government established an informal notification system that required banks and major firms to report to the authorities any

impending sales of companies or large blocks of shares to foreigners, particularly OPEC countries. This informal response to potential FDI is typical of the German foreign investment regime and will be the subject of more detailed discussion throughout this chapter.

At the outset of this chapter, it should be stressed that the German reunification of October 1991 has the potential to change past trends radically. For the most part, the West German system is discussed herein; however, since October 1991, economic policy in Germany has been dominated by the need to restructure the eastern economy and to supplement eastern living standards without placing undue inflationary pressures on the system. A focal point of the restructuring involves the privatization of about 9,000 state-controlled conglomerates that existed in the former East German regime. These developments have significant short- and long-term implications for the availability of German capital in international markets and the potential allocation of foreign capital in the country.

Recent Investment Patterns

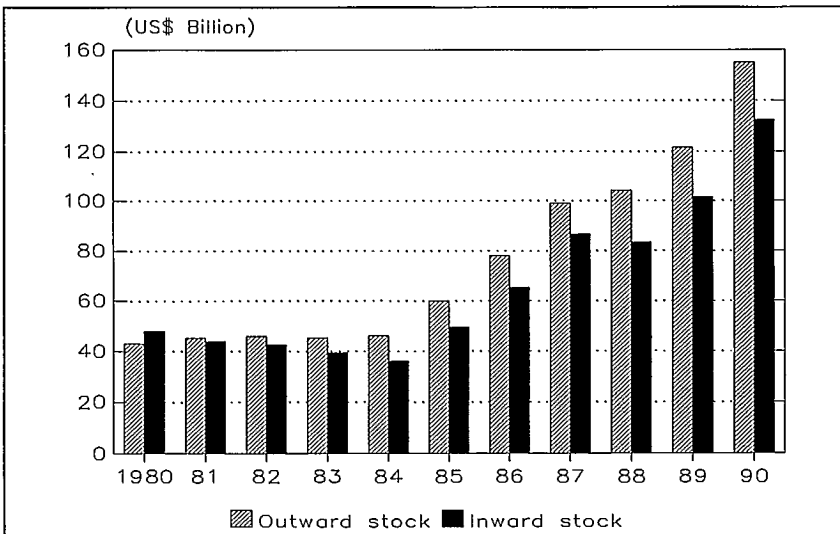
Germany has traditionally maintained a balance between its inward and outward direct investment activities. In the 1980s, however, this balance deteriorated somewhat as German outward direct investment grew relatively faster than FDI in Germany. As indicated in Chart 2-1, the book value of German direct investment abroad reached US\$ 155.1 billion in 1990, having grown at an average annual rate of 13.7% since 1980. In comparison, the stock of FDI in Germany grew, on average, by 10.7% a year during that period, reaching US\$ 132.5 billion by the end of 1990. Since the mid-1980s, however, both German inward and outward direct investment have shown more balanced growth, in sharp contrast to the experience in the first half of the 1980s, when German direct investment abroad grew about ten times faster than FDI in Germany.⁵⁹

Germany ranks behind the United States, the United Kingdom, and Canada as a recipient of international direct investment. The German share of the global stock of inward direct investment jumped from 3.4% in 1967 to 9.4% in 1980, dropping thereafter to 8% by

⁵⁹ Deutsche Bundesbank, *Die Kapitalverflechtung der Unternehmen mit dem Ausland nach Ländern und Wirtschaftszweigen, Reihe 3, Zahlungsbilanzstatistik*, Nr. 3, April 1991.

the end of 1990.⁶⁰ In 1989, the European Community was the source of over one-third of total FDI in Germany, while the United States was the largest direct investor, holding just under one-third of the value of those assets. Among other principal source countries, Switzerland, Great Britain, Japan, and France accounted for 14.2%, 8.7%, 7.4%, and 6.3% of total FDI, respectively. Canadian direct investment in Germany amounted to just over 1% of total FDI at the end of 1989.⁶¹

Chart 2-1
Stock of Inward and Outward Direct Investment, Germany, 1980-90



Source: Investment Canada compilations based on data from U.S. Department of Commerce and From Deutsche Bundesbank.

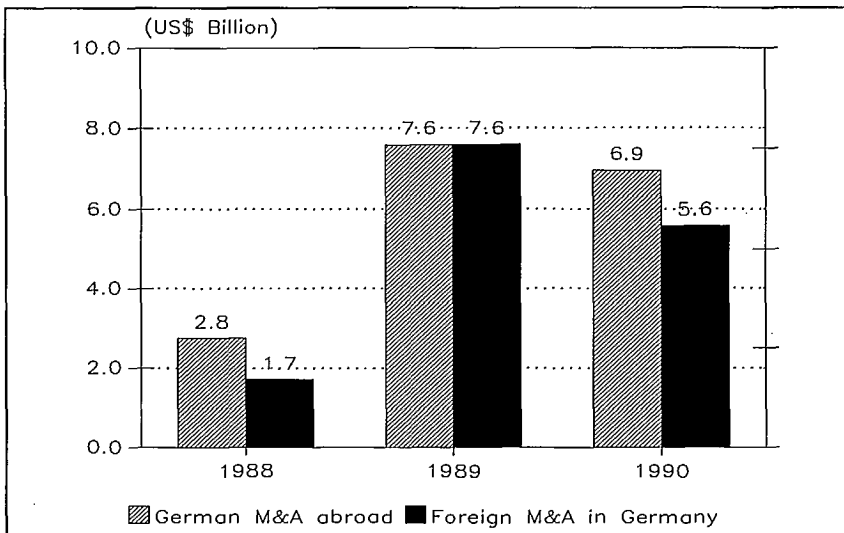
As in most European economies, cross-border merger and acquisition (M&A) activity in Germany intensified in the late 1980s in the wave of the industrial restructuring that took place in anticipation of "Europe 1992" (see Chart 2-2). According to a recent survey by KPMG Dealwatch, West Germany ranked a distant second to the

⁶⁰ John Rutter, *Recent Trends in International Direct Investment*, Washington: United States Department of Commerce, International Trade Administration (August 1992).

⁶¹ Deutsche Bundesbank, op. cit., p. 24.

United Kingdom among European countries as a destination for cross-border acquisitions in 1989. Foreign acquisitions of German companies that year were valued at US\$ 7.6 billion, up 350% from the previous year. In 1990, West Germany continued to rank behind the United Kingdom in terms of cross-border acquisitions, although the value of transactions dropped to US\$ 5.6 billion. Over 90% of the total value of cross-border acquisitions in West Germany in 1988 (US\$ 1.7 billion) were undertaken by EC-based companies.

Chart 2-2
Transborder Merger and Acquisition Activity in Germany, 1988-90



Source: KPMG Dealwatch 91.

The corresponding value of West German merger and acquisition activity abroad remained unchanged at about US\$ 7 billion in 1989 and 1990. In fact, German companies have been a powerful force, with the market values of publicly quoted German companies rising in recent years owing in part to an aggressive

acquisition strategy.⁶² In sharp contrast to foreign acquisitions in West Germany, almost 84% of overseas German acquisitions in 1988 (by value) involved target companies located in North America.

The foreign-owned firms' share of German sales, employment, and assets has remained fairly stable for a decade or so. Several measures of foreign control and ownership of German non-financial corporations since the mid-1980s are shown in Table 2-1 below.

Table 2-1
Foreign Ownership and Control in Germany

- ▶ In 1985, foreign-owned firms accounted for 14.3% of sales, 6.9% of employment, and 7.1% of all non-financial corporate assets, whereas by 1990 these figures changed to 14.0%, 7.8% and 8.7%, respectively.¹
- ▶ In 1990, the inward stock of FDI in Germany stood at 5.8% of GDP, up from 4.9% in 1980, but only marginally higher than the ratio of 5.7% in 1976.²
- ▶ The share of inward direct investment stock in Germany's gross private non-residential capital stock increased from 2.3% in 1982 to 2.9% in 1990. After reaching 3.1% in 1976, the ratio of FDI to Capital stock has remained below 3% during the last decade and a half.³
- ▶ Germany's 50 largest companies by sales included the following 12 foreign-owned firms in descending order of 1990 turnover: Opel (General Motors, U.S.); Ford (U.S.); IBM (U.S.); Shell (U.K.; the Netherlands); Esso (U.S.); Unilever (U.K.; the Netherlands); BP (U.K.); Philips (the Netherlands); Philip Morris (U.S.); Mobil Oil (U.S.); Asea Brown Boveri (Sweden, Switzerland); and Nestlé (Switzerland).⁴

¹ *Deutsch Bundesbank*.

² Investment Canada compilations based on data from various sources.

³ *Ibid.*

⁴ IL&T Germany (September 1991), pp. 4-5.

⁶² Four German companies appeared in the top ten companies in the Financial Times (London)'s European Top 500 survey published in 1991. Three of these made cross-merger acquisitions: Allianz bought Firemen's Funds (U.S.) for US\$ 3.3 billion in 1990; Siemens share of the 1989 Plessey (U.K.) acquisition was US\$ 2 billion; and Deutsche Bank paid US\$ 1.5 billion for Morgan Grenfeld (U.K.) in 1989 as well.

Formal Barriers to Direct Investment

Regulatory Framework

In terms of formal restrictions to FDI, there is no question that West Germany is open for business. On most investment matters, West Germany extends national treatment status to foreign investors.⁶³ There is no screening of foreign firms entering the country and no pre-notification requirements for FDI.

In practice, essentially all transactions with non-residents, including the formation or acquisition of West German companies, the transfer of profits abroad, and the repayment of capital to foreign investors, are not regulated and can be made freely. In theory, however, the government has the authority under the *Foreign Trade and Payments Act* to restrict acquisition of domestic companies, real estate, vessels and securities by non-residents for reasons of foreign policy, foreign exchange, and national security. These formal restrictions have never been invoked in practice, and it appears unlikely that the West German authorities would resort to those measures.

The Foreign Trade Regulations enacted under the *Foreign Trade and Payments Act*, require that foreign investors notify the German *Bundesbank* and its state branches (*Landeszentralbanken*) when they acquire 25% or more of an existing company's capital. These reporting requirements are mainly intended to facilitate a statistical record of cross-border capital flows.⁶⁴

Under German law, no formal procedural rules exist regulating takeover bids or other private agreements for the takeover of public companies. In 1979, the Stock Exchange Committee of Experts, affiliated with the Ministry of Finance, promulgated a set of "Guidelines for Public Tender and Exchange Offers" that is similar to

⁶³ "National treatment" means that a country will accord to foreign-owned firms the same laws, regulations, and administrative practices as would apply to domestic investors in like situations.

⁶⁴ Kaestner, R.; Bunsen, C.; and Fabritius, A., "West Germany", in *International Financial Law Review, The Regulations Governing Mergers and Acquisitions Across the European Community*, U.K.: Euromoney Publications (1989), p. 76.

tender offer regulations in other countries. These guidelines are not binding or enforceable, however; nor do they provide for any sanction if not fulfilled.⁶⁵ In German law no provision exists to the effect that a shareholder owning (or intending to acquire) a certain percentage of the shares of a stock corporation would be obliged to make a tender offer for all of the remaining shares of that corporation.

Sectoral Restrictions on FDI

Relative to other European countries, West Germany has few sectoral restrictions on FDI. There are no sectoral restrictions justified on national security grounds. As a member of the OECD, West Germany adheres to the Code of Liberalization of Capital Movements, although like most member countries, it has lodged a limited reservation to the Code in a number of sectors. The German authorities have agreed to apply, without exception, the OECD Code of Liberalization of Capital Movements to the new eastern states. As a general principle, there are no rules governing the degree of foreign ownership. One hundred percent foreign ownership is permitted in all industries, including banking and insurance.

As shown in Table 2-2, the reservation to the OECD Capital Movements Code restricts the ability of foreign enterprises to operate in two areas: the establishment of airlines within the territory of the Federal Republic; and the acquisition of German flag vessels. A brief discussion of the FDI restriction in these and other sectors follows.

Air Transport

The establishment of an "air transport enterprise" by foreign investors requires that West German nationals exercise majority control of the company. To obtain an airline license in Germany, an entity must use aircraft registered with German authorities. To obtain such a registration, owners of the aircraft must be either German nationals or companies domiciled in Germany and under the control of German nationals. Moreover, Germany operates a system of cabotage such that only airlines licensed in Germany have the right to provide commercial air transport between two points within its

⁶⁵ J. Michael Robinson, ed., *International Securities, Law and Practice*, Euromoney Publications (1985), p. 99.

national boundaries. As a result, German aviation law effectively reserves to German nationals the right of control of airlines operating exclusively within Germany. In addition, establishment of an airline enterprise in Germany whose headquarters are located abroad, may be subject to reciprocity requirements.

Table 2-2
Impediments to Inward Investment in All or
Some FDI Activity in Germany, by Sector

Industry	Reservation to OECD Capital Movements Code	Other Impediments	Public, Private, or Mixed Monopolies
Banking		X	
Broadcasting (Radio, TV, and Cable)			X
Post, telephone, and communications			X
Land transport (including railways and buses)			X
Air transport	X	X	X
Gaming: casinos, lottos, lotteries, and so on			X
Maritime transport	X		

Source: Organization for Economic Cooperation and Development, "Control and Impediments Affecting Inward Direct Investment in the OECD Countries" (Paris:1987).

Maritime Transport

In maritime transportation, registration in the German Ship Register (which permits the German flag to be flown) is reserved for ships owned by German nationals or companies controlled by nationals, domiciled in Germany. The registration restriction is designed to establish a "genuine link" between a vessel and its state of registry so that German public and private law can be enforced on

such vessels in conformity with international law. There are, however, no restrictions on foreign persons or entities whose vessels fly non-German flags with respect to the establishment or acquisition of companies in Germany. Foreign direct investment is thus given free access.⁶⁶

Banking

In addition to the sectors restricted to FDI by way of reservations to the OECD Capital Movements Code, West Germany also restricts FDI in banking by other impediments. The establishment of legally dependent branches of foreign banking institutions may be subject to reciprocity if not already covered by a bilateral agreement. Moreover, when the EC Second Banking Directive comes into effect, the establishment of subsidiaries by non-EC member countries will be subject to a reciprocity requirement.

Certain types of banking operations cannot be conducted by branches of foreign credit institutions – only by subsidiary companies. Foreign banking institutions, for example, can take lead management for the issuance of securities in D-Marks only through domestic subsidiaries that are legally independent entities. In addition, only foreign bank branches that have their head offices located in an EC country can act as depository banks for investment funds of German capital investment companies.⁶⁷

Postal and Telephone Services

Entry into the transport, telecommunications, lottery, and job placement sectors of the German economy is restricted by monopoly or quasi-monopoly regulations. The Federal Post Administration retains a monopoly on the networks, telephone service, and postal deliveries in Germany; and the provision of most telecommunications services is shared among three public enterprises. These monopolies

⁶⁶ Organization for Economic Cooperation and Development, *Germany: Examination of Position under the Code of Liberalisation of Capital Movements*, Committee on Capital Movements and Invisible Transactions, DAFFE/INV (91) 23 draft paper dated July 17, 1991, pp. 4-8.

⁶⁷ Organization for Economic Cooperation and Development, *Measures Affecting Direct Investment in OECD Member Countries*, July 1990, pp. 47-48.

are justified in that they preserve the revenues needed by the Post Administration to finance public infrastructure.

Radio and Television

The federal government is authorized to enact regulations for the provision of technical facilities to broadcast radio and television programs; however, licences to broadcast such programs in Germany are issued by individual *Lander* (state) authorities.

Land Transport

Private investment - by both residents and non-residents - is subject to restrictions in the provision of transport infrastructure and the provision of sea transport services between Puttgarden and Røby (Denmark). Railways are a public monopoly, although the authorities have been considering the possibility of giving third parties access to the German railway system.

Gaming: Casinos, lottos, lotteries, and so on

Other sectoral impediments to FDI exist at the *Lander* level, in particular the potential exists for discriminating against foreign investors in granting licences to undertake certain ventures. For example, lotteries, lottos, and racetrack betting are regulated by public monopolies, with laws in this area and the right to grant franchises determined at the *Lander* government level.

There are few restrictions or discriminatory measures against foreign investors after establishment. The few measures concern access to post office procurement of certain telecommunications equipment, and restrictions on foreign bank participation as lead managers with respect to the issue of DM-denominated bonds, as noted above.⁶⁸

Anti-trust and Mergers Policy

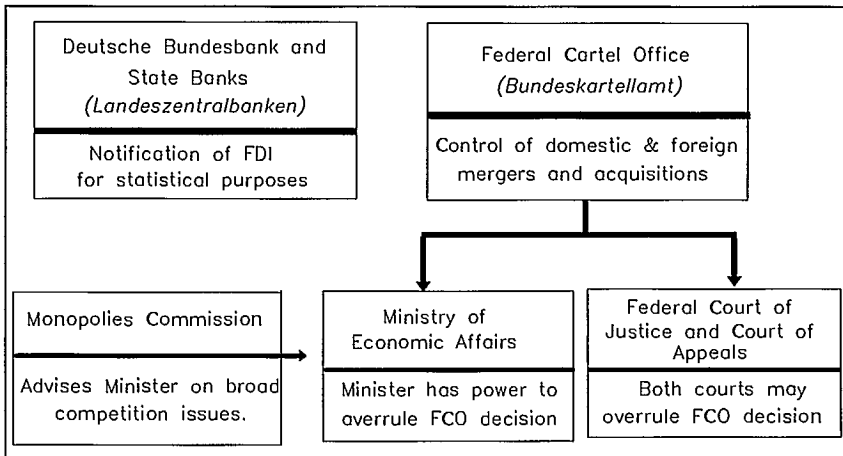
Serving as counterpoint to its freemarket policies towards foreign investment is West Germany's antitrust policy which relative

⁶⁸ U.S. Department of Treasury, *Survey of G-7 Laws and Regulations on Foreign Direct Investment*, Washington, D.C. (December 1988), pp. 3-4, section III.

to other European countries is generally considered restrictive. In 1958, the authorities brought into force the *Act Against Restraint of Competition* (GWB - *Gesetz gegen Wettbewerbsbeschränkungen*), informally known as the *Monopoly Act*. The main purpose of the law was to monitor and, if necessary, prevent the domination of West German market sectors through restrictive trade practices (cartels) or through mergers that might lead to an abuse of economic strength in Germany's national markets. This law applies in a non-discriminatory way to both domestic and foreign-controlled firms.

The Federal Antitrust or Cartel Office (FCO) in Berlin, known in Germany as the *Bundeskartellamt*, is the independent government agency entrusted with the responsibility of exercising the German Monopoly Law (see Chart 2-3). The FCO is not controlled by other government agencies; however, its decision to prohibit a merger may be overturned (in whole, or subject to conditions) by the Minister of Economic Affairs. As discussed below, the Minister has used his powers to overrule FCO decisions on several occasions.⁶⁹

Chart 2-3
Regulatory Framework for Control of
Foreign Direct Investment in Germany



Source: Investment Canada, based on information derived from various sources.

⁶⁹ IL&T, Germany (August 1990), *Business International: Business Europe*, p. 8.

The FCO's decisions can also be overruled by the Berlin Court of Appeals (the *Kammergericht*) or by the court of last instance, the Federal Supreme Court (the *Bundesgerichtshof*). The *Kammergericht* and the Federal Supreme Court have jurisdiction over all orders issued by the FCO and the Minister in merger cases. In proceedings before the *Kammergericht*, factual aspects are of great importance, and several orders have been quashed on the basis of wrong or insufficient fact findings by the FCO. Within the *Kammergericht*, a special antitrust panel deals with merger (and other competition) cases.

Among other institutions that monitor merger policy in Germany, the Monopolies Commission (*Monopolkommission*) is an independent panel of experts that renders its opinion biannually on the competitive situation (which include a review of the FCO's activities in merger cases). It also provides commentary on specific issues – e.g. media policy and the draft EC merger control regulation. Last but not least, it plays an advisory role to the Minister of the Economy on applications for special permission to proceed with a merger, which can be made when a merger has been prohibited.⁷⁰ The Minister, however, is not bound by the Commission's opinion on specific merger cases and is free to make an independent decision regardless of the panel's recommendation.

The FCO is authorized to prohibit any merger or acquisition if a position of "market dominance" results or is strengthened. Several enterprises can be considered as jointly holding a "market dominating position" if (a) there is no substantial competition among oligopolist, and (b) the enterprises belonging to the oligopoly have a superior market position in relation to other competitors in the market. In order to determine whether a merger will create a market dominating position or will strengthen an existing one, the FCO will conduct analysis not only of the present market situation but of developments after the proposed merger has taken place.

Germany's *Monopoly Act* contains a number of presumptions of market domination on the basis of high market shares. There is a presumption of market dominance for: (i) a single enterprise with a

⁷⁰ Michael Schutte and Cornelis Canenbley, "Federal Republic of Germany", in J. William Rowley and Donald J. Baker, eds., *International Mergers: The Antitrust Process*, Sweet & Maxwell (London, U.K.:1991), p. 149.

market share of at least one-third, and total sales of at least DM 250 million; (ii) three or fewer enterprises with a combined market share of at least 50 per cent; and (iii) five or fewer firms with a combined market share of at least 66.67 per cent. The three- and five-firm tests require total sales by each enterprise of at least DM 100 million in the last business year prior to the merger.⁷¹

According to one source, "if the market shares of the "top three" or "top five" enterprises reach 50 per cent or 66.67 per cent, respectively, it is presumed that they are market dominating, provided that there is no substantial competition and they have a superior market position in relation to their competitors. This presumption somewhat facilitates the finding of market domination, but still leaves the burden of proof with the BKartA (FCO) with regard to the absence of substantial competition or existence of a superior market position."⁷² For the purposes of merger control, the Act contains further, somewhat stricter and unqualified presumption of market dominance. The importance of that presumption is to shift the burden of proof from the FCO to the merging parties.

A certain degree of discretion is provided for, however, in terms of considerations relating to the necessary room for cooperation among enterprises. The FCO may allow a market-dominating merger to go through if it satisfies the "improved competitive structure" criterion stipulated in the *Monopoly Act*. This criterion essentially requires the parties to the transaction to demonstrate that as a direct result of the merger the competitive conditions in any market would be improved and that those improvements would outweigh the disadvantages of market dominance in a particular market.⁷³

In accordance with amendments to the *Monopoly Act* in 1973, the FCO now implements its merger control policies by means of a two-stage system of notification. Under German law a distinction is made between pre-merger and post-merger notification. The salient features of this system are summarized in Table 2-3.

⁷¹ Ibid; pp. 140-141.

⁷² Ibid.

⁷³ Ibid.

Table 2-3
The Merger Review Process in Germany

Domestic and foreign-controlled companies are required to submit **pre-merger notification** to the FCO¹ if:

- ▶ one of the enterprises participating in the merger had a sales volume of at least DM2 billion (US\$ 1.2 billion) for the fiscal year preceding the transaction; or
- ▶ if two or more of the enterprises participating in the merger had sales of at least DM1 billion each (US\$ 618 million) for the fiscal year preceding the transaction.

A **post-merger notification** to the FCO must be submitted immediately following the transaction if:

- ▶ the purchasing and the target company have a market share of 20% in Germany; or
- ▶ there is a turnover/sales volume of at least DM500 million (US\$ 309 million); or
- ▶ they collectively employ 10,000 workers.²
- ▶ In the pre-merger notification stage, the FCO must inform the parties within one month of receiving notification whether it intends to investigate the proposed merger. In such a case, any order prohibiting the merger must be issued within four months of the notification. The merger must not be consummated before the time limit expires or before clearance is given. Once the deal is approved by the FCO, it cannot be subsequently disallowed. The limitation period may be extended with the consent of the enterprises concerned, normally upon the suggestion of the FCO.
- ▶ In the case of post-merger notifications, the FCO has one year to determine whether the merger has resulted in, or strengthened, a dominant market position in Germany and, if so, to order divestiture.³ The one-year limitation period applicable in post-merger notification cases is not normally extended, although theoretically it could be.

¹ It is important to note that under the EC Merger Regulation, which went into effect in September 1990, mergers in Germany that have a "community dimension" will be handled by the European Commission, while the merger control regulations of the FCO will continue to apply with regard to smaller international takeovers.

² Kaestner, Bunsen and Fabritius, "West Germany", op. cit., p. 76.

³ *Ibid*, p. 76.

Informal Barriers to Direct Investment

Despite the absence of significant formal controls on FDI in West Germany, a host of informal barriers exist that can impede FDI in the economy, particularly if the investment involves the acquisition of control of a German-owned company. In brief, these obstacles pertain to structural and tactical barriers to corporate control. These barriers include the size and ownership structure of publicly quoted companies, the tactical barriers to takeovers that are built into company statutes, complexities in the structure of management boards, the power and influence that German banks command as the major source of equity capital in Germany, and the close-knit relationships between German banks and corporations - all of which enable German firms to successfully fend off contested takeovers.

Obstacles to Takeovers: The Ownership of Quoted Companies

With relatively few quoted companies, Germany offers foreign investors a limited number of takeover targets on its stock exchanges. A total of 628 domestic companies were listed on the country's Federation of Stock Exchanges (FSE) in 1989, with a total market capitalization of US\$ 365 billion.⁷⁴ In market value terms, the FSE was only one-half the size of the London Stock Exchange, although it ranked second among the European stock exchanges.⁷⁵ As a proportion of the economy, the German stock market accounts for 30% of GDP (up from 21% in 1988), while the London Stock Exchange (LSE) boasts a market value approximately equal to the value of national output.

In addition, the average market value of domestic listed companies on the FSE (US\$ 580 million) indicates that the German stock market is characterized by a relatively small number of large publicly quoted companies. The market value of the average German quoted company is about 25% higher than that of British firms listed on the LSE. In fact, in 1990, a few large German multinationals

⁷⁴ The eight stock exchanges that make up the FSE (the sixth largest market in the world in terms of turnover) are located in Berlin, Bremen, Dusseldorf, Frankfurt, Hamburg, Hanover, Munich, and Stuttgart. Of these, Frankfurt is the single most important, exchange and the only one where all foreign shares are quoted.

⁷⁵ Fédération Internationale des Bourses de Valeurs (International Federation of Stock Exchanges). *Activities and Statistics 1989 Report*, pp. 24-27.

raised their market values considerably through overseas acquisitions, which helped them boost their rank in terms of market capitalization among the top ten European companies.

In addition to the limited scope for foreign takeovers of quoted companies, there are strong takeover obstacles that arise because of the concentrated pattern of ownership of publicly traded companies (see Table 2-4 for a summary of ownership barriers). Although Germany has one of the most active trading markets when measured by the ratio of total trading volume to market value, a relatively small fraction of active shareholders account for most of the trading activity. Some sources estimate that the five most traded companies account for more than 30% of the total trade on the German stock exchanges, while the twelve most traded companies account for more than half. Another statistic on the absence of widespread share ownership indicates that in fact there are only 60 corporations (in West Germany) where more than 50% of the shares are held by the general public, and only 25 have more than 100,000 shareholders.⁷⁶

Compared with the other industrialized countries, Germany has a relatively small number of stock corporations (*Aktiengesellschaft*). Of 2,300 companies having an AG structure, about a quarter are listed on the stock exchanges; out of the listed companies a large number are family-controlled, are contained in a group of companies, or have shareholders holding sizable stakes. As a consequence, relatively few companies are considered to be potential targets for a public takeover bid.

The vast majority of acquisitions in Germany, including the rare management buyouts, take place in limited liability companies (*Gesellschaft mit beschränkter Haftung - GmbH*) or limited partnerships (*Kommanditgesellschaft*). They each have a small number of shareholders or partners, and they allow the acquirer, after the acquisition, to obtain direct influence on business decisions of the target company. The market structure in Germany therefore severely restricts access to publicly quoted companies and sets limits on takeover opportunities for domestic and foreign enterprises.

⁷⁶ Michael Oppenhoff, "Acquisitions and Takeovers in Germany and Eastern Europe", a paper presented at a seminar entitled *Acquisitions and Investment in the New Europe: The Legal and Strategic Environment*, Toronto, May 30, 1990, p. 5.

Table 2-4

Takeover Obstacles, Ownership and Control of Listed Companies in Germany

Hostile takeovers of publicly traded companies are difficult to achieve because of the concentrated ownership structure of firms. Acquisitions by tender offers are also constrained by the limited number of target companies available on the stock exchanges. Most listed companies are majority-owned or controlled by other business organizations or by banks, families, or individuals. The following highlights some of the structural characteristics of the German stock market ownership.

- ▶ In 1989, only 628 domestic companies, with a market capitalization of US\$ 365 billion (30% of GDP), were listed on Germany's eight stock exchanges (Federation of Stock Exchanges); in comparison, the London Stock Exchange had a capitalization value twice as high and equal to national output.
- ▶ Only 60 corporations have more than 50% of their shares held by the general public and only 25 have more than 100,000 shareholders.
- ▶ In 1988, it was estimated that banks and insurance companies owned more than 20% of Germany's publicly traded companies; Deutsch Bank estimates that friendly companies and banks alone hold 56% of shares in Germany's listed companies, while family holders account for still more.

Despite an increase in German stock market activity, few firms have gone public:

- ▶ One survey found that out of 2,300 public limited companies (AG's), only 619 with ordinary shares were quoted or traded on the stock market. The market capitalization of those companies was less than 360,000 private limited companies (GmbH).
- ▶ In 1987, only 45 of the top 100 German companies ranked by sales were listed on the stock exchanges.

Although Germany has a very active trading market, only a small fraction of shareholders are active participants.

- ▶ The five most- and twelve most-traded companies account, respectively, for 30% and over 50% of the total trade on the German stock exchanges.
- ▶ Trading in the German after-market (*Telefonhandel*) or over-the-counter market, which mostly involves banks and private shareholders, exceeds the turnover of the official exchanges.

The majority of trading in listed securities in Germany does, in fact take place outside the official stock exchanges via the so-called after-market (*Telefonhandel*), which is an unregulated telephone or over-the-counter market. Securities traded in the after-market are also quoted on the official exchange. Most of the trading in this market is between German banks, credit institutions, and family-owned businesses. This market has a turnover value that exceeds the official market; thus the stock market's official turnover figures significantly understate the daily volume of transactions for listed securities.⁷⁷

German banks have traditionally played an important and dominant role in the country's financial markets and hold a substantial slice of West German industry. Typically, banks hold 25% or more of the equity shareholdings in both major and smaller companies (listed as well as unlisted).⁷⁸ The majority of shares in many companies tend to be held by banks or individual families. Moreover, an essential characteristic of the German industry is that, despite the well-known large companies, most firms tend to be small and medium-sized companies owned by entrepreneurs, families, or small groups of individuals and are quite predominantly organized as partnerships or limited-liability companies. Many of these industries are leaders in their sectors, with control entrenched in family hands, or at least under family control, with only a minority of shares (often non-voting stock) quoted on the market.⁷⁹

Estimates have shown that banks and insurance companies together owned over 20% of public companies in Germany at the end of 1988. Almost half of the total equity holdings of the banking sector are held by three firms – the Deutsche; Dresdner; and Commerzbank.⁸⁰ In that event, the chances of obtaining control of a target are limited.

⁷⁷ Charles G. Kildeburn, ed. (1989), "Germany", in *The GT Guide to World Equity Markets*, London: Euromoney Publications, p. 87.

⁷⁸ *Ibid.*, p. 90.

⁷⁹ In many instances, the shares available for trading are often limited to as little as 10% of a company's equity capital.

⁸⁰ Coopers and Lybrand, *The Barriers to Takeovers in the European Community*, a study for the U.K. Department of Trade and Industry (June 1988), Country Report: Germany, vol. II, p. 41.

Obstacles to Takeovers: Aspects of Articles of Association and Company Law

As in France, German public companies are allowed to build in a wide range of anti-takeover defences in their respective Articles of Association, provided they receive a qualified majority of the shareholders' votes. For example, shareholders may reach an agreement to sell their shares to a predetermined person/institution in the event that a hostile takeover is announced. A common defence employed by some large quoted companies is to restrict the voting power of an individual shareholder. Giant public enterprises like Deutsche Bank, tire manufacturer Continental AG, Utility Veba AG, and chemical giant Bayer AG have introduced a clause in their Articles of Association that restrict the voting rights of a single shareholder to 5% or 10%, irrespective of the number of shares held.⁸¹ In addition, the sale of shares or stocks (other than bearer shares) by German companies to non-residents or foreign companies may also carry restrictions on the exercise of voting rights where the transfer itself is not restricted.⁸²

By imposing voting-right limitations, a target company has the potential to forestall an unwelcome bid, even after the raider builds up a considerable stake in the company. Other shareholders (e.g., banks and their "friendly" shareholders) opposed to the takeover could take concerted action to reject the bid decisively. It is conceivable, however, that shareholders might vote to abolish such a voting-right clause in the corporation's by-laws if the bidder were to offer them an attractive premium on the share price. Another tactic to circumvent voting-right restrictions would be to pool the votes of a group of non-related shareholders working together in favour of a takeover. In fact, this strategy was used recently in a highly controversial hostile takeover battle for German tire maker Continental AG by Pirelli of Italy (see case studies).

Apart from limiting voting power, German company law permits AG companies to issue non-voting rights up to an amount equal to that of all other shares issued. In the case of many corporations, only non-voting shares are listed and traded, while the

⁸¹ Ibid., p. 20.

⁸² Kaestner, Bunsen and Fabritius, "West Germany", op. cit., p. 76.

voting shares are closely held and/or issued as registered shares, the transfer of which requires consent by the corporation. In recent times, the issue of non-voting rights has been a common practice in the flotation of new AG's.

Cross-holdings in Germany are not uncommon, although the degree of cross-ownership is less than in France and Italy. For example, Allianz AG (Europe's largest insurance company) and Munich RE AG hold 25% of each other's equity. German company law, however, curtails voting-rights power to a maximum of 25% when companies hold each other's shares, irrespective of the size of that shareholding.⁸³

The strong structural and tactical obstacles to takeovers in West Germany severely limit in practice the success of hostile acquisitions, whether by domestic or foreign companies. According to the Coopers and Lybrand study (1989), there are only two recorded hostile takeover bids in Germany, both of which turned out to be unsuccessful. These cases are outlined briefly in the next section, which deals with case studies of FDI in West Germany.

Aside from provisions under company Articles of Association, many German companies assume a complex management structure that also impedes the acquisition of control of domestic firms via hostile takeovers (see Table 2-5).

Most large industrial stock companies listed on the exchanges in Germany take the legal form of an *Aktiengesellschaft* or AG. Management control of an AG is exercised through a mandatory two-tier board structure in which banks play a prominent role. The two boards of a typical stock corporation are the supervisory board and the management board. The members of the supervisory board (*Aufsichtsrat*), who set the long-term strategy of the corporation, are elected in part by the shareholders and in part by the work force; the members of the management board, who run the corporation on a day-to-day basis, are appointed by the supervisory board. The banks' position as shareholders gives them obvious influence over management – a position that is reinforced by the strong presence of their representatives on the supervisory boards.

⁸³ Coopers and Lybrand (June 1989), op. cit., p. 37.

Table 2-5
Takeover Obstacles:

Aspects of Company Law and Articles of Association in Germany

German publicly traded companies, like those of France, have strong voting-right restrictions in their respective Articles of Association that are intended to be an efficient defence measure against contested takeovers. Even a controlling or majority stake in the offeree's capital (e.g. a non-resident's equity) may have only limited voting power.

- ▶ At the end of 1989, the Articles of 23 corporations listed on the stock exchanges restricted the voting rights of a single shareholder to 5 or 10% of the total votes, irrespective of the number of voting shares held: Asko, Mannesmann, Bayer, Deutsche Bank, Continental, and Veba limit individual shareholders to 5% of the votes; at Hoescht, the limit is 15%, and at Volkswagen it is 20%. Shareholders may vote to abolish voting-right restrictions.
- ▶ *The German Stock Corporation Act* allows AG's to issue non-voting shares up to an amount equal to other shares issued; the issue of non-voting shares has been common in the recent flotation of AG's.
- ▶ Cross-shareholdings between companies in Germany are not uncommon; under German company law, voting-rights power is limited to 25% when companies own shares in each other's equity, regardless of the number of shares held. German subsidiaries are not allowed to hold shares of their parent companies.

Management control of a German stock company tends to be entrenched through a two-tier board structure. A supervisory board, whose members are elected by shareholders and employees, in turn appoints members of the management board. In a hostile takeover situation, this system tends to perpetuate company control with incumbent management unless the acquiror is able to work out a control agreement. Under German company law,

- ▶ Removal of supervisory board members requires a 75% majority of votes, not a "50%+" simple majority; thus a 51% share of the voting stocks in a target company may not yield control to the acquiror in the short term. At least 75% of the voting stock is a minimum condition for assuring control.
- ▶ Members of both boards hold office for a term of five years; thus even a 75% acquisition of the voting stock of the target company may not ensure the removal of supervisory board members by the acquiror(s); the board members can continue to control the company until the expiry of their term of office.

As a result of the two-tier board system and the long-term appointments to both boards, management of the target company is quite independent, and the acquiror cannot expect, in the absence of a control agreement, to gain immediate access and control of the company, particularly in a contested takeover situation.

The two-tier board structure has the potential to block the transfer of management control even after a hostile takeover is successful. In effect, a control agreement is required.

Because of mandatory provisions under German company law, a 75% (not a "50% plus") majority is required to terminate the term of office of a supervisory board member, to change the articles of association; or to institute a control agreement that would permit direct access to the management of the target company. Both supervisory board members and the management board members are elected by the supervisory board for a term of up to five years. Their removal can only be effected for a just cause or at the expiry of their term of office. Thus even control of 75% or more of the shares of a company, that being the level required to remove supervisory board members, does not automatically ensure the removal of the board of managing directors, who can remain in control until the expiry of their term of office.

As a result of the two-tier board system and the long-term appointments to both boards, management of the target company can be quite independent. Under these circumstances, an acquiror cannot expect to gain immediate access and control of the company unless a control agreement is worked out. This aspect of German company law acts as a formidable barrier to post-acquisition control.⁸⁴

The German government has been under some pressure to enact stricter banking regulations to limit the influence of the banking

⁸⁴ In his article, "Germany Takeover Barriers: Obstacles to Foreigners Are Nothing but a Myth", *Financial Times (London)*, Dr. Hans-Jochen Otto asserts that the by-laws of nearly all German corporations have been modified to allow a simple majority of the votes to be sufficient to remove management. Our discussion on takeover barriers has been limited to large publicly quoted companies (AG's), which are subject to the provisions of the *Stock Corporations Act*. Unlisted companies, which are mostly private limited companies called *Gesellschaft mit beschränkter Haftung* or GmbH, form the bulk of Germany's business enterprises (there were in excess of 360,000 GmbH companies at the end of 1988). Acquisition of a GmbH can be achieved only on friendly terms, since it typically has few shareholders with control vested in family hands. Moreover, such businesses are not constrained by formal rules and regulations; therefore most takeovers demand considerable interpersonal communication between the foreign (or domestic) acquiror and the German target. Frequently, the language barrier between foreigners and Germans tends to impede the success of a GmbH takeover. Foreign investors often overcome this obstacle by resorting to the use of a German financial intermediary in carrying out the negotiation.

community over private enterprise. A committee has been studying ways and means to curtail the far-reaching powers of German banks. Its proposals include: a 15% limit on the shares that a bank may own in a non-banking firm; a cut in the number of company supervisory boards on which a bank director may sit (currently 10); and a ban on company action reducing shareholders' voting rights – an antitakeover mechanism often adopted by German companies. It appears, however, that few analysts believe that the committee's deliberations will impose a major curb on the powers of German banks.⁸⁵

Other Informal Barriers: Government/Business Linkages; State-Controlled Enterprises

The closely interwoven ownership structure of German corporations and banks tends to create additional informal barriers to foreign investment. In particular, the strong commercial links between industry and banks in Germany pose a number of formidable obstacles to the success of hostile takeovers. These commercial linkages are cemented in a variety of ways, the main elements of which are discussed as follows (see Table 2-6).

In addition to direct ownership of corporate equity, German banks are indirectly able to extend *de facto* control of business by exerting considerable influence over management of their client companies. This influence is built up primarily through the process of providing a wide range of *universalbanken* services to their clients. For example, all securities transactions in Germany are effected directly or indirectly through the banks, which act as both banker and stockbroker. They also act as underwriters and investment advisers. In fact, German companies, instead of using several banks, have historically fostered close ties to one bank only ("Hausbank").

In exchange for influence over management policy, German banks have served as the traditional source of funds for firms looking to expand in the German market. Bank finance has therefore limited the need for the German capital market to raise corporate finance through the issue of share capital. Furthermore, there are no large pools of cash readily available in other organizations. Germany does

⁸⁵ *Business International: Business Europe*, "German Banks Face Shareholding Restrictions", The Economist Intelligence Unit (U.K.) (July 10, 1989), pp. 1-2.

not have pension funds with assets available for investment, and the rights of insurance companies to invest in stock are quite restricted (pension funds are primarily collected by governmental institutions).⁸⁶

A large proportion of private family businesses, which account for as much as one-fifth of public ownership in Germany, generally deposit their bearer shares (non-registered) shares with banks in order to minimize transaction fees, and for safekeeping.⁸⁷ The banks then exercise proxy voting rights on behalf of the owners.

The Monopolies Commission reports that large personal and family holdings result in the control of 14 of the top 100 companies. Since the influence of German banks is largely concentrated in the top 100 companies, bank-held and proxy voting power (through depository shares) dovetail to produce an extraordinary degree of concentration of voting power across a broad range of German companies. It is estimated that through direct holdings and proxy voting rights, the banks are able to exercise as much as 98% of the votes at some annual shareholders' meetings.⁸⁸

Some critics have pointed out that the ability of the banks to fend off an unwelcome bid by exercising proxy votes is not a serious obstacle. As one author notes, "Their [the banks'] proxy powers relate to their role as depositories and may only be executed in support of resolutions supporting incumbent management unless the private shareholder-depositors instruct the bank otherwise. Such specific shareholders' instructions would be expected if an attractive tender offer was made which would allow shareholders to realize the

⁸⁶ In recent years, however, some policy measures have been introduced in an attempt to revive the dormant capital market. For example, the government has taken steps to cut taxes, which formerly penalized share issues. In addition, the fragmented stock exchanges are considering reforms in order to centralize the equity market under standardized trading practices. See "Another Unification Problem", *The Economist*, August 31, 1991, pp. 61-62.

⁸⁷ The majority of the German shares are issued in bearer (*Inhaber*) form. Registered (*Namen*) shares are relatively rare in Germany, with the exception of insurance company shares. As the majority of the shares are bearer shares, it is impossible to give an accurate percentage breakdown of shareholders.

⁸⁸ *Business International: Business Europe*, "German Banks Face Shareholding Restrictions", The Economist Intelligence Unit (U.K.) (July 10, 1989), p. 1.

value of their shares."⁸⁹ While commercial banks have a legal obligation to consult their clients about voting rights, there is evidence to suggest that in practice most clients seldom ignore the advice given by their respective banks.

Table 2-6
Takeover Obstacles: Business/Government Linkages in Germany

The pervasive influence of German banks from direct ownership of companies is further reinforced by several other factors:

- ▶ Banks have primary access to stockholders since the shares are commonly bearers' shares held in deposit by the banks; as depository banks, they are then able to exercise the voting rights of the stockholders by means of proxy.
- ▶ Direct holdings and proxy votes enable banks to cast as much as 98% of the votes at some annual shareholders' meetings.
- ▶ Proxy votes are used in support of incumbent management during hostile takeovers, unless shareholders instruct otherwise. Although banks must consult shareholders following a takeover offer, in practice the latter seldom ignore their bank's advice.
- ▶ The banks are closely associated with the possible target companies by virtue of providing a host of "Universalbanken" services and through their extensive representation on supervisory boards.
- ▶ In general, the availability of bank financing has severely limited the need for German capital markets to raise corporate finance through the issue of share capital; in addition, the absence of pension funds for investment and the restrictions on insurance companies to invest in stocks increases the importance of banks as a source of capital.
- ▶ The German corporate model exemplifies the continental European aversion to hostile takeovers that are more common in Anglo-Saxon cultures. The corporate culture emphasizes long-term growth and stability rather than the short-term profit maximization of shareholders' values. Company policies reflect this philosophy; for example, German companies provide no short-term dividends, and reports to shareholders are provided only once a year.

⁸⁹ Dr. Hans-Jochen Otto, op. cit., February 20, 1991, p. 15.

The power and influence that German banks are able to exert through their representation on the supervisory boards of major companies is well documented. A 1984 report by the West German Monopolies Commission showed that the three largest banks in Germany - Deutsche; Dresdner; and Commerzbank - had representatives who sat on supervisory boards of 76 of the top 100 companies in West Germany.⁹⁰ These representatives generally have the power to appoint and remove the board of directors of the company should a conflict of interest arise. For example, according to one source, the chairman of the Daimler-Benz's board of managing directors was chosen by Deutsche Bank, Germany's largest bank. At the time, Deutsche Bank owned 28% of Daimler-Benz, and its chief executive officer chaired the supervisory board of the company. The bank became dissatisfied with the performance of the chairman of the board of directors of that company, at which point it called a shareholders' meeting and was successful in obtaining his resignation.⁹¹

German corporate mentality with respect to hostile acquisitions is an intangible factor that may explain the relatively few hostile takeover bids. Germany epitomizes the European continental view that long-term growth through continuity in management is relatively more important than short-term goals that call for maximizing shareholders' values. In practice, this philosophy is buttressed by the fact that neither interim dividend payments nor reports are submitted to German shareholders other than once a year. As part of German corporate ethics, companies tend to avoid battles for corporate control in the interest of the company's long-term stability and growth, as well as the need to exercise responsibility toward employees well being. The conservative attitude of the German business community may explain why the vast majority of takeovers concern the purchase and sale of companies or small groups by way of private (off-exchange), friendly, negotiated deals arranged by personal contacts or specialized brokers and carried out with the help of trusted tax advisers, accountants, and lawyers.

Until the early 1980s, state ownership in the former West German economy was significant, and it limited the entry of foreign

⁹⁰ Coopers and Lybrand (June 1988), *op. cit.*, West Germany, p. 14.

⁹¹ *Ibid.*, p. 15.

firms in many strategic areas. In 1983, the West German government initiated a privatization program. Today, the former West Germany has little state ownership compared with other European countries.

Some of the major companies that have been either fully or partially privatized in recent years include: Veba AG (an electrical, chemical, oil trading/transport/service company); Viag AG (aluminum and chemicals); Volkswagen AG (automobiles); Deutsche Lufthansa (airline); Salzgitter AG (steel and shipbuilding); Deutsch Industrienlagen (industrial holding company); and Deutsche Pfandbriefanstalt (a federally owned mortgage bank). Some notable companies slated for privatization in the future include: Prakla-Seismos (oil exploration); the DSL Bank (the German Settlement and Land Mortgage Bank); and the GFN (hotels and restaurants).

As part of the reunification process, most of the public enterprises of the former German Democratic Republic are being privatized through the East German Treuhandanstalt, described as the "world's largest holding company" with over 8,000 companies on its books. Despite the fact that a massive privatization program is in the works, it is unlikely to be completed in the near future.⁹² To date, the vast majority of privatized companies have ended up in the hands of German-owned companies: only 115 of almost 3,000 enterprises sold by the *Treuhandanstalt* by the end of July 1991 were taken over by 84 foreign-owned firms.⁹³ It has been recently noted that the range of eligible purchasers of East German firms "effectively extends only to operating firms, and for a number of reasons including longstanding commercial contacts and tax legislation, these are mainly West German".⁹⁴

The FCO has subsequently expressed concern that since many privatizations have landed in the hands of West German buyers, this could lead to a "cartelization" of East Germany. Since the German unification, the FCO strongly intervened to block the acquisition of the GDR electricity sector by three West German companies – Rheinisch-Westfälisches Elektrizitätswerk (RWE), PreussenElektra, and

⁹² *Business International: Business Europe*, op. cit., The Economist Intelligence Unit (U.K.) (October 5, 1990), p. 3.

⁹³ *The Economist*, "Privatising East Germany", September 14, 1991, p. 21.

⁹⁴ OECD, op. cit., (July 1991), p. 14.

Bayernek – even though the deal originated with GDR's Ministry of Environment Protection, Energy and Reactor Safety.⁹⁵ The West German government does appear, however, to be giving more priority to the restructuring of the East German economy through West German capital infusion. To that end, the FCO may be forced to compromise on competition in the German market to some extent in order to keep East German companies under German ownership following privatization. In any event, there is likely to be a strong investment diversion effect as West German companies place relatively more of their investment funds in East Germany than in other countries.

Case Studies on FDI in Germany: A Brief Review

Not surprisingly, given the liberal nature of formal barriers to FDI in Germany, there are few recorded instances of government intervention to prevent a foreign takeover of a German company.⁹⁶ Moreover, given the elaborate business/financial linkages associated with the informal barriers, hostile takeovers simply do not develop to any degree. In other words, the broad economic structure precludes any substantial takeover activity.

Continental AG/Pirelli

The restriction on voting-rights power was the focal point of a highly controversial takeover battle in West Germany in 1991. The bid, made in early 1991, involved an acquisition of control by Pirelli of Italy, the world's fifth largest tire manufacturer, in Continental AG (ranked second), a Hanover-based German tire company, for US\$ 1.2 billion. Pirelli began accumulating shares in the Continental in mid-1990, but despite having a 34% stake in the German company,

⁹⁵ *Business International: Business Europe*, "German Unification: Antitrust Fears Mount", op. cit., The Economist Intelligence Unit (U.K.), (July 13, 1990), pp. 1-2.

⁹⁶ See Robert W. Gillespie, "The Policies of England, France and Germany as Recipients of Foreign Direct Investment", in Fritz Malchup et al. (eds.), *International Mobility and Movement of Capital* (New York: Columbia University, 1972)), pp. 415-16. One such instance involved a takeover attempt by Texaco (U.S.) for a controlling interest in a financially distressed German oil firm (Deutsche-Erdol) in 1966. The German government was firmly opposed to the deal, which initially led to a break-off in negotiations; however, for reasons unknown, the authorities subsequently withdrew their objections, and the transfer of ownership was ultimately accomplished.

Pirelli's voting rights were restricted to 5%, in accordance with a provision in Continental's Articles of Association. Pirelli claimed that the bid was friendly, but Continental's management rejected the offer, which it described as hostile. Deutsche Bank AG and Europe's largest insurance company (Allianz AG), each with a 5% stake in Continental, were two major German establishments opposed to the takeover.⁹⁷

In addition to the support received by the two financial giants, the three major German automakers (Daimler-Benz, Volkswagen, and BMW) also rallied behind Continental, each acquiring a 2% stake in the company at Deutsche Bank's behest. With the addition of the car companies' shareholdings and through proxy votes, it was expected that Continental would have the minority of 25% needed to defeat any motion requiring a large majority (75%).

In mid-March 1991, at an extraordinary general meeting that lasted 10 hours, a majority of Continental's shareholders voted in favour of a motion to scrap the 5% limit on voting rights. Pirelli, which claimed that its supporters held just over 50% of the shares (including its 5% stake), backed the resolution to overthrow the voting power restrictions, which required a simple majority. Pirelli, however, did not vote on another motion requiring a 75% majority – namely, that Continental put the Pirelli merger proposal before shareholders at the German company's annual meeting in July. This motion was defeated, and Continental regarded the outcome as an overwhelming indication that shareholders were opposed to the deal. Pirelli maintained that its aim was to achieve its objectives by "friendly" negotiations with the Continental management rather than through a resolution imposed by shareholder management.⁹⁸

The shareholders' vote in favour of removing the voting-rights restriction that Pirelli successfully won in March 1992 was never enacted pending an appeal to the Hanover court. In 1992, the court annulled the decision, on the grounds that Pirelli had failed to disclose its ownership of more than 25% of Continental's shares, as required by the *Stock Corporation Act*. Pirelli's takeover prospects

⁹⁷ *Business Week*, "Cracks Are Opening in Fortress Germany", April 1, 1991, p. 40.

⁹⁸ *M&A Europe*, "High Noon in Hanover: Pirelli's Historic Breakthrough", IMC Business Communications (March/April 1991), p. 10.

became more remote in July 1992, when for a second time it failed in its attempt to remove the 5% voting-rights restriction. After winning the vote to get rid of the voting restrictions in mid-1991, Pirelli's Mr. Ulrich Weiss, chairman of the Continental supervisory board, ruled that the voting rights on Pirelli's direct and indirect shareholding in Continental would remain limited to 5%; at that point, Pirelli had owned 5% of the voting shares and options on a further 33.4%.

Bibliographisches and FA Brockhaus / Maxwell Communications

The following is an example of where the German establishment sought a "white knight" in the face of a contested takeover. Maxwell Communications Corporation (MCC) of the United Kingdom made a contested bid for Bibliographisches Institut and FA Brockhaus AG (BIFAB), a German publisher, in May 1988; however, BIFAB regarded MCC as an unsuitable partner from the outset and began to seek a German white knight. A majority of the shares of BIFAB were family-owned - in this case, by 40 members of the Brockhaus and Meyer family. As a result, the MCC bid was unsuccessful, and BIFAB was sold to a Germany company, Langenscheidt KG.⁹⁹ Later, the computer manufacturer Nixdorf experienced financial difficulty, and the German electronics giant Siemens quietly acquired it before foreigners had an opportunity to make an offer.

Feldmühle Nobel / Flick Brothers

This case is one of the few hostile takeover bids recorded in German corporate history. It demonstrates further, however, the potential use of restricted voting-power provisions for shareholders. Flick Brothers of the United Kingdom made an attempt to take over Feldmühle Nobel (FN) AG in 1987. The offer failed, and in a defensive move FN subsequently restricted voting power to 5% for individual shareholders, regardless of the number of shares held. Following the abortive bid, however, Flick Brothers, continued to increase their stake in FN, raising their stake to 40% with the help of

⁹⁹ Coopers and Lybrand (June 1988), op. cit., p. 47.

some supporting buyers.¹⁰⁰ Many observers were of the opinion that the strategy by Flick Brothers was motivated by "a personal vendetta against Deutsche Bank ... against what they see as the stultifying old boy network of German managers and bankers who are said to crush shareholders' rights and thus a vigorous market in corporate control along the Anglo-American lines."¹⁰¹

Fichtel and Sachs AG / Guest, Keen & Nettleford

There is no strong evidence that the FCO applies the merger law discriminately against foreign companies; however, the following is an example of a blocked foreign-to-domestic transaction. Moreover, it also atypically involves a conglomerate or vertical merger rather than a horizontal one (i.e. in the same industry). In 1976, the FCO blocked a merger between a British group - Guest, Keen, and Nettleford (GKN) - and Fichtel and Sachs AG (F&S). The latter was Germany's leading supplier of automobile clutches, with a market share of 70%.¹⁰²

The German Supreme Court upheld the FCO's decision to prohibit the merger, which had subsequently been reversed by the Berlin Court of Appeals. In the FCO's view, F&S held a dominant position in the German market for clutch supplies. Despite GKN's diversified operations (GKN manufactured automotive parts other than clutches), the FCO ruled that F&S would be incorporated into the financially much stronger GKN group, thus reinforcing F&S's market dominance.

¹⁰⁰ This case shows that it is possible to purchase a substantial interest in a stock corporation on the open market without the knowledge of the target company or the banks. The secret acquisition of a 40% stake in the company was made possible by the high disclosure thresholds (25%) under the *German Stock Corporation Act*; in addition, failure of shareholders to notify the company "instantly" of their shareholdings above the 25% threshold does not carry any penalties. "Instantly" is not legally defined but is generally understood to mean within two weeks.

¹⁰¹ Coopers and Lybrand (June 1989), op. cit., p. 46., a quote from the *Financial Times* (London), May 22, 1989.

¹⁰² Organization for Economic Cooperation and Development, "Merger Policies and Recent Trends in Mergers" (Paris:1984), p. 28.

The following are other relevant cases:

- ▶ During the petroleum crisis in the mid-1970s, there were particular concerns that Middle Eastern governments, with their new-found oil wealth, would come to dominate some sectors of German industry. Iran's acquisition of a 25% interest in Krupp, as well as Kuwait's acquisition of a 14% interest in Daimler Benz, heightened those concerns. A number of major companies reacted to those fears by limiting shareholder voting rights to no more than 5% of total equity, as allowed under company law.¹⁰³
- ▶ In 1967, in a case involving another oil company, Germany's Dresdner Bank sought to find a buyer for its 30% share in one of three remaining German-owned oil firms, Gelsenkirchner Bergewerk (GB) AG. Both American and French firms showed an interest in acquiring GB; however, the government, with the backing of the bank, sought a German white knight, which appeared in the form of Germany's largest electrical producer.¹⁰⁴
- ▶ A highly controversial case in which the FCO prohibited a merger involved FDI in terms of the impact of subsidiaries on the domestic economy. This decision was ultimately overruled by the Court of Appeals. In 1980, the French subsidiary of Bayer AG notified that it intended to acquire the synthetic rubber business of Firestone France, a subsidiary of Firestone Inc. (U.S.A.). Synthetic rubber originating from Firestone France accounted for only 0.4-0.8% of the German market; however, the FCO's investigation concluded that Bayer AG (the parent) held a dominant position on the German market for synthetic rubber and that an increase of 0.4-0.8% of the market would only strengthen the already-existing dominant position. Accordingly, the FCO notified Bayer AG of its decision to block the transaction. Bayer appealed the decision before the Berlin Court of Appeal on grounds that the transaction had

¹⁰³ A.E. Safarian, *Governments and Multinationals: Policies in Developed Countries*, British-North American Committee (December 1983), pp. 42-3.

¹⁰⁴ Robert W. Gillespie, "The Policies of England, France and Germany as Recipients of Foreign Direct Investment", in Fritz Malchup et al. (eds.) *International Mobility and Movement of Capital*, Columbia University Press (New York: 1972), p. 416.

already received the approval of the French government and that it should be subject to French takeover laws and not German antitrust policy. The Court of Appeals reversed the decision of the FCO for a variety of procedural defects and issued a preliminary order allowing the consummation of the merger.¹⁰⁵

Conclusion

Germany has few formal controls restricting foreign direct investment. A significant hurdle is its antitrust law, which forbids dominant market positions resulting from either foreign or domestic takeovers. Few sectors of the economy are formally closed to FDI.

There are, however, some serious informal obstacles to the acquisition of German companies. Close financial and corporate linkages, characteristic of the German universal banking model, act as strong deterrents to hostile takeovers. Commercial linkages between banks and corporations lead to a corporate structure in which a small fraction of active shareholders control the votes of a large proportion of outstanding shares. In some of the listed companies, the Articles of Association provide for a general voting restriction for shareholders, irrespective of the number of voting shares held. The interest of the minority shareholders are also protected by a two-tier board system that contributes to management autonomy and obstructs the removal of management personnel. The German banks also reinforce their voting power through "proxy" votes on behalf of shareholders whose bearer shares are held in deposit by the banks. Last but not least, banks are closely associated with possible targets through their banking services and their representation on supervisory boards.

¹⁰⁵ Organization for Economic Cooperation and Development, *International Mergers and Competition Policy* (Paris:1987), pp. 36-37. In another merger case - Philip Morris and Rothmans - the Berlin Court of Appeals limited the FCO's order prohibiting a merger between companies situated outside Germany to the German part of the merger. The FCO passed a prohibition order to quash the acquisition of shares in Rothmans (U.K.) by Philip Morris (U.S.A.), since in the German market for cigarettes only four out of five major competitors would be left following the merger. The Berlin Appeals Court, however, was under the opinion that under international law such prohibition must be limited to what is "necessary" to deal with the domestic effects of the merger. See Schütte and Canenbly (1991), op. cit., p. 144.

CHAPTER 3
ITALY

ITALY

Introduction

Italy, like France, has recently relaxed its formal treatment of FDI. New legislation has been passed liberalizing aspects of the regime. No foreign investment registration or approval procedures exist other than in some sectors of "national interest" ruled by legislation that prohibits or imposes limits on investment by all companies, both domestic and foreign. Authorization for large-scale industrial greenfield investments and expansions by domestic and foreign firms is required; the government, however, welcomes these investments, particularly for the underdeveloped Mezzogiorno region in the south of Italy, and offers domestic and foreign investors many financial incentives to locate there.

Nevertheless, there continue to exist significant informal barriers to direct investment in the country. As in several other European countries, competition legislation became a central policy focus prior to "Europe 1992", and Italy's antitrust legislation has implications for FDI. Testimony to the informal constraints on FDI is the high concentration of Italian companies that are privately owned and controlled by a small number of Italian families. As well, there are a large number of firms under direct state control. Most takeovers in Italy are friendly and private, lying beyond the purview of the stock exchange.

Institutional Developments

In the postwar reconstruction period of the 1950s and 1960s, Italy put emphasis on attracting foreign investment. This was especially the case for the Mezzogiorno, the underdeveloped southern region of Italy. Substantial investment incentives were provided for Italy's economically depressed regions.

In the 1970s, Italian government policy was intentionally more restrictive, with major direct investments requiring approval by an interministerial committee. Direct investments were also subject to exchange controls, limiting the movement of foreign capital and income. These limitations were virtually lifted if the foreign investments qualified as "productive enterprises" or as expansions of

existing "productive enterprises".¹⁰⁶ The large public sector played a role too; the high number of state enterprises limited the activity of foreign investors in certain sectors.

In the late 1980s, a number of sweeping reforms were introduced to liberalize exchange controls on FDI activity in Italy. Most FDI controls in Italy until then took the form of restrictions placed on currency movements for inward and outward direct investment. In October 1988, the Italian Exchange Office (*Ufficio Italiano de Cambi, UIC*) - responsible for implementing the government's exchange guidelines under the supervision of the Ministry of Trade - abolished the country's principal law on foreign investment, Law No. 43 of 1956. As a result, the distinction between productive and non-productive investment was dropped and controls on foreign exchange liberalized.

To comply with the EC's July 1, 1990, deadline on the liberalization of Capital Movements, the last of Italy's exchange controls were lifted on May 14, 1990. The reforms liberalized most of the remaining exchange restrictions on Italian direct investment abroad. As of that date, Italian residents were permitted to invest abroad and open current accounts with foreign credit institutions. Residents could acquire shares and create lira or non-lira deposits abroad without restriction, and they could open lira or non-lira credit lines for overseas entities.

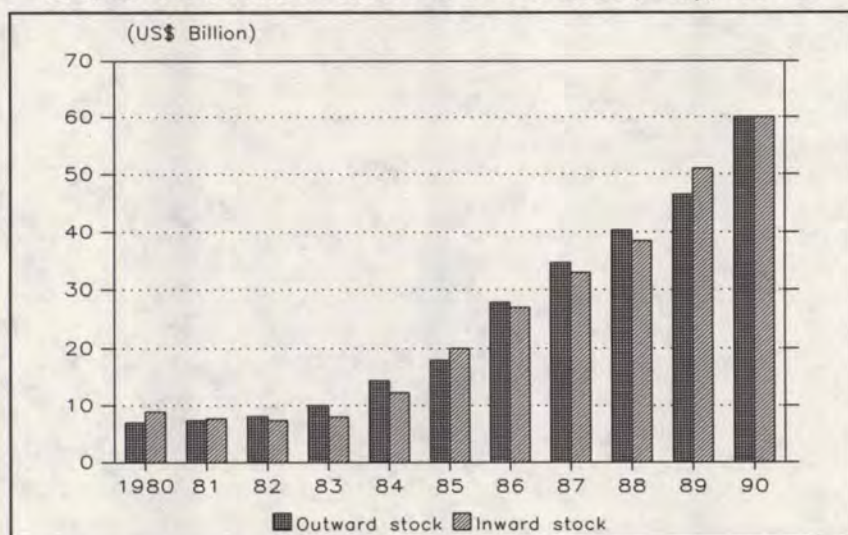
After considerable debate, the Italian Parliament passed the country's first antitrust statute on October 10, 1992, bringing Italian regulations more closely into line with EC competition rules. Apart from the need to regulate an unprecedented increase in merger and acquisition activity, the adoption of the competition legislation could no longer be delayed from a political perspective because of the urgency of bringing Italian legislation in line with that of other major EC countries. Most other EC member countries had by then responded to the acceleration of the European integration process by enacting antitrust policies that were consistent with those prevailing at the EC level.

¹⁰⁶ Safarian (1983), op. cit., p. 44.

Recent Investment Patterns

The recent surge in FDI activity in Italy demonstrates the increasing importance of the country as a destination for international direct investment. In the 1980s, inward direct investment in Italy grew at a significantly faster pace than in any other G-7 country. With an average annual growth of almost 21%, the stock of FDI in Italy soared from US\$ 9.0 billion in 1980 to US\$ 60 billion at the end of 1990.¹⁰⁷ In fact, the pace of inward FDI growth in Italy was more than one and a half times faster than that of all G-7 countries during that period. This remarkable pace of FDI growth resulted in raising Italy's share of the global stock of direct investment from 1.8% in 1980 to 3.7% in 1990.

Chart 3-1
Stock of Inward and Outward Direct Investment, Italy, 1989-90

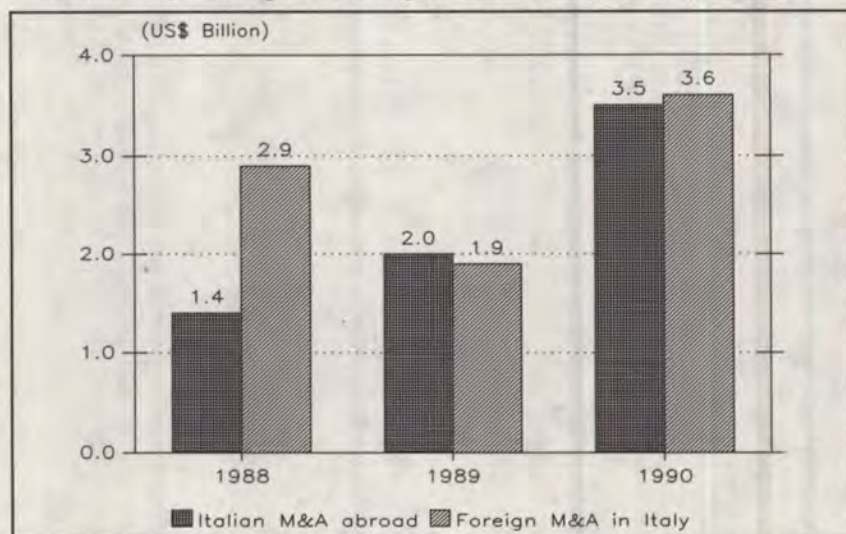


Source: Investment Canada compilation based on data from the International Monetary Fund, *Balance of Payments Yearbook*.

¹⁰⁷ International Monetary Fund, *Balance of International Payments* (1991).

The significant growth of FDI in Italy over the 1980s was matched by a similar expansion in Italian direct investment abroad (see Chart 3-1). The stock of Italian direct investment abroad rose from US\$ 7.0 billion in 1980 to US\$ 60 billion by year-end 1990, representing an average annual growth rate of 24% for the period. The levels of FDI in Italy and Italian direct investment abroad were generally close during most of the 1980s, reaching an even \$60 billion by the end of 1990. In 1990, the stock of inward FDI in Italy amounted to 5.5% of GDP, up from 4.7% in 1985. While the share of FDI in Italy's GDP is roughly in the same neighbourhood as the ratios for Germany, France, and the United States, it is significantly below that of the United Kingdom and Canada where FDI stock represent, on average, approximately 21% of GDP.

Chart 3-2
Cross-Border Merger and Acquisition Activity in Italy, 1988-90



Source: KPMG Dealwatch 91, op. cit.

In the late 1980s, like most economies in Western Europe, Italy was swept by mergers and acquisitions as firms restructured and rationalized in response to the competitive pressures of "Europe 1992" (see Chart 3-2). Foreign acquisitions of Italian companies

totalled US\$ 3.6 billion in 1990 – almost twice the value of transactions in 1989 (US\$ 1.9 billion).¹⁰⁸ In 1988, approximately two-thirds of all cross-border acquisitions in Italy were undertaken by non-EC, non-North-America-based companies.

Italian companies were equally active in acquiring foreign enterprises abroad in the late 1980s. In 1990, Italian cross-border acquisitions of foreign companies totalled US\$ 3.5 billion, up from US\$ 2.0 billion in 1989. In 1988, Italian concerns acquired foreign firms worth US\$ 1.4 billion, of which more than four-fifths belonged to the European Community. In general, Italian acquisitions abroad have kept pace with the amount of foreign acquisitions in Italy, a well-balanced pattern which is similar to that found between inward and outward direct investment activity in Italy.

Formal Barriers to Direct Investment

The abolition of Italy's principal law on foreign investment removed the distinction between so-called "productive" and "nonproductive" investment, as well as the limitations placed on remittances of earnings from "nonproductive" investment. Under current exchange control laws, foreigners may, without limitation, acquire control of (or a shareholding or participating interest in) any Italian entity, provided that the transfer of funds necessary for the operation takes place through a bank authorized to act in Italy. At the same time, transfer of profits, dividends and interest, royalties and fees, and repatriation of capital by foreign investors is unrestricted, subject to reporting requirements set out by the Ministry of Finance. Under *Law 197* of July 1991, transfers of currency and/or securities abroad in amounts greater than Lira 20 million must be reported to the Italian Exchange Office, UIC, and must therefore be channelled through the Italian banking system.

The government may impose restrictions on foreign transactions on a temporary basis to contain short-term pressures on the balance of payments or instability in the foreign exchange market. The expiration dates for all such measures would, however, have to be announced at the time the restrictions were imposed and could not exceed six months.

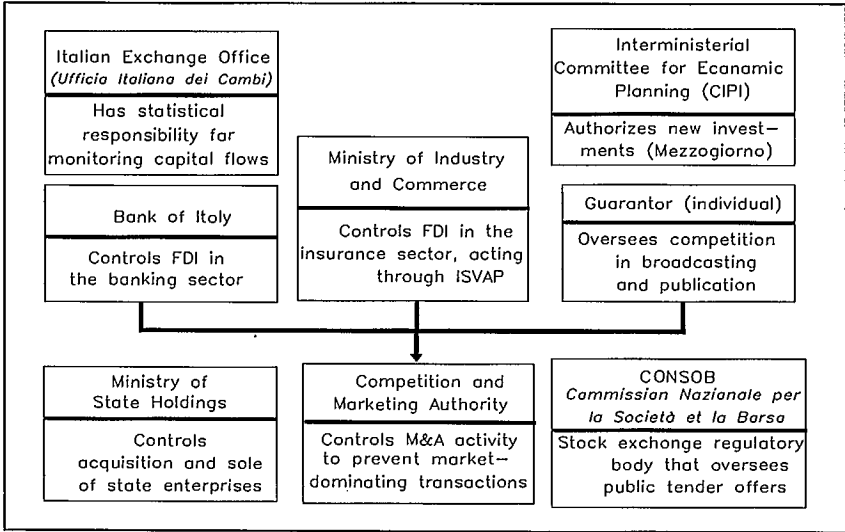
¹⁰⁸ KPMG *Dealwatch* 91, op. cit., p 37.

Regulatory Framework

There is no obligation to obtain prior authorization or to notify any governmental body or agency for FDI to proceed in Italy. Private merger and acquisition transactions are not legally subject to prior substantive scrutiny by governmental, judicial, or other bodies, except when they fall within the scope of antitrust-law or when they involve special industries.

Large-scale domestic and foreign greenfield investments – particularly in the underdeveloped Mezzogiorno region in the south of Italy – are, however, subject to authorization. Several key departments involved in the administration of FDI activity in Italy are shown in Chart 3-3.

Chart 3-3
Regulatory Framework for Control of Foreign Direct Investment in Italy



Source: Investment Canada, based on information from various sources.

Table 3-1
Planned Industrial Investments in the Mezzogiorno Region of Italy

Introduced in 1986, the system of planned contracts (*contratti di programma*) is a special incentive package designed for large industrial groups with highly innovative and research-intensive investment projects in the Mezzogiorno. In general, all industrial investments by domestic and foreign investors in that region, as well as in other parts of Italy, must receive prior authorization by the Interministerial Committee for Economic Planning (CIPI) if:

- ▶ the investments are valued at over Lira 20 billion (US\$ 16 billion); or
- ▶ expansions of existing businesses are worth more than Lira 8 billion (US\$ 6.5 billion).

Applications go to the CIPI and are signed as a contract with the Ministry of the Mezzogiorno. Ventures are considered authorized if CIPI does not turn them down within three months. Proceeding with an unauthorized investment project entails a penalty of 25% of the project's cost and makes it impossible to obtain permits from local and provincial governments or public agencies.¹

In February 1990, the authorities introduced a new type of planned contract to facilitate investments by foreign MNCs. In particular, MNCs operating through small local subsidiaries were reportedly facing difficulty in meeting the requirements of the existing planned contract (*contratti di programma*). To address this problem, two forms of planned contract were introduced:

- ▶ New company planned contracts (*Contratto d'Impresa*) were introduced to provide incentives to foreign MNCs, even if they were not present in Italy as a large group. The company contracts required that MNCs hold a significant position in its sector abroad or in Italy and that the investment include production facilities, research, and training.
- ▶ In addition, the authorities also introduced planned contracts for small and medium-sized enterprises (SMEs) in order to create a better environment for investments by larger companies. Under this program, SMEs need to form a consortium in order to qualify for investment incentives.²

¹ IL&T (Italy), August 1991, pg. 6.

² *Business International: Business Europe*, "MNCs Choose a New Route into the Mezzogiorno", The Economist Intelligence Unit (U.K.)

Foreign and domestic companies in Italy can take advantage of a planned-contract system of investment incentives designed for new investments in Italy's Mezzogiorno region. The projects must be approved by the Interministerial Committee for Economic Planning

(*Comitato Interministeriale per il Coordinamento della Politica Industriale "CIPI"*) and signed as a contract with the Ministry of Mezzogiorno. Table 3-1 gives a brief description of the planned contract system for the Mezzogiorno.

Although the foreign-exchange-control responsibilities of the Italian Exchange Office (UIC) were largely eliminated by the reforms liberalizing capital movements, the agency retains the power to gather statistical data on foreign exchange transactions of both residents and nonresidents. Operators and authorized intermediaries must, for statistical purposes, transmit data to the UIC on their foreign transactions exceeding the equivalent of Lira 20 million. This is done by filling out a *comunizione valutaria statistica* (Foreign Exchange Statistical Return).

Under new antitrust laws enacted in 1990, large-scale mergers and acquisitions, whether by domestic or foreign investors, must be made known to Italy's newly established competition body, the *Autorità Garante della Concorenza* (Competition and Market Authority, or the "Authority"). Apart from notifying the Authority in advance for large acquisitions, foreign investors are subject to prior authorization rules for undertaking acquisitions in certain industries of "national interest" (namely, banking and insurance, broadcasting and the media). Takeovers in these industries are governed by special legislation that prohibits or imposes limits on foreign investment. The powers to investigate merger and acquisition activity in these industries are vested in their respective supervisory bodies (not the Competition Authority).

In the case of commercial banks, the regulatory authority is the Bank of Italy, while the comptroller of private insurance companies (ISVAP) is entrusted with overseeing the insurance sector. The relevant authority for overseeing competition in broadcasting and publishing is an individual, called the Guarantor, who is appointed by Parliament for a fixed term. All three regulatory bodies must consult the Competition Authority, however, before they can adopt measures relating to competition.

Italy has a relatively vast public sector, and takeovers of state-owned or -controlled enterprises must receive the approval of the Ministry of State Holdings. Recent administrative rules require that prior notification be given to the Ministry of State Holdings of any

intended sale or purchase of controlling blocks of shares in a company directly or indirectly controlled, or to be controlled, by state-holding entities. Such prior notice must include the reasons, objectives, and terms of the proposed transaction, as well as its economic and financial impact, and how it fits in with government plans. Within 20 days of the notice (this term may be extended), the Ministry may provide its "recommendations" and "directives" to the state-controlled prospective seller (or buyer), whose company must take them into account when making its final decision. There are no sanctions, however, if the recommendations are ignored.

Since 1974, Italy's stock exchanges have been controlled and supervised by the local Chambers of Commerce, although ultimate authority is vested in the *Commission Nazionale per la Società et la Borsa* (CONSOB). Established in 1974 by an Act of Parliament, CONSOB was modeled partly after the Securities and Exchange Commission in the United States and partly after the Stock Exchange Operators in France.

One of its major functions is to administer all public tender offers for quoted companies on Italy's stock exchanges, ensuring the transparency, sufficiency, and accuracy of information to the public during the takeover process.¹⁰⁹ Its role is limited to approving or refusing approval of the prospectus, stipulating the nature of the disclosure to be contained therein, and when necessary, imposing on the offeror alternative or further disclosure requirements. It is the only body that can list, suspend, or delist equities and bonds.

Sectoral Restrictions on FDI

By virtue of special legislation, certain sectors of national interest to Italy are restricted to investment by both domestic and foreign enterprises and individuals. The restrictions range from a total ban on investment to the imposition of certain limits on investment activity. In addition, FDI activity in some sectors, is also restricted under Italy's limited reservation to the OECD Capital Movements Code. Finally, FDI is blocked or limited in the many state

¹⁰⁹ Prior to the 1974 statute establishing the CONSOB, the Milan Stock Exchange Stockbrokers' Committee issued a voluntary Code of Conduct (the Milan Code) that applied to all tender offers launched on that exchange. The Milan Code is not binding on target and offeror unless accepted by both of them with respect to targets on the Milan exchange; it has played a marginal role in most of the acquisitions in Italy.

monopolies and mixed private and public monopolies in Italy. The various sectors restricted to FDI are illustrated in Table 3-2, followed by a brief discussion of the restrictions.

Banking and Financial Services

In banking, special restrictions apply to the acquisitions of shares by foreign investors in certain state-owned banks that are defined as being of "national interest" (currently Banca Commerciale Italiana, Credito Italiano, and Banca di Roma). Foreign investors may acquire shares in these banks (a minority of shares are traded on the stock exchanges), but foreign purchasers who are not nationals of an EC country are not entitled to votes from those shares under Italian banking laws. All mergers and transfers of ownership of banks require the authorization by the Bank of Italy, whose powers are broad and discretionary.¹¹⁰ The special regulations are aimed at protecting the interests of depositors.

Mergers and acquisitions between banks may be implemented through a non-Civil Code procedure; this type of statutory merger must be authorized by decree of the President of the Republic.

In addition to the special rules governing mergers and consolidations in the banking sector, other FDI restrictions pertaining to the right of establishment in banking include those which have been invoked as a result of Italy's limited reservation to the OECD Capital Movements Code. The establishment of subsidiaries of foreign banks is subject to authorization by the Bank of Italy. A minimum of L15 billion (US\$ 11 million) is required for the opening of a subsidiary. Some regions have autonomous powers with regard to the establishment of new banks and the opening of subsidiaries. Establishment of branches of banks originating in non-EC member countries is subject to a reciprocity requirement.¹¹¹ The establishment and operation of branches of non-EC banks will continue to be regulated in accordance with national law.

¹¹⁰ R. Casati and F. Arossa, "Italy", in *Euromoney Books and the International Financial Law Review*, *International M&A Law*, London: Euromoney Publications PLC (1991), p. 49.

¹¹¹ Organization for Economic Cooperation and Development, *Measures Affecting Direct Investment in Member Countries*, Committee on Capital Movements and Invisible Transactions, (March 1991, DAF/INV(90)31/REV2), pp. 62-65.

Table 3-2
Impediments to Inward Investment
in All or Some FDI Activity in Italy, by Sector

Industry	Reservations to OECD Capital Movements Code	Other Impediments	Public, Private or Mixed Monopolies
Banking	X	X	
Insurance	X	X	
Broadcasting (Radio, TV, and Cable)	X		X
Post, telephone, and telecommunications			X
Air transport	X		
Maritime transport	X		
Land transport (railways)			X
Petroleum	X		
Nuclear energy and energy production			X
Tourism			X

Source: Organization for Economic Cooperation and Development, "Control and Impediments Affecting Foreign Direct Investment" (Paris:1987).

Foreign non-bank financial intermediaries are not permitted to establish branches in Italy, although this policy is currently under review.¹¹² Furthermore, stockbrokerage services in Italy may only be provided by Italian nationals.

Insurance

The establishment of branches and agencies of insurance companies originating in non-EC member countries is subject to prior authorization by the Ministry of Industry and Commerce (which reviews the case in consultation with ISVAP). The establishment of

¹¹² Ibid., p. 62.

insurance companies from non-EC countries is subject to reciprocity requirements.

Media Publishing

In addition to antitrust provisions that apply to all firms (domestic and foreign), the *Newspaper Publishing Law* of 1981, as amended in 1983, in 1985, and again in 1987, has certain restrictions on foreign ownership of Italy's media publishing business. The law provides that the majority of the voting shares of companies engaged in publication of daily newspapers cannot be held by non-resident companies and/or individuals, not even through a trustee or fiduciary company. Furthermore, non-resident companies and/or individuals (or fiduciary companies) cannot, directly or indirectly, "control" any Italian daily newspaper or newspaper publishing company. Any transfer of shares in violation of the above provisions is considered null and void.

Radio and Television Broadcasting

Italy passed legislation in August 1990 to regulate the radio and television industry. The laws provide that private concessionaires (who may obtain an administrative "concession" to engage in radio or television broadcasting) or their parent companies cannot, directly or indirectly, be controlled by non-EC entities. Controlling companies incorporated in countries that allow ownership of their domestic broadcasting firms by Italian individuals or companies (reciprocity rule) are, however, excluded from the prohibition.

Air Transportation

In air transportation, ownership of aircraft is reserved for the state and other public entities, as well as Italian unincorporated and corporate bodies with registered offices in Italy whose capital is at least two-thirds owned by Italian residents. The Chairman, two-thirds of the Board, and the General Manager must be Italian nationals. Non-residents may operate national airline services under licence where international conventions so provide or if the Head of State grants permission based on "national interest" reasons. Non-Italian airlines are not allowed to establish their own ground-handling facilities in airports that are directly managed by the state or where

they have been awarded in partial concession to companies whose capital is essentially public.

Maritime Transportation (and Fishing)

In maritime transportation, ownership of ships (including fishing vessels) by foreign-controlled enterprises or citizens is permitted if over 50% of the ownership rests with Italian nationals, or with Italian public or private institutions. Maritime cabotage as well as maritime services of port areas are reserved for Italian-owned ships, unless international conventions indicate otherwise.¹¹³ Fishing in territorial waters is reserved to Italian nationals, but land-based fish-processing activities are open to foreign investment without restriction.

Petroleum

In the petroleum sector, foreign investment in the exploration and exploitation of liquid and gaseous hydrocarbons is subject to reciprocity.¹¹⁴ By law, state enterprises must own 51% of any joint venture in oil exploration activity.

Tourism

Licences for tour operators or travel agencies are granted subject to a reciprocity requirement to non-EC residents, irrespective of whether they are established in the form of an individual undertaking or as an intermediary of subsidiaries from EC companies or domestic companies with the participation of non-EC investors. Reciprocal conditions may apply and can be satisfied if an agreement on tourism co-operation exists.

State Monopolies

Finally, FDI is proscribed in state-regulated monopolies that include postal services and telecommunications, railways, public utilities (water, gas, and electricity), nuclear energy, and RAI

¹¹³ OECD, *Impediments Affecting Inward Direct Investment in OECD Member Countries* (Paris:1987), pp. 46-47.

¹¹⁴ *Ibid.*

television broadcasting at the national level (local broadcasting is open to FDI).¹¹⁵

There are few discriminatory measures against foreign investors after establishment. The few measures involve access to government subsidies in the film industry, access to domestic capital markets, restrictions on domestic lending in banking, and a prohibition on operating airline ground-handling facilities.¹¹⁶

Antitrust Framework and Merger Policy

Italy's new antitrust bill establishes a competition watchdog – the Competition and Market Authority. Among the market activities falling under the purview of the Act, the Competition Authority will monitor restrictive trade practices that distort competition (e.g. price rigging, cartels, and collusive market arrangements), control the abuse of monopoly power, and review mergers and concentrations that could potentially create dominant market positions, especially those occurring in strategic sectors (e.g. banking and insurance). The statute applies to all privately and publicly held companies, as well as to all those in which the state holds a controlling interest. They do not apply, however, to those companies which have the statutory duty of managing services of general economic interest and are operated on the market under a monopoly.

The Italian antitrust statute follows in many respects the EC Merger Control Regulation and recognizes the supremacy and separate scope of the application of EC law. Provisions are included in both regulations that aim to resolve any possible jurisdictional conflict by coordinating the respective regulatory authorities' review.

Under the merger provisions of the Act, mergers, consolidations, direct or indirect acquisitions of control of any or part of any business enterprises by way of asset sales, stock sales, contracts or "establishments of "concentrative" joint-venture partnerships or companies", are to be scrutinized as to their impact on competition and market concentration.

¹¹⁵ Ibid.

¹¹⁶ U.S. Department of Treasury, *Survey of G-7 Laws*, op. cit., (1988), p. 6.

A controversial aspect of the new competition bill, Article 26, is the power vested with the Authority to block, for "crucial reasons pertaining to the national economy", acquisitions of domestic enterprises by foreign companies. These acquisitions are to be subject to full Cabinet approval. In the case of non-EC companies, there appears to be considerable discretion. With respect to EC companies, there is a specific condition such that a blockage can only occur if the country of the foreign investor fails to provide reciprocal agreement for acquisitions by Italian firms in their jurisdiction. It remains to be seen, however, how these provisions will be applied.

With the above exception, there are no similar reciprocity or protective provisions elsewhere in Italian merger and acquisition legislation (apart from requirements in media and broadcasting, and in the insurance and banking industries). Table 3-3 describes the merger review process under the new antitrust bill.

With regard to publishing, the *Newspaper Publishing Law*¹¹⁷ strikes down as null and void any merger, acquisition, or other transaction that brings about a "dominant market position" in the newspaper industry. Agreements falling within the scope of the statutory prohibition include "transfers of and lease or management agreements concerning newspapers, as well as transfer of shares or participating interests in (newspaper) publishing companies".¹¹⁸ The creation of a "dominant market position" is voidable upon legal proceedings by the Guarantor, who is generally entrusted with the task of overseeing compliance with this law.

Any proposed merger or acquisition of insurance companies, regardless of size, must obtain prior authorization from the Ministry of Industry and Commerce, in consultation with the regulatory and supervising agency ISVAP. If a merger, acquisition, or joint venture involving an insurance company falls within the scope of the antitrust laws, the Competition Authority must additionally be notified, and the agency may then take appropriate action if necessary. The ISVAP must also be notified of any direct or indirect acquisition of shares in an insurance company that exceeds 2% of its capital stock; any subsequent changes in excess of 1% must also be reported to ISVAP.

¹¹⁷ Law No. 416 of August 5, 1981.

¹¹⁸ Casati and Arossa (1991), "Italy", op. cit., pg. 45.

Acquisitions of controlling interests are subject to ISVAP's prior authorization. Insurance companies may not, in general, acquire control of companies engaged in business not related to insurance.

In August 1990, the Italian Parliament passed legislation to regulate the radio and television industry. The provisions of that Act (Law No. 223) aim at prohibiting all agreements that may create a dominant market position in the broadcasting industry. In brief, the main provisions of the law require that in order to engage in radio or television broadcasting, all individuals and companies, unless state-owned, must obtain an administrative "concession" from the Telecommunications Ministry. Such concessions may only be granted to companies and cooperatives incorporated in Italy or in other EC countries and that have specific share capital thresholds. It establishes a National Registry of Broadcasting Concessionaires, maintained by the Guarantor, and in which all concessionaires must be registered; all agreements (including mergers) among public and private broadcasting concessionaires are null and void if any of the parties is not registered in the National Registry.

Table 3-3
The Merger Review Process in Italy

Under the new competition legislation, the Competition Authority must receive pre-notification of all mergers and acquisitions, irrespective of the nationality of the firms:

- if the aggregate of the domestic turnover of all enterprises involved amounts to at least inflation adjusted L500 billion (US\$ 390 million); or
- if the domestic turnover of the enterprise to be acquired amounts to at least inflation adjusted L50 billion (US\$ 39 million).¹
- For banks and insurance companies, the turnover thresholds are replaced by a reference to, respectively, one-tenth of the resources and the premium paid.
- The Authority must launch a formal investigation within 30 days from the receipt of the notification if it deems that the proposed transaction may result in the creation or strengthening of such a dominant position in the domestic market as to eliminate or substantially reduce competition.² The criteria for assessment include those listed in the EC merger regulation.

(continued)

- ▶ If the circumstances warrant it, the transaction may be suspended or enjoined by the Authority. In any event, the Authority must issue its decision within 45 days of launching the investigation; otherwise the transaction is deemed to be approved. Moreover, the Act requires that the Competition Authority inform "immediately" all companies under review of a decision to clear the transaction at any stage during the investigation.³ In addition to simply enjoining the transaction, the Authority may (when the concentration has been completed) prescribe any measure to restore actual competition. The Authority can impose fines upon the concerned parties if their orders are ignored.

Finally, the antitrust statute also establishes prior authorization requirements by the Bank of Italy for acquisitions by non-banking entities of certain interests in banks and other credit institutions. In effect, these provisions are designed to curtail the expansion of non-banking interests in Italy's financial institutions. Companies such as Fiat, Olivetti, and Ferruzzi already have shares in Italian banks and wish to increase them.

In particular, the statute requires both domestic and foreign-owned companies to obtain prior authorization by the Bank of Italy when:

- ▶ acquiring directly or indirectly 10% or more of the voting shares of an Italian commercial bank. The purchase of any subsequent 2% stake in such a bank is also subject to the Bank of Italy's approval.
- ▶ Moreover, industrial companies (entities not belonging to, or ultimately controlled by, the financial sector) are prohibited from acquiring ownership of more than 20%, or the control, of a commercial bank. These laws, however, do not apply to acquisitions of merchant banks and investment firms.⁴

¹ Casati and Arossa, "Italy", op. cit., pp. 42-49.

² Ibid., p. 46

³ Ibid., p. 46

⁴ Ibid., p. 46

The Competition Authority, established in October 1990 and entrusted with overseeing Italy's antitrust laws, is still in its infancy, but so far, relatively few cases have been reviewed by the department. Domestic or foreign takeovers notified under the Act during the first year of operation did not result in any controversial decisions.¹¹⁹ It remains to be seen, however, whether the new body will be truly autonomous or whether, as some observers fear, the law will lead to greater political involvement in business.

¹¹⁹ Organization for Economic Cooperation and Development, *Annual Report on Developments*, (Paris: October 1991).

Informal Barriers to Direct Investment

In Italy, the relatively small size of the stock markets implies that the pool of quoted companies available for acquisitions is limited. In addition, the ownership and control of most quoted companies is concentrated in the hands of a few family groups or is under the jurisdiction of the state. In short, the almost complete lack of true public companies that enjoy widespread ownership and independent management creates strong obstacles to the success of contested takeovers.¹²⁰ These market characteristics have been summarized quite succinctly as follows:

The dominance in the Italian economy of the state, a few major conglomerates, and a mass of small private companies results in a market fundamentally different from the Anglo-Saxon world where the economies are dominated by a large number of quoted companies with few controlling interests.¹²¹

Obstacles to Takeovers:

The Ownership Barriers to Takeovers of Publicly Traded Companies

The Italian stock market has traditionally played a minor role in the domestic economy. The major factor that continues to constrain its growth is the concentration of stock participations in the hands of a significantly limited number of controlling groups. The shares traded on the stock exchanges typically represent, for many companies, only a minority interest in listed companies, while controlling interest rests with large family or industrial groups. Very few companies exist where a majority of the shares are widely held.

According to one survey, only seven of 211 domestic companies quoted on the stock exchanges in 1989 offered more than 50% of their shares to the public at large.¹²² More importantly, five of those seven companies – Fiat (Agnelli), *Istituta per la Reconstruzione Industriale* (IRI), *Generali*, Ferruzzi (Montedison), and De Beneditti – accounted for close to 70% of market capitalization of

¹²⁰ For a summary of the informal barriers, see Table 3-4.

¹²¹ Vincent Thompson of Morgan Grenfell, "Identifying M&A Targets in Italy: Why Local Help Is Needed" in *M&A Europe*, September/October 1989, vol. 2, p. 50.

¹²² Coopers and Lybrand, *The Barriers to Takeovers in the European Community*, a study prepared for the United Kingdom Department of Trade and Industry (June 1988), Country Report: Italy, Vol. III, pp. 12-15.

the Italian stock exchanges. With the exception of IRI - a state-run conglomerate - the rest are understood to be effectively controlled by family groupings.

A number of companies of substantial size have chosen to remain unlisted. Of the large conglomerates that are quoted on the stock exchanges, many are in fact controlled by family interests and even managed by members of the controlling family. Control is effected through minority stakes. For example, the Pirelli family runs Industrie Pirelli with a holding of under 10%, while the Agnelli's hold 40% of Fiat. In fact, among those enterprises, the insurance company Generali was considered to be the only large, independently owned public company in Italy.¹²³ A survey of Italian companies in 1987 showed that only a quarter of the top 100 firms, ranked by sales, were listed on the stock exchanges.¹²⁴

The ownership structure of listed companies in Italy therefore severely impedes the success of Anglo-American-style hostile takeovers. Table 3-4 summarizes the various obstacles to takeovers related to the ownership of publicly traded companies on Italy's stock exchanges. These circumstances may help explain why the number of hostile takeover attempts in Italy has thus far been extremely low.

The significant rise in the number of takeovers in Italy in recent times involves private, friendly acquisitions, mostly involving off-exchange transactions, or else purchases on the stock exchanges in concert with controlling shareholders. For example, purchases of shares in Fiat, Montedison (Ferruzzi), and Olivetti (De Benedetti) are generally private and are processed by Mediobanca, an Italian merchant bank, which in turn is owned by the same group.¹²⁵ Acquisitions are almost always in cash rather than shares because stock swaps are legally cumbersome and Italian entrepreneurs are generally reluctant to be minority shareholders.

¹²³ Ibid.

¹²⁴ Booz Allen Acquisitions Services for the European Commission (December 1989), p. 23.

¹²⁵ Ibid.

Table 3-4
Takeover Obstacles: Ownership and Control of Listed Companies in Italy

In Italy, the scope for takeovers of publicly traded companies is constrained by the relatively small size of the stock exchanges, as well as by the concentration of stock participations in the hands of an extremely limited number of controlling groups. The structural characteristics of the stock exchange and the ownership spread of the listed companies are as follows:

- ▶ In 1989, a total of 211 domestic companies with a total market capitalization of US\$ 135 billion were listed on Italy's 10 stock exchanges (there were no foreign listings that year, as was the case in 1989).¹ By market capitalization, Italy ranks at the bottom among the stock exchanges of the G-7 countries, being about three-fifths the size of the Paris stock exchange and representing less than a fifth of the value of domestic companies on the London stock exchange. In fact, a sizable amount of trading takes place outside the main exchanges.
- ▶ Most of Italy's largest quoted companies are relatively small enterprises, on a European scale. In a recent survey of Europe's top 500 companies, only five Italian companies were ranked in the top 100 and 13 in the top 200 when measured by market capitalization.²

The historically family-owned business structure in Italy has led to a highly concentrated shareholding spread with very few companies where a majority of the shares are widely held; family or industrial groups often tend to hold controlling interests in most listed companies.

- ▶ In 1989, it was estimated that on the Milan Stock Exchange (the country's largest stock exchange, representing 90% of the quoted capitalization in Italy), the five largest groups (Generali, FIAT, IRI, De Benedetti, and Ferruzzi) owned interests in listed companies amounting to about 70% of market capitalization; they also controlled about 35% of the 211 companies listed on the stock exchange.
- ▶ Only 7 of the 211 listed companies offered more than 50% of the shares to the public in general; in fact, the percentage of shares floated on the stock exchange for listed companies is often lower than 25%, the minimum threshold required by the CONSOB as a prerequisite to listing a company on the stock exchanges. In 1989, no fewer than 81 of the 211 listed companies (35%) floated less than 25% of their shares on the stock exchange.

The highly concentrated ownership of publicly traded companies creates a serious obstacle to hostile takeovers. Most acquisitions of listed companies are private, off-exchange transactions, or else purchases on the stock exchange with the agreement of controlling shareholders. Many involve small and medium-sized companies.

¹ Federation Internationale des Bourses de Valeurs (1989), pp. 25-27.

² Financial Times (U.K.), "European 500", January 11, 1991, p. 16.

Private family companies (whether listed or not), which represent the target of the vast majority of takeovers in Italy, are typically small and medium-sized enterprises. These firms constitute the bulk of the corporate sector and are the most dynamic enterprises in the Italian economy. Because of a fragmented industrial structure, Italy's so-called middle market has an abundance of highly entrepreneurial small companies with a high export orientation and productivity.¹²⁶

Articles of Association and Company Law Barriers

For cultural reasons, family groups in Italy tend to guard their controlling interest in family-owned businesses more tenaciously than in other parts of Europe. This tendency permeates the entire size spectrum of businesses in Italy - from small private enterprises to the large family-controlled companies. These enterprises are structured and financed in such a way as to ensure family control.

The control of large family-dominated quoted companies has been further consolidated through a form of business organization called the *Società in accomandita per Azioni* (Sapa).¹²⁷ The Sapa is a limited partnership taking the form of a joint stock company in which interests are maintained in shares of common stock. By transferring their respective shareholdings to such business organizations, shareholders linked by family ties can ensure that upon the death of family members the control of large corporations will continue to reside within the family unit.¹²⁸ This form of corporate organization is used increasingly as a holding entity for controlling interests in listed companies to perpetuate control and to eliminate direct ownership. The general partners in the Sapa form of

¹²⁶ Companies with fewer than 100 workers account for nearly 60% of total employment in Italy. In comparison, France, Germany, and the United Kingdom account for only 20-25% of total employment in their economies. A Fortune survey of the top 500 non-US companies included only six from Italy compared with 39 from France, 53 from Germany, and 74 from the United Kingdom. See *M&A in Italy*, M&A Europe, September/October 1989, p. 52.

¹²⁷ In addition to the Sapa, the *Società per Azioni* (Spa) - companies or corporations limited by shares - is the only other form of enterprise that may be listed on one of the Italian exchanges.

¹²⁸ Casati and Arossa (1991), "Italy", op. cit., p. 45.

organization are further able to consolidate their position through a partner's agreement, which usually includes rights of first refusal, options, restriction on transfers and similar protective devices.

Although there are no specific regulations or case laws regarding defensive tactics to counter hostile takeovers in Italy, various anti-takeover techniques may be adopted on the basis of general principles of corporate law. In general, these involve restrictions on actions by the target, provisions in the Articles of Association and shareholders' agreements, and concurrent bids. These defences are generally less severe and restrictive in their potential to deflect hostile takeovers than similar obstacles found under company law in Germany and in France. Table 3-5 provides a brief description of some of these company-imposed barriers.

In a takeover situation in Italy, a major problem often encountered by the acquiror is the lack of financial information on private companies. As a rule, the transactions relating to off-exchange, private mergers and acquisitions are not legally subject to substantive scrutiny by government or judicial bodies unless they involve state-controlled enterprises or banks and insurance companies. As there is no legal requirement to prepare consolidated accounts, these are generally available only for quoted companies. Many small, private unlisted companies are not required by law to carry out an independent audit. Therefore, potential acquirors may not receive an accurate picture of the company's financial position from the company books since they are prepared mainly for tax purposes. Even the valuation of investments in quoted companies is based on very flexible criteria, giving wide discretion to the directors. For example, when paying a premium above the market price for control of a listed company, the acquirer may write off the difference, thus recording a large artificial loss.

The lack of sophisticated Italian takeover laws is blamed for the relatively few public offers in Italy. In 1980 and 1987, there were only 10 public offers made in Italy, compared with over 900 in the United Kingdom, 68 in France, and 29 in the Netherlands.¹²⁹ In most cases, these were offers by the controlling shareholders for the minority interest, in order to obtain a delisting of the stock, rather than an offer involving a change of control.

¹²⁹ *Business International: Business Europe*, "Italy: End to Deadlock on Public Offer Rules", The Economist Intelligence Unit (U.K.) (November 6, 1989), p. 3.

Table 3-5
Takeover Obstacles:
Aspects of Company Law and Articles of Association in Italy

Capital Increases

- ▶ Any increase in the share capital must be approved by shareholder resolutions at a meeting properly convened. The Articles may be amended to authorize the Director to increase the corporate capital at any moment within a specified time limit (no longer than five years). Under new takeover laws, however, any change in the capital structure pending a hostile takeover is forbidden.

Rights of First Refusal

- ▶ Shares in listed companies are freely transferable, and the right of first refusal (i.e. a preemption right whereby any share to be sold must be first offered to specified persons or institutions) cannot be introduced in the company by-laws after incorporation unless the company receives the unanimous consent of shareholders. If approved by shareholders, the first-refusal rights may be used as a defensive measure against unwanted takeovers.

Disclosure Requirements

- ▶ All shares must be registered, and bearer or non-registered shares are not permitted in Italy. In addition, a direct or indirect holder of more than 2% of the capital of a listed company must notify the CONSOB within 30 days of the date on which the limit is exceeded. These requirements enable management to monitor closely any attempt to take over their company through the creeping acquisition of shares.

Self Tenders

- ▶ Italian company laws impose strict limits on a firm's ability to purchase its own shares. In general, the buy-back plan must be approved by the shareholder resolution at a duly called meeting. Public companies can purchase no more than 10% of the capital, and no voting rights apply to those shares. Similar limitations apply to the purchase of shares in parent companies by subsidiaries.

Voting Rights

- ▶ All common shares issued by companies in Italy must be entitled to one vote per share; however, up to 50% of the capital of companies (Spa or Sapa) may be comprised of limited voting and non-voting shares.

Sapa

- ▶ This form of corporate organization in Italy is becoming increasingly used as a holding entity for controlling interests in listed companies to perpetuate control and sever it from ownership.

In early 1992, the Italian government enacted stricter takeover laws in order to increase the transparency of takeover bids. Under the new legislation, takeovers are to be regulated for the first time, new rules are to govern public offers for blocks of shares and new issues, and new requirements for disclosure of holdings are to be implemented.

Disclosure is compulsory for any holding above 2% in a quoted company and above 10% for a holding company by a quoted company in an unquoted firm. The law applies to transactions in any securities conferring voting rights. Another important aspect of the legislation deals with the extent to which the purchaser of a block of shares, which confers control, will have to make a bid for all or part of the remaining shares. This measure depends on the size of the purchase and the threshold for control in that particular firm. In this context, CONSOB has been given the legal mandate to determine what constitutes control of a given company. In general, the legal concept of control in Italy can exist with as little as 10% of the shares.¹³⁰

In an effort to gear up Italian stock exchanges for competition in the European Internal Market, the authorities took several major steps in 1991 that affect stock exchange activities. These included: legislation on insider trading; opening up listings on the stock exchanges to foreign companies (as of January 2, 1992, only two foreign companies had signed up for listing); the start of computerized trading; and completion of the regulation for phasing out stockbroking houses and replacing them with securities firms – *società d'intermediazione immobiliare* (SIMs).¹³¹

Other Informal Barriers: State Enterprises

Along with the relatively few major conglomerates that dominate the economy and the large number of small and medium-sized family-controlled firms, state-owned companies hold a considerable stake in Italy's mixed market economy. The state enterprises are mainly grouped under three giant holding companies

¹³⁰ *Business International: Business Europe*, "Italy Passes Takeover Law", The Economist Intelligence Unit (U.K.), (February 7, 1992), p. 5.

¹³¹ *Business International: Business Europe*, "Italian Exchange Gears Up to Compete", The Economist Intelligence Unit (U.K.), (January 10, 1992), p. 5.

– *Istituto per la Ricostruzione Industriale* (IRI); *Ente Nazionale Idrocarburi* (ENI); and *Ente Partecipazioni e Fiananziamento Industria Manifatturiera* (Efim). State control is generally exercised via 100% or majority share ownership, in companies that are legally indistinguishable from private ones. They are governed, however, to various degrees by corporate law under the authority of the Ministry of State Holdings.

Although neither IRI nor Efim are quoted on the stock exchanges, both have a large number of subsidiaries with listings on Italy's stock markets. The IRI, being one of the world's largest conglomerates, holds several hundred operating companies that employ some 400,000 people in a wide range of industrial and service sectors. With major subsidiaries like Stet (electronics and telecommunications), Sip (the domestic telephone company), Alitalia (the national airlines), Sirti (telecommunications engineering), Italcable (international telecommunications), Banca Commerciale Italiano, and Credito Italiano (national "interest" banks), and many more, the IRI accounts for a fifth of Italy's stock market capitalization.

Companies owned or controlled by the state could in principle be sold, in whole or in part, to private or other investors. Controlling blocks of shares in companies controlled by ENI, as well as any shares in companies controlled by Efim, may only be transferred after prior authorization by the Ministry of State Holdings. On the other hand, shareholding interests in companies controlled by IRI – the largest state entity – may be transferred without prior authorization. The IRI, however, often makes the sales and transfer of shares contractually subject to government consent.

Foreign investment is prohibited in state-owned monopolies such as postal services, telecommunications, electricity, gas, water, nuclear energy, railways, and tobacco. In other state-owned sectors where FDI is permitted, it is impossible to even attempt an unfriendly acquisition given the extremely small proportion of publicly traded stock of listed state entities and the requirement for political consent to any such transfer.

In addition, private-sector firms, whether domestic or foreign, face competitive disadvantages in those sectors dominated by state enterprises. Private sector firms will likely not do as well in terms of government contracts as state-owned enterprises. In addition, public

enterprises have relatively easier access to ministries, banks, and state agencies, and they can always count on the availability, through parliamentary authorization, of endowment funds. These funds function like capital stock in private firms but require no dividend payouts and therefore place private forms at a competitive disadvantage.¹³²

Italy's budget for 1990 contained provisions for large-scale privatization of state-owned enterprises. The major objective of the privatization drive was to reduce Italy's heavy public debt load and to inject greater competitiveness and efficiency into the public sectors. The government is to resort increasingly to privatization over the next five years as a means of raising revenues; however, it has emphasized that 51% of equity in privatized industries will continue to reside in public hands.

Some well-known state enterprises were privatized in the late 1980s. The textile company Lanerrossi was sold to the Marzotto group in 1987. Financially-ailing Alfa Romeo was taken over by Fiat in 1986, which made a white-knight bid over its rival Ford. The SME, which held IRI's food interests, was sold to Buitoni in a controversial political deal, as was the sale of Italtel to Fiat's telecommunications subsidiary Telettra.

The industries slated for privatization in the 1990s include, among others: state-owned banks; the Italian railroad company, Ferrovie dello Stato; Italy's major public insurance company, INA; the electric company, ENEL; and the three major state holding companies, IRI, ENI, and Efim.¹³³

In 1990, the government also passed the Amato Law (named after Treasury Minister Guilano Amato) which relates to the partial privatization of state-controlled banks. The law was welcomed by the local banking community as an important step towards preparing the banks for the increased competition posed by the single European Market. In November 1990, the first merger under the Amato law, that of the Banco di Roma; the savings bank, Casa di Risparmio di

¹³² IL&T, Italy (August 1990), p. 5.

¹³³ Ibid.

Roma; and the state commercial bank, Banco di Santo Spirito, won approval from the Ministry of State Holdings.¹³⁴

Privatization of Italy's state-owned banks is, however, not expected to bring immediate investment opportunities for institutional investors. The vast majority of the 1,100 or so state-owned banks and financial firms are not well enough known, nor is their financial position sufficiently strong, to make a share offering feasible in the short run. In the near future, the Bank of Italy expects the main competition in the domestic financial services sector to be between the large banks and the smaller regional ones. Foreign banks are expected to concentrate on merchant banking, the bond market, and mutual funds.

The Amato Law is expected to weaken Italy's long tradition of political interference in banking. The law allows private capital into the state banks to a limit of 49%, while the state will retain a 51% share, controlling management and appointments.

As an alternative to outright privatization, the Italian government is also encouraging joint ventures between state enterprises and both foreign and domestic companies. While Italian firms appear to receive preference over foreign companies in the sale of privatized assets, there are numerous examples of joint ventures or alliances where foreign partners are sought because of anticipated advantages in technology and human resources.

Some of these alliances have occurred in industries in which Italy enjoys a comparative advantage and those which are crucial for Italy's economic development in the 1990s – in particular, electronics and telecommunications. Major joint ventures between state enterprises and foreign firms in those sectors include SGS-Thompson (France), in semiconductors; Ansaldo-ABB (Sweden), in electrical equipment; and Italtel-AT&T (United States), in telecommunications. In aerospace and nuclear power, where Italy is at a technological disadvantage, the strategy adopted by most foreign firms has been to

¹³⁴ *Business International: Business Europe*, "Italian Banks Enter New Era", The Economist Intelligence Unit (U.K.), December 7, 1990, p. 6.

obtain favourable licensing arrangements and other arms-length transactions.¹³⁵

Case Studies on FDI in Italy: A Brief Review

The market structure of Italy, with its relatively high concentration and its high degree of public ownership, makes government intervention to block takeovers unnecessary; however, government interference is hardly without precedence.

Alfa Romeo / Ford Company (U.S.)

A well-known case involves the attempt by Ford Company of the United States to acquire Italy's state-owned car manufacturer, Alfa Romeo. In early 1986, Ford announced plans to acquire Alfa Romeo – a bid that received the support of Giovanni Agnelli, chairman of Fiat, in light of the fact that it would relieve Italy's taxpayers from subsidizing the financially ailing state enterprise. Fiat had earlier shown an interest in Alfa Romeo.¹³⁶

By June 1986, however, a great deal of political furore had erupted over the deal. Fiat officials expressed concern over Ford's plans to establish an operation in Italy; similar concerns were also voiced by Italian politicians who were reluctant to let Alfa's controlling interests be transferred to a foreign enterprise. In October 1986, Fiat made a formal bid for Alfa in spite of the fact that IRI, the giant Italian holding company that owned Alfa, and the majority of the company's work force were generally in favour of the Ford offer.

The Italian Prime Minister assured Ford's chairman, Donald Peterson, that the government's decision on the rival bids would not be a political one; it would instead, be based on financial and industrial considerations. A turning point in the takeover battle came in November, when the workers' union switched its support to Fiat after the Italian automaker raised its offer for Alfa above that of Ford and guaranteed a promising future for Alfa's employees. Fiat emerged as a white knight. The case demonstrates the threat of

¹³⁵ IL&T, Italy (August 1990), p. 5.

¹³⁶ Coopers and Lybrand (1989), "Italy", op. cit., pp. 37-38.

political intervention in Italy when it involves the acquisition of an important Italian business by foreign interests.

The following cases are a few examples of major MNCs that have recently invested in the Mezzogiorno, following the planned contract process described earlier. The cases are illustrative of the procedures required.

- ▶ In November 1989, Texas Instruments Italia¹³⁷ (TII) signed a contract with the Italian government worth L1.7 trillion (US\$ 1.3 billion) and received L965 million in subsidies, or almost 57% of the total investment. The company was able to get the contract after protracted negotiations with the government that lasted for almost a year. The contract calls for investments to cover the construction of a new site and the expansion of existing facilities, as well as two new research centres, the launching of five research projects, and a training program. The contract also stipulates that the government will undertake a number of infrastructure investments, at an additional cost of L16 billion (US\$ 12.9 million), as well as provide TII with certain exemptions from labour laws. Almost a year after the deal was signed, TII was generally happy with its investment. The company did face some difficulties in implementing the project, however, one of which was a delay in approval of the capital grants. The reasons for the delay. They included the lengthy procedures, lack of staffing at the Ministry, a perpetual government crisis, and a desire on the part of the government to postpone payments because of a lack of funds.
- ▶ In May 1990, Bull Italia and its parents, Bull HN Inc., signed a planned contract with the Mezzogiorno Ministry for L245.6 billion (US\$ 20 million). The investment called for the creation of two research centres and four software production facilities. In addition, Bull was to also form a number of research consortia with local universities and research centres. As in TII's case, it took a long time - more than a year and a half - to reach a final agreement with the government.

¹³⁷ *Business International: Business Europe*, "MNCs Choose a New Route into the Mezzogiorno", The Economist Intelligence Unit (U.K.), (October 26, 1990).

Conclusion

In the 1980s, Italian laws on foreign investment were liberalized, and significant growth in FDI occurred. Exchange controls were lifted, allowing profits, dividends, and capital to move freely. A newly established antitrust agency assesses the competitive impact of large mergers and takeovers in Italy, but no regulatory body or agency to scrutinize FDI proposals exists. Foreign direct investment in banking, insurance, and a few other sectors considered important to the national economy is subject to prior authorization.

Informal barriers play a significant role in constraining the movement of FDI in Italy. In particular, the lack of a sizable stock market and the closely held ownership of most public companies under family or state control make hostile acquisitions very difficult to achieve. A large part of the economy is ultimately controlled or owned by the state, which sets *de facto* limits on the participation of foreign capital in many sectors of the Italian community. The success of Anglo-Saxon-type hostile takeovers in the future appears to be very remote unless fundamental changes are made in the market structure. In particular, the reforms must include policies to increase access to more companies, with a greater percentage of their shares being made available to the general public.

In addition, foreign (as well as domestic) enterprises face a competitive disadvantage vis-à-vis state enterprises in securing government contracts and preferential loans and subsidies. Under Italy's new antitrust statute, the Competition Authority is empowered to block takeovers by foreign companies on so-called "national interest" grounds. It remains to be seen, however, how the government will apply this potentially powerful piece of legislation.

CHAPTER 4
UNITED KINGDOM

UNITED KINGDOM

Introduction

The United Kingdom has a relatively open-door policy towards foreign direct investment. No authorizations are required for investments by non-residents or by established foreign-controlled enterprises. As in other G-7 countries, the U.K. government maintains restrictions on FDI activity in certain sectors of the economy. By and large, U.K. governments have focused on performance rather than on ownership of private firms in its economy.

There are comparatively few informal barriers to FDI in the United Kingdom relative to other industrialized countries. The informal barriers mainly concern the application of merger law to foreign takeovers. In the 1980s, a number of foreign takeovers were blocked by the U.K. government, under the terms of the British antitrust policy, because they were found to "operate against the public interest". In addition, while a considerable number of privatizations occurred during the 1980s, the U.K. government has taken steps, through "special share" provisions, to ensure that the government continues to maintain veto power over changes in the control of a privatized company or in its articles of association - including changes to limits on shareholdings by foreign enterprises.

Institutional Developments

In the sixties and seventies, under both Labour and Conservative governments, industrial policy in the United Kingdom tended to be more interventionist. There was special support given to major domestic companies in order to maintain a U.K. presence in certain industries that were in competition with foreign-controlled firms. The automobile and R&D sectors are examples where British firms were favoured through subsidies and procurement practices - for example, British Leyland Motors and ICL.¹³⁸ In addition, as in other industrialized countries, developments in petroleum attracted government attention in the 1970s. The decision to establish the British National Oil Corporation (BNOC) in 1975 was influenced by the U.K. government's concern over stable energy supplies. The

¹³⁸ Safarian, *Governments and Multinationals* (1983), op. cit., pp. 29-33.

labour government aimed at 51% state participation in production through BNOOC.

The *Exchange Control Act* of 1947 proved to be a significant obstacle to the free movement of capital, interest, and dividends in and out of the United Kingdom. Under the terms of this Act, the U.K. government had wide powers over inward and outward direct investment and other international transactions. In particular, the financing of foreign direct investment for the establishment of a new firm or the acquisition of control of an existing British firm would require authorization, as would significant purchases by non-residents of shares on the stock market. Many of the powers under the Act were implemented by the Bank of England, whose concerns about inward and outward direct investment centred on balance-of-payments effects. Beyond exchange controls, the overall treatment of inward direct investment was generally liberal: all but small direct investment cases were reviewed by the Treasury, the Industry Department, and other relevant departments, and only in specific instances when national interest was involved.¹³⁹

In October 1979, the Thatcher government repealed the *Exchange Control Act* of 1947 and announced the complete abolition of U.K. exchange restrictions on transactions and transfers between residents and non-residents. No other OECD country had achieved that degree of liberalization. The abolition of exchange controls accelerated the internationalization of London as a financial market and opened up the domestic market to international competition. The suspension of exchange controls was accompanied by a wide range of structural reforms such as tax reform and a reduction in direct tax rates, tight control of public spending, a pioneering privatization program, labour market reforms, deregulation of financial services, and monetary and fiscal restraint.

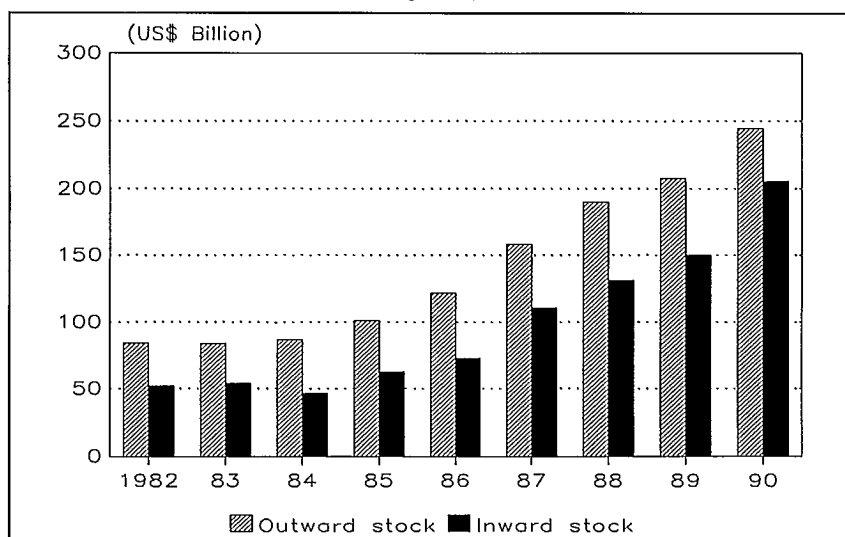
Recent Investment Patterns

The United Kingdom continues to play its historically prominent role in international direct investment activity. It ranks as the second largest destination and source of worldwide stock of direct

¹³⁹ Ibid., p. 32.

investment, second only to the United States.¹⁴⁰ Japan's emergence as a major global investor in the 1980s has posed a threat, however, to the United Kingdom's ranking as a source country for outward FDI.

Chart 4-1
Stock of Inward and Outward Direct Investment,
United Kingdom, 1982-90



Source: Investment Canada compilations using the International Monetary Fund, *Balance of Payments Yearbook*, various years.

At the end of 1990, the book value of FDI in the United Kingdom stood at US\$ 205.6 billion, up 37% from the previous year. The U.K. share of the global stock of inward direct investment in 1990 was about 12.5%, the same level as in 1980. The corresponding value of U.K. overseas direct investment in 1990 increased 18% to US\$ 244.8 billion (see Chart 4-1). From 1984 to 1989, the stock of FDI in the United Kingdom grew at an average annual rate of 21% compared with an average growth of almost 17%

¹⁴⁰ John Rutter, *Recent Trends in International Direct Investment*, Washington: United States Department of Commerce, International Trade Administration (August 1992).

in U.K. direct investment abroad.¹⁴¹ The relatively faster growth of FDI in the United Kingdom since the mid-1980s has resulted in a gradual decline in the ratio of the outward to inward stock of direct investment.

At year-end 1987, almost half of the total FDI in the United Kingdom originated from North America, while FDI from Western Europe accounted for 36% of the total assets. The 1980s marked a decade in which a significant shift took place in the flow of FDI into the United Kingdom, as the United States gradually declined as a source of FDI to other countries. Most notable among the new source countries were Switzerland and Canada. The U.S. share in the United Kingdom's stock of FDI dropped from 57% in 1984 to a low of 46% in 1987. The Netherlands and Switzerland are, respectively, the second and third largest foreign direct investors in the United Kingdom. While the Swiss share of FDI jumped from 5.3% in 1984 to 7.3% in 1987, the Netherlands investment, including direct investments in the petroleum sector, actually declined from around 21% in 1984 to 15% in 1987. Canada, as the fourth largest source of FDI in the United Kingdom, increased its share from 2.9% in 1984 to about 5.4% at year-end 1987.¹⁴²

Australia and Japan are among the other major foreign direct investors in the U.K. economy. The prospect of a European Free Market in 1992 has served as the major catalyst increasing FDI from those source countries. By year-end 1987, both Australia and Japan accounted for about 3.5% of FDI in the United Kingdom.¹⁴³ The United Kingdom accounts for over 40% of total Japanese investment in the European Community.¹⁴⁴ The U.K. statistics may not fully reflect Japan's involvement in the British economy, however, since many Japanese investments are in fact carried out by Luxembourg-based holding companies.

¹⁴¹ International Monetary Fund, *Balance of Payments Yearbook* (1990), Part I, pp. 726-27.

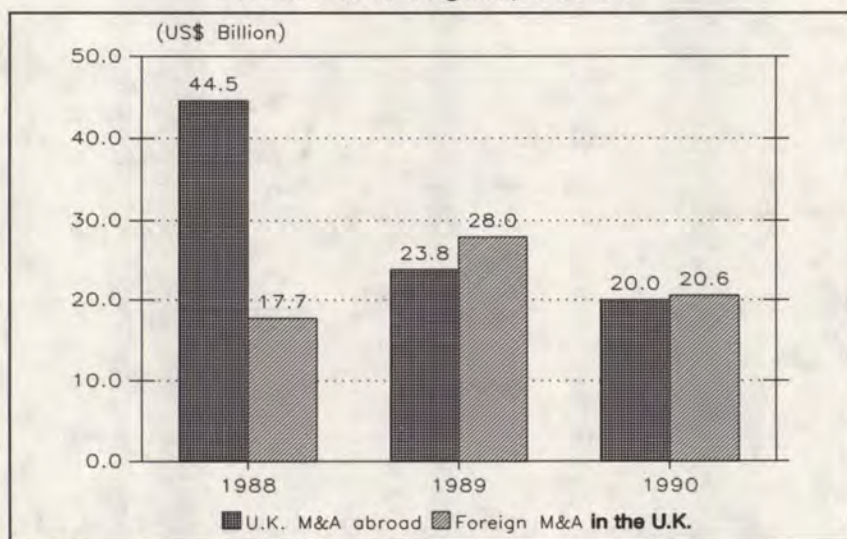
¹⁴² U.K. Central Statistics Office, "Census of Overseas Assets", in *Business Monitor* 4, 1987, p. 42.

¹⁴³ *Ibid.*

¹⁴⁴ IL&T, United Kingdom (October 1992), p. 3.

In the late 1980s, the United Kingdom ranked second only to the United States as a destination, as well as a source, of cross-border mergers and acquisitions activity in the G-7 countries. According to KPMG Deal Watch, mergers and acquisitions in the United Kingdom amounted to US\$ 20.6 billion in 1990, down from the peak of US\$ 28 billion in 1989 (a drop of 26.4%). In comparison, U.K. companies accounted for US\$ 20 billion of mergers and acquisitions abroad in 1990 – a 16% drop from the previous year and a dramatic drop of 55% from the peak of \$44.5 billion in 1988. Chart 4-2 indicates that the United Kingdom has generally maintained a good balance as a recipient and source of cross-border merger and acquisition activity in the late 1980s.

Chart 4-2
Cross-Border Mergers and Acquisitions Activity
in the United Kingdom, 1988-90



Source: KPMG Dealwatch 91.

In 1988, non-EC companies were responsible for almost four-fifths of the total value of cross-border merger and acquisition deals in the United Kingdom (worth US\$ 17.7 billion). North American firms accounted for 23% of the total purchases, while enterprises from the

rest of the world (other than EC firms) were behind 55% of the takeovers. In general, the pattern of takeover activity is consistent with the view that non-EC direct investors have in recent years targeted the United Kingdom as a springboard to the Community. Table 4-1 highlights recent trends in the relative importance of foreign-controlled firms in overall British employment, corporate assets and sales, assets, and the capital stock of the economy.

Table 4-1
Foreign Ownership and Control in the United Kingdom

- ▶ In 1987, foreign-controlled firms accounted for 20% of manufacturing production, but 13.5% of employment; average labour productivity in foreign-controlled firms was therefore 50% higher than in U.K.-owned firms.
- ▶ Another measure of the importance of foreign-owned firms in the U.K. economy is the ratio of the stock of FDI to the net wealth of various industrial and financial sectors. This ratio in 1987 was 16.5% for the banking sector, 10% for other financial institutions and 10% for industrial and commercial companies. In contrast, in 1982 these ratios were 14%, 3%, and 13%, respectively.¹
- ▶ In 1989, foreign-owned firms accounted for 24.1% of sales, 21.1% of value-added, and 14.9% of employment in the manufacturing sector of the United Kingdom. The shares were up from, respectively, 20.3%, 18.7%, and 14.0% in 1985.²
- ▶ In 1991, the inward stock of foreign direct investment in the United Kingdom amounted to 22.2% of GDP, a share which doubled from 11.1% in 1979³. The United Kingdom has the highest ratio of FDI to GDP among the G7 countries.
- ▶ Inward direct investment stock as a proportion of United Kingdom's gross private non-residential capital stock increased from 3.9% in 1980 to 9.1% in 1991⁴.

¹ Lloyds Bank Economic Bulletin, Number 138, June 1990.

² Data obtained from the Office of Trade and Economic Analysis, U.S. Department of Commerce

³ Industry and Science compilations using data from various sources

⁴ Ibid.

Formal Barriers to Direct Investment

Regulatory Framework

FDI in the United Kingdom is not subject to prior notification requirements or screening by a government agency. Under the 1975 *Industry Act*, however, the U.K. government retains the statutory power to prohibit a proposed transfer of control of an important U.K. manufacturing undertaking to a non-resident where the transfer is considered contrary to the national interest of the United Kingdom. In theory, therefore, there is scope for the government to block foreign investments. In practice, however, these powers have never been used. The United Kingdom relies on the merger review process established under the *Fair Trading Act 1973* to scrutinize and if necessary, block foreign takeovers. This allows responsibility for politically difficult decisions to be passed to the Mergers and Monopolies Commission.¹⁴⁵

Under the terms of its antitrust policy, the United Kingdom retains powers to prohibit, or to subject to conditions, mergers and takeovers by non-EC investors when there is a lack of reciprocal access by U.K. firms in the market of the acquiring country. If, in the view of the authorities, the absence of reciprocity in that state would cause the takeover to be against the public interest in the United Kingdom, the government would be justified in blocking the transaction. Although these provisions exist, no merger has been blocked to date on these grounds.

Sectoral Restrictions

As is the case in all G-7 countries, foreign investors face restrictions on FDI activity in certain sectors of the U.K. economy. The United Kingdom maintains one limited reservation to inward investment under the OECD Capital Movements Code, covering air and marine transport, and broadcasting. In addition, the United Kingdom maintains reciprocity requirements with regard to foreign investment in banking and financial services, the establishment of non-EC insurance companies, and mergers and takeovers involving

¹⁴⁵ M. Thorneycroft, "United Kingdom", in *International Financial Law Review, The Regulations Governing Mergers and Acquisitions Across the European Community*, U.K.: Euromoney Publications (1989), p. 70.

investors from non-EC countries. As well, FDI activity is prohibited in certain other sectors by virtue of being public or private monopolies. The various forms of sectoral restrictions are shown in Table 4-2.

Table 4-2
Impediments to Inward Investment in All or Some FDI Activity
in the United Kingdom, by Sector

Industry	Reservations to OECD Capital Movements Code	Other Impediments	Public, Private, or Mixed Monopolies
Banking		X	
Insurance		X	
Broadcasting (Radio, TV, Cable)	X		X
Post, telephone, and communications			X
Land transport (including railways, buses, and road construction)			X
Air transport	X		
Maritime transport	X		
Tourism		X	
Overall energy production and public utilities			X

Source: Organisation for Economic Cooperation and Development, *Control and Impediments Affecting Foreign Direct Investment*, (Paris:1987).

Air Transportation

In air transport, ownership of U.K.-registered aircraft is restricted to Her Majesty's government, Commonwealth citizens, citizens of the Republic of Ireland, British protected persons, bodies incorporated and having their principal place of business in the Commonwealth, and firms carrying on business in Scotland. Unless the Secretary of State for Trade and Industry (SSTI) permits otherwise, air transport licences may not be granted by the Civil Aviation

Authority to applicants if they are not U.K. nationals or bodies incorporated under the law of the United Kingdom and not controlled by U.K. nationals.

Cabotage is reserved for national airlines. Finally, the Articles of Association of the U.K. carrier, British Airways, restricts the number of foreign-held shares at any one time to not less than 25% of the ordinary voting equity.¹⁴⁶

The nationality restrictions on air transport licences are intended to prevent U.K. airlines from being taken over by foreign airlines. The limitation of foreign shareholding in British Airways is designed to protect the rights of the company to fly particular international routes.¹⁴⁷

Maritime Transportation and Fishing

In maritime transport, military freights of a sensitive nature can only be shipped by a "British" flag ship, which by law must be wholly owned by British subjects or bodies incorporated under, and subject to, the laws of the United Kingdom, a Crown Dependency, or a Dependent Territory. Under the *Merchant Shipping Act 1988*, the registration of commercial fishing vessels is reserved for U.K. residents or enterprises who qualify under ownership and control thresholds relating to the vessel.¹⁴⁸ Under the Act, a registered British fishing vessel must be at least 75% owned by British citizens resident and domiciled in the United Kingdom and/or a company that is incorporated in the United Kingdom and has its principal place of business there.

¹⁴⁶ OECD, *Measures Affecting Direct Investment in OECD Member Countries*, DAF/INV (90) 31/REV 2, (Paris:March 1991), pp.112-14.

¹⁴⁷ Under the current bilateral air services agreements made between states, a contracting state usually has the right to prevent an airline designated by the other state from operating the agreed services if it is not satisfied that the airline is substantially owned and effectively controlled by the nationals of the other state.

¹⁴⁸ OECD, *Measures Affecting Direct Investment*, op. cit. (March 1991), p. 114.

Broadcasting

The United Kingdom's limited reservation on inward investment in broadcasting prohibits non-EC residents control. Investment up to, but not including, control is permitted. According to the *Broadcasting Act 1990*, "controlling interest" is defined as more than 50% of the equity shares of capital or more than 50% of the voting shares.

These restrictions apply to certain categories of licences issued by the Independent Television Commission (ITC) and Radio Authority, including those for local radio stations, domestic satellite services, teletext services, and others. The *Broadcasting Act 1990* liberalized considerably, however, the nationality restrictions applying to licensees of the ITC and Radio Authority that existed under the *Cable and Broadcasting Act 1984*. In particular, non-EC investment restrictions have been lifted in relation to various cable and satellite licences.

Banking and Financial Services

Foreign investment in banking, financial services, the establishment of non-EC insurance companies, and mergers and takeovers involving investment from non-EC countries may be subject to a reciprocity requirement by the U.K. government.

To date, reciprocity requirements have not been applied in practice to foreign investment in banking (and financial services), although the *Financial Services Act 1986* permits this. These powers are intended to encourage the liberalization of financial services in other countries and to obtain greater opportunities for U.K. firms to establish themselves and provide services in those countries.

A policy of reciprocity also applies for the lead-management of sterling issues. Under this policy, foreign-owned institutions that have the capacity in the United Kingdom to act as an issuing house are eligible to lead-manage sterling issues only if, in the view of the Bank of England, there are reciprocal opportunities in the foreign domestic capital market of the institution concerned for equivalent U.K.-owned institutions.¹⁴⁹

¹⁴⁹ Ibid.

Under Europe 1992, the establishment of branches of, and the provision of services by, banks of EC origin will be governed by the EC Second Banking Directive when it comes into effect. The subsidiaries of non-EC banks will be treated as EC institutions, but their establishment will be subject to the reciprocity provisions of that Directive. The establishment and operation of non-EC banks will continue to be regulated in accordance with national law.

In addition to the reciprocity provisions for the establishment of bank branches and subsidiaries in the United Kingdom, the acquisition of shares of British banks are governed by other statutes. Under the *Banking Act 1987*, no individual or entity, irrespective of nationality, can acquire more than 15% of the voting equity of a banking institution incorporated in the United Kingdom without first notifying the Bank of England. The Bank can block the acquisition for prudential reasons, if the bidder is deemed to be "not fit and proper". The acquisition can also be blocked if it is deemed to threaten the interests of the depositors.¹⁵⁰

Insurance

Under U.K. legislation, the establishment of insurance companies from non-EC member countries may be subject to a reciprocity requirement, but, as with banking and financial services, this power has not been invoked. Furthermore, when the necessary EC directives on investment services and insurance are agreed and come into force, the establishment of subsidiaries of non-EC institutions will also be subject to these directives' reciprocity provisions.

Apart from the reciprocity conditions relating to the establishment of insurance companies, the *Insurance Companies Act 1982* controls the acquisition of shares of U.K. insurance companies. This Act empowers the SSTI to block the acquisition of one-third or more of the voting shares of a U.K. insurance company, whether established within or outside the United Kingdom, if the acquirer, irrespective of nationality, is deemed to be "not fit or proper".¹⁵¹

¹⁵⁰ Thorneycroft, "United Kingdom", op. cit., p. 67.

¹⁵¹ Ibid.

Tourism

Licences for charter flights or package holidays that are contracted for in the United Kingdom can only be granted to U.K.-registered companies, but such companies can be foreign-owned. The reason for this restriction, according to the U.K. authorities, is to protect the consumer and to ensure that these companies work within the terms of international agreements.

Other Sectors: Manufacturing and Defence

The U.K. government holds a special share in two privatized industries - British Airways PLC and Rolls Royce PLC. This special share prevents the alteration of the companies' Articles of Association without government consent. The articles of both companies restrict the number of foreign-held shares at any one time to 29.5% of the ordinary voting shares. They also impose citizenship requirements for the companies' directors.

The Articles of Association of the VSEL Consortium PLC ensure that the Chairman, the Chief Executive Officer, the Managing Director, and a majority of all directors are British. There is also a veto over disposal of all of the material part of the company's assets.

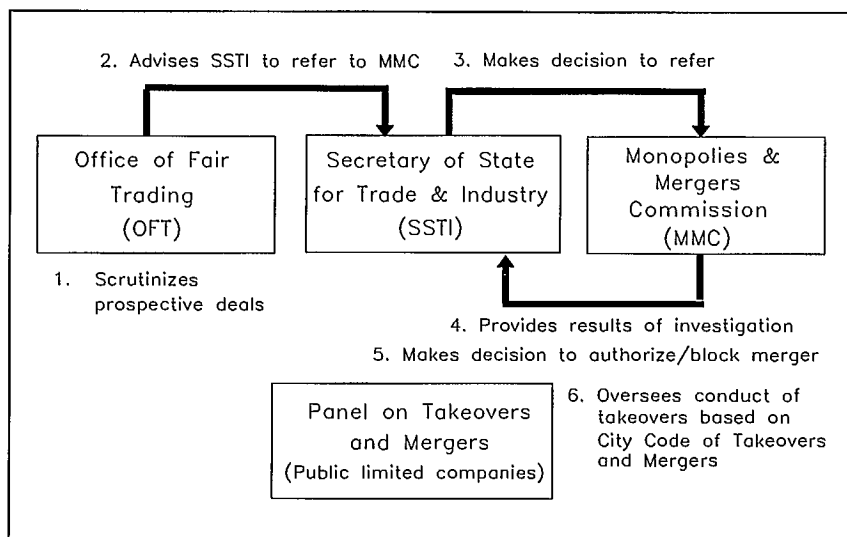
The Antitrust Framework and Merger Policy

There are three agencies that have distinct but interrelated responsibilities for the control of domestic and foreign merger and takeover activity in the United Kingdom. These are: 1) the Department of Trade and Industry, whose activities are the responsibility of the Secretary of State for Trade and Industry (SSTI); 2) the Office of Fair Trading (OFT), headed by the Director General of Fair Trading (DGFT); and, 3) the Monopolies and Mergers Commission (MMC), a non-political statutory body that investigates the mergers referred to it (see Chart 4-3).

In the United Kingdom, takeovers and merger activity are regulated by the *Fair Trading Act 1973* (FTA) and the EC Merger Control Regulation that entered into force in September 1990. The FTA applies to transactions involving publicly owned companies as well as private companies. Merger control policy is coordinated by the Competition Policy Division, Branch 1 of the Department of

Trade and Industry. There are other departments that are responsible for specific sectors of the U.K. industry, and they participate in decision-making on mergers relevant to their particular sector.¹⁵²

Chart 4-3
Regulatory Framework for Merger Policy (including FDI)
in the United Kingdom



Source: Investment Canada.

The Competition Policy division of the OFT is responsible for monitoring merger activity in the United Kingdom. It includes a Mergers Secretariat, which convenes an ad hoc "Mergers Panel" comprising representatives of various other government departments who generally have an interest in a merger under consideration, and who assist the OFT in advising the SSTI by appraising the effects of a prospective merger or takeover.

The MMC is an independent, publicly funded body established by statute to carry out investigations into particular industries and into

¹⁵² David F. Hall, "United Kingdom", in J. William Rowley and Donald J. Baker, eds., *International Mergers: The Antitrust Process*, U.K.: Sweet and Maxwell (1991), pp. 226-27.

specific mergers and acquisition proposals, at the request of the SSTI. The origin of the present MMC dates back to 1948, when the United Kingdom passed its first significant Act to limit the growth of monopolies. Since then, the *Monopolies and Mergers Act 1965* and the *Fair Trading Act 1973* have set out British antitrust policy. The MMC plays a purely investigatory role and is not empowered to initiate a merger enquiry on its own. The MMC consists of 35 full and part-time members who are appointed by the government. These members are selected from a cross-section of British economic life.

In addition to the MMC and the Department of Trade and Industry, the Panel on Takeovers and Mergers also plays a prominent role in the administration of U.K. merger policy. Since 1968, takeover offers involving U.K. publicly-quoted companies have been subject to the regulations in the City Code on Takeovers and Mergers which is administered by the Panel (there is no comparable regulatory body for transactions relating to private companies).¹⁵³ The Panel is composed of representatives of many City of London financial bodies, such as the Confederation of British Industry, the Bank of England, and the Stock Exchange. The Code does not have the force of law, but it seeks to achieve a fair balance between the differing interests of parties in a takeover.¹⁵⁴ In general, the Code attempts to ensure equality of treatment for all shareholders of the same class, equality of information, fairness and clarity of information concerning public offers, and sufficient time and information for shareholders to reach a properly informed decision.

The U.K. merger review process is carried out in three phases and involves the participation of the departments and regulatory bodies shown in Chart 4-3. Neither U.K. nor foreign bidders are obliged to inform the U.K. authorities when they propose or carry through a merger. It is possible, however, as discussed shortly, for the prospective parties to receive a confidential, non-binding opinion on whether the merger will be subsequently challenged. The various stages of the merger review process are described in Table 4-3.

¹⁵³ The provisions of the Code are similar to those contained in the European Community's draft "Proposal for a 13th Council Directive on Company Law" concerning takeovers and general bids.

¹⁵⁴ Thorncroft, "United Kingdom", op. cit., p. 69.

Table 4-3
The Merger Review Process in the United Kingdom

Phase I - Monitoring of mergers and decision to refer

The OFT conducts a preliminary investigation of a merger or acquisition to determine whether the transaction falls within the purview of the 1973 Act. The Director General of the OFT makes a non-binding recommendation to the SSI as to whether or not the merger should be investigated by the MMC. Panel officials of the OFT and interested Ministries will also occasionally advise the Director General.

The SSI can overrule the recommendation of the OFT. The SSI, however, is statutorily barred from requiring the MMC to investigate a merger unless it qualifies under either an asset-value test or a market-share test, as follows:

- ▶ In the case of the **asset test**, the gross value of the U.K. company being acquired must exceed £30 million (US\$ 53 million);
- ▶ In the case of the **market-share test**, the transaction must result in 25% or more of goods or services of the same description being supplied by one enterprise.

Phase II - Investigation and reports

Subject to an investigation order from the SSI, the MMC will review a merger to determine whether the transaction is likely to **operate against the public interest**. In general, the MMC submits a report to the SSI within six months of launching an investigation. The SSI, however, may limit the investigation period to three months if, for any special reason, the screening process must be expedited.

Phase III - Remedies

If the MMC finds the merger not to operate against the public interest, then the SSI must accept that decision and allow the transaction to proceed. If, however, the MMC should find that the merger is harmful to the public interest, the SSI has the power to block the merger, to require divestiture if it already has been implemented, or in appropriate cases to permit the merger to proceed, subject to appropriate safeguards.

As indicated in Table 4-3, the SSI is legally empowered to prevent any takeover or merger that operates against the "public interest". The term is broadly defined in section 84(1) of the FTA; it requires that, in determining whether any particular merger "operates or may be expected to operate in the public interest", the MMC will

consider the impact of the transaction on such factors as the maintenance and promotion of competition in the United Kingdom, the promotion of consumer interests, the development of new products, the reduction of costs, the balancing of the distribution of industry and employment, and the promotion of the competitive activities of the U.K. companies abroad.

While the U.K. government has formally announced that the merger review policy should give greater consideration to those factors in the FTA which promote competition and less to those which involve social and economic interventionism (e.g. regional and employment policy, balance of payments, trade policy), in practice, other public interest issues are often important in influencing the decision-making process.¹⁵⁵ Indeed, as discussed in the informal investment barriers section, there have been a number of instances in which factors other than competition have influenced decision-making with respect to foreign takeovers.

In cases involving mergers or takeovers by non-EC investors, the extent to which firms from the United Kingdom have reciprocal access to the non-EC investor's country of origin is an issue. This consideration is reflected in an entry in Annex E of the OECD Capital Movements Code governing the United Kingdom, which states that "a merger or takeover involving investors from a non-EC state may be prohibited or subjected to conditions if absence of reciprocity in that state would cause the merger or takeover to be against the public interest in the United Kingdom". The effect of extending the scope of reciprocity to include public interest issues, however, provides the United Kingdom with broad powers to block or alter the terms of a proposed merger by non-EC countries on non-competition grounds.

Under the United Kingdom's merger policy, neither domestic nor foreign interests are required to notify the authorities of a merger proposal, either in advance or even after the merger is consummated. This does not, however, preclude the authorities from investigating the merger within a specified time limit and forcing a divestiture. There are several ways in which a clearance of a merger or

¹⁵⁵ In its Blue Paper on Mergers Policy (HMSO, 1988), the Department of Trade and Industry notes that "for many years, the policy has been to give prominence to competition as a criterion for reference, though other public interest issues have also featured".

acquisition can be obtained and thereby minimizing the inherent risk of being challenged by the authorities in a post-merger situation. The clearance procedures, all of which require that the OFT be notified in advance, are briefly described below.¹⁵⁶

The acquiror may, prior to making the merger public, obtain a **confidential, non-binding** indication of whether the merger is likely to be referred for investigation. The OFT consults with other government departments, and based on these consultations, will only provide confidential guidance to the acquiror with regard to the likelihood of a reference or whether it is impossible to give guidance without further consultation.

A more reliable route appears to be the **statutory clearance** procedure which was introduced in 1990. This system guarantees the merging parties that a proposed merger will not be referred for investigation if notified in advance. The merger notification must be made in a prescribed form, and appropriate fees must be paid prior to the completion of the transaction.

Finally, prenotification under the **informal clearance** procedure does not guarantee the merging parties an immunity from reference. This is especially so, because there is no specified consideration period (as in the case of the statutory clearance system) within which the authorities must review the merger proposal.

In addition to merger review under the FTA, the EC Merger Control Regulation, which came into effect in September 1990 and which applies to "concentrations with a Community dimension", covers mergers in the United Kingdom that could materially affect competition in the EC. By acceding to the EC Merger Control Regulation, the United Kingdom, like other member countries, has transferred jurisdiction for certain large-scale mergers from national competition authorities to the EC Commission's new merger task force.

¹⁵⁶ The procedures are discussed extensively in David F. Hall, "United Kingdom", *op. cit.*, pp. 233-41. The *Companies Act 1989* introduced four main changes to the merger provisions of the FTA: a new "fast track" procedure for obtaining advance clearance of mergers; procedures for the SSI to accept binding undertakings from the parties to a takeover, instead of referring the merger to the MMC; the creation of criminal sanctions for giving false or misleading information to the OFT or the MMC; and provisions for the changing of fees in respect of merger investigations.

Informal Barriers to Direct Investment

There are significantly fewer informal barriers to FDI in the United Kingdom than elsewhere in Europe. In particular, hostile takeovers of a U.K. company are relatively much easier to accomplish than in the continental European countries of the G-7. The Anglo-Saxon approach to contested takeovers has been lauded for promoting the efficiency of the market system. For example, observers note that the prevalence of hostile takeovers in the United Kingdom "enable shareholders to exert a direct influence on the company's management and on the allocation of its resources ... the mere threat of a takeover can be sufficient to obtain a more efficient management of the company. This leads to an overall more efficient economy with active, sophisticated financial markets, good information on companies, and high standards of transparency and accountability."¹⁵⁷

The market structure of the U.K. stock exchange is conducive to takeovers of publicly quoted companies, whether by domestic or foreign interests. In other European countries, companies are significantly more difficult to take over from a structural point of view. Various features of the market encourage a high degree of merger and acquisition activity. Several factors promote a healthy market for corporate control in the United Kingdom: the ownership pattern of U.K. companies; their traditional reliance on equity share capital, as opposed to debt, to finance expansion; the liberal rules of the stock market that prohibit companies from imposing restrictions in their Articles of Association (for example, on the transferability of their shares or on voting rights of certain classes of shares); and more generally, the technical sophistication of financial markets.

In 1989, there were 1,758 domestic companies listed on the London Stock Exchange (LSE), with a market capitalization value of US\$ 814 billion (approximately equal to the U.K. gross domestic product). Market capitalization of the LSE was more than twice the market value of all domestic companies on the German stock exchanges, the second largest market in the European

¹⁵⁷ Booz Allen Acquisition Services (1989), op. cit., pp. 53-56.

Community.¹⁵⁸ In fact, the United Kingdom has the largest stock exchange capitalization in Europe, approximately equal to the combined capitalization of the French, German, and Italian stock exchanges. Over 40% of all EC quoted companies are U.K. companies quoted in the United Kingdom.

Thus publicly traded companies in the United Kingdom have structural characteristics that generally tend to promote takeover activity. The evidence in support of this observation is the fact that the United Kingdom has a relatively higher frequency of hostile takeover bids than other G-7 countries. In 1988, for example, there was a total of 44 contested public takeover bids launched in the United Kingdom, compared with six in France and none in West Germany or Italy. The significantly higher incidence of public takeover bids is in part a reflection of the relative ease with which they can be financed by capital markets in the United Kingdom – debt/equity ratios there are, on average, lower than in other EC countries. In addition, financial markets in the United Kingdom offer a higher degree of technical sophistication than other markets in Europe.¹⁵⁹

Implementation of Antitrust Legislation

Notwithstanding the generally liberal foreign investment climate in the United Kingdom, a number of informal barriers can impede foreign investments, particularly if they involve hostile takeovers of domestic companies. Perhaps the most significant of these obstacles relates to the discretionary power of government to block takeovers that operate against the "public interest". Government policy regarding takeovers has at times appeared inconsistent with the rules and procedures prescribed by law. In more recent years, however, the government has emphasized the pre-eminence of competition-policy factors and downplayed political interventionism as the focus of its merger control policy. In particular, as a matter of policy, it has taken the position to consider predominantly those factors in the FTA which tend to promote the

¹⁵⁸ Fédération Internationale des Bourses de Valeurs, *Activities and Statistics 1989 Report*, pp. 24, 27.

¹⁵⁹ Booz Allen Acquisition Services (1989), *op. cit.*, pp. 14-16.

operation of the free market (essentially competition) and less to those which involve social and economic interventionism (regional and employment policy, balance of payments, trade policy, and so on).

Government/Business Linkages and Tactical Barriers

Government/business linkages can produce a strong alliance to avert controversial takeovers by foreign interests. In concert with these linkages, actions by management or Boards of Directors can produce tactical defences to deflect hostile takeover bids. Political lobbying for and against takeovers has been a practice of British antitrust policy for a long time. While the Panel on Takeovers and Mergers plays a vital role in ensuring that hostile takeovers are conducted fairly by the companies involved, there are several ways by which actions by management or Boards of Directors of the target company can frustrate or defeat hostile takeover bids. The various tactics often employed by management to counter hostile bids are discussed in Table 4-4.

Table 4-4
Takeover Obstacles: Management/Board Actions
to Contest Hostile Takeovers in the United Kingdom

In most Anglo-Saxon economies, the corporate philosophy is based on maximizing shareholder value, and the directors of the company have a fiduciary duty to the shareholders. Furthermore, shareholders have the ultimate power to dismiss management if some more valuable alternative is put to them. It is often in the interest of the management/board of a target company to strongly oppose a hostile takeover bid by attempting to influence shareholders to reject the bid. The following summarizes some of the defensive actions against hostile takeovers that management of a U.K. company can employ in an attempt to defeat contested takeover bids:

- The management/board of the target may use its influence to persuade the SSI, via the Director General of the OFT, to refer a contested takeover to the MMC for an investigation. If a reference to the MMC is made, the City Code on Takeovers and Mergers, requires the takeover to lapse until the MMC submits its recommendation to the SSI. In some cases, the MMC may take up to six months to make its recommendation. The target has the advantage that the government may ultimately block the merger on the basis of the MMC's recommendation. In the event that the MMC decides in favour of the takeover, the target's management may use the time to marshal its defences. For example, by the time the MMC has cleared the

(continued)

bid, the target company's management may have taken action to increase the share price beyond the reach of the bidder, thereby frustrating the takeover; or, alternatively, the target may solicit an offer from a white knight.

- ▶ The target may attempt to convince its shareholders that the share price of the bidder (assuming the bidder is paying in shares) is not sustainable by exposing weaknesses in the bidder's management, financial records, and prospects. The City Code requires the bidder to disclose, in its offer document, financial and other relevant information about itself; the target's management can use the information to build a case against the bidder's share price offer, even if the bidder is offering cash for the target.
- ▶ The target's directors can attempt to convince its shareholders that its shares are more valuable than the price offered by the bidder. It can project a higher profit and/or dividend flow for the company based on new products, innovations, and so on, in the future. While this may have the effect of raising the offer price by the bidder, it may also increase the target's share price beyond the level which the bidder is willing or able to pay.

In spite of the various defences, management/board actions to combat hostile bids are subject to relatively greater restrictions in the United Kingdom than in other countries. The shareholding public and the investment institutions are averse to mechanisms such as "poison pills" that would make their companies bid-proof because they do not want to discourage high prices for their shares. In addition, General Principle 7 of the Code prohibits a target from taking action that would frustrate a bid or deny its shareholders the opportunity to decide on the bid's merits, unless the action has been approved by the shareholders. This applies not only to actions that might be taken after the announcement of an offer but also beforehand if the directors of the target have reason to believe that a bona fide offer may be imminent.

Other Informal Barriers: State-Controlled Enterprises

A tradition of state ownership in the United Kingdom has in the past affected the activity of foreign investors. In 1979 however, the British government under Prime Minister Thatcher embarked upon a significant privatization program. Major state-owned companies that were privatized by mid-1988 include British Airways, British Airport Authority, British Gas, British Telecom, British Petroleum, Britoil, and Cable and Wireless. In addition, the government also disposed of many state assets, including some large ones such as North Sea oil exploration licences, and encouraged the sale of local council housing to tenants.

More recently, the government privatized public utilities, including 12 area water boards. In early 1991, the U.K. government sold 60% of the shares of state-owned electricity generating companies – National Power and PowerGen – to the private sector. Some of these privatizations have been controversial in view of the heavier charges levied on consumers in order to pay dividends and cover the financial and commercial risks. The problem of high-cost nuclear power stations presented a serious complication, and in the end the government decided to retain these in the public sector. Under the *Ports Act 1991*, several ports including the port of Tees and Hartlepool in northeast England and the ports of Clyde, Forth, and Medway were recently privatized.

Since the privatization program was launched in 1979, more than 40 companies worth an estimated £48.5 billion (US\$ 86 billion) have been privatized. By the end of financial year 1995/96, the U.K. government anticipates that it will have privatized companies worth a combined total of £60 billion.¹⁶⁰ The plans call for a further sell-off of residual holdings in some of the companies that have already been privatized.

In addition, other public monopolies like British Coal and British Rail have been targeted for future privatization on a piecemeal basis. Both are in a weak financial position, with British Coal still suffering from excess capacity and low prices and British Rail continuing to rely heavily on large government subsidies.¹⁶¹ To date, the privatizations have generally been successful in achieving productivity gains and widening the share and property ownership of the privatized resources.

The U.K. government has imposed limits on foreign holdings in a few strategically sensitive privatized industries. The government holds special shares in two privatized companies – British Aerospace PLC and Rolls Royce PLC. This prevents the alteration, without government consent, of certain Articles of Association. The government also restricts the number of foreign-held shares in these companies at any one time to 29.5% of the ordinary voting equity. The articles also impose citizenship requirements for the companies' directors. These restrictions have been imposed in order to maintain

¹⁶⁰ IL&T, United Kingdom (October 1992), pp. 4-5.

¹⁶¹ Ibid., p.5.

the United Kingdom's essential security interest.¹⁶² British Airways imposes a 25% limit on foreign ownership. The various restrictions on foreign equity participation in the privatized industries are summarized in Table 4-5.

Table 4-5
Other Informal Barriers:
Limits on Shareholdings in Privatized Industries in the United Kingdom

With the exception of a few privatized companies, the U.K. government has instituted a so-called "**golden share**" rule. The government holds a "golden share" in each of 38 privatized companies, enabling it to block an acquisition if it so chooses. Under the various "golden share" rules:

- ▶ the government has the power to veto changes in the control of the company or its Articles of Association;
- ▶ they provide limits on individual and foreign share ownership in privatized companies. For example, individuals, regardless of their nationality, cannot own more than 15% of the equity capital of privatized companies such as Amersham International, BAA (formerly British Airports Authority), British Airways, British Gas, British Telecom, British Steel, and Cable & Wireless¹;
- ▶ The U.K. government has special foreign equity restrictions in two privatized industries - British Aerospace and Rolls Royce - in order to protect the United Kingdom's essential security interests. In both companies, foreign equity participation is limited to 29.5% of the ordinary voting equity. In addition, the companies' Articles of Association require that the Board of Directors be British citizens.²
- ▶ Foreign-ownership of British Airways is limited to 25% of the voting equity, but this rule is separate from the terms of the government's golden share.
- ▶ There is no time limit as to when the rules would expire. In some cases there are expiration dates with a renewal option. For example, the government relinquished its "golden share" when Ford (U.S.) acquired Jaguar.

¹ IL&T, United Kingdom (1989), op. cit., p. 5.

² OECD, op. cit., (July 23, 1991), pp. 27-28.

¹⁶² OECD, *United Kingdom: Examination of Position Under the Code of Liberalization of Capital Movements*, Committee on Capital Movements and Invisible Transactions, Draft Report to the Council, DAFFE/INV (91) 16, drafted July 23, 1991, pp. 20-21.

Case Studies on FDI in the United Kingdom: A Brief Review

In the case of takeovers, the Department of Trade and Industry acknowledges that "for many years, the policy has given prominence to competition as a criterion for reference, though other public interest issues have also featured."¹⁶³ This statement reflects in part the fact that political lobbying for and against both foreign and domestic acquisitions of U.K. companies has been a part of U.K. antitrust practice.

British Petroleum / Kuwait Investment Office

A highly politicized foreign takeover in which factors other than competition influenced the decision-making was the attempted acquisition of control of British Petroleum (BP) by the government of Kuwait's investment agency, the Kuwait Investment Office (KIO), in 1988. KIO had acquired a 21.6% holding in BP, which the MMC ruled was an acquisition that gave KIO sufficient control to influence BP's policy. This conclusion was based largely on the fact that other holdings in BP were extremely fragmented (95% of the shareholders held just under 10% of the shares) and KIO shareholding was 12 times the size of the next largest. Given the low turnout at BP's general meetings, the shareholdings of KIO gave it the "near certainty" of defeating special resolutions.¹⁶⁴

The SSTI referred the case to the MMC on the grounds that "the implications of BP coming under the influence or control of a government with substantial oil interests and which is a member of OPEC raise question of public interest."¹⁶⁵ The MMC found that the merger would operate against the public interest because the interests of the Kuwaiti government would probably come into conflict "sooner or later" with those of BP (a downstream supplier of

¹⁶³ Département of Trade and Industry, Blue Paper on Mergers Policy (HMSO, 1988). The Blue Paper was in response to an 18-month review of merger policy by the government that was prompted by concerns over the existing procedures governing mergers, especially with regard to the time taken by the MMC to submit its recommendation to the SSTI.

¹⁶⁴ Monopolies and Mergers Commission, *Kuwaiti Investment Office/BP*, MMC report, Cm. 227, October 1988.

¹⁶⁵ *Financial Times* (U.K.), "How Companies and Countries Fend Off Foreign Predators", May 19, 1988, p. 3.

oil), keeping in mind that oil is "a most important strategic commodity." Eventually the SSTI forced a reduction in KIO's shareholding in BP from 21.6% to less than 10%.

Westland/Sikorsky (U.S.)

In 1986, Sikorsky, the U.S.-based helicopter manufacturer, made a bid to acquire Westland, the United Kingdom's only helicopter manufacturer. The transaction was ultimately blocked as a result of strong opposition from pro-EC lobbyists within the U.K. Cabinet who were in favour of a counter bid by a four-nation European consortium led by Aerospatiale of France, British Aerospace, General Electric Company of the United Kingdom, Augusta of Italy, and Messerschmitt Boelkow Blohm of West Germany. A political crisis developed and two Ministers resigned over the Sikorsky offer. This deal demonstrates the presence of a strong pro-European lobby within the U.K. government whose preference for European companies taking over British companies can prove to be an impediment to non-European companies that seek to negotiate a successful acquisition.¹⁶⁶

Sotheby / Stephen Swid - Marshall Cogan

In 1983, the SSTI overruled the advice of the OFT, which had recommended that a takeover bid for the United Kingdom's Sotheby by two U.S. individuals – Stephen Swid and Marshall Cogan – be allowed to proceed. Instead, the bid was referred to the MMC for a full investigation, thereby "nullifying the OFT clearance and short-circuiting all of the United Kingdom's agreed procedures."¹⁶⁷ This demonstrates that any clearance received by foreign investors concerning the acquisition of a British company may be overturned.

Royal Bank of Scotland / Hongkong Shanghai Bank

Foreign acquisitions of U.K. banks have been subject to strict scrutiny in view of their importance to the U.K. economy. In 1981, the Hong Kong and Shanghai banking corporation launched a

¹⁶⁶ *Financial Times* (U.K.), "Heseltine and the Westland Affair: Rescue Offers Depend on Workload and Product Packages", January 10, 1986, p. 9.

¹⁶⁷ *Ibid.*

contested takeover bid for the Royal Bank of Scotland. The Hong Kong bank initially approached the Bank of England to obtain a formal consent to bid for the fifth largest British clearing bank.

The Bank of England opposed the takeover of the Royal Bank by a foreign bank that effectively lay outside the control of British regulation. Despite the Central Bank's obvious dislike of the proposed deal, the Hong Kong bank proceeded to make the bid and was met with stiff opposition by the Royal Bank of Scotland. The deal eventually became a hotly contested political battle involving the Bank, the Treasury, the Foreign Office, the Prime Minister's Cabinet Office, and finally the Cabinet itself. The takeover became the subject of an investigation by the MMC. In submitting its recommendation against the transaction, the MMC stated that for reasons of "public interest" it was blocking the takeover. The recommendation cited that the acquisition would "diminish confidence and morale in Scottish Business". Other factors, such as monopolistic practices or market share considerations, presumably did not influence the final decision. Rather, the prospect of a British clearing bank controlled from outside the jurisdiction of the Bank of England appeared to be the overriding concern.¹⁶⁸

Anderson Strathclyde / Charter Consolidated

In 1981, Charter Consolidated, registered in London but with strong South African links, was allowed by the Under-Secretary for Trade and Industry to bid for the Scottish company Anderson Strathclyde. The Secretary himself owned an interest in the Scottish company and therefore did not participate in the decision-making process; however, the deputy to the Under-Secretary overruled the recommendation of the MMC to veto the bid.¹⁶⁹

The following is a brief outline of four other foreign takeovers blocked under the United Kingdom's merger control policy:

- ▶ Hiram Walker's (Canada) failed-bid for Highland Distilleries (U.K.) in 1980 – The MMC said that Highland would be more

¹⁶⁸ P. Earl and F.G. Fischer III, *International Mergers and Acquisitions*, London: Euromoney Publications Ltd. (1986), pp. 44-45.

¹⁶⁹ *Ibid.*, p. 49.

successful as an independent company and that the takeover would be contrary to regional and national interests.

- ▶ Enserch Corporation's (U.S.) bid for Davy Corporation (U.K.) in 1981 – The MMC ruled against the takeover, citing that it was important for Davy Corporation, an international engineering company, to be identified as a U.K. company in order to protect its export contract.
- ▶ The bid by General Motors and Ford of the United States to acquire part of British Leyland, the state-owned automobile manufacturer in 1986 – The bid was eventually withdrawn when the government refused to allow the U.S. auto manufacturers to acquire effective control of the acquisition. The U.K. government in effect invoked the "golden share" rule, which effectively gives the government the right to prevent changes in the Articles of Incorporation or in ownership of state companies slated for privatization.¹⁷⁰
- ▶ The bid by Scandinavian Airlines Systems (SAS) for British Caledonian in 1988 – After a heated political debate about the SAS bid, the MMC authorized instead British Caledonian's merger with British Airways, citing that the merger between the two was not against the public interest.

Other Cases: State-controlled Firms and Takeovers

In July 1990, the SSTI announced that the degree of state control, if any, of the foreign acquiring company would be an important criterion in deciding whether to make a reference to the MMC. The policy was designed to prevent acquisitions of British companies by state-owned or state-controlled foreign interests as a means of "back-door nationalization".¹⁷¹

The new merger reference policy of the Department was based on the proposition that state-controlled companies are always likely to behave in fundamentally different ways than privately owned ones

¹⁷⁰ United States Department of Commerce, *Investment Climate Statement: United Kingdom*, International Trade Administration, March 1988, p. 22.

¹⁷¹ U.K. Department of Trade and Industry, Press notice 90/457, July 26, 1990.

because the state, as a shareholder, is unlike other private-enterprise shareholders. State-owned firms may have objectives distinct from normal commercial objectives, such as maximizing the financial return on a shareholder's investment. They do not face the threat of financial failure. The SSTI raised additional concerns that acquisition by foreign state-controlled firms could result in the control of certain sectors of the economy being in foreign government hands, which would be detrimental to U.K. interests. Also, the market for corporate control could be adversely affected because state-owned firms themselves are generally insulated from takeovers and takeover pressures.¹⁷²

The EC Commission criticized the hard line adopted by the U.K. government towards takeovers of local firms by foreign state-owned enterprises. The Commission felt that since there are fewer state-owned firms in the United Kingdom than in other EC states, the U.K. policy on this issue discriminated against foreign firms. As a result, in October 1991 the U.K. government reversed its earlier policy to refer foreign takeovers to the MMC on the grounds that the foreign acquirer was a state-owned or controlled firm. The U.K. authorities reached an agreement with the European Community to align its policy with EC law; the government pledged that it would refer foreign state-controlled takeovers to the MMC only if the prospective merger or takeover raised issues of public interest (notably security concerns) or if the transaction would have a harmful impact on competition.¹⁷³

From the time the U.K. government announced its merger reference policy involving takeovers by state-controlled firms in July 1990 until its removal in October 1991, five mergers were referred by the SSTI to the MMC for investigation. Four of those cases involved French state-owned companies. Only one of the five cases was blocked. In three of the five cases the SSTI decided to refer the mergers to MMC for full investigation against the advice of the OFT. Some of these cases are discussed below.

¹⁷² *Financial Times (U.K.)*, "Struggling to Hold the Back Door Closed", International Capital Markets and Companies section, May 7, 1991.

¹⁷³ IL&T, U.K. (October 1992), p. 8.

Woodchester / Crédit Lyonnais

The first merger reference by the SSTI (against the advice of the OFT) following the new policy announcement in July 1990 involved the acquisition by Crédit Lyonnais, a French nationalized bank, of a 45% shareholding in Woodchester, an Irish financial services company with operating subsidiaries in the United Kingdom. The reference was made despite the fact that the companies' combined market share was 1% or less, and there was, therefore, virtually no competition problem to be investigated. The MMC accepted in principle that the fact of state control might operate against the public interest but indicated that there could be no general presumption that it does so.¹⁷⁴ The transaction was allowed to proceed.

ICI / Kemira Oy

Of the five cases, the only state-controlled takeover found to operate against the public interest by the MMC involved the acquisition of ICI's nitrogenous fertilizer business by Kemira Oy, a Finnish state-owned chemical company. The MMC's conclusion was based principally on concern about the impact of the merger on competition as a result of the substantial market share that Kemira Oy would have had after the merger, rather than as a result of Kemira Oy's being state-controlled. The decision of the MMC to allow the other mergers to proceed has led, however, to strong speculation in the press that the government's policy to stop "back-door nationalization" may have been undermined by the competition watchdog.¹⁷⁵

Conclusion

In summary, the United Kingdom has one of the most liberal foreign investment regimes among the industrialized economies. There is no law or regulatory body concerned exclusively with investment by non-residents. In the late 1970s, the United Kingdom abolished all forms of exchange controls on inward and outward

¹⁷⁴ Monopolies and Mergers Commission, *Crédit Lyonnais/Woodchester*, MMC report, Cm. 1404, January 1991.

¹⁷⁵ *Financial Times* (U.K.), "Borrie Points to Disarray: Takeover and Merger Policy", May 8, 1991.

direct investment, thereby stimulating capital flows. While the government retains statutory powers under the *Industry Act 1975* to block foreign acquisitions of important U.K. manufacturing undertakings, so far those special powers have never been invoked.

In general, the United Kingdom has few informal investment barriers; however, the application of its merger control law can serve as an informal barrier to FDI. The government emphasizes the pre-eminence of competition issues in reviewing domestic and foreign takeover proposals; but sensitivity to political factors has sometimes influenced the decision-making process, as our case studies clearly demonstrate. In 1990, the United Kingdom adopted a policy to refer takeovers to the MMC when state-controlled foreign companies were involved. These measures were apparently taken in order to avoid so-called "back-door nationalizations". The government, however, subsequently retracted its hard-line policy following objections raised by the EC Commission. In the 1980s, the United Kingdom launched a privatization program that has widened share and property ownership. Foreign equity holdings in many privatized industries have, however, been subject to so-called "golden share" rules, whereby control is retained in the hands of the U.K. government or British nationals.

CHAPTER 5
JAPAN

JAPAN

Introduction

In recent years, Japan has been criticized by its trading partners for the lack of reciprocal access to its markets. Escalating friction on this front is particularly evident with the United States, stimulated by the huge U.S. trade deficits with Japan and, perhaps more importantly, by the tremendous increases in Japanese direct investment in that country. These factors have led to support among some Americans for sanctions and "managed" trade with Japan on a *quid pro quo* basis. Among the European countries, there was considerable sensitivity, throughout the 1970s and 1980s, to the way in which Japanese direct investments often took the form of assembly operations in key strategic sectors.

In response, Japan's relatively closed economy has been opened to some degree over the past decade, in particular, formal FDI regulations have been liberalized. Still, more than in other industrialized countries, there are significant informal barriers to FDI in Japan relating, in large part, to its distinct economic structure and culture. While the flow of direct investments to and from Japan is relatively unimpeded, there continues to be a marked disparity in the level of FDI in Japan and Japanese overseas direct investment activity. This imbalance reflects the difficulties that foreign businesses face in undertaking direct investments in Japan, whether through new business establishments or acquisitions of Japanese companies.

Institutional Developments

In the immediate postwar period, foreign investments were virtually prohibited in Japan gaining approval only after a cumbersome application process. Meanwhile, Japan's role as an investor abroad expanded rapidly. These developments partly reflected a long-standing determination to keep that country independent, both economically and socially but yet to modernize by promoting international trade and investment.

Postwar Japanese policy was based on the *Foreign Exchange and Foreign Trade Control Law of 1949* and the *Foreign Investment Law of 1950*.^{*} Rigid, formal restrictions existed on most imports and incoming capital, allowing little scope for foreign-controlled firms to

operate except through licensing or joint ventures controlled in Japan. Throughout the 1950s and the 1960s, foreign direct investment, whether in the form of new investments or takeovers, was approved only after careful scrutiny.

In 1964, as a member of the OECD, Japan was required to relax controls on the convertibility of the yen. In 1967, the government began to liberalize its controls on direct investment under pressure from other industrialized countries and in accordance with OECD membership stipulations. Through the 1970s, exchange controls on external financing were brought into line with OECD guidelines.

Until 1979, FDI in Japan was strictly regulated under the Foreign Investment Law. This law was repealed in 1979, and controls on FDI were incorporated in a revised *Foreign Exchange and Control Law* (FECL), which became effective on December 1, 1980. The 1980 FECL fundamentally altered the treatment of FDI in Japan from one based on "restriction in principle" to one based on "freedom in principle, unless otherwise specified". The new principle marks the cornerstone of Japan's FDI regime today.¹⁷⁶

In July 1989, the United States and Japan launched the Structural Impediments Initiative (SII) talks, which involved a unique effort by the respective governments to address U.S. concerns pertaining to the relative impermeability of the Japanese market to foreign exports and investment. As a result of the SII talks, the Japanese authorities have agreed to some specific U.S. demands to amend the FECL. These measures are aimed at liberalizing further some of the controls on foreign investment and relaxing other trade barriers.

Recent Investment Patterns

Japanese direct investment statistics provide a clear indication of how the economy remains insulated from foreign capital. The amount of foreign investment in Japan pales in comparison with the amount of Japanese direct investment abroad. Other measures of foreign penetration also indicate the relative insignificance of external capital in the Japanese economy.

¹⁷⁶ Safarian, *Governments and Multinationals* (1983), op. cit., pp. 24-29.

According to direct investment data published by the Japanese Ministry of Finance (MOF), the cumulative value of FDI in Japan reached US\$ 22.8 billion at the end of fiscal year 1991-92. In comparison, the outstanding value of Japanese overseas direct investment in 1991 was over 15 times higher, at US\$ 352.8 billion. Discounting for exchange rate movements, the magnitude of Japanese overseas direct investment since 1980 has, on average, been 14 times higher than the corresponding value of inward direct investment.

Foreign direct investment in Japan over the 12-month period ending March 31, 1992, reached a new high, pointing to a growing interest among foreigners to penetrate the Japanese market. First, Japan attracted a record-high FDI flow of US\$ 4.3 billion, which raised cumulative USFDI in Japan from US\$ 18.5 billion in fiscal 1990-91 to US\$ 22.8 billion in fiscal 1991-92. Second, the average value of investments was in excess of US\$ 1 million for the first time.¹⁷⁷

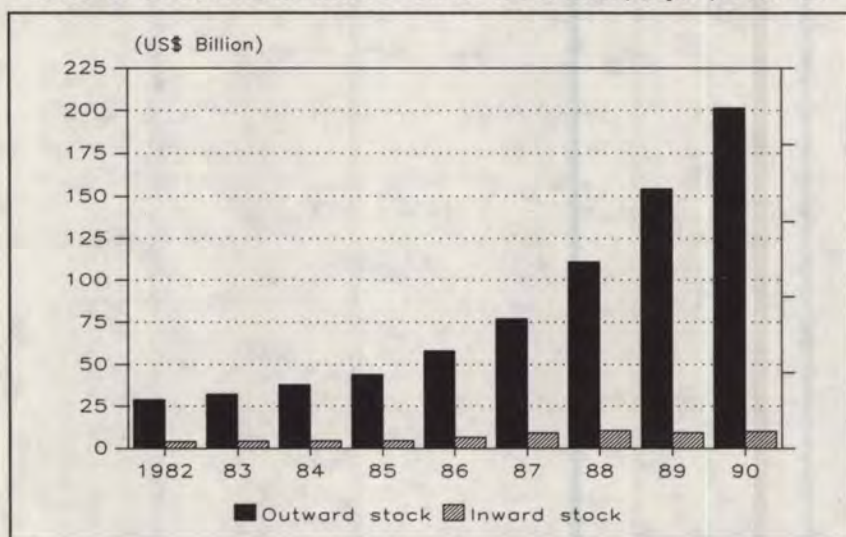
The United States accounts for the bulk of cumulative FDI in Japan (43.5%), followed by the Netherlands (7.8%), Switzerland (5.9%), Germany (4.9%), Canada (4.8%), and the United Kingdom (4.8%) as the other major sources. The U.S. share of cumulative FDI in Japan has dropped sharply since 1989, when it accounted for one-half of the total FDI; in the interim, Canada and the Netherlands have increased their stakes, respectively, from 1.2 % and 4.7% to the present levels.

Other data sources indicate an imbalance between Japanese outward and inward direct investment assets. As illustrated in Chart 5-1, the stock of Japanese overseas direct investment, as a component of the economy's external assets, amounted to US\$ 154.4 billion at the end of 1989. On the liabilities side, foreign direct investment in Japan up to 1989 totalled only US\$ 9.2 billion, or about 6% of Japan's external direct investment assets. The ratio of outward to inward direct investment in fact doubled between 1984 and 1989. It is important to bear in mind as well that the level of Japanese overseas investment would be considerably higher if the

¹⁷⁷ It is more likely that the average value increased not because of a substantial change in the value of transactions, but rather as a result of a proportionately greater decline in the number of cases notified and approved. See Japan Economic Institute, "Foreign Direct Investment in Japan Jumps", *JEI Report* (July 24, 1992, No. 28 B), pp. 4-8.

reinvested earnings of Japanese multinationals were included in the data.

Chart 5-1
Stock of Outward and Inward Direct Investment, Japan, 1982-90



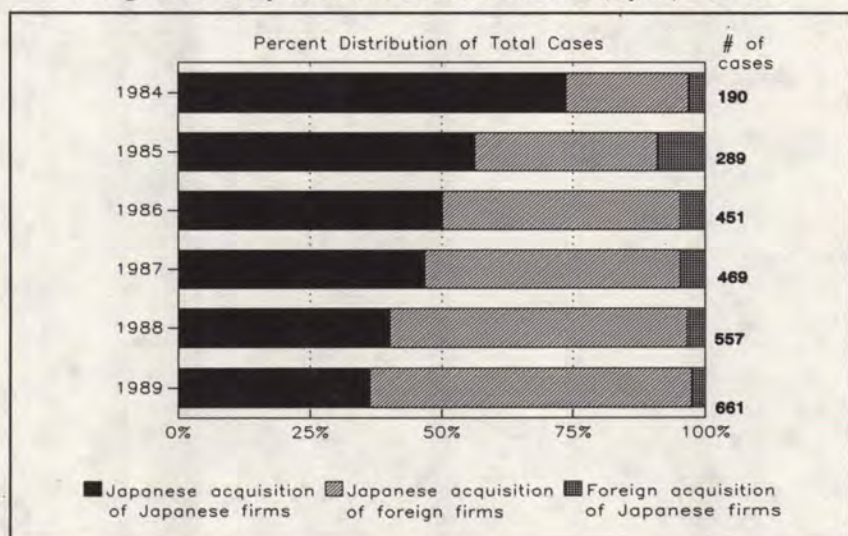
Source: International Monetary Fund, *Balance of Payments Yearbook*, various.

The phenomenal growth of Japan's overseas direct investment in the 1980s resulted from a high level of merger and acquisition activity by Japanese-owned firms. According to a KPMG survey, the cross-border merger and acquisition activity of Japanese multinationals totalled US\$ 18.0 billion in 1990, up 23% from the previous year.¹⁷⁸ In comparison, foreign acquisitions of Japanese-owned companies amounted to only US\$ 24 million in 1990, considerably below the level of acquisitions in the previous year (US\$ 274 million). In short, these figures serve to confirm the sharp

¹⁷⁸ Japan accounted for the largest international acquisition deal in 1990, when the Matsushita Corporation of Japan acquired entertainment giant MCA (U.S.) for US\$ 6.6 billion. Another Japanese company - Fujitsu - ranked 17th among the top 20 deals in 1990 by acquiring ICL, a U.K.-controlled electrical and electronics manufacturer, for US\$ 1.3 billion.

imbalance that exists between outward and inward direct investment activity in Japan.

Chart 5-2
Merger and Acquisition Announcements in Japan, 1984-89



Source: Yamaichi Securities Co. Ltd., "Japan and Mergers: Oil and Water", JEI Report (April 6, 1990, No. 14 A), Table 8, p. 9.

Foreign acquisitions of Japanese-owned companies account for an insignificant portion of overall merger and acquisition activity in the Japanese economy. A study by Yamaichi Securities Co. Ltd. indicates that only 17 of the 661 mergers and acquisitions announced in 1989 (i.e. 2.5%) involved foreign purchases of Japanese-owned firms (see Chart 5-2). The vast majority of transactions involved Japanese purchases of either Japanese or foreign-owned firms.¹⁷⁹ On average, foreign mergers and acquisitions accounted for just over 4% of all transactions announced between 1984 and 1989, peaking at around 9% in 1985.

¹⁷⁹ Japan Economic Institute, "Japan and Mergers: Oil and Water?", JEI Report (April 6, 1990, No. 14 A), p. 1-15.

Table 5-1
Foreign Ownership and Control in Japan

In comparison with other industrialized countries, the Japanese economy remains highly insulated from foreign competition. The following are some indicators of the relative participation of foreign firms in the Japanese market.

- ▶ In 1990, foreign-owned firms accounted for 0.9% of assets, 1.2% of sales, and 0.5% of employment of all industries in Japan. The ratios represented a modest increase from the 1985 shares of, respectively, 0.6%, 0.9%, and 0.3%¹.
- ▶ In 1988, the total stock of FDI in Japan accounted for less than 0.2% of Japan's gross, private non-residential capital stock; despite the liberalization of the FDI regime in the 1980s, this ratio remained virtually unchanged throughout the last decade and is by far the lowest of any G-7 country.

While foreign investors have made very slow progress in penetrating the Japanese market, the foreign companies operating in Japan appear to be performing very well. In December 1989, the Japanese Ministry of International Trade and Industry (MITI) published a report based on a survey of 1,282 majority-owned foreign companies in Japan (i.e. firms in which 50% or more of the ownership was in non-resident hands). According to the survey:

- ▶ Foreign companies in the survey had an average pre-tax profit-to-sales ratio of 6.8% – more than double the 2.8% reported by Japanese companies. In particular, foreign firms demonstrated a relatively superior performance in consumer electronics, where, on average, foreign affiliates reported a pre-tax profit-to-sales ratio of 14.4% versus 4.7% for Japanese companies.
- ▶ The MITI survey also reported that of the 300 most profitable companies in Japan in 1989, 14 were majority-owned foreign affiliates. Rank by profits, and the corresponding percentage of foreign-ownership, these companies included: IBM Japan, 100%; Tonen Corp. (petroleum), 50%; Fuji Xerox, 50%; Coca-Cola Japan, 100%; Esso Seikiyu, 100%; Banyu Pharmaceutical, 50%; Amway Japan, 100%; Nestlé Japan, 100%; Nihon Digital Equipment, 100%; Bayer Yakuhin, 75.6%; Yokogawa-Hewlett-Packard, 75%; NCR Japan, 70%; Nippon Petroleum Refining, 50%; and BMW Japan, 100%.

¹ Data obtained from the office of Trade and Economic Analysis, U.S. Department of Commerce.

Table 5-1 shows several other indicators of foreign participation in the Japanese economy. In addition, the relative performance of foreign-owned firms in the Japanese economy is also outlined in the table. Despite a relatively insignificant presence in the Japanese

economy, majority-owned foreign firms are shown to be more competitive than domestic firms in certain areas of activity.

Formal Barriers to Direct Investment

Regulatory Framework

The amendments to the FECL in 1980 introduced some major changes to the legal framework for the control of FDI in Japan. Under the old system, all FDI was explicitly prohibited unless authorized under a cumbersome application process. The new rules essentially made all FDI in Japan "free in principle" unless specifically prohibited. Formal entry restrictions on FDI were suspended in all but a number of key sectors. Foreign investors were allowed to have majority or 100% ownership of Japanese entities, whether through greenfield investment or by acquisition. With respect to acquisitions, the consent of the target company was no longer required under the new law, thereby making acceptable, in principle, hostile takeover bids.¹⁸⁰ In 1984, the Japanese government further lifted limits on FDI shareholdings in 11 "designated" companies considered to be strategic industries.¹⁸¹

Under the revised FECL and as a result of very recent changes in policy introduced in January 1992,¹⁸² foreign investors are no longer required to seek explicit, official permission for FDI proposals and prior notification to the MOF for all forms of FDI has been replaced with a system of ex post reporting for most types of FDI. Prior notification is now only required for investments in certain designated primary industries and other sectors which concern national security of related interests. In such instances the prospective foreign investor must give prior notification to the MOF,

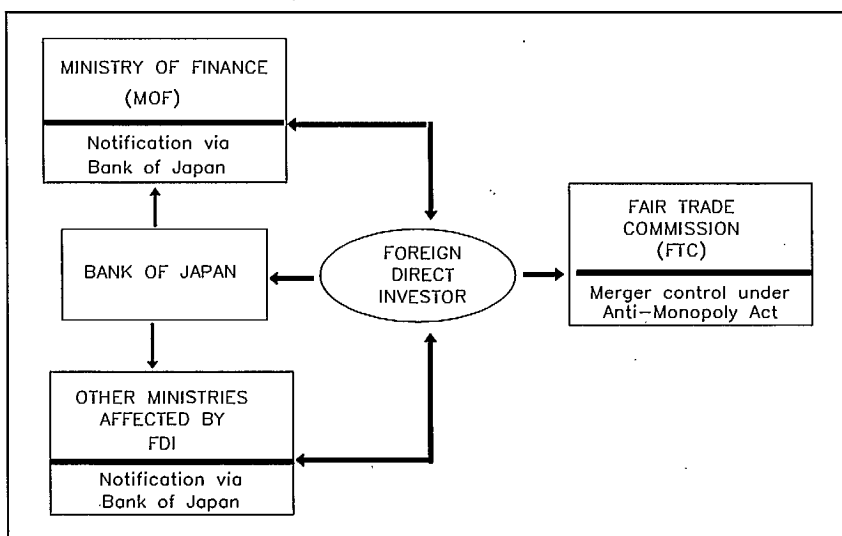
¹⁸⁰ Safarian, op. cit. (1983), p. 26.

¹⁸¹ Under the 1980 amendments to the FECL, prior notice had to be given for foreign purchases of shares in a group of 11 listed companies, where foreign investors already held 25% or more of the companies' shares. Six of them were in oil refining; the rest belonged to the high-technology sector, such as Fuji Electric. These "designated" companies were protected from further foreign equity participation until May 1984, when the system was abolished in response to U.S. pressure.

¹⁸² *Investing, Licensing and Trading Conditions Abroad*, IL&T Japan (July 1992), Business International Corporation, p. 4.

as well as to any other Ministry with jurisdiction over the affected industry, via the Bank of Japan (see Chart 5-3).

Chart 5-3
Regulatory Framework for Control of FDI



Source: Investment Canada.

For those investments that must be notified in advance, the foreign investor must wait for a "suspense" period of 30 days before proceeding with the investment. During the 30-day period, the authorities investigate the details of the investment proposal submitted by the prospective foreign investor. In practice, however, most new foreign investments, including those proposed by established foreign-controlled enterprises, are "automatically granted". Some studies have indicated that the MOF has shortened the period for reviewing notifications to 15 days in routine cases, and the process can take as little as just one day.¹⁸³ In certain exceptional circumstances (so-

¹⁸³ KPMG Peat Marwick McLintock, *Investing in Japan*, London: KPMG (1989).

called "peacetime controls"), however, the government has the power to extend the review period to five months.¹⁸⁴

Article 27 of the FECL gives the MOF statutory power to recommend the indefinite suspension or alteration of a proposed investment, in whole or in part, if the investment is found to jeopardize national security interests or if it could significantly damage the national economy or Japanese enterprises engaged in similar lines of business (these restrictions apply to four industries discussed later in the section on sectoral restrictions). Table 5-2 outlines the FDI review process and the conditions attached to the suspension or alteration of FDI proposals by the MOF.

In addition to direct investment transactions, the FECL (1980) also calls for prior notification of technological agreements between a resident and a non-resident. In particular, residents who wish to conclude a technological induction agreement with a non-resident must jointly submit a report to the MOF and other relevant ministries within three months prior to the agreement date. As with capital investment proposals, there is a 30-day suspense period, which may be shortened or extended to allow for ministerial review.¹⁸⁵ In general, except for technology agreements in certain designated categories and those involving a technology transfer valued at more than Y100 million, the contract can be signed as soon as notification is given. Transactions involving "designated technologies" are reviewed quite thoroughly and often require the licensor and licensee to submit more information than is required for filing of notification (see the discussion of informal barriers).¹⁸⁶

¹⁸⁴ United Nations Centre on Transnational Corporations, *National Legislation and Regulations Relating to Transnational Corporations*. United Nations publications (1988), Sales No. E.83.II.A.7, p. 15.

¹⁸⁵ Price Waterhouse, *Doing Business in Japan*, (1990), pp. 26-27.

¹⁸⁶ D. Bailey, G. Hart, and R. Sugden, *A Description of Recent Japanese Policy Towards Transnational Corporations*, University of Birmingham (mimeo, August 1991), pp. 34-35.

Table 5-2
Legislative Regime in Japan

As of January 1992, the FECL requires foreign direct investors to submit an expost report to the MOF after most investments are made. Prior notification to the MOF via the Bank of Japan (Foreign Exchange Council) is, however, mandatory for direct investments in certain primary industries and other industries that concern national security. Direct investments in Japan are distinguished from other capital transactions. Besides majority equity ownership of enterprises or the establishment of branch operations, investments that come under the direct investment regulations include:

- ▶ any acquisition of shares in unlisted companies;
- ▶ acquisition by a foreign investor of the shares of a listed company that reach 10% or more when added to those owned by related persons; and
- ▶ acquisition of loans of more than one-year maturity or securities privately placed in Japan, *under certain circumstances*.¹

Note that included are foreign investments which make a substantial change in the ownership of enterprises already established in Japan. This requirement applies to foreign investors who already own 50% or more of the enterprise's total stock issue or total subscribed capital.²

When prior notification of direct investment is required, it must be submitted on a prescribed report form to the MOF and other relevant Ministries through the Bank of Japan within three months, or as otherwise designated by the ministerial ordinances, of the anticipated date of investment. Following submission of the report, the investors are subject to the following rule: there is a 30-day suspense period during which the government investigates the report. This suspense period can be shortened to less than 30 days; alternatively, it can be extended up to five months from the date of submission under special "peacetime controls".

Requests or orders for suspension or modification of specific aspects of the direct investment transaction can be recommended if the MOF (or any other Ministry concerned) considers the transaction to:

- ▶ imperil the national security, disturb public order, or threaten the safety of the general public (for example, investments pertaining to nuclear power, weapons, explosives, or special vaccines);
- ▶ have serious adverse consequences on domestic enterprises in the same or related business, or on the "smooth performance of the national economy" (these investments cover the so-called "four exceptions" listed under the OECD Capital Movements Code - agriculture, forestry, and fisheries; mining; oil; leather and leather products);

(continued)

- ▶ the investment is in an area where there is lack of reciprocity or the absence of an international agreement on direct investment between Japan and the investor; or
- ▶ the investment is deemed to be a "capital transaction", which requires obtaining a licence from the MOF under emergency situations.

If the MOF recommends an alteration of the proposed investment, in whole or in part, for any of the above reasons, foreign investors have 10 days within which to alter their direct investment according to the MOF recommendation. If investors fail to make the necessary changes to their plans, the authorities may issue an order to suspend the foreign investment indefinitely; however, the MOF has never used its power to alter or suspend a foreign investment since the FECL was amended in 1980.

¹ Price Waterhouse, *Doing Business in Japan* (1990), pp. 26-27.

² UNCTC, op. cit. (1988), pp. 115-30.

Japan's Fair Trade Commission (FTC) is another administrative agency that can recommend against an investment, whether by domestic or foreign interests, if it violates Japan's antitrust laws. The FTC does not participate in formal government procedures to approve proposed joint ventures, foreign licences, or distribution agreements; instead, its review takes place after the plan has been approved by the MOF and other appropriate ministries.¹⁸⁷

The Japanese securities market is heavily regulated. The most important and comprehensive statute governing public offerings is the *Security Exchange Law* (SEL) of 1948. The Act is administered by the MOF through its Securities Bureau. As in many other areas of economic regulation in Japan, there are few judicial precedents to follow concerning securities law. The normal practice is for the MOF to provide administrative interpretations of the relevant statutes, in the form of directives. These directives provide the guidelines for the day-to-day functioning of the securities market. The bureau administers the law mainly through formal and informal recommendations to securities issuers, brokers, and dealers, or through disciplinary action against them.

On the administrative side, two major amendments to the SEL were made in 1990: (1) the introduction of the so-called 5% rule; and (2) changes in takeover bid (TOB) regulations. To a large extent,

¹⁸⁷ Ibid, p. 4.

the new takeover laws mirror similar laws elsewhere, particularly in the United States. The TOB rules are expected to provide increased flexibility and certainty in making tender offers and to permit hostile acquisitions to proceed in an orderly fashion.

Under the so-called 5% rule, all beneficial owners (and cooperative holders) who acquire more than 5% of the stock of a public company must file a detailed report with the MOF within the five business days following such an acquisition.¹⁸⁸ A copy of the report must also be submitted to the stock exchange and the company. Any material change in the contents of the initial report and any change in ownership of at least 1% of the outstanding shares must also be reported. The purpose of the 5% rule is to prevent an unexpected loss to general investors from fluctuations in the market price as the result of an undisclosed buying-up of block shares.

The TOB regulations have been substantially amended. Takeover bids that are subject to the regulations under the SEL consist of purchases of equity securities in a company that would result in the aggregate shareholding by the bidder (and deemed co-bidders) being in excess of 5% of the aggregate issued shares. Before amendment, this threshold was 10%. If the purchases are made from 10 or fewer sellers during a 60-day period, however, those transactions are outside the scope of the regulation unless the aggregate shareholding after the purchase exceeds one-third of the aggregate issued shares.

Under the new regulations, a tender offer can now be commenced by public notice in a newspaper, giving substantial flexibility and speed to the TOB. Foreign firms are no longer asked to notify the MOF 10 days prior to launching a takeover bid. Instead, on the day of submitting the bid, foreign investors are now required to notify the MOF and to announce through daily newspapers its purpose, the bidding price, the number of shares sought, the bidding period, and other particulars. Also abolished is a previous requirement that the agent of a non-resident bidder be either a

¹⁸⁸ "Beneficial ownership" includes the right to vote and the right to dispose of shares; accordingly, there may be more than one beneficial owner in the case of particular shares. As in the United States, the rules adopt the "group" concept of beneficial ownership: persons bearing a special relationship to each other, or acting in concert, are each deemed to own beneficially all of the shares owned by any of them.

securities company or a bank in Japan; now the bidder may use any resident in Japan as the agent.

Some analysts have pointed out the critical role played by the government as promoter and protector of industry, as well as its regulator. The MOF, while traditionally being responsible for supervising the securities market, also promotes the activities of brokers through regulations and administrative guidance. To address the conflict inherent in this dual role, the MOF recently established the Securities and Exchange Surveillance Commission to monitor stock trading.

Sectoral Restrictions on FDI

As discussed in the previous section, the FECL requires some foreign investors to give prior notice of their investments to the MOF. Foreign direct investment (which includes greenfield investments and acquisitions of stocks in Japanese companies) and investments by foreign-controlled enterprises in Japan are, in most cases, automatically approved except in certain sectors and under certain conditions.

First, FDI in primary industries – agriculture, forestry and fisheries, mining, oil, and leather and leather products manufacturing – is restricted; these restrictions are maintained by Japan as its only formal reservation on inward direct investment under the OECD Capital Movements Code. Restrictions on FDI in these sectors are designed to ensure the "smooth performance of the national economy". Foreign direct investment is also restricted in other industries, including aerospace and electricity generators, for national security and related reasons. The various industries restricted to FDI are outlined in Table 5-3.¹⁸⁹

Agriculture, Forestry and Fisheries

Under the FECL, foreign investments in agriculture, forestry, and fisheries require careful case-by-case examination in

¹⁸⁹ Sectoral restrictions are outlined in detail in OECD, *Japan: Sixth Examination of Reservations to the Code of Liberalization of Capital Movements*, Committee on Capital Movements and Invisible Transactions, Draft Report to the Council, DAF/INV (90) 14 Rev 1, drafted February 26, 1991, pp. 22-35.

consideration of their effects on the national economy. The FDI restrictions in agriculture are imposed in order to ensure stable supplies of foodstuffs, to contribute to the preservation of land and water, and to enable small scale Japanese producers to maintain their livelihood. The FDI restrictions in forestry are motivated by concern for the preservation of forestry resources, while in fisheries, foreign participation is considered to be detrimental to the restructuring of the Japanese fishing industry.

Table 5-3
Sectoral Impediments to Inward Investment
on All or Some FDI Activity in Japan

Industry	Reservation to OECD Capital Movements Code	Other Impediments	Public, Private, or Mixed Monopolies
Banking		X	
Broadcasting (Radio, TV, Cable)	X		
Post, telephone, and communications		X	
Air transport		X	
Maritime transport		X	
Fishing	X		
Mining and minerals	X		
Petroleum	X		
Agriculture	X		
Forestry	X		
Leather and leather products manufacturing	X		
Electricity generation		X	
Tobacco and salt			X

Source: OECD, *Control and Impediments Affecting Inward Direct Investment in OECD Member Countries*, Paris: OECD (1987).

Mining

Although FDI in mining is restricted, the establishment of new enterprises with up to 50% of foreign capital is permitted. Japan's virtual dependence on imported minerals and issues related to the stable supply of mineral resources are reasons for FDI restriction in this industry.

Petroleum

Given Japan's almost complete dependence on imported oil, the stable supply of oil is considered indispensable to Japan's stability and economic growth; thus foreign-controlled firms may be restricted from refining and sales activities. The *Petroleum Industry Law* requires foreign investors to obtain authorization to establish new enterprises and build new oil refineries. Notification or registration is required for oil distribution (these restrictions apply both to residents and non-residents).

*Leather and Leather Products Manufacturing*¹⁹⁰

Under the FECL, FDI proposals affecting this sector are closely scrutinized for their economic impact on Japanese firms. The small scale of domestic enterprises and perceived problems arising from historical and social factors are the reasons for these restrictions.

Banking

The establishment of branches or subsidiaries of foreign banks or foreign securities houses, according to Japanese banking laws, requires authorization and is subject to reciprocity conditions. The MOF must determine whether Japanese banks and securities houses in the applicant country have equivalent status as foreign banks or securities houses; however, no foreign banking applications have been denied or delayed because of reciprocity considerations. Foreign financial institutions may manage investment trust funds in Japan only through a subsidiary.

¹⁹⁰ The four industries – agriculture, forestry, and fisheries; mining; petroleum; and leather and leather products – are in fact grouped together under the terms of one formal reservation in the OECD Code.

Insurance

Foreign insurers are required in all cases to lodge an initial deposit (yen cash) for the establishment of branches. Only yen-cash Japanese government bonds and other securities approved by the government are accepted as deposits from insurers established or to be established in Japan.

Air Transportation

Foreign participation in air transport is restricted in Japan for reasons of national security and public order. A licence to operate an air transport business may be granted only to enterprises where none of its representatives and less than one-third of its officers are non-Japanese nationals, and where less than one-third of its voting rights are held by non-Japanese nationals. Cabotage and other air services in Japan are reserved for national companies, two-thirds of whose voting rights are owned by Japanese nationals, and at least two-thirds of whose directors and whose Director General are Japanese.

Space Industry

In a related sector, FDI in Japan's aerospace industry is subject to scrutiny in order to protect essential national security interests, as well as international peace and security. The activities of the space industry, such as the outflow of space-industry technology, are closely related to the defence industry, even though they are pursued for civilian use.

Maritime Transportation

For reasons of national security and public order, maritime cabotage in Japan is restricted to national-flag vessels. Registration of ships requires ownership by Japanese nationals or by companies incorporated in Japan, whose partners and directors are nationals. Restrictions do not apply on the percentage of foreign shareholdings but depend on the vessel owner's nationality; thus foreigners can obtain a 100% shareholding of a Japanese company that owns Japanese vessels.

Broadcasting and Telecommunications

Foreign participation in Japan's telecommunication sector is restricted through limits on foreign shareholders in Nippon Telephone and Telegraph (NTT), which was privatized in 1985. Furthermore, non-residents may not get a licence to operate a telecommunications business. In broadcasting, non-residents are prohibited from obtaining a licence to operate a radio or television station, and they may not establish a cable television station.

As a result of liberalization in the telecommunication industry, many new common carriers have entered the changing telephone market. Foreign participation is allowed up to a maximum of 33% of the stock of new common carriers; in broadcasting, foreigners can own up to 20% of the stock.

Electricity Generation

Foreign direct investment in the electric utility industry is subject to careful examination in order to ensure the maintenance of public order and the protection of public safety. The rationale for restricting FDI in the industry is that accidents in the generation of electricity would pose a danger to Japan's people and to economic activity, and restoring the supply of electricity from an alternative source would be difficult.

Monopolies

Foreign direct investment is prohibited in public monopolies, which include postal services, tobacco manufacturing, and the purchase, import, manufacturing, and sale of salt.¹⁹¹

There are no restrictions or discriminatory measures against foreign investors after establishment.

Antitrust Framework and Mergers Policy

The Fair Trade Commission (FTC), an independent agency associated with the Office of the Prime Minister, is responsible for

¹⁹¹ OECD, *Control and Impediments Affecting Inward Direct Investment in OECD Member Countries*, op. cit., pp. 47-49.

administering the 1947 *Anti-Monopoly Act* (AMA - originally written by the occupying authorities), the basic legal instrument for control of antitrust policy in Japan. In general, as is the case in most countries, Japan's antitrust legislation applies to both domestic and foreign enterprises. There are, however, two exceptions: merger provisions of the AMA apply only to Japanese enterprises but may also apply to a foreign enterprise which establishes a Japanese subsidiary if the subsidiary merges with another Japanese enterprise; and (b) provisions which restrict the shareholding practices of large financial companies apply only to Japanese enterprises (including Japanese subsidiaries of foreign enterprises). The AMA contains provisions that deal with certain stock acquisitions by companies and other business entities, mergers, and the acquisition of businesses. Such transactions may be prohibited where their effect is to "substantially restrain competition in any particular field of trade" or where unfair trade practices are used to accomplish such transactions.

Under the AMA, mergers and the acquisition of businesses require prior notification to the FTC; by contrast, the acquisition of stock, even when it involves the purchase of the majority of the voting stock, is not subject to pre-notification (these transactions, however, must be notified to the MOF under the FECL). Pre-merger notification is mandatory for all mergers irrespective of size, but pre-notification for the acquisition of a business is mandatory when, among other factors, the transaction involves the acquisition of whole or a "substantial part" of a business or fixed assets used for business in Japan.¹⁹² There is a 30-day waiting period after notification is given before a proposed merger or acquisition may proceed. The FTC, however, has the discretion to shorten or extend the required waiting period, but an extension may not exceed 60 days.

Since 1947, the AMA has been amended three times—in 1949, 1953, and, most recently, 1977. The 1977 amendment introduced measures to control the acquisition of stocks by large non-financial companies and all financial companies, which threaten to lessen competition. The 1977 amendment to the AMA introduced

¹⁹² Toshiaki Takigawa and Mitsuo Matsushita, "Japan", in J. William Rowley and Ronald J. Baker, eds., *International Mergers: The Antitrust Process* (Sweet and Maxwell: 1991), pp. 868-85. The provisions dealing with mergers applies to Japanese companies but can extend to a foreign company that establishes a Japanese subsidiary if the subsidiary merges with another Japanese company. Restriction on stockholdings applies to Japanese companies, including Japanese subsidiaries of foreign companies.

provisions that in effect prohibit large non-financial stock companies (those with capital in excess of Y10 billion or net assets in excess of Y30 billion) from acquiring or holding stock of companies in Japan in excess of their capital or net assets, whichever is greater. Financial companies are prohibited from acquiring or holding more than 5% (10% in the case of insurance companies) of the total outstanding stock of a Japanese company.¹⁹³ Table 5-4 gives a summary of merger control policy in Japan.

The primary objective of these provisions is to prevent the concentration of economic power through either the formation of corporate groups or the control by financial companies of other companies. Institutional investors, mostly banks and insurance companies, account for a large segment of the shareholdings in many companies by virtue of being a major source of finance for non-financial companies (see discussion in the section on informal barriers). Both banks and insurance companies can seek an FTC exemption from these thresholds, depending on the transaction. While the acquisition of stocks by foreign companies is not subject to pre-notification, the AMA law does require foreign non-financial corporations that own stocks in a Japanese company to file an annual report with the FTC within three months of the fiscal year-end of the Japanese company.

In addition, certain international contracts (including stock and asset acquisitions) between foreign and Japanese companies are subject to special notification requirements where such agreements may contain provisions constituting unreasonable restraint of trade or unfair trade practices. The FTC rules identify five kinds of contracts, including joint ventures or technology licences, that must be notified to the FTC within 30 days after being concluded. The review procedure normally takes 60 days, and alterations to the contract are negotiable. In effect, the FTC may review and suspend, or call for alterations to, existing contracts at any time for breach of antitrust rules, even after the transaction is formally approved by the MOF and other relevant Ministries. Foreign investors therefore face the prospect of having approved contracts reviewed and modified by the Japanese authorities.

¹⁹³ *Ibid.*, p. 868.

Table 5-4
The Merger Review Process in Japan

In Japan, mergers, acquisitions, and stockholdings are prohibited under the *Anti-Monopoly Act* (AMA), when they may result in substantial restraint of competition. The Act is administered by the Fair Trade Commission (FTC), and, in general, applies to both domestic and foreign companies. Under the Act, mergers and the acquisition of businesses (but not stock purchases) must be notified to the FTC prior to consummation. The following outlines briefly some of the main elements of the above transactions:

- ▶ A pre-merger notification must be filed with the FTC, regardless of the size of the merger; mergers involving the banking, transportation, electricity, and gas sectors are subject to specific laws related to those industries.
- ▶ The acquisition of stocks is not subject to pre-notification, even when they result in the purchase of the majority of the voting stock. Companies must, however, meet certain annual reporting obligations for stockholdings: non-financial domestic companies whose assets exceed ¥2 billion (US\$ 1.5 million) must report to the FTC within three months of the last day of the business year.
- ▶ Pre-notification to the FTC for the acquisition of businesses must be made when the acquisition involves:
 - the whole or a "substantial" part of, a business or fixed assets used for a business in Japan;
 - the leasing or management of the whole, or a substantial part of, a business in Japan; or
 - a contract providing for a joint profit-or-loss account for a business in Japan.

Amendments to the AMA in 1977 introduced prohibitions that apply specifically to stock acquisitions or holdings of large non-financial companies and all financial companies. In particular:

- ▶ Non-financial firms capitalized at ¥10 billion (US\$ 74 million) or more and with net assets of ¥30 billion (US\$ 223 million) or more may not hold shares in companies that exceed their paid-up capital or net assets, whichever is greater; and
- ▶ Banks may not own more than 5% of the shares of a single company (the limit is 10% for insurance companies).

Once a notifiable transaction (either a merger or business acquisition) is reported to the FTC before consummation, there is then a 30-day waiting period during which the merger or acquisition may not proceed, and the FTC investigates whether or not the transaction will result in substantially restraining competition. This requires an investigation of a host of relevant

(continued)

market factors. The FTC may shorten the suspense period or, in consultation with the parties, lengthen it to a maximum of 60 days.

Notifiable transactions may not be consummated before the statutory waiting period has elapsed. The FTC may use remedial powers such as injunctions, prohibitions, dissolutions, or divestitures against transactions that reduce competition substantially. Most problematic mergers and acquisitions are settled, however, in consultations between FTC and the parties before they are notified. Formal merger investigations have rarely been conducted by the FTC; in fact, there have been no investigations since 1974.

In general, the FTC has considerable autonomy to pursue its investigations under the AMA. Other agencies, in particular the pro-business Ministry of International Trade and Industry (MITI) has been known to encourage mergers, both horizontal and vertical, in the interest of economic efficiency. The MITI and other Ministries are not prohibited from issuing their own opinions on a particular merger but the FTC is not required to concur with those opinions.

Merger control provisions under the AMA were prohibitive in the early days of the legislation. The restrictive provisions were largely abolished with amendments to the AMA in 1949 and 1953. There have been only 20 merger cases since the AMA was enacted, and the last formal case was decided in 1973. Most mergers that run into problems are generally discussed and resolved during the pre-notification consultations between the FTC and the merging companies (see below).¹⁹⁴

Informal Barriers to Direct Investment

Despite various government measures introduced to liberalize the FDI regime in Japan over the last decade, foreign investors continue to face a host of institutional and cultural barriers. Many of these are subtle, and formidable. They account for the relative impermeability of Japan to foreign investment.

In Japan, FDI via greenfield investment (or through expansion of existing businesses) is relatively easier to achieve than via mergers

¹⁹⁴ Ibid., p. 876.

and acquisitions. The liberalization of Japan's investment laws cleared the way for foreign firms to acquire control, or even ownership, of existing Japanese ventures. Occasional government intervention and a market characterized by cross-shareholdings have, however, been effective deterrents against foreign participation in domestic merger and acquisition activity.

As an alternative to takeovers, the vast majority of foreign multinational companies have shown a strong preference for the wholly owned (100%) subsidiary as the medium for breaking into the Japanese market.¹⁹⁵ Some well-known foreign multinationals like IBM, Texas Instruments, Bang and Olufsen, Motorola, Eastman Kodak, General Electric, Procter and Gamble, and others have successfully established new businesses in Japan. Even in this environment, many established foreign firms confront significant hurdles in competing with Japanese enterprises. These informal obstacles relate to exclusionary business practices and cultural idiosyncrasies that are inherent in the Japanese business system. The various forms of FDI barriers are discussed in the following sections.

Obstacles to Takeovers: The Ownership Barriers to Takeovers of Quoted Companies

Measured by market capitalization, the Tokyo stock exchange is among the three largest markets in the world. Relative to the United States and the United Kingdom, however, the ownership of the publicly traded companies is highly concentrated in the hands of institutional investors as opposed to individuals. This basic structural characteristic of the market and the high degree of cross-shareholding that exists among business groups in the Japanese *Keiretsu* structure are significant obstacles to the success of hostile takeovers in Japan.

Banks, insurance companies, manufacturers, and other institutional investors control far more of the shares of publicly owned companies in Japan than individuals. The distribution of equity shareholdings among different classes of investors indicates that roughly three-quarters of the equity of publicly traded companies at the end of fiscal year 1990 was owned by institutional investors; Japanese individuals accounted for the balance. In contrast,

¹⁹⁵ A. T. Kearney, *Trade and Investment in Japan: The Current Environment*, American Chamber of Commerce in Japan (June 1991), p. 2.

institutional investors owned about 53% of the market value of all U.S. equities in 1990 as opposed to the 47% owned by individuals.¹⁹⁶

The institutional investors in any one of the nearly 2,100 companies listed on the Japanese stock exchanges (Tokyo, Osaka, and other exchanges) typically include other members of the same corporate groupings or *keiretsu*, the firm's customers, its major bank, as well as other banks providing financing, plus the insurers that handle the companies' pension funds or corporate insurance. Financial institutions, such as banks and trust banks, life insurance, and non-life insurance companies, own about 63% of the corporate equity held by institutional investors in Japan, while non-financial corporations (industrial and commercial companies) make up the balance. Moreover, excluding brokerage houses and investment trusts that normally invest for short-term gains, the data suggest that the vast majority of the Japanese institutions are composed of businesses that have invested for the long haul.

Among the financial institutions, banks hold a considerable stake in publicly traded companies. The availability of bank credit has been of great importance for Japanese industry. The proportion of capital employed in industry has primarily come through the banking system rather than through the share market. As discussed in the previous section, banks in Japan are allowed to hold up to 5% of the shares of a non-bank company (banks in the United States are prohibited from owning non-bank shares in order to avoid a concentration of financial power). The bank that coordinates lending to a business and oversees its financial status is expected to have the largest shareholding among the banks. Therefore, a company's lead bank will usually consolidate its position by purchasing 4% to 5% of the firm's shares; coupled with the substantial investments in equity in Japan by insurance companies, as much as 40% of a non-bank corporation's outstanding stock can be held by financial institutions as a group.

The concentration of ownership of publicly traded companies in the hands of Japanese institutional investors who are motivated by long-term objectives as opposed to short-run profit-oriented goals is a

¹⁹⁶ Japan Economic Institute, "Corporate Governance in Japan", *JEI Report* (September 4, 1992, No. 34 A), pp. 2-8.

significant obstacle to the success of hostile takeover bids in Japan. A related issue, bearing directly on the distribution-of-ownership pattern, is the existence of a complex network of cross-shareholdings among Japanese companies under the Japanese *keiretsu*.

Keiretsu are groups of firms characterized by close business relations and long-term business commitments among their members. Firms in these groupings are linked to one another through cross-shareholdings, time-honoured buyer/supplier arrangements, interlocking directorates, the interchange of personnel among constituent companies, and the sharing of information concerning product development and distribution. Businesses in the *keiretsu* engage in mutual shareholdings with the understanding that their shares will not be traded on the stock exchanges as long as the partnership lasts. As a result, it is individuals and not investors that dominate trading in the stock exchanges in Japan, even though they do not dominate share ownership. According to one source, individuals account for two-thirds of the activity on the Tokyo Stock Exchange but own only 22% of all stocks in Japan.¹⁹⁷

The *keiretsu* can be characterized as having several fairly distinct forms of inter-firm groupings. An important form of *keiretsu* organization consists of corporate groups that are primarily vertical in nature. A manufacturing concern stands at the centre of a supply-distribution network and usually dominates the other group members who make up the main company's subsidiaries, subcontractors, and important customers. In these vertical arrangements, each member fulfils a specific function and is fully integrated into the production and marketing strategies of the core manufacturing business. In addition, this form of corporate structure is strengthened by long-term, mutual agreements concerning supplier/buyer relations that exist largely under an unwritten, intragroup covenant.

Large Japanese companies have extensive cross-shareholdings through which they consolidate vertical (upstream) linkages in their respective lines of business. When one enterprise is highly dependent on another company for supplies, and hence for its

¹⁹⁷ Lincoln, E.J., "Japanese Bonds and Stock Markets" in Okimoto, D.I. and Rohlen, P. (eds.), *Inside the Japanese System: Readings in Contemporary Society and Political Economy*, California: Stanford University Press (1988), pp. 58-60.

uninterrupted operations, a substantial portion of the dependent firm's stock is often held by the other.

Examples of vertical groups include Nissan and Toyota in the auto industry, Nippon Steel in metal production, and Hitachi and Toshiba in electronics. Major firms, such as Toyota Motor Corporation, and Nissan Motor Company Ltd., have representatives on the boards of subcontractors and parts suppliers by virtue of cross-stockholdings.¹⁹⁸ In addition, control in vertical structures is sometimes established by means of exclusive sales arrangements instead of stock ownership. For example, Aisin Seiki Co. Ltd., a manufacturer of transmissions, clutches, brakes, and other automotive products, is a member of the Toyota Group, a group that sells 70% of its output to Toyota. These types of vertical distribution groups protect vertical suppliers from the threat of foreign buy-outs, while at the same time they make it difficult for new foreign suppliers to penetrate the market by establishing greenfield investments.

In horizontal *keiretsu*, linkages among the industrial groups are far-flung, stretching to almost every corner of the economy. Unlike the vertical *keiretsu*, which have a relatively tighter, more concentrated membership, firms within the horizontal *keiretsu* can range from textiles to insurance, from auto production to construction, and from consumer electronics to breweries. They typically exhibit extensive cross-shareholding, and they also engage in intragroup financing by a common bank.

Even more powerful, and with greater implications for economywide control in Japan, is the existence of the so-called financial *keiretsu* (*kinyu keiretsu*). In this case, groups of firms are organized around a financial institution. A few Japanese banks and insurance companies are the dominant players in this system, wielding a considerable degree of power and control over Japanese non-financial corporations. Member firms of the financial *keiretsu* buy and sell shares to each other, but the cohesiveness of the group is maintained through extensive mutual stockholdings, through the role of banks as a major source of finance, and by the personal contact and rapport among its leaders.¹⁹⁹ In contrast to the

¹⁹⁸ Japan Economic Institute, "Japan and Mergers" (1990), op. cit., p. 10.

¹⁹⁹ There are six financial institutions in the *keiretsu* – namely, Mistui Bank, Mitsubishi Bank, Sumitomo Bank, Fuyo Bank, Sanwa Bank, and the Dai-Ichi Kangyo Bank.

enterprise groups, the members of the *kinyu keiretsu* are linked primarily by financial considerations rather than by products.

Table 5-5 summarizes the ownership barriers to takeovers of publicly traded companies in Japan. The relative importance of institutional investors and the existence of the industrial and financial *keiretsu* result in extensive cross-stockholdings in Japan, which is a significant impediment to the success of hostile takeovers. In this environment, foreign acquisitions may be accomplished if institutional investors are in favour of the takeover. This can lead to so-called "friendly" forced acquisitions, where the foreign acquiring company bypasses a hostile management and takes its case directly to the shareholders. The promise of relatively better performance, and of higher dividends and prices, by the acquiring company may be sufficient to persuade shareholders to pressure management to agree to the acquisition.

Table 5-5

Takeover Obstacles: Ownership of Listed Companies and the *Keiretsu* in Japan

In Japan, long-term institutional investors account for a significant proportion of the ownership of publicly owned companies:

- ▶ In 1990, Japanese banks, insurance companies, manufacturers, and other institutional investors held about 72% of the shares of publicly owned companies; Japanese individuals owned 23% of those shares, while foreigners (both individuals and institutional investors) held roughly 5% of the shares.
- ▶ Among Japanese institutional investors, banks (including trust banks) and insurance companies accounted for 43% of the equity ownership, while non-financial companies held a quarter of those shares.

More significantly, as institutional investors, there are many Japanese corporations that engage in extensive mutual stockholding within the *keiretsu* business structure. The cross-stockholdings symbolize long-term business ties among the companies, and these shares are not traded as long as the partnership lasts. For example, in one form of the *keiretsu*, Japanese auto makers like Toyota and Nissan often have representatives on the boards of subcontractors and parts suppliers by virtue of cross-stockholdings. In addition, insurance companies and trust/pension-fund institutions form an important part of a company's "stable shareholders"; because these firms are interested in long-term dividend income, they tend to hold shares rather than actively trade them.

(continued)

The *keiretsu* business groups are very dominant players in the Japanese stock exchanges. For example:

- ▶ A study by Jarding Fleming Securities indicates that of the 1,612 companies listed on the Tokyo Stock Exchange (TSE) as of November 1990, 1,100 belonged to *Keiretsu* groupings (financial and industrial) and accounted for 78% of its market capitalization.
- ▶ Of these, 846 companies, representing 61% of the TSE's market capitalization, belonged to the bank-centred *keiretsu* (*kinyu keiretsu*); 254, amounting to 17%, were members of the industrial enterprise groups.

The effect of cross-stockholding and stable shareholding of equity within the various forms of the *keiretsu* organization is to reduce sharply the percentage of shares traded on the open market, thereby limiting the opportunity for "outsiders" to acquire shares. Consequently, an important characteristic of the stock market is that individuals tend to dominate trading in the markets even though they do not dominate share ownership.

From the perspective of the stable shareholders, the long-term stability and growth of the company is an important corporate objective, and this goal itself plays a decisive role in defeating hostile takeover bids. At the same time, though, these shareholders can put pressure on management to accede to a merger or acquisition if they feel it is in their best interests.

There is evidence to indicate that the cohesiveness of the financial *keiretsu* has been gradually eroding since Japan deregulated its financial markets in the 1980s.²⁰⁰ Financial deregulation paved the way for Japanese firms to directly raise capital in equity markets in Japan and abroad; this may explain the decline in the importance of the six major financial *keiretsu* – centred on the Mitsui, Sumitomo, Fuyo, Sanwa, Mitsubishi, and Dai-Ichi Kangyo – as sources of finance for Japanese firms. Furthermore, the average size of shareholdings in a bank-centred *keiretsu* has decreased significantly in recent years. For example, as of March 1990, each company within the financial

²⁰⁰ These financial groups accounted for 35% of the lending to Japanese firms on the Japanese stock exchanges at the end of fiscal year 1988, down from 40% in 1974. By another measure, the dependence of large Japanese corporations on the *keiretsu* to finance their operations dropped dramatically during this period – from 46.7% in fiscal year 1974 to 11.1% in fiscal year 1988. The percentage of total shares in Japan owned by the six financial *keiretsu* also dropped from 23% in fiscal year 1974 to about 16% in fiscal year 1988. See Japan Economic Institute, "Keiretsu and Other Large Corporate Groups in Japan", *JEI Report* (January 12 1990, No. 2 A), pp. 10-11.

keiretsu held an average of 1.42% of the total shares of other companies, down from 1.52% of shares held three years earlier.²⁰¹

The recent economic slowdown, weak stock market performance, and shrinking corporate profits in Japan are causing some institutional investors to question the efficacy of the Japanese system of corporate governance. In this system, management, with the backing of mostly friendly institutional investors, is given a relatively free hand in managing the long-term success of companies, while being less preoccupied with short-term profit-maximization goals. Return on investment in terms of dividends in the near term are less of a concern to shareholders, just so long as the company is capable of producing a reasonable long-term return.

The economic downturn and depressed stock prices, however, have prompted institutional investors to review their long-standing relationships with management. There is optimism that institutional investors will promote a shift in corporate philosophy that will lead to an increase in management accountability in the future. Through the process of change, Japanese business practices may well become more transparent.²⁰²

Other Barriers

The degree to which the liberalization of formal FDI barriers in Japan has succeeded in opening the economy to foreign investors must be ultimately judged against the continued presence of other institutional and cultural barriers. Apart from the strong takeover obstacles created by the *keiretsu* business structure, there remain a host of other institutional barriers that impede FDI in Japan. The important barriers, as identified by foreign investors – most notably the U.S. administration and U.S. business – are summarized in Table 5-6.

The U.S.-Japan SII talks, which were launched in July 1989 and culminated in a Joint Report in June 1990, were an effort to identify structural impediments to international trade and investment in both economies. Japanese barriers to trade and investment were perceived

²⁰¹ IL&T, Japan (July 1992), op. cit., p. 8.

²⁰² Japan Economic Institute, "Corporate Governance" (1992), op. cit.

by the U.S. administration as factors contributing to the significant and growing bilateral U.S. trade deficit with Japan in the 1980s.²⁰³ The Joint SII Report calls for the Japanese authorities to take measures to remove structural barriers to trade and investment in six specific areas.²⁰⁴ Antitrust-related measures figure prominently in these commitments. Some of the important barriers are discussed below and are summarized in Table 5-6.

Distribution System

Japan's complex distribution system was a major issue during the SII talks. Critics felt that the complexity and rigidity of Japan's distribution system raises the cost of new market entry and limits penetration by foreign firms. In fact, Japan's distribution sector is considered to be a third distinct form of *keiretsu* that is essentially organized by manufacturers to tie together their retail and wholesale outlets.²⁰⁵

Many Japanese retail outlets for manufactured goods are not independent entities; instead, they engage in subcontractor-type relations that give Japanese manufacturers considerable control over the market. In addition, the relationship between distributor and manufacturer is one in which the former provides the latter with information concerning the type of products to be manufactured. Moreover, distributors and retailers in Japan tend to promote the product of one company, effectively barring other firms from entering the market since the cost of establishing an independent distribution system would be prohibitive.

²⁰³ Despite the elimination of most of Japan's formal tariff and non-tariff trade barriers, the adoption in both countries of macroeconomic policies intended to move the trade accounts in the direction of equilibrium, and a 50% appreciation of the yen against the dollar, the impact on the U.S. trade deficit had been disappointingly weak.

²⁰⁴ Japan promised to boost public works spending over the next 10 years to bridge its savings-investment gap; speed up and streamline the regulatory process for opening or expanding large retail outlets; overhaul land-use policies, including the relevant parts of the tax system; strengthen antitrust enforcement to counter exclusionary business practices; make *keiretsu* relationships more open and transparent; and promote measures to lower prices at home.

²⁰⁵ Recent developments in the SII talks are summarized in R. D. Anderson, "Competition Policy Aspects of the U.S.-Japanese Structural Impediments Initiative: Implications for Canada", *Canadian Competition Policy Record* (Ontario: Fraser & Beatty Publications Inc., May 1991), pp. 39-47.

Table 5-6
Structural Impediments to Trade and FDI in Japan

For many years the U.S. administration and U.S. businesses have identified many structural and institutional barriers that impede trade and investment by American (as well as other foreign-owned) companies in Japan. Perceptions in the United States regarding trade and investment barriers for U.S. firms seeking to enter the Japanese market were formally addressed in the SII talks. The major barriers, in no order of importance, can be outlined as follows:

- ▶ **The high cost of doing business in Japan** (relative to other countries) caused by high land prices and the resulting impact on rents, housing, and industrial real estate.
- ▶ **Multi-tiered distribution systems** characterized by exclusive trading relationships, cross-ownership with manufacturers, and high-cost physical distribution.
- ▶ **Interlocking business and ownership relationships known as *keiretsu***, which tend to favour doing business within the *keiretsu* group rather than with foreign or domestic outsiders, and related exclusionary business practices.
- ▶ **Ministry guidelines, policies, and regulations that lack transparency and often consist of administrative guidance** to Japanese firms, thereby discriminating against foreign companies.
- ▶ **Difficulties in locating and hiring qualified personnel** in a labour market characterized by extreme shortages, lifetime employment, and attitudes that discourage employment with foreign enterprises.

Since the SII Joint Report was announced in 1991, the FTC has taken a number of steps to implement some of the specific commitments of the agreement. For example:

- ▶ In response to concerns about Japan's highly fragmented and layered distribution system, the authorities streamlined the regulatory process for opening and expanding large stores by removing abuses under the *Large Retail Stores Law*; until then, this piece of legislation was a significant legal barrier for large stores seeking to open business in communities.
- ▶ To strengthen antitrust enforcement against exclusionary business practices in distribution, anti-monopoly surcharges were raised from between 0.5% and 2% to 6%.
- ▶ The authorities have also issued specific "get-tough" guidelines under the AMA concerning unfair practices in distribution, with respect to patent and know-how licensing agreements, and import distributorship contracts.

(continued)

Notwithstanding the accomplishments, the U.S. administration indicated a desire to "reinvigorate" SII in early 1992.¹ In its opinion, Japanese efforts to meet commitments concerning exclusionary business practices and *keiretsu* relationships have not been fully satisfactory; the pricing mechanism and the distribution system are also contentious issues, but less of a priority, while Japan's saving/investment imbalance and land-use policies are no longer a target.

¹ Japan Economic Institute, "Washington, Tokyo Examine Ways to Revive SII Process", JEI Report (March 6, 1992), pp. 7-8.

High real estate prices and stringent regulations on opening stores in Japan have created significant entry barriers for new distributors, while protecting existing firms. In general, the acute shortage of retail space has resulted in exorbitant rents that impede the entry of newcomers into the retail business. In addition, government agencies have considerable discretion with respect to the issuance of permits.²⁰⁶

The fragmented nature of the Japanese distribution system has been perpetuated by particular legislation known as the *Large Retail Stores Law*. Until recently, many aspects of this law were considered to be the source of the most pressing problems in the Japanese distribution system. The law protects small retailers by imposing extensive restrictions on the activities of all stores with floor space of more than 500 square metres.

The SII talks committed the Japanese authorities to increase the transparency of Japan's complex distribution system and to promote fairness in business practices. In particular, Japan undertook to strengthen antitrust enforcement against anti-competitive practices in the distribution sector and to address, by legal steps and voluntary guidelines, the problem of business practices that restrict competition or exclude foreign firms from business opportunities in Japan. Reform of the Japanese system through deregulation, strengthened antitrust enforcement, and the improvement of import-related infrastructure is expected to ease the entry of new firms and allow imports to penetrate the Japanese market with more speed and less cost.

²⁰⁶ Ibid., pp. 27-29.

For example, the Japanese authorities have streamlined the regulatory process for opening and expanding large retail outlets by removing abuses of the Large Retail Store Law. The MITI's administration of the law had turned a "notification" process into an approval system for large store openings and for the expansion of existing retail services. Potential store owners had to reach a consensus with local commercial interests before MITI would allow the formal notification process set by the law to begin. The law in effect gave small merchants the legal authority to stop, or indefinitely delay, a new large store from opening in their communities. The law required "adjustment" between store owner and local community of store size, hours, opening days, and number of store holidays.

The authorities have also taken some measures to strengthen antitrust enforcement against exclusionary business practices in the distribution sector. For example, the FTC has raised the anti-monopoly surcharge to 6% on sales, from between 0.5% and 2%. This surcharge on sales was imposed on companies found to have illegally formed cartels. In reviewing these measures, however, the U.S. administration argued that the surcharges – the principal means by which violators of the AMA are punished – need to be higher; they cited surcharges near the European level of 10% as a more effective deterrent. The Japanese government has also issued many guidelines on unfair trade practices in distribution and related business practices (e.g. customer allocation agreements, exclusive dealing, resale price maintenance, and non-price vertical restraints).

Government / Business Linkages: Administrative Guidance

In general, business is more regulated in Japan than in most other industrialized countries. This regulatory activity is usually undertaken in private in the form of consultations with relevant Ministries and industries. The MOF normally provides directives on many aspects of Japanese regulations; these take the form of so-called "administrative guidance".

Foreign firms may not have equal opportunities to participate in the process by which the MOF or any other department develops official policies relating to these directives. In fact, some foreign investors in the banking sector have noted that it is difficult to get any clear written statements of the rules or policies. The lack of transparency of government rules, and the informal ways in which

they are put into practice generally tends to leave considerable latitude for the authorities in matters affecting foreign investors.

For sensitive investments, a three-pronged discussion among the Japanese firm, the foreign investor, and MITI usually occurs. In some cases, representatives of industry groups or rival manufacturers that feel threatened by the new investment join these discussions. Foreign investors have sometimes found it to their advantage to engage in informal talks with MITI before filing a formal application for approval of a direct investment.

Some authors have concluded that "while the scope for exercising administrative guidance to deny foreign investment was reduced by the 1980 changes to the FECL, the practice is still very much alive".²⁰⁷ In essence, the "pre-notification discussions" form a key part of the system of administrative guidance. At such discussions, foreign investors are informally briefed by relevant Ministry officials of the terms and conditions under which their investment proposal is likely to be approved.

Pre-notification discussions are generally more significant in non-routine situations or in those cases where foreign investment is in sensitive technologies. In fact, failure to discuss a sensitive investment proposal with Ministry officials prior to submitting a formal notification can result in a refusal to accept notice on the grounds of insufficient information. "Insufficient" information implies a failure to engage in pre-notification discussions and a failure to provide information when requested by the relevant officials. In particular, international contracts that cover the transfer of intangible assets such as patents, know-how, designs, or trademarks between foreign investors and Japanese businesses in "designated technologies" require extensive pre-notification negotiations with MITI.²⁰⁸

²⁰⁷ David Birebaum and Sharon Zackula, "Foreign Investment in Japan: Current Limits and Restrictions", *East Asian Executive Reports* (October 9, 1988), pp. 15-20.

²⁰⁸ Bailey, Hart, and Snugden, "Policy Towards Transnational Corporations" (August 1991), *op. cit.*, pp. 35-36.

Keiretsu Relationships and FDI

In addition to being a formidable barrier to hostile takeovers, the network of formal and informal ties among Japanese companies, known in Japan as *keiretsu*, can promote preferential group trade, negatively affect FDI in Japan, and give rise to anti-competitive business practices. To address these problems, the SII report calls upon Japan to make the *keiretsu* relationships more open and transparent and to take specific measures to achieve that objective. The measures include strengthening the powers of the FTC, which will publish guidelines to clarify enforcement of the AMA to ensure that the *keiretsu* neither hinder fair competition nor discriminate against foreign firms. In addition, the authorities agreed to restrict cross-holdings of shares and to require divestiture of shares when the FTC determines that such shareholdings may lead to violations of the AMA.

The government also committed itself to amending certain provisions of the FECL in an effort to further liberalize Japan's policies on FDI. In particular, the amendments would abolish the broad authority of the Japanese government to block FDI on economic grounds; and relax, or abolish, the prior notification requirement for FDI and the importation of technology into Japan.

The SII talks called for the Japanese authorities to provide more transparent and fair procedures for the implementation of "administrative guidance" in order to ensure that it does not restrict market access or undermine fair competition.

State-controlled Enterprises

Like most other industrialized countries, Japan launched a massive privatization program in the mid-1980s that left many key industries and commercial enterprises in the hands of the private sector. Between 1985 and 1987, many important state enterprises were privatized.

In 1985, the privatization of two large telecommunication monopolies, Nippon Telephone and Telegraph (NTT) and Kokusai Denshin Denwa (KDD), paved the way for new entrants into the Japanese telecommunications sector. At the time, no foreign interests were allowed to participate in those privatizations. In July 1992,

however, the government for the first time opened the shares of NTT to direct foreign ownership. The Japanese import and distribution network of the tobacco industry, which had been a government monopoly for 80 years, was also privatized in 1985. In 1987, the Japan National Railways company was privatized, splitting the organization into 11 firms, among them six passenger railway companies and one freight company. Japan Airlines Ltd. (JAL) was privatized at the same time, opening the door to new foreign carriers, including Delta, American Airlines, and British Caledonia Airlines.

Case Studies on FDI in Japan: A Brief Review

As suggested earlier, FDI in Japan via the establishment of majority or wholly-owned Japanese subsidiaries is relatively easier to undertake than takeovers, particularly if the latter involves a contested acquisition. In Japan, FDI via acquisitions of Japanese companies is a rarity compared with all other forms of FDI. Until recently, the few attempts at hostile takeovers that did occur were successfully quashed, primarily by government intervention.

The fact that, to date, foreign investors have made only three uncontested acquisitions of Japanese publicly quoted companies bears testimony to the relative impermeability of the Japanese market to foreign takeovers. It also suggests that many potential deals are terminated before the notification stage. All other takeovers have involved private, off-exchange companies, acquired through friendly deals. In 1984, Merck (U.S.) acquired Banyu Pharmaceuticals in the first public takeover, followed by the highly publicized acquisition of Japan's electronics firm, Sansui, by the United Kingdom's Polly Peck in October 1989.

Sansui Electric / Polly Peck International

A survey of foreign takeovers in Japan indicates that only a handful of foreign takeover bids for quoted Japanese companies were met with a favourable response from the Japanese target. The landmark acquisition in 1989 of a publicly quoted Japanese firm - Sansui Electric - by the British-based Polly Peck International is often used by Japanese authorities as an example of their openness to foreign investment. Sansui, a company in financial difficulty at the time of the acquisition, has considerable prestige in Japan and is

listed in the first section of the Japan and Osaka Stock Exchanges. Polly Peck carefully made its way through the myriad of regulations and worked closely with the major bank shareholders to ensure their full support (namely, Bank of Japan, 5%; Mitsubishi, 4%; Sanwa Bank, 3.5%; and Taiyo Kobe Bank, 2.9%).²⁰⁹ The deal gave Polly Peck 51% ownership in Sansui, and it ranked second only to Merck's earlier acquisition of Japan's Banyu Pharmaceutical for US\$ 314 million in 1984.

Koito Manufacturing / T. Boone Pickens

Another celebrated takeover case involved an American investor – T. Boone Pickens – who, in 1989, acquired 20.2% of the shares of Koito Manufacturing Company, a leading manufacturer of automotive lighting equipment in Japan. Despite increasing his stake in Koito to 25% and becoming the largest single shareholder of the company, a request by Pickens for a seat on the Board of Directors was rejected by Koito's management. In particular, Koito was able to fend off his request with the backing of Toyota Motor Corporation, which owned 19% of Koito but had three seats on the board (Toyota also accounts for 46% of Koito's sales). After a majority of Koito shareholders voted against granting the board seat, T. Boone Pickens continued to increase his shareholding, which reached 30% in March 1990.²¹⁰

Minebea Co. / Trafalgar Glen International

The first, controversial attempt at a hostile takeover in Japan involved an Anglo-American venture. In 1985, Trafalgar-Glen International Finance Services Company, launched an acquisition bid for Minebea Company, Japan's leading manufacturer of ball bearings. According to one author, legal restrictions apparently helped Minebea from being taken over.²¹¹ These restrictions included the filing of documents with the MOF and other relevant Ministries because the

²⁰⁹ After the acquisition, Polly Peck liquidated certain subsidiaries of Sansui in order to strengthen the company's ailing financial position. Each of the above banks now holds less than one-half of its previous shares.

²¹⁰ IL&T, Japan (July 1990), p. 6.

²¹¹ T. Hinmura, "A few foreign firms now buying into Japan", in *The Japan Economic Journal*, May 20, 1989, p. 3.

foreign firm intended to buy over 10% of Minebea's shares. In addition, the MOF postponed a quick decision on the case because part of Minebea's shares were defence-related (army pistols, industrial fasteners, and aircraft bolts). The 1980 Law gave the government this discretion, and the "decision making process, normally completed within thirty days, was stretched out to four months."²¹²

By delaying a decision on the case, the MOF in effect allowed Minebea the time to make defensive preparations against Trafalgar's bid. Trafalgar-Glen tried to exercise warrants and convertible bonds in its possession, which amounted to 30% of Minebea's stock, and eventually made a \$1.4 billion-tender offer for the company's outstanding stock. Minebea, however, was able to place shares with friendly shareholders and dilute Trafalgar's holding by issuing new bonds. As a result, Trafalgar failed to acquire effective control of Minebea. In 1986, a Japanese court dismissed Trafalgar-Glen's subsequent suit to stop Minebea's defensive moves as a restraint on competition.²¹³

The Trafalgar-Minebea case demonstrates that Japanese policy on FDI, albeit very flexible in principle, has the potential to become more restrictive in practice. In this instance, Trafalgar's failure to engage in informal, pre-notification discussions with Ministry officials concerning their views on the takeover of a vital Japanese concern was ultimately the major reason behind the Ministry's rejection of the hostile bid. Safarian notes that the Japanese notification system exists "for information purposes, to protect a few designated sectors, and for emergency uses, but not as barriers to direct investment as in the past. This is clearly an approach which can be operated liberally, as is the stated intent in cabinet, but one that can also quickly be made more stringent should circumstances so require."²¹⁴

Other Cases: Contractual Obligations

An important area in which Japanese FDI policy is alleged to lack transparency and consistency concerns the FTC's process of

²¹² K. Ishizumi, *Acquiring Japanese Companies: Mergers and Acquisitions in the Japanese Market* (Cambridge, Mass./Oxford: Basil Blackwell, 1990).

²¹³ Ibid.

²¹⁴ Safarian, *Governments and Multinationals* (1983), op. cit., pp. 27-28.

reviewing contractual obligations between domestic firms and foreign interests. These contractual obligations take on various forms, from joint ventures and foreign licensing to distribution agreements. As noted before, the FTC is statutorily empowered to move against both domestic and foreign businesses whose agreements violate Japanese antitrust laws. Armed with this mandate, the FTC enjoys considerable regulatory discretion to review contracts between domestic and foreign firms and impose sanctions accordingly; the review may occur after the transaction is approved by the MOF and other relevant Ministries, or at any time during the contract's tenure. A few cases of this nature are discussed below.

- ▶ *Komatsu / Bucyrus-Erie* – In 1980, the FTC came out in support of the Japanese construction machinery firm, Komatsu; it contended that its joint venture set up in the early 1960s with U.S.-based Bucyrus-Erie was unfair. In particular, the contract called for Bucyrus-Erie to provide Komatsu with the technical knowledge to build power shovels; in return, the American firm would control Komatsu's exports of the product, as well as have the authority to veto the introduction of competing products by Komatsu in Japan. The FTC ruling came after the usual sort of informal pressure to move.²¹⁵
- ▶ *Mitsubishi / Caterpillar Tractor* – During the 1980s, the FTC would often review contracts between Japanese and foreign enterprises that were restricting technology transfers from the Japanese partner's point of view. On several occasions, the FTC enforced antitrust measures to alter the terms of a contract that restricted exports or the development of competing products by Japanese partners. For example, the FTC forced Caterpillar Tractor of the United States to renegotiate and revise an approved contract with Mitsubishi, since it restricted the transfer of technology and set limits on the Japanese partner's right to develop and market products. The FTC cited provisions in the contracts that were apparently considered to be "unfair trade practices" that violated the standards of Japan's AMA.²¹⁶

²¹⁵ *The Economist*, "Komatsu Tries to Dump Bucyrus", February 2, 1980, p. 71.

²¹⁶ IL&T, Japan (July 1990); op. cit., p. 5.

Conclusion

Despite recent steps to liberalize the treatment of direct investment, the remaining formal and informal barriers keep the Japanese market virtually closed. The variety of informal barriers makes it particularly difficult to judge the benefits of this liberalization. It is clear that the informal practices in Japan remain as effective barriers to foreign investment, and likely more so than Japanese formal barriers. These informal barriers include: the *keiretsu* (especially the cross-holdings and intercorporate financial and business links); the lack of transparency of Ministry policies and regulations under the system of so-called "administrative guidance"; structural problems in the labour market relating to the practice of lifetime employment and the acute shortage of qualified personnel; a complex distribution network; exorbitant land prices; and, more broadly, the Japanese culture and language.

Building on the SII talks between Japan and the United States, there is reason for cautious optimism that more liberalization will occur. In view of the persistent and significant difference between Japanese overseas direct investment activity and FDI in Japan, however, a considerable amount remains to be done to bring Japan into the same league as other G-7 countries in their treatment of direct investment. In reviewing the institutional barriers to FDI in Japan, the United Nations made the following observation:

The real test for the Japanese authorities will come when a genuinely established foreign company puts in an unwanted bid for a significant Japanese company. Legally there seems to be few barriers to such bids. Doubts, however, remain as to whether Japanese investors would yet be willing to sell equity control to a foreigner in such circumstances, and if they did, whether the Ministry of Finance would authorize the acquisition.²¹⁷

²¹⁷ United Nations Centre on Transnational Corporations, *Transnational Corporations in World Development: Trends and Prospects* (New York: UNCTC, 1988), p. 244.

CHAPTER 6
UNITED STATES

UNITED STATES

Introduction

The United States has traditionally welcomed foreign direct investment (FDI). With few exceptions, its policy towards FDI has been based on two fundamental tenets: the right of foreign firms to establish in the United States; and their right to receive national treatment. In part, the liberal attitude towards FDI was shaped by the significant role played by foreign financing in the development of the country, particularly in the nineteenth and early twentieth centuries. But, more importantly, the fundamental principles of right of establishment and national treatment were seen as serving the national interests of the United States in its role as the dominant source country of international direct investment.

Recent developments, however, have led the United States to question its historically liberal international investment policies. During much of the postwar era, U.S. direct investment abroad far exceeded FDI in the United States. In the 1980s, however, the balance of investment flows shifted, following an unprecedented growth of FDI. A wave of foreign merger and acquisition activity, principally by Japanese and U.K. investors, contributed to the significant rise in FDI. In this milieu, successive U.S. administrations have been under pressure from Congress to introduce protectionist measures. The U.S. government has, over time, responded by introducing procedures that could be used to block foreign takeovers and that could potentially function as a blunt protectionist-policy instrument.

Institutional Developments

The emergence of the United States as a major host country of FDI in the 1980s was accompanied by a great deal of public controversy, including dissension between Congress and the Administration. Much of the anti-FDI rhetoric sounds strangely familiar.

[It is] ... reminiscent of that felt by Canadians, Europeans, and many developing countries at the expansion of United States multinationals in the 1950s and 1960s – a resentment epitomized by Jean-Jacques Servan-Schreiber's warning in *Le Defi Americain* that United States investment would destroy established European firms. The warning was plainly misplaced.²¹⁸

²¹⁸ *World Financial Markets*, Morgan Guaranty Trust, New York, June 29, 1989, p. 1.

Many in Congress continue to sponsor legislation that would have the effect of restricting or retarding FDI in the United States. Until now, the only successful major piece of legislation affecting FDI has been the Exon-Florio Amendment (Exon-Florio), Section 5021 of the *Omnibus Trade and Competitiveness Act* of 1988. As discussed later, some significant amendments to that Act were also introduced in October 1992, strengthening the Exon-Florio provisions.

Exon-Florio permits the President to prohibit or reverse the acquisition (in any form) of a U.S. business by a foreign person or entity if it is felt that the acquisition would harm "national security" in a manner not adequately addressed by other federal laws. In practice, the administrative review of foreign investments and the recommendation of action to the President is the responsibility of the Committee on Foreign Investment in the United States (CFIUS), which was originally established in 1975.²¹⁹ Originally, the CFIUS had a limited mandate to monitor the impact of both direct and portfolio foreign investment in the United States; to coordinate policy on such investment; to perform certain analyses and reviews; to develop legislative proposals; and to consult with foreign governments. The Committee also had no authority itself to reject (or even compel a foreign investor to delay) any investment in the United States.

Since 1988, Exon-Florio has led to the evolution of an *ad hoc* foreign investment screening mechanism in the United States, with the CFIUS reviewing the national security implications of foreign investments and making recommendations to the President as to whether or not an investment should be permitted. In spite of the broad powers given to the President to block foreign takeovers, there is little evidence to suggest that the United States has become less accessible to foreign investors as a result of Exon-Florio. Given the general nature of the Exon-Florio rules, however, they are open to misuse by future U.S. administrations.

Specifically, there is speculation that the new administration under President Clinton could take a more activist position on foreign investment policy issues than did the Bush administration. The Clinton administration has placed emphasis on new policies that

²¹⁹ The CFIUS was established in 1975 by President Gerald Ford's Executive Order in response to growing public anxiety and congressional concerns about the investments in the United States by members of the Organization of Petroleum Exporting Countries.

reflect a greater interest in U.S. "economic" security than in national security in the narrow military sense. This attitude could result in industrial policies that would have implications for the ownership of U.S. businesses. Advocates of "managed protectionism" from within and outside the administration are seeking a more activist industrial policy. While the President will no doubt be required to balance carefully the managed trade interests of the Democratic party with more liberal interests, he could pursue policies like those used by some European governments to attract FDI but have them subject to certain conditions. Following the European model, many options, including the setting of performance standards for foreign investors and the provision of preferential treatment for investments with substantial local content, have been suggested.²²⁰

Tax policy changes in the United States could also affect foreign investment. During the presidential campaign, President Clinton announced that his administration would raise US\$ 45 billion in revenues by preventing tax avoidance by foreign corporations. Although the specifics of the plan were unclear, he expected the revenues would come from better enforcement of existing rules and an increase in staff to work on transfer-pricing issues. No changes to current transfer-pricing or other tax laws, however, are expected to take place.²²¹

Recent Investment Patterns

The United States is now the world's largest source and destination of international direct investment. As illustrated in Chart 6-1, at year-end 1991, the cumulative stock (book value) of FDI in the United States amounted to about US\$ 408 billion, while the corresponding amount of U.S. direct investment abroad was valued at US\$ 450.2 billion.²²²

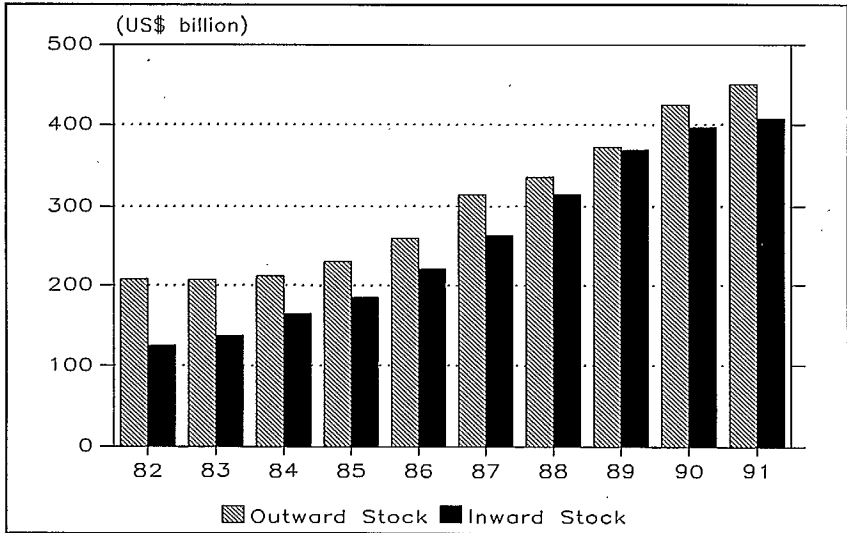
²²⁰ See "Clinton Seen More Interventionist But Specifics Unclear, Even in Tax" in *Foreign Investment in the United States: News & Analysis*, (Washington, D.C.: BNA International Inc., December 1992), Vol. 4, No. 12, pp. 3-6.

²²¹ *Ibid.*

²²² U.S. Department of Commerce, *Survey of Current Business*, Bureau of Economic Analysis (August 1992), pp. 11-12 and 141-42.

Relatively faster growth of FDI stock in the 1980s resulted in a considerable narrowing of the gap between the level of FDI in the United States (FDIUS) and that of U.S. direct investment abroad (USDIA). From 1982 to 1991, FDIUS grew at an average annual rate of 14.3% compared with 9.3% for USDIA. With FDIUS growing at a relatively faster pace during that period, the level of inward investment, which represented 60% of the level of USDIA in 1982, rose to 90% of USDIA by the end of 1991.

Chart 6-1
U.S. Stock of Inward and Outward Direct Investment, 1982-91



Source: U.S. Department of Commerce, *Survey of Current Business*, Bureau of Economic Analysis, Washington, 1992.

The unprecedented level of FDI activity in the United States produced important shifts in the global pattern of international investment in the 1980s. While there was a dramatic rise in the U.S. share of the global stock of inward direct investment during that decade, its dominant position as the major home country of international direct investment declined sharply with the emergence of alternative sources. Data from the U.S. Department of Commerce indicate that the U.S. share of the global stock of outward direct investment declined from 43% in 1980 to about 26% in 1990; in

contrast, the United States accounted for about 25% of the global stock of inward direct investment in 1990, up from a relative share of 16.4% a decade earlier.²²³

The United States underwent a gradual transformation to a major FDI host country starting in the 1970s, as Graham and Krugman have noted.²²⁴ The amount of FDIUS in 1975 was only 22% of USDIA versus 60% in 1982 and 90% in 1991.²²⁵ One of the reasons for the balancing of incoming and outgoing FDI was U.S. monetary policy in the early 1980s. In 1989, the level of direct investment in the United States was sixteen times what it had been in 1975; USDIA had only tripled during the same time period.

Since the mid-1980s, Japanese FDI in the United States has grown considerably. From roughly US\$ 10 billion in 1982, the stock of Japanese direct investment grew at an average annual rate of 27% to US\$ 87 billion by year-end 1991. Because of it having been the most prominent source of FDIUS growth in the United States in the 1980s, Japanese investment has been the subject of public controversy in recent years. The fact, however, that inward investment from the United Kingdom also grew at a relatively faster pace during that period (having grown at an average annual rate of 16.8% from 1982 to 1991) and that the United Kingdom continues to be the largest direct investor in the United States did not receive as much public attention as did Japanese investment activity.

Today, Japan ranks second only to the United Kingdom as a direct investor in the United States, followed by the Netherlands, Canada, and Germany. The remarkable pace of Japanese direct investment in the 1980s resulted in a closing of the gap between Japanese and British direct investment in the United States. In 1991, Japan accounted for 22% of the stock of FDIUS (up from a relative share of 5.7% in 1980), compared with 26% for the United Kingdom (up from a relative share of 17.0% in 1980).

²²³ See John Rutter, *Recent Trends in International Direct Investment*, Office of Trade and Economic Analysis, U.S. Department of Commerce, Investment Analysis Division (August 1992), Tables 6 and 8.

²²⁴ E. M. Graham and Paul Krugman, *Foreign Investment in the United States*, Institute for International Economics, Washington, 1989, p. 32.

²²⁵ U.S. Department of Commerce, *Survey of Current Business*, pp. 111-12 and 141-42.

Table 6-1 shows several measures of the relative importance of FDI in the U.S. economy.

Table 6-1
Foreign Ownership and Control in the U.S. Economy

The FDI stock in the United States is roughly twice that in the United Kingdom, the next largest host country to global FDI. The following indicators suggest that U.S. affiliates' assets, sales, employment, and value-added abroad are a relatively small portion of the total U.S. economy.

- ▶ In 1989, the stock of FDI in the United States accounted for 4.5% of total U.S. domestic net worth.
- ▶ In 1990, the U.S. affiliates of foreign multinational companies (MNCs) in manufacturing accounted for 18.6% of all manufacturing assets, up from a relative share of 8.8% in 1985.
- ▶ In 1990, the sales of U.S. manufacturing affiliates of MNCs represented 16.4% of total manufacturing sales in the United States, up from 8.0% in 1985.
- ▶ 10.8% of total U.S. manufacturing employment in 1990 was generated by U.S. affiliates of MNCs, up from 8.0% in 1985.
- ▶ In 1989, U.S. affiliates accounted for 13.4% of value-added activity in manufacturing – a sharp jump from the 8.3% share attributed to the affiliates in 1985.
- ▶ In the 1980s, the ratio of inward FDI to GDP in the United States doubled from 3.6% in 1981 to a peak of 7.2% in 1990. It fell marginally to 7.9% in 1992. The 1990 share exceeded the corresponding ratio of FDI to GDP in Germany and France but represented only a third of the British (21.2%) and Canadian (19.0%) shares.¹
- ▶ Inward FDI in the United States as a proportion of gross private non-residential capital stock more than doubled in the last decade, from 2.0% in 1981 to 4.2% in 1991. Compared with other countries, the share of FDI in capital stock in the United States is higher than that of Germany and France, but well below that of Canada and the United Kingdom.²

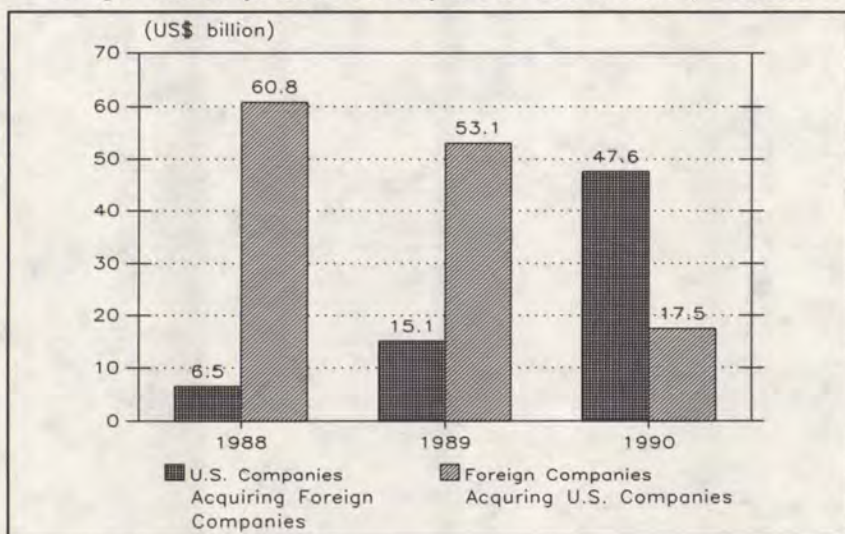
¹ Industry Canada compilations using data from various sources.

² Ibid.

The significant increase in FDI in the United States in the late 1980s was in large part fueled by a wave of cross-border merger and acquisition activity. Chart 6-2 traces the level of foreign merger and

acquisition activity from 1988 to 1990. Based on data from *Mergers and Acquisitions*,²²⁶ foreign acquisitions of U.S. companies peaked at about US\$ 60 billion in 1988; they declined over the next two years having reached almost US\$ 48 billion by 1990. In 1989, the average size of transactions was US\$ 136 million but had dropped by more than 40% to about US\$ 80 million by 1990. Some of the major Japanese acquisitions in the United States were undertaken during that period.²²⁷

Chart 6-2
Merger and Acquisition Activity in the United States, 1988-90



Source: *Mergers and Acquisitions* (Philadelphia: MLR Publications, 1989, 1990, and 1991).

²²⁶ *Mergers and Acquisitions* (Philadelphia: MLR Publications, 1989, 1990, and 1991).

²²⁷ During that period, seven of Japan's top ten worldwide acquisitions involved U.S. firms, and the purchase price in each case exceeded US\$ 1 billion: Matsushita acquired MCA (1990 - US\$ 6.6 bn.); Sony acquired Columbia (1989 - US\$ 3.4 bn.); Bridgestone acquired Firestone Rubber Co. (US\$ 2.6 bn.); Aoki acquired Westin (1988 - US\$ 1.4 bn.); Dai-ichi Kangyo Bank acquired CIT Group (1989 - US\$ 1.3 bn.); and Nippon Mining acquired Gould (1988 - US\$ 1.1 bn.). See *KPMG Deal Watch* 91, p. 19.

In 1988, U.S. purchases of foreign firms were roughly one-tenth of the value of foreign acquisitions in the United States. Since 1988, however, U.S. takeovers have increased each year, while foreign acquisitions have fallen from their peak level. Towards the end of the 1980s, a more traditional pattern had re-emerged, with many U.S. multinationals locating production facilities in Western Europe in order to create a vantage point from which to compete in the EC market.

Formal Barriers to Direct Investment

The formal barriers to FDI that do exist in the United States are similar to those in most developed countries. In general, foreign investors are free to establish a U.S. branch or subsidiary without substantial control or review by any government authority. The absence of foreign exchange controls also facilitates such investment. Existing restrictions are limited to specific sectors deemed to be sensitive or related to national security, such as maritime transportation, communications, and defense. Foreign investments are also subject to various disclosure requirements under federal laws, which exist mainly for statistical purposes.

While U.S. laws do not generally distinguish between acquisitions and new investments, one notable exception is the Exon-Florio Amendment to the 1988 *Omnibus Trade and Competitiveness Act*. The Exon-Florio provisions call for a review and prohibition of foreign takeovers of U.S.-owned businesses when the "national security" of the country is threatened.

Along with the CFIUS, two other federal agencies have regulatory authority over matters relating to both domestic and foreign investment by virtue of U.S. antitrust policy. The Federal Trade Commission (in conjunction with the Department of Justice) is the principal body entrusted with enforcing merger control regulations in the country, and the Securities and Exchange Commission is responsible for overseeing the U.S. securities market.

In addition to the various federal regulations that affect FDI, statutes regulating the eligibility of foreign individuals and companies to engage in business have been passed in many states. Like federal laws, some of these impose restrictions on FDI activity in specific sectors under their jurisdiction. Matters governed by state law include the formation of contracts relating to acquisitions and mergers

or other business combinations (including joint ventures), as well as the conduct of a Board of Directors; all of these can influence both domestic and foreign investors alike.

Regulatory Framework

The *Omnibus Trade and Competitiveness Act* became law on August 23, 1988. It is a broad piece of legislation, encompassing all U.S. trade-negotiating objectives, including FDI objectives.²²⁸ The Act has been described as:

landmark legislation ... [for it] ... provides the President with tariff and nontariff negotiating authority for the Uruguay Round of the GATT, strengthens and expands Section 301 retaliation authority, reduces licensing requirements for exports, stresses exports to developing countries, contains provisions to help small business and agricultural exports, adds anti-dumping and countervailing duty provisions to handle practices not covered by existing law, significantly strengthens protection of United States-owned intellectual property, and provides the President with authority to bar imports and foreign investment on national security grounds.²²⁹

While the Exon-Florio Amendment is only one part of a much larger Act dealing with U.S. trade priorities, many recognize it as placing a significant change of emphasis on U.S. economic policy.²³⁰

The Exon-Florio provision, section 5021 of the *Omnibus Trade and Competitiveness Act*, altered and amended section 721 of Title VII of the *Defense Production Act* of 1950. With subsequent Executive Orders,²³¹ the President delegated the authority vested in

²²⁸ See Alan M. Stowell, *United States International Trade Laws*, 1989 edition, (Washington: BNA Books Inc., 1989), pp. 453-89.

²²⁹ *Ibid.* (see Foreword by Eugene T. Rossides).

²³⁰ See, for example, the new series of EC reports: *Report on United States - Trade Barriers and Unfair Trade Practices*, European Commission, Brussels, April 1990.

²³¹ Under Executive Order 12661, December 27, 1988, 54 FR 779 delegated authority to the chairman of the CFIUS; under Executive Order 11858, 7 May, 1975, 40 FR 20263 (amended by E.O. 12188, 2 January, 1980, 45 FR 989, and E.O. 12661, already cited) stipulated that the Secretary of the Treasury would be the chairman of the CFIUS. In practice, the staff chairman, currently Stephen J. Canner, and sub-cabinet officials from the departments of State, Commerce, Defense, Justice, the office of the USTR, the OMB, and the CEA are responsible for its investigations, as well as other relevant officials should it become necessary.

him to review foreign investments to the CFIUS, under the official chairmanship of the Treasury. The investigative powers and procedures of the CFIUS under the Exon-Florio Amendment are summarized in Table 6-2. The powers of the CFIUS were considerably extended and formalized by the passage of the Exon-Florio rules; however, the final decision on whether to approve or block a transaction must be made by the President.

Table 6-2
Legislative Framework for FDI Review

The Exon-Florio Amendment provides the U.S. President (or his designate) with the authority to investigate, block, or suspend foreign mergers and acquisitions if:

- ▶ there is credible evidence that the foreign interest might take action that "threatens to impair the national security" of the United States; and
- ▶ existing law, other than the *International Emergency Economic Powers Act*, is inadequate to "protect the national security".

In practice, the CFIUS, under the authority delegated to it by the President, is charged with conducting a formal investigation of the national security implications of FDI. The CFIUS is comprised of the Secretaries of the Treasury (chair), Defense, State, and Commerce, the Attorney General, the U.S. Trade Representative, Chairman of the Council of Economic Advisors, and the Director of the Office of Management and Budget. Operations are administered by the Treasury Department's Office of International Investment.

Parties involved in certain foreign investments in the United States may request a review of the investment's national security implications. Notifications to the CFIUS of takeover activity are **voluntary**. If a filing is not made to the CFIUS, however, the President retains the right to order a foreign acquirer to divest itself of a U.S. entity. The President could determine (based on a CFIUS investigation) that there are national security reasons for such a divestiture. A notice for review can be filed by either party to an investment or by a member of the CFIUS. Third parties to the transaction cannot submit a notice to the CFIUS.

The Exon-Florio statute establishes the following time frames for completing a preliminary review and any subsequent investigation:

- ▶ Within **30** days of receiving notification of a proposed merger or acquisition, the CFIUS must conclude a preliminary review and determine

(continued)

whether a full investigation should be undertaken; if the CFIUS concludes that a full investigation is not necessary, then the transaction is deemed not to be a threat to national security.

- ▶ If a full investigation is initiated, the CFIUS has an additional **45** days within which to complete the inquiry and report to the President. The CFIUS recommends to the President whether the transaction should be blocked, or if no unanimous decision can be reached, the CFIUS submits to the President a statement of opposing views.
- ▶ Upon receiving the CFIUS recommendation, the President has **15** days to decide what action, if any, is to be taken with respect to the transaction; the President has final authority on the matter and can either accept or override the CFIUS recommendation.

At the time of its inception, the CFIUS had a modest role, which was primarily to monitor major takeovers. In the first 13 years of its existence, the CFIUS only examined 30 mergers, takeovers, and acquisitions.²³² Those investigations resulted in only one instance of a withdrawn proposal and two cases where "assurances" were sought by the CFIUS and accepted by foreign investors. In contrast, as of June 4, 1992, almost four years after the enactment of Exon-Florio, the CFIUS had reviewed 710 cases, 13 of which proceeded to an extended CFIUS review.²³³ Nevertheless, only nine of those cases went to the President for a decision and, except for one, all of those transactions were approved.

Under Exon-Florio, there are three key issues that must be examined in order to determine whether to file notice to review a foreign takeover:

- 1) Does the transaction constitute an **"acquisition"**?
- 2) Would it result in **"control"**? and,
- 3) If so, could it impair **"national security"**?

²³² *New York Times*, 24 April, 1989.

²³³ "Exon-Florio: A Primer for Foreign Investors and Foreign Lenders Doing Business in the United States", Patrick L. Schmidt, *International Business Lawyer* (October 1992), p. 485-489.

The Exon-Florio regulations cover an "acquisition, merger, or takeover" of an entity by the purchase of its voting securities, the conversion of its convertible securities, or the acquisition of its convertible voting securities or proxies. A joint venture would be deemed an acquisition if the foreign interest would gain control through such a venture. As before, "greenfield investments" (i.e. entirely new business establishments by foreign firms) are exempt from filing notice under the regulations.²³⁴

The regulations define "control" in a very broad sense. It involves having the power through "ownership of a majority or dominant minority" of the total voting securities or by "proxy voting, contractual arrangements or other means" to "determine, direct or decide matters affecting an entity". The regulations do not establish minimum percentages of stock ownership that would conclusively indicate control. Furthermore, they allow an investigation of a takeover to proceed "... even if the board of directors of the company were comprised entirely of United States nationals."²³⁵

The most contentious issue since the introduction of Exon-Florio concerns the definition of "national security". Neither the statute nor the final regulation precisely defines "national security". This lack of transparency in the definition can serve as a barrier to FDI and will be discussed further in the section on informal barriers.

Specific FDI cases in the United States were particularly instrumental in leading to the introduction of the Exon-Florio Amendment in 1988 and the further amendments introduced in 1992. The Exon-Florio Amendment arose in response to the attempted takeover in 1987 of Fairchild Semi-Conductor Corporation (a French-owned, U.S.-based, computer company) by the Japanese company Fujitsu. Concern about control of U.S. defence contractors by foreign government-controlled entities led to further legislative changes in 1992. In this instance, new measures were prompted largely by the proposed acquisition of the missile division of the United States LTV Corporation by the French government-owned enterprise Thomson CSF (see description in the case studies section). The *National Defense Authorization Act 1992* (H.R. 5006, also

²³⁴ *Ibid.*, p. 486-87.

²³⁵ *Ibid.*

known as the "Byrd Amendments")²³⁶ and the *Defense Production Act Amendments 1992* introduced those measures. While the Byrd Amendments do not appear to modify the purpose of the Exon-Florio provision, they could be interpreted as strengthening these regulations. The main provisions of the *Defense Authorization Act* are summarized in Table 6-3.

These new measures effectively inverted the review process involving acquisitions by foreign government entities: before the amendments, investments in defence companies by foreign government entities were presumed to be allowed unless the Secretary of Defense made an exception; now, such investments are presumed to be denied unless an exception is made to permit them. It is now assumed that transactions involving foreign government-owned or -controlled companies automatically involve a national security risk.

These legislative changes also introduced a new industrial policy consideration to the review of foreign acquisitions. The President may now consider **technological leadership in critical defence areas** when determining whether to block a transaction.²³⁷ This may have significance for a wide variety of foreign companies considering direct investment in the United States.

Securities Regulation

Another area of formal investment regulation facing foreign investors concerns the Securities and Exchange Commission (SEC) in the United States, which regulates the public offering of securities. This part of the regulatory framework, however, affects domestic and foreign investors equally. The agency is responsible for the

²³⁶ H.R. 5005 incorporates changes proposed by Senator Robert Byrd (D) and co-sponsored by Senator James Exon (D).

²³⁷ In addition to submitting a detailed report to Congress on any foreign takeover case that is reviewed fully by the CFIUS, the President must also present a report to Congress every four years, starting in 1993, that evaluates: 1) whether there is "credible evidence of a coordinated strategy" by any foreign country or company involved in developing or producing "critical technologies" for which the United States is a leading producer; and 2) whether there are "industrial espionage activities" directed by foreign governments against U.S. companies aimed at obtaining commercial secrets related to critical technologies.

Table 6-3
The U.S. National Defense Authorization Act 1992
and Its Impact on the Exon-Florio Provisions

The *National Defense Authorization Act 1992* amends the Exon-Florio provisions in these respects:

- ▶ An in-depth, 45-day investigation by the CFIUS is now mandatory in all instances where an **entity controlled by, or acting on behalf of, a foreign government** seeks to engage in a transaction that could result in foreign control and affect national security.
- ▶ In reviewing transactions pursuant to Exon-Florio, the President and the CFIUS must henceforth take into account the following additional factors: the potential effects of the transaction on 1) sales of military equipment or technology to any country that either supports terrorism or may encourage the proliferation of missiles or nuclear/chemical/biological weapons; and 2) U.S. international technological leadership in areas affecting national security.
- ▶ The President must now submit to Congress a written report on each case referred to him for decision, irrespective of whether the transaction is blocked or not. The report must include a detailed explanation of the findings and the factors that were taken into account in reaching the decision. In prior cases, the President was required to report to Congress only when a transaction was blocked and, even then with no great detail.
- ▶ If a U.S. party to an Exon-Florio transaction is engaged in the development of a "defence-critical technology" (undefined) or an activity important to the defence industrial and technology base, the Department of Defence (DOD) or affiliated agencies are now responsible for conducting a "technology risk assessment". In other words, DOD must evaluate the risk posed by the transaction with regard to the diversion of defence critical technology from the United States;
- ▶ Section 835 of the *National Defense Authorization Act* prohibits the purchase by a foreign government-controlled entity of a U.S. Department of Defence (DOD) contractor or a Department of Energy (DOE) contractor with access to "proscribed information". It applies to contractors who have been awarded contracts worth more than \$500 million by the Defense or Energy departments in a single fiscal year.
- ▶ The awarding of DOD (or DOE national security program) contracts involving "proscribed information" to any company **already** controlled by a foreign government is prohibited. "Proscribed information" will be defined in forthcoming regulations from both the DOD and the DOE.

administration of the *Securities Exchange Act* of 1934 (the "Exchange Act") and the *Securities Act* of 1933 (the "Securities Act"). Even non-U.S. securities are subject to SEC regulations if they are offered, sold, or traded in the U.S. securities market. Any public offering of securities must be registered with the SEC and with the appropriate agency in whose state the securities will be offered.

The *Exchange Act* regulates tender offers and proxy solicitations,²³⁸ and it requires, subject to thresholds, disclosure of ownership. All investors, whether domestic or foreign, must file detailed information with the SEC when they acquire more than 5% of the shares of a publicly held corporation. The filing must be completed within 10 days of crossing the 5% threshold.

Reporting Requirements

All foreign direct investment activity in the United States is also subject to reporting requirements under various federal statutes. Certain government agencies and departments impose disclosure requirements on foreign operations. Specifically,

1. The *International Investment Survey Act*, 1976 requires, for statistical and analytical purposes, initial and subsequent reporting of foreign transactions in the United States (sometimes as often as quarterly) for foreign firms;²³⁹
2. The *Agricultural Foreign Investment Disclosure Act*, 1978, requires disclosure of foreign acquisitions, transfers, and holdings of land used for farming, ranching, forestry, and timber production. Unlike the *International Investment Survey Act*, information made available under this Act may be publicly disclosed;²⁴⁰
3. The *Domestic and Foreign Investment Improved Disclosure Act*, 1977, requires that anyone acquiring 5% or more of the

²³⁸ These occur when two or more groups solicit the vote of shareholders of a company in competition with each other (i.e. in a proxy contest).

²³⁹ *Doing Business in the United States of America - A Guide for the Foreign Investor*, Deloitte Haskins & Sells, November 1985, pp. 160-61.

²⁴⁰ *Ibid.*, p. 161.

equity in a company report their citizenship and residence to the SEC;²⁴¹

4. The *Foreign Investment in Real Property Tax Act*, 1984, concerns the disclosure of information relating to foreign holdings of domestic corporations;²⁴² and,
5. The *Tax Equity and Fiscal Responsibility Act*, 1982, requires reporting of transactions with related non-U.S. corporations.²⁴³

Sectoral Restrictions on FDI

As a member of the OECD, the United States was an active participant in persuading other OECD members to accept the Declaration and Decisions on International Investment and Multinational Enterprises in 1976, and a Code of Liberalization of Capital Movements in 1982 (revised in 1986).²⁴⁴ Despite advocating liberalization of capital movements, the United States, like other member countries, continues to maintain a host of reservations to the Capital Movements Code. Moreover, in a few sectors, certain state and federal laws impose reciprocity requirements on foreign investment, permitting such investment only if the investor's country of origin admits U.S. enterprises on the same or similar terms.

The bulk of U.S. sectoral restrictions on inward FDI are based on national security concerns. The United States, with its primary defence role in the West, has resorted to national security considerations in imposing restrictions on FDI in strategic sectors of the economy. The various forms of sectoral restrictions on FDI are

²⁴¹ Michael V. Seitzinger, "Foreign Investment in the United States: Major Federal Restrictions", in *Foreign Direct Investment: Effects on the United States*, House Subcommittee on Economic Stabilization (Committee on Banking, Finance and Urban Affairs), 100:1 (CRS - Committee Print 101-2), July 1989, p. 58.

²⁴² *Doing Business in the United States of America*, Deloitte Haskins & Sells, November 1985, pp. 161-62.

²⁴³ *Ibid.*, pp. 162-63.

²⁴⁴ J. David and P. S. Stevens, "Antitrust Merger Control and National Security Review of Foreign Acquisitions in the United States", *Journal of World Trade* (Geneva, February 1990), p. 40.

Table 6-4
Sectoral Impediments to Inward Investment on
Some or All FDI Activity in the United States

Industry	Reservations to OECD Capital Movements Code	Other Impediments	Public, Private, or Mixed Monopolies
Banking		X	
Insurance		X	
Broadcasting, radio and television	X		X
Post, telephone and telecommunications	X		X
Land transport	X		
Maritime transport	X		
Fishing	X		
Real estate	X		
Mining, minerals	X		
Petroleum	X		
Nuclear industries	X		
Exploitation of water resources	X		

Source: Organisation for Economic Development and Cooperation, Controls and Impediments Affecting Inward Direct Investment (1987).

outlined in Table 6-4. Following is a description of the major restrictions on FDI across the various industries.²⁴⁵

Banking

A complex situation exists with regard to foreign investment in banking and financial services in the United States. In part, this is

²⁴⁵ The discussion of the various sectoral restrictions is based on the following studies: OECD, *Foreign Direct Investment: Policies and Trends in the OECD Area* (Paris: OECD, forthcoming publication), pp. 187-98. Paul McCarthy, "Establishment of a New Business Enterprise" in *Foreign Investment in the United States: A Practical Guide*, ed. John I. Forry (Washington, D.C.: BNA International Inc.), pp. 1-14.

due to the existence of federal and state laws, as well as regulations administered by the respective banking authorities.

A foreign corporation that seeks to establish a domestic bank subsidiary or to acquire control of a national or state bank must comply with the *Federal Bank Holding Act* of 1956. The establishment of a national or state banking subsidiary will subject the foreign bank or owner to the limitations of the *Glass-Steagall Act*, which prohibits a corporation from carrying on both depository and investment banking.

The U.S. representative offices of foreign banks that maintain only correspondent bank relations and gather information are not subject to substantial federal regulations. Branches of foreign banks that wish to conduct depository banking directly in the United States must, however, receive permission to do so from federal or state authorities. In addition, they are subject to regular examination by the banking authorities of the jurisdiction granting permission. Such foreign bank branches are not subject to the *Glass-Steagall Act*.

If, on the other hand, a foreign bank decides to enter the U.S. market indirectly by establishing or acquiring a subsidiary, it will not face regulations that specifically restrict the operation of foreign-controlled subsidiaries. It will, however, face regulations that apply to both foreign and domestic investors regarding the geographic scope of the operations. For example, a foreign bank (like a domestic investor) may choose to establish either a national or state bank. The choice will have little or no effect on the scope of the bank's operations in the United States, however. Under U.S. banking laws, national banks are not national in operation and must conform to state restrictions that generally confine their operations to a single state or, in a few states, to just a certain portion of the state. State banks are similarly restricted in the scope of their operations.

Furthermore, the Federal Reserve Board will refuse to designate a foreign-controlled commercial or investment bank as a primary dealer in government debt instruments if the government of the foreign bank's country of origin does not allow the same competitive opportunities to U.S. financial institutions.

Broadcasting, Radio and Television

Licences to participate in radio and television broadcasting are denied to foreign individuals, corporations, and governments by the Federal Communications Commission (FCC). Limited exceptions are made for the operation of a radio in an aircraft, for amateur radio operation, and for the transmission of information relating to air navigation and flight safety.

Foreign investment in this sector is further limited by restrictions on minority involvement in a company. An FCC licence is denied to any domestic corporation with non-U.S. corporate directors or in which more than 20% of the stock is owned or voted by foreign corporations. Foreign shareholder participation in the Communications Satellite Corporation (COMSAT) is limited to 20%, and all directors and officers of that corporation must be U.S. citizens.

There is no general federal regulation of foreign ownership of "common carriers" such as telephone and telegraph industries. Common carriers engaged in the provision of international service, whose capital stock is more than 15% owned, directly or indirectly, by a foreign telecommunications entity or on whose board of directors a representative of a foreign telecommunications entity sits, are considered to be "dominant" carriers. In general, dominant carriers are subject to greater regulatory scrutiny than are nondominant carriers. In the latter case, foreign ownership is limited to less than 15% of capital, and no foreign representative can be on the board of directors.

United States law does not prohibit the granting of cable landing licences to foreign-owned or -controlled companies; the President, however, has the authority to deny such licences if it would serve to secure equivalent rights for U.S. companies in foreign countries, maintain the rights of the United States or its citizens abroad, or promote the security of the United States.

Air Transportation

Domestic air transport of passengers and goods is limited to domestically registered aircraft. A domestic carrier is defined as one in which no more than 25% of the voting shares are held by foreign

interests. The view has also been that foreign investors may not "control" a U.S. airline.²⁴⁶ The chief executive officer and two-thirds of the board of directors of an airline must be U.S. citizens. The U.S. Department of Justice can exercise its jurisdiction with regard to any antitrust concerns involved when an acquisition of a domestic carrier occurs.

The U.S. Department of Transportation has the authority to grant foreign registered aircraft the right to transport goods and persons between points within and outside the country if it finds that the carrier is technically qualified and that such transport is in the public interest. Approval is generally granted if there is a treaty or other international agreement with the country of registration wishing to provide the service, or if the country of registration affords similar privileges to aircraft registered in the United States.

Maritime Transportation

Neither a foreign enterprise nor a foreign-controlled enterprise may engage in fresh water or coastal shipping, dredging, or salvaging. They may not transport supplies from a point within the United States to an offshore rig or platform on the continental shelf; operate a hazardous waste incinerator ship; or, without the approval of the Secretary of Transportation, acquire a mortgage or charter vessels owned by a U.S. citizen or last documented under U.S. law.

Registration of vessels is restricted to U.S. persons. A corporation will qualify as a U.S. person only if it is organized under domestic law. This means that its chief executive, chairman of the board, and a majority of a quorum of its board of directors must be U.S. citizens, and not less than 75% of its equity must be owned and controlled directly or indirectly by U.S. citizens.

²⁴⁶ In 1992, British Airways submitted a US\$ 750-million proposal to the Department of Transportation to acquire 24% of USAir voting interest and 44% of total USAir equity (voting and non-voting equity). British Airways would also have had super-majority voting rights over certain USAir management decisions. In January 1993, however, British Airways had to submit a revised bid in which the governance provisions of the transaction were significantly altered to reflect the *de facto* concerns expressed by the Department of Transportation with respect to the original bid. British Airways now owns 19.9% of the voting rights and 24.6% of equity shares in USAir as a result of a US\$ 300-million investment approved by the Department of Transportation in March 1993.

By contrast, there is no general prohibition against foreign-owned or registered vessels operating to or from U.S. ports in the international transport of goods or persons. A certain level of merchandise exports, which are supported by government loans, must be shipped on U.S. flag vessels, unless waived by the Maritime Administration. The transport of military supplies and personal effects of military and civilian employees is reserved to national flag carriers.

Fishing

Foreign-flag vessels may not fish, or process fish, in the 200-nautical-mile "exclusive economic zone" or within the boundaries of any state except under the terms of the Governing International Fisheries Agreement (GIFA) or other agreements consistent with U.S. law. Foreign fishing is defined as fishing from a vessel that was not built in the United States or that is not registered under the laws of the country. Registration of a vessel is limited to U.S. persons, including corporations organized in the country whose management and ownership are largely composed of U.S. citizens.

Mining, Oil & Gas

Federally owned lands may be leased for the exploration of oil and gas or for the mining of coal and certain other minerals to U.S. citizens, partnerships or associations of such citizens, and U.S. corporations. Such corporations may be controlled by foreign persons, unless their country prohibits U.S. citizens or corporations from leasing its public lands for mineral development.

Federal leases for all minerals of the outer continental shelf may be issued, under applicable regulations, to U.S. citizens or resident aliens, or to U.S. corporations, regardless of foreign stock ownership. Foreign investors have made extensive use of U.S. subsidiaries for such offshore leasing. Geothermal steam and related resource-development leases of federal land may likewise be issued to foreign subsidiaries but not to branch offices.

Electricity and Other Forms of Energy

While foreigners investing through a branch office may not operate a hydroelectric power facility, they may operate such a facility by investing through a U.S. subsidiary or affiliate.

Neither a foreign enterprise nor a foreign-controlled enterprise may engage in operations involving the utilization or production of atomic energy. Determinations of foreign ownership or control are made on a case-by-case basis.

Foreign investors may obtain a licence to construct an ocean thermal-energy-conversion (OTEC) facility in the territorial sea of the United States, or obtain a licence to operate a mobile OTEC plantship, by investing in a U.S. subsidiary and by meeting certain corporate management restrictions. Licences are not granted to foreign investors who propose to undertake the investment through a branch office.

State-Regulated Sectoral Restrictions

Individual states have jurisdiction to act with respect to certain matters falling under the purview of the OECD Capital Movements Code. A number of industries are regulated heavily at the state level, such as banking, insurance, and public utilities. Many states prohibit FDI participation in those industries, particularly in the banking field, and may restrict foreign ownership or management of local companies. The following outlines important examples of state sectoral restrictions.²⁴⁷

In **banking**, some states provide for an outright ban on the establishment of state branches by foreign banks while others choose to grant licences under limited conditions. If a foreign bank decides to establish or acquire a state bank, the consent of the state banking authorities is required.

All states require non-state (U.S. and foreign) **insurance** companies to acquire a licence to open a branch. Almost all states impose minimum capital and surplus requirements to operate insurance businesses, and most apply the same requirements to both domestic and foreign investors. A few states, however, impose higher capital and deposit requirements on out-of-state or non-U.S. insurers than are applied to locally organized insurers. Some states impose reciprocity conditions as a criterion for allowing foreign insurers to operate locally.

²⁴⁷ A more detailed description of the various sectoral FDI restrictions at the state level is available in OECD, *Foreign Direct Investment*, *op.cit.* (March 1992).

In certain states, the construction and operation of **hydroelectric and geothermal power plants** by out-of-state or foreign investors are subject to a variety of regulations. Many state laws restrict any out-of-state **railroad** from directly operating in its jurisdiction. As for the operation of **vessels**, non-residents are sometimes subject to stricter maritime regulations than are U.S. or state residents. While no licensing statute appears to regulate FDI in the shipping sector at the state level, foreign investors in some states are required to pay higher licence fees.

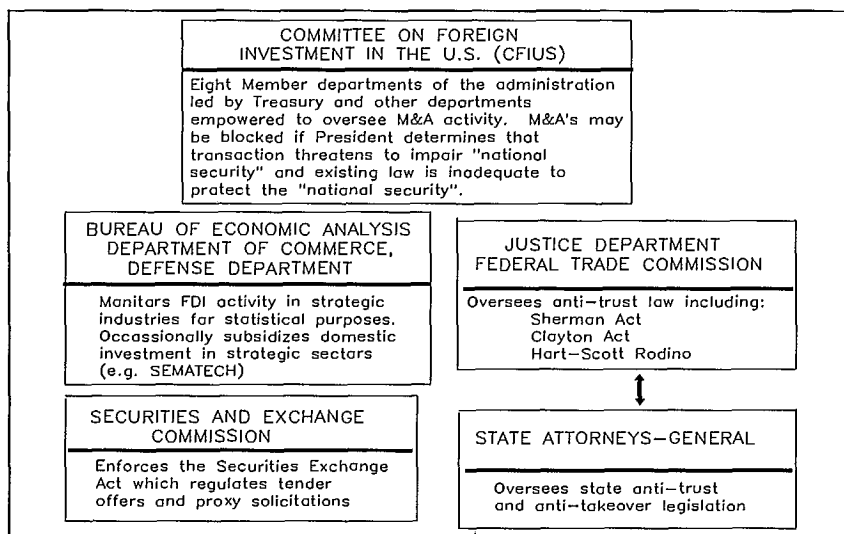
Some 15 states have stringent restrictions on non-resident foreigners and foreign corporations owning **agricultural land** and other **real estate** property. The restrictions have been legislated in response to concerns about non-resident foreigners raising land prices and gaining control of basic domestic resources. Also, it is felt that foreign corporate purchasers threaten the continued use of land for family farming in the United States. A large number of states regulate commercial **fishing** operations from vessels owned by out-of-state residents. In a few states, fishing activities by foreigners are explicitly regulated by licensing requirements.

Antitrust Framework and Mergers Policy

As in other G-7 countries, mergers and acquisitions involving either domestic or foreign entities are subject to U.S. antitrust laws. In comparison with other countries, however, merger control has been a relatively unimportant policy instrument in the regulation of takeovers by foreign investors in the United States. The overall evidence tends to suggest that very few corporate acquisitions involving foreign investors have in fact been challenged under U.S. antitrust laws.²⁴⁸

²⁴⁸ According to government sources, of approximately 2,000 acquisitions in the United States involving foreign business enterprises over 10 years, only a dozen were challenged by the U.S. antitrust authorities. In addition, judicial decisions generally have not supported antitrust suits brought by private parties and, in particular, have thus far prohibited very few acquisitions by foreign investors. See Paul McCarthy in *Foreign Investment in the United States* (1989, updated in 1991) *op. cit.*, Chapter 7, p. 19.

Chart 6-3
Regulatory Framework for the Control of FDI in the United States



As illustrated in Chart 6-3, enforcement of the merger statutes is entrusted to two federal agencies: the Antitrust Division of the U.S. Department of Justice (DOJ); and the Federal Trade Commission (FTC). The DOJ is headed by the Attorney-General. It acts through the Antitrust Division (headed by the Assistant Attorney-General) to enforce the *Sherman Act* and, jointly with the FTC, the *Clayton Act* (see discussion below). The Antitrust Division has only investigatorial and prosecutorial powers, while relying upon the federal courts to adjudicate anticompetitive mergers.

The FTC is an independent agency not directly accountable to either the President or Congress. The Chairman, who is designated by the President, is the chief executive of the agency and is authorized to enforce, among other statutes, the *Federal Trade Commission Act* and the *Clayton Act*. Unlike the DOJ, the FTC has investigatorial, prosecutorial, and adjudicative authority.²⁴⁹

²⁴⁹ See Donald I. Baker, "United States of America", in *International Mergers: The Antitrust Process*, ed. J. William Rowley and Donald I. Baker (London: Sweet & Maxwell (1991), pp. 470.

Table 6-5
The Merger Review Process in the United States

Under the *HSR Act*, notice of a proposed acquisition of a U.S. corporation, together with supporting documents, is to be given to the FTC and the DOJ if either party is engaged in activity affecting interstate or foreign commerce, and

- (a) either the buyer or the acquired enterprise has total assets or annual sales of US\$ 100 million or more and the other party has total assets or annual sales of US\$ 10 million or more; and
- (b) as a result of the acquisition, the **buyer** would end up holding:
 - (i) 15% or more of the voting securities or assets of the acquired enterprise, or
 - (ii) voting securities and assets of the acquired enterprise in excess of US\$ 15 million.

Section 7A(c) of the *HSR Act* lists 11 provisions concerning transactions that are exempt from the filing requirement. The FTC can also provide additional exemptions to those listed in the *HSR Act*.

Once a notifiable transaction is filed with the FTC and the DOJ, there is a 30-day waiting-period (15 days if the acquisition is by a cash tender offer) during which the parties must not complete the deal. The FTC or DOJ may, however, extend the statutory waiting period for an additional 20 days (10 days for cash tender offers) by issuing a "Second Request" for documents and information. The second waiting period begins only after the parties have complied with the particulars of the "Second Request".

During the relevant waiting period, the FTC or the DOJ must investigate whether the effect of the proposed transaction, under Section 7 of the *Clayton Act*, may be "substantially to lessen competition or tend to create a monopoly" in any particular geographic and product market. If the reviewing agency is satisfied that the transaction does not give rise to antitrust problems, then the parties can proceed to complete the transaction upon expiry of the waiting period. If, however, the agency finds that the transaction violates the antitrust provisions, it may disallow the merger at the end of the statutory waiting period by obtaining a preliminary injunction barring the acquisition. Alternatively, the authorities have recourse to various negotiated solutions involving restructuring, divestiture by consent decree, and so on, which can be undertaken in the premerger or postmerger situation.

Non-compliance may result in a court order requiring compliance and a civil penalty of up to \$10,000 for each day the violation continues.

The U.S. merger-control framework also allows for injunctive and damage suits by injured private parties. In this regard, state attorneys-general, who enforce both state and federal antitrust laws, also have the right to bring injunctive actions in the federal courts. Hence a merger that is not challenged by either the FTC or DOJ may be challenged in a private suit by a private plaintiff or a state attorney-general.

With respect to the *Sherman Act*, Section 1 broadly prohibits transactions that result in an actual restraint of trade and commerce, and it prohibits acquisitions that result in an unreasonable restraint of trade and commerce. Section 2 broadly prohibits transactions involving a specific intent to monopolize, or attempt to monopolize, an industry, including a combination or conspiracy with such intent.

Section 7 of the *Clayton Act* is by far the most important of the antitrust laws governing corporate acquisitions, and it broadly prohibits any corporation or other person engaged in commerce from acquiring the whole or any part of the stock or assets of an enterprise if "the effect of such acquisition may be substantially to lessen competition, or to tend to create a monopoly" in any particular geographic and product market.²⁵⁰ This has been held to apply to newly organized joint-venture corporations and now applies to individuals and partnerships as well.²⁵¹

Section 7A of the *Clayton Act* was added by the *Hart-Scott-Rodino Anti-trust Improvements Act* ("HSR Act") of 1976 and requires all mergers and acquisitions above certain size thresholds to be notified in advance to both the FTC and the DOJ. Through consultations, the two agencies decide which one will investigate any particular transaction. Certain regulatory statutes contain provisions that explicitly exempt mergers from the *Clayton Act* if approved by

²⁵⁰ *Clayton Act*, as quoted in U.S. Department of Justice, *Antitrust Enforcement Guidelines for International Operations*, November 1988, p. 3 (emphasis added).

²⁵¹ See *United States v. Penn-Olin Chemical Company*, 378 United States 158 (1964).

the relevant regulatory agency.²⁵² The various prenotification thresholds and the regulatory procedures for review are outlined in Table 6-5.²⁵³

Informal Barriers to Direct Investment

While the United States is generally considered to be an open economy, a number of informal and intangible impediments to FDI do exist. In the mid-1970s, a discussion of "administrative restrictions" in the United States published by the British-North American Committee observed:

Perhaps the most significant deterrent, especially to the smaller company, is the sheer size and complexity of the United States as an economy and a country ... few Americans realize the physiological barrier which exists to direct investment in the United States by smaller foreign-owned companies.²⁵⁴

The litigiousness of the United States has also been mentioned as an impediment to investment, most recently in the *Financial Times*, by referring broadly to the U.S. "regulatory climate".²⁵⁵

²⁵² The exemptions extend to mergers and takeovers involving telephone and telegraph companies (but not radio and television) approved by the Federal Communications Commission under the *Communications Act* of 1934; mergers involving rail, motor, and water carriers approved by the Interstate Commerce Commission under the *Interstate Commerce Act*; and mergers involving newspapers approved by the Attorney-General under the *Newspaper Preservation Act* of 1970. Mergers and acquisitions involving banks fall under the purview of the *Bank Merger Act* and the *Bank Holding Company Act*. Such transactions, while not being exempt from the antitrust laws, require that the DOJ bring an antitrust action to block a bank merger within 30 days of being approved by the appropriate regulatory agency. For a discussion of these exemptions see Donald I. Baker, "United States of America", op. cit. (1991), pp. 450-451.

²⁵³ There are additional thresholds that apply to situations where both parties to the merger or acquisition are foreign entities as well as when a U.S. entity acquires foreign assets or voting securities; see Donald I. Baker, *International Mergers* (1991), op. cit., pp. 479-80. It is worth noting that it is through Hart-Scott that DOJ and DOC may be aware of transactions that may later (or indeed never) come to the attention of the CFIUS.

²⁵⁴ Simon Webley, *Foreign Direct Investment in the United States: Opportunities and Impediments*, British - North American Committee (London: BNA, September 1974), p. 36 (emphasis in original).

²⁵⁵ "Hospitality Undermined", *Financial Times*, 15 October, 1991, p. 34.

Other recent studies have also pointed to state environmental, product-liability, and antitakeover regulations,²⁵⁶ as well as wider national economic issues such as exchange and interest rates and the value of the dollar, as wielding an influence on investment decisions.²⁵⁷ These impediments to investment are tempered to some degree, however, by the fact that stock market trading in the United States is the most active and open among the G-7 countries.

Obstacles to Takeovers: Exon-Florio

National Security Definition

Perhaps the most restrictive of the informal takeover barriers is the lack of a clear and precise definition of "national security" under Exon-Florio. According to the final regulations, national security "... is to be interpreted broadly and without limitation to particular industries". In addition, it states that "generally speaking, transactions that involve product services, and technologies that are important to U.S. national defense requirements will usually be deemed significant with respect to national security". Furthermore, a notice to the CFIUS is "clearly appropriate when, for example, a company is being acquired that provides key products or key technologies essential to the U.S. defense industrial base".²⁵⁸

Definitions of national security can have both economic and cultural dimensions, in addition to the obvious military dimension. In the United States, as in other G-7 countries, economic goals are becoming more important as there is a "growing belief that the strength of a national economy is inseparable from national security".²⁵⁹ Clearly, there is considerable room for discretion in defining national security concerns. The broad and liberal interpretation of national security, as applied to takeovers reviewed

²⁵⁶ *State Legislative and Regulatory Policies Affecting European Investment in the United States*, Price Waterhouse for the European Institute, Washington, 1991.

²⁵⁷ *European Investment in the United States: Key Issues, Location Criteria and Implications*, KPMG Peat Marwick for the European Institute, Washington, 1991.

²⁵⁸ 54 Federal Regulation 58,775 (1991)

²⁵⁹ Ellen Frost and Edward M. Graham, *The New Global Environment, The Globalization of the Defense Industries, and National Security* (forthcoming), p. 2.

by the CFIUS, has the potential to create a *de facto* screening agency for all foreign takeovers in the United States.

The importance of precedence in determining what forms of transactions will likely be considered as a threat to national security cannot be ignored here. For instance, after the CFIUS recommended that the initial offer by Tokuyama Soda of Tokyo to purchase General Ceramics of New Jersey be blocked, James Florio responded that the mechanism seemed to be working and that the United States must continue to defend itself from "inappropriate foreign takeovers".²⁶⁰ Even the State Department, traditionally sensitive to foreign concerns, has maintained that national security should include broadly defined economic considerations.²⁶¹ The lack of transparency has resulted in several companies seeking approval before proceeding with an investment, even when the links to national security are tenuous at best. As Assistant Secretary Dallara testified before a House Subcommittee:

It may come as no surprise to you that CFIUS has considered a wide range of transactions. They include foreign purchases of everything from lawn seed and tulip bulb companies to defence contractors, whose operations are classified.²⁶²

Of course, tulip bulbs and lawn seed are not commodities normally linked to national security considerations, and admittedly the head of the CFIUS has stressed that it is not necessary to notify the Agency of such cases.²⁶³ The problem is, however, that with voluntary notification, the CFIUS must act within 90 days to block a transaction, or not at all. On the other hand, if no notification is made the Administration may act at any time; hence, a number of investors have taken the precaution of notifying acquisitions with only

²⁶⁰ *New York Times*, 24 April, 1989.

²⁶¹ Remark from a speech by Lawrence Eagleburger, Deputy Secretary of State, as reported in the *Globe and Mail*, 9 February, 1990, p. B4.

²⁶² Testimony of the Hon. Charles H. Dallara, Assistant Secretary of the Treasury for International Affairs, before the House of Representatives Subcommittee on Commerce, Consumer Protection, and Competitiveness (Committee on Energy and Commerce), 19 March, 1990, p. 5.

²⁶³ Remarks of Stephen J. Canner, Director, Office of International Investment, U.S. Treasury, and Staff Chairman, Committee on Foreign Investment in the United States: "Exon-Florio and the CFIUS Experience", Plaza Hotel, New York, 27 June, 1989.

a tangential relationship to national security. In testimony before a Senate subcommittee, Senior Deputy Assistant Secretary of the Treasury Niehuss revealed that notifications in 1989 represented about 30% of applicable transactions, whereas in 1990 an estimated 50% of acquisitions valued at over \$US 1 million were notified to the CFIUS.²⁶⁴

Performance Requirements

Observers have pointed out the potential to use Exon-Florio to effect changes in the foreign investment proposals that are reviewed and ultimately allowed by the CFIUS. In the Monsanto-Huels AG case (see case studies), Huels agreed to a number of concessions to win approval of the investment, among them "an agreement to keep production in the United States for at least five years, keep the research and development ... [in the U.S.], and make products available to the American semiconductor industry".²⁶⁵

In this context, Graham and Krugman note that: "Exon-Florio reviews ... may have already resulted in the de facto imposition of performance requirements".²⁶⁶ Needless to say, the imposition of performance requirements conflicts with U.S. policy priorities vis-à-vis those of other countries' policies. Whether or not performance requirements have been negotiated (and it should be noted that information on subsequent CFIUS investigations has not been as forthcoming), it is important to recognize that the power to impose them through moral suasion does exist with Exon-Florio.

Hostile-Takeover Policy

An additional takeover obstacle is created by the potential for target companies to use the Exon-Florio regulations in order to foil hostile-takeover bids. In testimony by Christopher Wall (a prominent Washington lawyer) in 1990, he admitted being "...retained by

²⁶⁴ Statement by John M. Niehuss, Senior Deputy Assistant Secretary of the Treasury before the Subcommittee on Science, Technology, and Space of the Senate Commerce, Science, and Transportation Committee, 10 October, 1990, p. 4

²⁶⁵ *New York Times*, "Agency on Foreign Takeovers Wielding Power", April 24, 1989.

²⁶⁶ Graham and Krugman, *Foreign Direct Investment* (1989), p. 115.

United States companies seeking to use the Exon-Florio Amendment as a defense tactic in the event of a hostile foreign takeover bid".²⁶⁷

Sometimes referred to as the "Pentagon Ploy", targets of a hostile takeover by a foreign company may invoke Exon-Florio and thereby delay the takeover for a minimum of 30 days and up to 90 days if the CFIUS undertakes an investigation. The target company could cause additional delay by refusing to provide either the bidder or the CFIUS with the information required in the Exon-Florio notice (e.g. business activity, classified contract, and so on).²⁶⁸ This strategy can result in unusual delays, thereby frustrating the foreign acquirer who may be forced to withdraw its bid. Alternatively, the delaying tactic enables the target company to seek a white knight.

A brief summary of the informal barriers to FDI that are connected to the passage of the Exon-Florio regulations is illustrated in Table 6-6.

Special Considerations Related to High Technology

It is undeniable that the United States remains sensitive to foreign investments - particularly takeovers - in high-tech sectors. Pressure groups such as the Economic Strategy Institute have publicized the apparent loss of U.S. primacy in high-tech industries and have urged further protectionist legislation. National security considerations also play an increasing role in foreign investment considerations in high-tech sectors. At least two member agencies of the CFIUS, the Commerce Department and the Defense Department, maintain lists of key high-tech industries ("emerging technologies" in the former case, and "critical technologies" in the latter) that show signs of becoming target industries in need of government support.²⁶⁹

²⁶⁷ Statement of Christopher R. Wall, partner with Winthrop, Stimson, Putnam & Roberts, Washington, D.C., before the House of Representatives Subcommittee on Commerce, Consumer Protection, and Competitiveness (Committee on Energy and Commerce), 31 July, 1990.

²⁶⁸ Schmidt, P.L., "Exon Florio", op. cit., p. 487.

²⁶⁹ US Council on Competitiveness, *Gaining New Ground: Technology Priorities for America's Future*, (Washington: 1991).

Table 6-6
U.S. Informal Barriers to FDI: Exon Florio and Related Issues

National Security Definition

- ▶ Neither the Exon-Florio statute nor the regulations attempt to define "national security", and the CFIUS takes a broad interpretation of what activities and industries are of relevance to national security.
- ▶ There is a lack of transparency in the regulations.
- ▶ The broad definition of national security allows economic security to be taken into consideration as well when screening.

Performance Requirements

- ▶ Performance requirements are sometimes imposed on foreign investors as a condition for approving their investment proposals. In effect, implied in the power to block foreign takeovers is the power to demand changes informally before acceptance. While U.S. federal policy is generally opposed to the imposition of performance requirements (even in exchange for investment incentives), under Exon-Florio there is scope to extract undertakings from potential foreign investors as a condition of acceptance.

Block or Delay of Foreign Takeovers

- ▶ The target of a hostile foreign-takeover bid can potentially use the Exon-Florio regulations as a defence against the hostile bid. If successful in invoking Exon-Florio, the target can cause a minimum delay of 30 days and up to 90 days if the CFIUS undertakes an investigation. In addition, by refusing to cooperate with the acquirer in submitting the relevant information necessary to file a notice with the CFIUS, the target may in effect delay a hostile bid to the point where the bid is eventually withdrawn.

High-Technology Considerations

- ▶ Consortia can be structured to limit foreign participation.

On the other hand, the United States seems to be moving towards the relaxation of antitrust policy with respect to domestic high-tech industries. The *National Cooperative Research Act* (NCRA) now permits cooperation in pre-competitive semiconductor R&D; that was previously prohibited by law. The NCRA applies equally to joint R&D by foreign-controlled and domestic firms, although in some

cases foreign-controlled firms have been excluded from high-tech consortia by other means (see below).

An extension of NCRA-type legislation covering joint manufacturing was recently enacted by the Clinton Administration. The National Cooperative Production Amendment (NCPA) of 1993, which came into effect on June 10, 1993, permits co-venturers in joint manufacturing consortia to qualify for reduced exposure to antitrust attack once they notify the Department of Justice. In effect, the NCPA amends the NCRA and allows parties involved in joint manufacturing ventures, like those involved in R&D joint ventures, to notify the DOJ and the Federal Trade Commission in order to be subject to actual, rather than treble, damages in the event of a successful antitrust challenge.²⁷⁰ Previously, such protection from antitrust suits by the government or private parties was offered only to those involved with joint R&D ventures under the NCRA.

Unlike in the case of R&D ventures, however, the NCPA stipulates that in order to qualify for favourable treatment with respect to antitrust sanctions, the principal production facilities of the joint venture must be located in the United States. Moreover, the companies must be U.S. companies or companies from nations that treat U.S. companies fairly under their antitrust laws governing joint production ventures.

The treatment of U.S. companies by other nations is intended to cover not only a country's domestic antitrust law but also all international agreements and other binding obligations to which that country and the United States are parties. In that context, Canada would be in compliance with the requirements of the NCPA by virtue of providing national treatment of U.S. investment under the Canada-U.S. Free Trade Agreement of 1989.

Foreign-controlled firms have been excluded, however, from R&D consortia now permitted under the NCRA. SEMATECH (Semiconductor Manufacturing Technology), a consortium of 14 U.S. semiconductor manufacturers, is quite candid about its aims: "Its mission is simple: to provide the United States industry the domestic

²⁷⁰ *Foreign Investment in the United States, News and Analysis*, "Clinton Signs Bill Easing Antitrust Law for Parties in Joint Production Ventures" (Washington: BNA, June 6, 1993), p. 1-28.

capability for world leadership in semiconductor manufacturing."²⁷¹ SEMATECH's annual budget is US\$ 200 million per annum, half of which is provided from DARPA (the Defense Advanced Research Products Agency) funds. The remainder comes from the 14 member firms, which in turn comprise 80% of the semiconductor manufacturing capacity in the United States. Under SEMATECH bylaws, membership is restricted to U.S. companies.

Other U.S. research and development consortia exist, many of which do not allow foreign participation, although exemptions for Canadian firms sometimes exist because of the Canada-U.S. Free Trade Agreement. These include SEMI/SEMATECH (a sourcing consortium for SEMATECH) and MCC (Microelectronics and Computer Technology Corporation), both in Texas, and the NCMS (National Centre for Manufacturing Sciences), a machine tool consortium with headquarters in Ann Arbor, Michigan.

Finally, it should also be noted that, aside from the NCRA, the United States has passed other legislation recognizing the contribution of technology to its economic future. These include the *Bayh-Dole Act* and the *Patent Term Restoration Act*, which focus on legal protection for inventors; and the *Technology Transfer Act* of 1986 (in conjunction with Executive Order 12591), which encourages technology transfer between federal laboratories and private industry. Future recommended developments include the further strengthening of the U.S. Office of Science and Technology Policy (OSTP) and an increase in DARPA funding for civilian projects.²⁷² These and other possible measures in the future could serve to blur the distinction between the private and public sector; however, foreign company eligibility for some of these programs is not a foregone conclusion. As a recent report for the European Institute warned:

In the United States federal system, the need to balance constituent interests against national interests often produces compromises that chip away at longstanding national policies. Political pressures from the grass roots and special interests have made some successful and nearly-successful attempts to erode United States open trade and investment policies.... National treatment could become a casualty of this process – not in the immediate future, but gradually. Failure to

²⁷¹ "SEMATECH - Innovation for America's Future" (a SEMATECH pamphlet), 1990, p. 7.

²⁷² U.S. Council on Competitiveness, "Gaining New Ground", pp. 16-17 and 46.

conclude an acceptable agreement in the Uruguay Round multilateral trade negotiations could speed this process by increasing the influence and emotional appeal of protectionist interests.²⁷³

Obstacles to Takeovers:

Antitakeover Laws and Corporate Law at the State Level

In recent years, various states, under their corporate law provisions, have introduced measures to impede hostile takeovers by both foreign and domestic firms. These measures include the adoption of charter and by-law provisions; the adoption of shareholder-rights plans (poison pills); and the granting, under certain circumstances, of lock-ups on corporate assets or securities.²⁷⁴

Forty states had adopted some type of statutory takeover control by mid-1992, and at least 38 of them had written more than one type of takeover-regulation technique into their corporation laws.²⁷⁵

In many states, such antitakeover statutes were largely in response to unwanted takeovers of local businesses by foreign investors. In particular, the state authorities expressed concern about the negative economic impact of such takeovers, citing unnecessary debt problems and massive job losses, as well as the adverse results of junk-bond financing that followed such activity. These actions, however, are in conflict with attempts by various states to attract foreign capital in view of its potential to create employment and other benefits.

Following a Supreme Court decision striking down a state antitakeover statute in 1984, state corporate law ceased, for a period of time, to be significant in precluding merger and acquisition activity in United States. In 1987, however, the Supreme Court upheld Indiana's control-share acquisition statute. Since that decision, a second generation of state-level antitakeover statutes have mushroomed.

²⁷³ "Policies Affecting European Investment in the United States", Price Waterhouse, 1991, Section II, p. 18.

²⁷⁴ A description of the various forms of state antitakeover statutes can be found in *Mergers and Acquisitions*, "From the Hustings: The Role of States With Takeover Control Laws" (Investment Dealer's Digest: New York), September/October 1992, pp. 61-62.

²⁷⁵ *Mergers and Acquisitions*, op. cit., September/October 1992.

Some states have enacted control-share acquisition statutes, which generally require approval of voting shares for stockholders whose ownership exceeds certain percentage thresholds. Approval of these voting rights must be obtained from a majority of disinterested shareholders – that is, from those shareholders affiliated with neither the investor nor the incumbent officers or directors.

In some states, fair-price supermajority statutes have been passed to minimize the possibility that a bidder might pay one price for a controlling interest in a target company and then squeeze out the remaining shareholders at a lower price. In effect, the purpose of the statute is to prevent two-tier offers that squeeze out minority shareholders.²⁷⁶

Under business combination freeze-out statutes, hostile acquirers must wait for a certain period of time before they can complete mergers with unwilling target firms, even if the acquirers have purchased a majority of the target's shares in tender offers. The waiting period may extend anywhere from two to five years. Additional conditions may be imposed on the acquirer even after the waiting period has lapsed.

A few states have enacted so-called recapture-of-profit laws that allow a company to recover profits from an investor who discloses an intention to acquire control but then sells the holdings within 18 months of the disclosure. Recapture may be waived if the investor held the shares for a sufficient period of time before the disclosure was made.

To date, the Pennsylvania Senate has passed some of the strictest antitakeover statutes, with stiff "raider disgorgement" provisions. The Pennsylvania statutes restrict the voting rights of any group or investor who acquires 20% or more of a company's stock. In addition, the statutes also allow for the seizure of all profits made by short-term investors who sell equity securities within 18 months after acquiring 20% or more of a company's stock. Furthermore, employees are protected from the negative effects of plant closings and other disruptions caused by an acquisition. The statutes call for

²⁷⁶ IL&T, United States (September 1989), pp. 6-7. These laws are in effect in Arizona, Florida, Idaho, Indiana, Louisiana, Minnesota, Missouri, and both North and South Carolina.

the acquirer to assume responsibility for existing collective bargaining agreements and to provide severance pay for employees who lose their jobs as the result of a takeover.²⁷⁷

Case Studies on FDI in the United States: A Brief Review

This section provides brief case studies of several foreign direct investment proposals in the United States. The first involves state antitakeover legislation, and the remaining have been investigated by the CFIUS under the Exon-Florio provisions. In discussing case studies it is important to bear in mind that there are many investments that did not become case studies because Exon-Florio deterred investors entirely from entering the United States.

MAMCO / CATIC

This is the only takeover that has been disallowed under Exon-Florio. The China National Aero-Technology Import and Export Corporation (CATIC), attempted to purchase MAMCO of Seattle, a fabricator of metal parts for commercial aircraft. MAMCO had no classified contracts, but export controls governing some of their products did exist. Up to 90% of MAMCO's business was with Boeing, also of Seattle. Although national security was invoked in the February 2, 1990 order to divest, there have been suggestions that this decision was based instead on broad foreign policy considerations (i.e., CATIC is state-owned, and the transaction took place not long after the Tiananmen Square massacre). In addition, it was also reported that CATIC had violated U.S. export control laws in 1984 when it purchased two CFM-56 General Electric aircraft engines and then engaged in "reverse engineering" by taking them apart in order to learn manufacturing secrets.

As a recent summary of the case in the Harvard International Law Journal pointed out, however, MAMCO did not even employ full-time designers or engineers, and the company was also described

²⁷⁷ "A Paradoxical Anti-Takeover Bill", *New York Times*, Money section, April 8, 1990; and "Pennsylvania Acts on Takeover Bids", *Financial Times* (London), Business Law section, July 19, 1990.

elsewhere as a "metal basher" and "machine shop".²⁷⁸ The national security rationale for the rejection of the proposal therefore appears weak. This case indicates that policy concerns other than national security may influence decisions under Exon-Florio.

Norton Co. / BTR PLC

This was an attempted hostile takeover of Norton Co. of Worcester, Mass., by BTR PLC of the United Kingdom in early 1990. Although Norton had a number of contracts in defence-related industries, the President recommended, on June 25, 1990, that no action be taken against the takeover. Because of significant opposition to the deal by the local community, however, as well as by the management and Board of Directors of Norton, the Massachusetts state legislature responded quickly and enacted a new antitakeover law in April 1990. The law had the effect of precluding BTR from immediately replacing a majority of the members of the Board of Directors of Norton through a BTR-sponsored proxy solicitation. As a result of this law, Norton had sufficient time to find a white knight to acquire the company on a friendly, negotiated basis. Ironically, the white knight was itself a non-U.S. company - the Compagnie Saint-Gobain of France - this acquisition was also subject to investigation by the CFIUS.

Monsanto Electronic Materials Co. / Huels AG

The first CFIUS investigation under Exon-Florio was the sale of Monsanto Electronic Materials Co. (MEMC) - a subsidiary of Monsanto Corp. - to Huels A.G., of West Germany. Huels A.G. is a subsidiary of VEBA AG, a West German conglomerate with interests in the chemicals industries. According to an account of this investigation in the U.S. business press, MEMC "was the last major U.S.-owned manufacturer of silicon wafers for the merchant market, and the only U.S. producer of 8-inch wafers for that market".²⁷⁹

²⁷⁸ Jim Mendenhall, "United States: Executive Authority to Divest Acquisitions under the Exon-Florio Amendment - the MAMCO Divestiture", *Harvard International Law Journal*, vol. 32 (1991), p. 290.

²⁷⁹ Bradley R. Larschan, "A Review of Exon-Florio Investigations to Date", in *Foreign Investment in the United States: News and Analysis*, op. cit., (London and Washington: BNA, May 1990), p. 18.

Silicon wafers are flat discs used in the manufacture of semiconductors.

President Bush recommended that the deal go ahead on 3 February, 1989, on the unanimous recommendation of the CFIUS. This recommendation was made, however, only after a series of meetings were held between CFIUS officials and Huels. The CFIUS was careful not to make official requests, but pressure came from the Defense Department, Representative Florio, SEMATECH (a technology consortium of which MEMC was a member), and the CFIUS itself, for particular assurances. On January 23, 1989, Huels Chairman Carl Krauch sent written assurances to Treasury Secretary Nicholas Brady, promising: first, to maintain production in the United States for five years; second, to conduct R&D in the United States; and, third, to make silicon wafers available to the U.S. semiconductor industry. The publicity surrounding these undertakings was unanticipated and details surrounding subsequent cases have been less forthcoming.

Semi-Gas / Nippon Sanso KK

On July 27, 1990, President Bush confirmed the sale of Semi-Gas, a subsidiary of Hercules Inc., Wilmington, Delaware, to Matheson Gas Products, Inc., a New Jersey subsidiary of Nippon Sanso KK, of Tokyo. Semi-Gas makes gas cabinets used in semiconductor production. Following the President's approval, however, the Justice Department announced that it would seek to block the sale through the courts,²⁸⁰ citing antitrust considerations. Ultimately, however, the case was thrown out of court. This example points to the increased ambiguities and uncertainties faced by foreign investors in the United States, particularly in the case of hostile, high-tech, or otherwise controversial takeovers.

LTV Corporation / Thomson-CSF

The proposed Thomson-CSF acquisition of LTV's Missile Division is undoubtedly the most important foreign investment considered by the CFIUS in the United States since the adoption of the Exon-Florio provision in 1988. It acted as the catalyst to the most recent changes to the Exon-Florio Law (the Byrd Amendments of 1992). The case involved a bid (eventually withdrawn) by French

²⁸⁰ *Financial Times*, 2 January, 1991, p. 2.

government-controlled enterprise Thomson-CSF to acquire the Missile and Aerospace Division of LTV Corporation of Dallas, Texas. LTV Corporation is an important U.S. defence contractor that produces several important weapon systems, including the Multiple Launch Rocket System, and the ENRINT advanced anti-missile system. Thomson CSF is a French electronic company whose parent company, Thomson SA, is 60% owned by the French government.

LTV Corporation had been operating under bankruptcy court protection for nearly six years when the takeover bid was launched. Thomson first notified the CFIUS of its intention to purchase LTV's Missile Division in April 1991. It teamed with General Motors Corporation's Hughes Aircraft Company Division and the Carlyle Group, a Washington merchant bank, in order to make the bid. Both of those companies withdrew, however, as the deal became controversial.

Concerns were raised about the potential Thomson-LTV deal and the possibility that such a deal could jeopardize national security by giving the French access to critical U.S. defence technology. Technology transfers to third countries were also cited as a concern in view of Thomson's sales of weapons systems to countries like Libya and Iraq. Additional concern was raised that the deal could lead to job losses for U.S. workers, as Thomson might shift LTV subcontract work from U.S. suppliers to suppliers in France. Thomson responded by arguing that it had received initial assurances from the Department of Defense that the acquisition would be approved and that it had committed itself to comply with all applicable regulations and security requirements.

Pressure from Capitol Hill regarding the LTV-Thomson deal was intense. In a 93-4 vote, the Senate condemned the deal in a non-binding resolution. In July 1992, Thomson withdrew its bid and attempted to restructure it; within a few weeks, however, its efforts to acquire only a minority interest in LTV collapsed. Eventually, LTV's aerospace business was acquired by a group of U.S. firms: Loral Corporation, the Carlyle Group, and Northrop Corporation.

Armstrong World Industries / Belzberg Family

This case involved the unsuccessful hostile-takeover bid for Armstrong World Industries Inc., of Lancaster, Pennsylvania –

manufacturers of floor tile and building products – by the Belzberg family of Vancouver. It was a classic 1980s takeover battle, with the Belzberg's attempting "greenmail"²⁸¹ and using highly leveraged debt instruments, while Armstrong diluted holdings through new stock issues and rewrote the rules to include "poison pills".

This prompted the state legislature to respond by passing Bill 1310, one of the toughest antitakeover laws in the United States.²⁸² Essentially Bill 1310 allowed a poison-pill defence to be enshrined in the state's statute books by stipulating that any new shareholder acquiring and then selling 20% of the voting shares of a company must hand over the profits to the target company (this is called a disgorgement provision).²⁸³

While some Pennsylvania companies feared that such legislation would serve to lower stock prices and company valuation in the long run, there are few indications that state legislatures are becoming less likely to pass such legislation.

Conclusion

It is interesting to note that federal, state, and local governments, while often wary of foreign takeovers – particularly in high-tech industries – actively encourage, and sometimes subsidize, foreign greenfield investments in the United States. Many state and city governments, eager for new sources of jobs and tax revenues, attempt to lure major foreign investment projects to their respective jurisdictions. Forty-two of the 50 states have offices or some form of representation in 24 countries worldwide in order to attract foreign investment to their locale; 36 states have offices in Japan. Investment incentives take various forms and include the provision of infrastructure and land free of charge, industrial development bonds (for financing projects at low interest rates), and tax relief.

²⁸¹ A situation involving the sale of shares, back to the target company, by the hostile acquirer often resulting in a handsome profit to the acquirer.

²⁸² *Report on Business Magazine* (Globe and Mail), September 1990, p. 35.

²⁸³ *Ibid.*, p. 18.

Of course, this only highlights what A. E. Safarian has termed the contradictory character of the approach by industrialized countries to FDI, and particularly that of the United States. On the one hand, they do things to attract FDI; on the other, they put laws, regulations, and institutions in place to ensure that only high-quality investments are made.²⁸⁴

It may be said, therefore, that the policy priorities of the United States are currently in a state of flux and contradiction. Although encouraging greenfield investment, the United States is increasingly wary of M&A activity; some elements are becoming increasingly protectionist, while others are seeking to lower international investment barriers. Furthermore, while an FDI screening agency still does not exist in the United States, the fluidity with which antitrust laws and national security considerations may be interpreted (particularly because of Exon-Florio) gives U.S. authorities (both state and federal) wide latitude to influence FDI takeover behaviour. The FDI regulations in the United States underwent substantive changes in the 1980s. As Graham and Krugman pointed out in 1989:

Much discussion of policy toward FDI focuses on the possibility that future legislation might establish formal screening mechanisms and performance requirements. In fact the existing CFIUS structure could be used as the instrument of a highly interventionist policy without any further legislative action; all that would be needed would be a broad interpretation of CFIUS's mandate.²⁸⁵

It is not a contradiction to observe that while the United States is one of the least restrictive of the G-7 countries with respect to incoming FDI, foreigners face an increasing number of restrictions concerning their investments.

²⁸⁴ A.E. Safarian, "Rapporteur's Comments", in *Corporate Globalization through Mergers and Acquisitions* (University of Calgary Press, 1991), p. 247.

²⁸⁵ Graham and Krugman, *Foreign Direct Investment in the United States*, Institute for International Economics, (Washington: 1989), p. 100.

CHAPTER 7
CANADA

CANADA

Introduction

Canada has an increasingly liberal foreign investment regime. In 1985, the newly elected federal government replaced the restrictive *Foreign Investment Review Act* (FIRA) with the *Investment Canada Act* (ICA) and established Investment Canada as an agency to promote Canada as a "safe and profitable place to invest". The legislative change signaled a major shift in policy towards foreign investment by recognizing the importance of foreign capital and technology for Canada while at the same time retaining a mechanism to review significant foreign investments.

At the time of Confederation in 1867, most foreign investment in Canada came from the United Kingdom in the form of portfolio investment. By 1900, however, FDI had risen to where it accounted for one-quarter of total foreign investment in Canada. Increasingly, after 1900, more and more gross capital imports came from the United States, almost exclusively in the form of direct investment. Following the Second World War, U.S. direct investment to Canada increased dramatically again. The stock of FDI then accounted for one-half the level of total foreign investment in Canada. The level of foreign ownership and control in Canada's economy became the highest in the industrialized world.

Not surprisingly, therefore, Canadian attitudes towards foreign investment seek to reconcile two realities. On the one hand, there is a high degree of foreign ownership and control of Canadian industry. On the other hand, there is a continuing need for foreign direct investment to bring technology and management expertise; more generally, FDI promotes efficiency and competition in Canada's small, open market. Government policy on foreign investment in Canada aims to balance these two conflicting realities.

Institutional Developments

Public awareness of the high social and political costs of FDI was raised for the first time in 1958 with the release of the *Report of*

*the Royal Commission on Canada's Economic Prospects.*²⁸⁶

Subsequent studies intensified public concern about the high level of foreign control in Canada. Following the recommendations of the 1973 *Gray Report*, the then Liberal government established the Foreign Investment Review Agency to screen foreign investment to ensure that the proposal would provide a "significant benefit to Canada". Under FIRA, the review activities applied to all acquisitions (direct or indirect) and to new business investments by foreign investors.

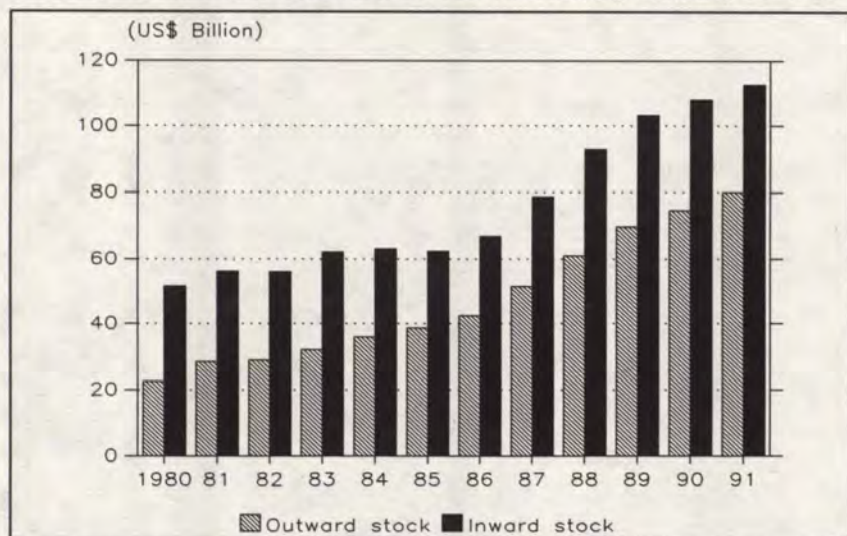
The establishment of the Investment Canada in 1985 by a newly elected Conservative government marked a major departure from the restrictive foreign investment policies under FIRA. The ICA called for a review of only the large foreign takeovers of Canadian business, and it changed the criterion for approval from one based on "significant benefit to Canada" to "net benefit to Canada". The Canada-U.S. Free Trade Agreement (FTA) in 1989 marked an important step towards liberalizing Canada's trade and investment relations with the United States. Under the terms of that accord, the ICA was amended, and the treatment of U.S. direct investment to Canada was considerably relaxed relative to that from other nations. In September 1992, the governments of Canada, the United States, and Mexico successfully negotiated the North American Free Trade Agreement (NAFTA) which will result in an extension of the provision governing U.S. investment in Canada to Mexican investment as well.

Recent Investment Patterns

At year-end 1992, the stock of FDI in Canada was estimated to have reached Cdn\$ 136.6 billion (US\$ 107.5 billion). The corresponding value of the stock of Canadian direct investment abroad (CDIA) amounted to \$Cdn 99.0 billion (US\$ 78 billion). In the last decade, a faster growth of CDIA relative to FDI stock resulted in bringing about a better balance between Canada's inward and outward direct investment activity. With CDIA expanding at more than one and a half times the rate of FDI in the last decade, the ratio of outward to inward direct investment increased from roughly 50% in 1982 to about 73% in 1992 (see Chart 7-1).

²⁸⁶ Walter Gordon, Chairman, *Report of the Royal Commission on Canada's Economic Prospects* (November 1957).

Chart 7-1
Stock of Inward and Outward Direct Investment, Canada, 1980-91



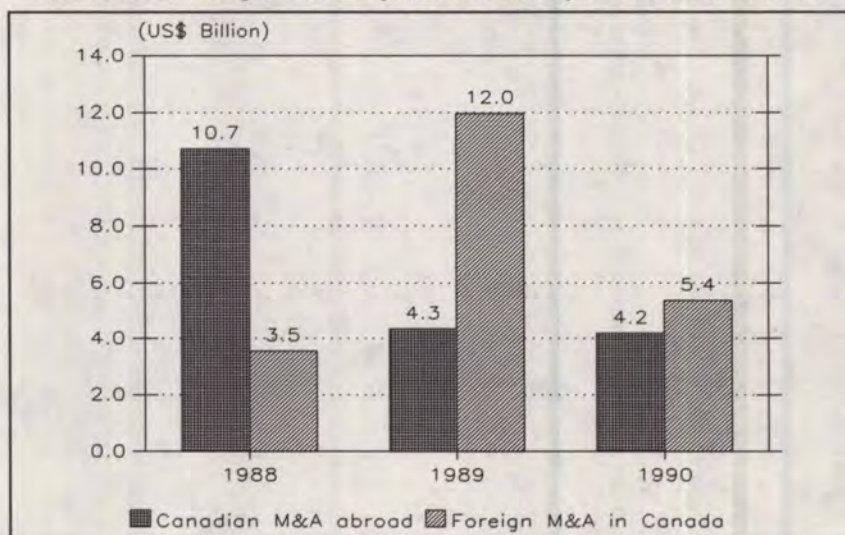
Source: Investment Canada compilations based on data from Statistics Canada and the OECD.

In the mid-1980s, some fundamental shifts among the major sources of FDI in Canada were observed. Most notably, the United States, which has traditionally been the dominant source of FDI in Canada, experienced a sharp decline in relative shares. Almost three-quarters of the total FDI stock in Canada in 1985 was accounted for by the United States; by year-end 1992, however, less than two-third of FDI was of U.S. origin. In the interim, other industrialized countries, notably the United Kingdom and Japan raised their importance as home countries of FDI to Canada. The United Kingdom increased its share of total FDI from 9.8% in 1985 to 12.5% in 1992; the gain of 2.7 percentage points represented over one-half the increase in the EC share of FDI in Canada during this period. Japan's share of FDI roughly doubled from 2.2% in 1985 to 4.1% in 1992; in 1991, Japan alone accounted for about 58% of FDI from the Pacific Rim countries.

Canada's importance as a destination of global direct investment also changed dramatically in the past three decades. In 1967, as the largest destination of international direct investment,

Canada held over 18% of the world's stock of inward direct investment. As other important host countries of FDI began to compete for global capital in the 1970s and 1980s, Canada experienced a gradual drop in its relative share - from less than 16% of total inward direct investment in 1973 to just over 10% in 1980. In 1990, Canada accounted for only 6.6% of an estimated US\$ 1.6 trillion of global inward direct investment; it ranked behind the United States, the United Kingdom, and Germany as a recipient of global FDI.²⁸⁷ As shown in Table 7-1, however, Canada's FDI stock as a proportion of its gross private non-residential capital stock is still the highest among the industrialized countries.

Chart 7-2
Transborder Merger and Acquisition Activity in Canada, 1988-90



Source: KPMG Dealwatch 91.

As in most industrialized economies, cross-border merger and acquisition activity in Canada picked up considerably in the late 1980s. The Canada-U.S. Free Trade Agreement was preceded and

²⁸⁷ See John Rutter, *Recent Trends in International Direct Investment*, op. cit. (August 1992).

Table 7-1
Foreign Ownership and Control in Canada

Based on the most recent data on foreign control from Statistics Canada,

- ▶ the foreign-controlled share of corporate **assets** (in both financial and non-financial corporations) in Canada reached 18.9% in 1988, up 0.6 of a percentage point from 1987 and 2.0 percentage points from 1983;
- ▶ the foreign-controlled share of corporate **revenues** was 25.3% in 1988, down from 25.7% in 1987;
- ▶ the foreign-controlled share of corporate **profits** increased very marginally, from 26.2% in 1987 to 26.3% in 1988.
- ▶ In **non-financial** industries, the foreign-controlled share of corporate **assets** in 1988 jumped 1.5 percentage points to 26.2%. That marked the third consecutive year of increase following the general downward trend since 1971, when the share of foreign control peaked at 37%.

FDI stock as a proportion of Canada's gross, private non-residential capital stock is the highest of all the major industrialized economies:

- ▶ In 1992, the inward stock of FDI in Canada amounted to just over 10% of gross private non-residential capital stock. The ratio stood at around 11% in 1975, declining thereafter to a low of 8.8% in 1982, and then rising gradually back to double digits in 1991. By comparison, the 1991 ratio of FDI to capital stock in the United Kingdom was 9.1%, 4.2% in the United States, and 2.8% in both Germany and France (at year-end 1989).
- ▶ Inward foreign direct investment as a proportion of Canada's GDP remained generally steady throughout the 1980s: it dropped from 20.9% in 1980 to 18.2% in 1988. Thereafter, the ratio rose from 18.3% in 1989 to just under 20% in 1992. Among the G7 countries, only the United Kingdom had a higher proportion of FDI in GDP than Canada in 1990 (22.2% for the U.K. versus 19.5% for Canada).

followed by a wave of corporate restructuring that led to a marked rise in cross-border takeovers. According to KPMG Dealwatch, foreign acquisitions of Canadian enterprises in 1989 (the first year of the FTA) reached a record high of US\$ 12 billion, - an increase of 237% in value over the previous year. In 1990, cross-border acquisitions dropped sharply to US\$ 5.4 billion. In comparison, foreign acquisitions by Canadian multinationals amounted to less than US\$ 5 billion in 1989 and 1990 (see Chart 7-2); in 1988, the level of

Canadian mergers and acquisitions abroad reached a record high of US\$ 10 billion, although a significant part of that amount was the result of a single takeover.²⁸⁸

Foreign control of industries appears to be relatively much higher in Canada than in any other G-7 country. Notwithstanding the differences that exist in measuring foreign control data in those countries, the greater significance of foreign firms in the Canadian economy is not surprising, given that the nation has historically relied heavily upon foreign capital for much of its economic development. Several indicators of the relative importance of foreign participation in the Canadian economy are shown in Table 7-1.

Formal Barriers to Direct Investment

Although a number of federal as well, as provincial, Acts, regulations, and policies have implications for foreign investors in Canada, the cornerstone of foreign investment policy is the *Investment Canada Act*, which came into effect in June 1985, replacing the more restrictive *Foreign Investment Review Act*. A government agency, Investment Canada, was established to administer the Act²⁸⁹. The Agency has a three-pronged mandate:

- ▶ to promote investment in Canada by Canadians and non-Canadians;
- ▶ to undertake research and provide policy advice on matters relating to investment; and
- ▶ to review major foreign investments to determine if they are likely of net benefit to Canada.

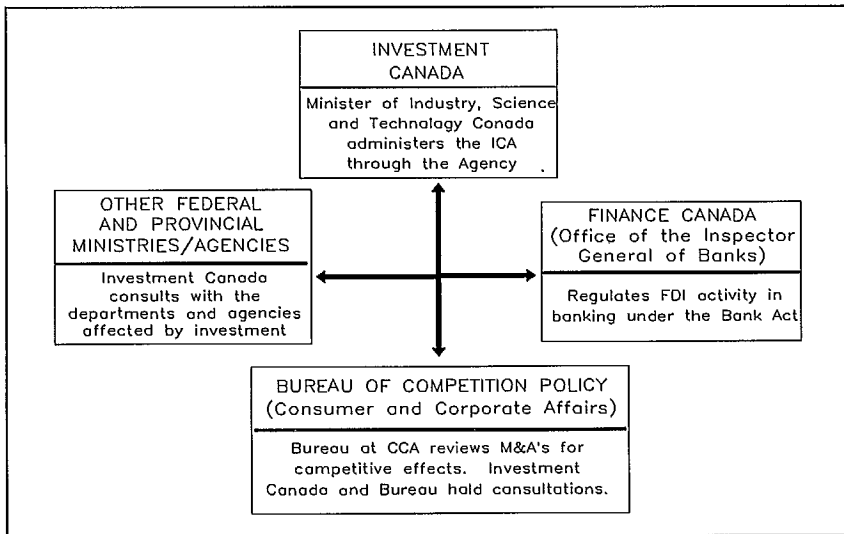
²⁸⁸ On April 1, 1988, Canada's Campeau Corporation acquired U.S.-controlled Federated Department Stores Inc. for US\$ 6.7 billion – the largest Canadian takeover of a foreign enterprise.

²⁸⁹ Effective June 25, 1993, parts of Investment Canada including the investment review functions, along with parts of the department of Communications, Consumer and Corporate Affairs and Industry, Science and Technology were merged to form the new department of Industry and Science Canada. The investment review provisions of the ICA are still in force with the Minister of Industry and Science now being the responsible Minister.

Regulatory Framework

In carrying out its mandate, Investment Canada advises and assists the Minister responsible for Investment Canada (hereinafter referred to as the "Minister"). Other major departments and organizations that are directly or indirectly involved in monitoring FDI activity in Canada are shown in Chart 7-3.

Chart 7-3
Regulatory Framework for the Control of FDI in Canada



Source: Investment Canada.

In reviewing large takeovers, Investment Canada consults with provincial and federal government departments, agencies, and industries that may be directly or indirectly affected by the investment. Among the key ministries, Investment Canada holds consultations with the Bureau of Competition Policy at Consumer and Corporate Affairs Canada in order to seek the Bureau's assessment of the competitive effects of a merger involving foreign firms (see the section in this chapter on Merger Policy). Investment Canada generally accepts the Bureau's competitive assessment for the purposes of the competition component of the "net benefit to

Canada" test. In addition, the two agencies attempt to coordinate the timing of the announcement of their decisions on a particular merger.

The Department of Finance Canada is another important ministry responsible for monitoring domestic and foreign banking activities under the *Bank Act*. In practice, the Inspector General of Banks is responsible to the Minister of Finance for the administration of the *Bank Act*. In regard to regulating foreign banking activities, the Minister of Finance is entrusted with the responsibility of reviewing and approving acquisitions of control of a foreign bank subsidiary authorized to carry on business in Canada (commonly referred to as a Schedule B bank). In addition, direct and indirect takeovers of a corporation by a foreign bank, as well as other types of transactions involving foreign banks, fall under the purview of this ministry.

Table 7-2
Foreign Direct Investment Review Process, in Canada

Under the 1985 *Investment Canada Act* (ICA), the establishment of new Canadian businesses and small takeovers by foreign investors are exempt from review but require notification to Investment Canada (the Agency). All new businesses are exempt from review, except if they occur in industries that affect Canada's "cultural heritage". In contrast, foreign **acquisitions of control** of large-scale Canadian business enterprises are subject to review by the Agency. Large takeovers are subject to different thresholds that could trigger a review, depending on whether the acquisition involves U.S. or non-U.S. investors.

Acquisitions by **non-U.S. investors** that trigger a review include:

- ▶ a direct acquisition of a Canadian business with gross assets of Cdn\$ 5 million (US\$ 4.4 million);
- ▶ an indirect acquisition of a Canadian business with gross assets of Cdn\$ 50 million (US\$ 44 million); or
- ▶ an indirect acquisition of a Canadian business as part of a larger non-Canadian acquisition in which the Canadian assets acquired are less than Cdn\$ 50 million but constitute more than 50% of the total international and domestic assets.

continued

Under the investment provisions of the 1989 Canada-U.S. Free Trade Agreement (FTA), acquisitions by **U.S. investors** that trigger a review are considerably larger, as follows:

- ▶ a direct acquisition of a Canadian business with gross assets of Cdn\$ 150 million (US\$ 131 million);
- ▶ all indirect acquisitions of a Canadian business are exempt from review as of January 1, 1992.

All **non-reviewable acquisitions** of Canadian business (as with new business establishments), regardless of size, are notifiable under the ICA. For U.S. investors, the higher takeover thresholds established under the FTA do not apply to certain "sensitive sectors", where U.S. investors are subject to the same thresholds that apply to takeovers by non-U.S. investors. These sensitive sectors include **uranium ownership and production, cultural businesses, transportation industries, and financial services.**

All reviewable direct investments by foreign investors must be filed with Investment Canada in advance or, in the case of indirect investments, within 30 days of finalizing the deal. The Minister responsible for Investment Canada determines whether the investment proposal (takeover) is likely to be of "net benefit to Canada"; the Minister has 45 days from the day of initiating a review to come to a decision, but can extend the review period by an additional 30 days. The investment is deemed approved if the Minister fails to render a decision within 75 days (including the extended review period of 30 days). The Minister may also reconsider a proposal that is rejected if foreign investors agree to undertakings that are likely to yield a net benefit to Canada. The new undertakings must be submitted by the foreign investor within 30 days of the date on which the investment proposal is rejected.

In general, the ICA calls for the notification of small acquisitions and the establishment of new businesses ("greenfield" investments) by foreign investors, while providing for a review of large acquisitions by non-Canadians. Investments that are specifically exempt from review but require **notification** include: the establishment of a new business; the direct acquisition of a business with assets of less than Cdn\$ 5 million (US\$ 4.3 million); and the indirect acquisition of a business with assets of less than Cdn\$ 50 million (US\$ 43 million).²⁹⁰ Foreign investments subject to **review**

²⁹⁰ The acquisition of a Canadian enterprise is considered "direct" where it involves acquisition of control of a corporation carrying on a Canadian business, and "indirect" where the acquisition involves the transfer of control of a non-Canadian corporation - a parent company - which in turn controls a Canadian corporation carrying on a Canadian business.

under the ICA include: a direct acquisition of control of a Canadian business with gross assets of Cdn\$5 million or more; an indirect acquisition of a Canadian business with assets of Cdn\$50 million or more; and an indirect acquisition of control of a Canadian business as part of a larger non-Canadian acquisition in which the Canadian assets acquired are less than Cdn\$ 50 million but more than 50% of the total international and domestic assets.

One exception to the review thresholds, relates to the area of Canada's "cultural heritage and national identity".²⁹¹ In these sectors, all takeovers and new businesses, irrespective of their size, may be subject to review at the discretion of the Minister (i.e. on the recommendation of the Governor-in-Council) in order to protect the public interest.²⁹²

The investment provisions of the Canada-U.S. Free Trade Agreement, which came into effect on January 1, 1989, require that Canada provide "national treatment" to U.S. investors and U.S. investments in Canada, except as otherwise provided under existing laws (for example, the ICA, which is grandfathered for this purpose) and certain other exceptions. The most significant impact of the FTA's "national treatment" principle is that Canada is prevented from adopting new investment rules that are more stringent than those which applied to U.S. investors prior to the FTA. Of course, the principle of "national treatment" for U.S. investors does not apply to large-scale investment or investment in particularly sensitive sectors.

Under the 1989 FTA, Canada continues to review direct acquisitions from U.S. investors but it calls for a progressive annual increase in the review thresholds, from \$25 million in 1989 to a peak of Cdn\$ 150 million (US\$ 128.5 million) by 1992. Screening of indirect U.S. acquisitions was phased out completely in 1992; the threshold was set at Cdn\$ 250 million (US\$ 214.2 million) in 1990, but rose to Cdn\$ 500 million (US\$ 428.4 million) in 1991.

²⁹¹ Industries belonging to Canada's cultural "heritage" include those involved in the publication, distribution, and/or sale of books, periodicals, newspapers, music in print or machine-readable form, film or video products, and audio and video music recordings.

²⁹² James M. Spence and Gabor G.S. Takach, *A Guide to the Investment Canada Act*, (Buttersworth, 1985), pp. 1-11.

Investment Canada must still be notified of all non-reviewable acquisitions and greenfield investments by U.S. investors.²⁹³

U.S. acquisitions in certain foreign-investment-sensitive sectors, however, cannot benefit from the higher review thresholds under the FTA. These sectors include: financial services, cultural industries, transport, and uranium ownership and production. U.S. takeovers of Canadian businesses in these sensitive sectors are subject to review by the Agency if they exceed the thresholds that generally apply to non-U.S. investors.

All reviewable investments require that investors file an application with Investment Canada prior to the closing of a direct acquisition, or within 30 days thereafter in the case of an indirect acquisition. Applications for investments in culturally sensitive sectors are required upon receipt of a notice of review. Moreover, there is provision for the Minister to permit an investment prior to the completion of a review if there are reasonable grounds to believe that the delay could cause undue hardship to the acquiror or jeopardize the operations of the Canadian business.

The review process has firm deadlines regarding the initiation and completion of a proposal. Investment Canada submits the review application to the Minister, together with any other information or written undertakings provided by the applicant, or any representation submitted by the province that is likely to be significantly affected by the investment. The Minister responds within 45 days of the receipt of an investment proposal on the matter of "net benefit to Canada". The Minister has the discretion to extend the review period for an additional 30 days or more. If the Minister does not come to a decision within 75 days, however, the proposal is deemed approved. In certain cases, rejected proposals may be reconsidered if the investor makes representation to the authorities or agrees to specific undertakings within 30 days.²⁹⁴

²⁹³ J. T. Kennish, "How the U.S./Canada Free Trade Agreement Affects Canada's Foreign Investment Legislation", *The Osler Outlook*, vol. 1, April 1990.

²⁹⁴ This process is considerably streamlined compared to FIRA. Under FIRA, if the government was unable to reach a decision within 60 days, it was entitled to extend the time of review for an unlimited period. See Spence and Takach (1985), op. cit.

At the completion of the review process, Investment Canada prepares a report and makes recommendations to the Minister. In determining whether an investment is likely to be of net benefit to Canada, the ICA requires that the Minister take into account certain specified factors, including (i) the effect of the investment on the level and nature of economic activity; (ii) the degree and significance of participation by Canadians in the Canadian business; (iii) the effect of the investment on productivity, industrial efficiency, technological development, product innovation, and product variety in Canada; (iv) the effect of the investment on competition within an industry (or industries) in Canada; (v) the compatibility of the investment with national industrial, economic, and cultural policies; and (vi) the contribution of the investment to Canada's ability to compete in world markets.

If it cannot be concluded that the transaction meets the net benefit test with respect to these factors, the applicant may not implement the transaction or, if implemented, must divest itself of the control of the Canadian business. The Minister has various injunctive and mandatory remedies available if the non-Canadian fails to dispose of the Canadian business after failing the net benefit test.²⁹⁵

Securities Regulations

Takeover bids for Canadian public companies are subject to regulations under applicable Canadian provincial securities legislation. When the target is a federally incorporated firm, then bids made to the Canadian shareholders are regulated by the *Canada Business Corporations Act*. In general, compliance with the *Ontario Securities Act* will constitute compliance with the takeover-bid legislation of the other provinces. The Ontario Securities Commission is responsible for enforcement of the *Ontario Securities Act* and has broad supervisory and regulatory powers to restrain, or take other action against, takeover bids that do not conform to securities laws and policies. The takeover-bid provisions of the *Ontario Securities Act* come into play when a bidder makes an offer to acquire 20% or more of a class of outstanding voting or equity securities of a corporation. For federally incorporated corporations, this threshold is lowered to 10% by the *Canada Business Corporations Act*. An "early warning" reporting requirement is triggered when the purchaser

²⁹⁵ *Ibid.*

acquires beneficial ownership or control of 10% or more of a class of outstanding voting or equity securities of a corporation. A press report must be issued immediately, and a detailed report must be filed within two days with the Ontario Securities Commission. A further press release and report are required each time the purchaser subsequently acquires an additional 2% or more of that class of securities.²⁹⁶

Sectoral Restrictions

Federal Government Restrictions

Since adhering to the OECD's Code of Liberalization of Capital Movements in 1985, Canada is the only OECD member that presently maintains a full reservation to the Code. The full reservation to the Code was lodged prior to the establishment of the Investment Canada Agency, when FIRA and the National Energy Program (NEP) were in place. By virtue of the full reservation, Canada reserves the right to act unilaterally on foreign investment without being bound by the terms of the Code. Nevertheless, Canadian authorities have agreed to carry out the provisions of the Code to the fullest extent possible.²⁹⁷

Canada maintains a relatively wide number of sectoral restrictions on FDI. Some of these restrictions are maintained as reservations to the Capital Movements Code, while others exist by virtue of additional impediments, including FDI restrictions in certain industries that operate as private, public, or mixed monopolies. Some of the sectoral limits on FDI are governed by federal laws; others fall under the purview of provincial laws. Table 7-3 shows the various forms of sectoral restrictions; what follows is a sector-by-sector description of the prevailing restrictions.

²⁹⁶ Ottenbreit, K.G.; Davis, J.C.; and Woods, F.D. "Canada" in Euromoney Books and International Financial Law Review, *International M&A Law*, London: Euromoney Publications PLC (1991), pp. 196-97.

²⁹⁷ The foregoing discussion on various sectoral restrictions was taken from the Organisation for Economic Cooperation and Development (1991). *Measures Affecting Direct Investment in OECD Member Countries*, Draft Note by the Secretariat (March 1991), Paris: OECD.

Table 7-3
Sectoral Impediments to Inward Investment
on All or Some FDI Activity in Canada

Industry	Reservations to OECD Capital Movements Code	Other Impediments	Public, Private, or Mixed Monopolies
Banking	X	X	
Insurance	X		X
Press, publishing, and printing	X		X
Broadcasting	X		
Post, telephone, and telecommunications			X
Air transport	X		
Maritime transport	X		
Real estate		X	
Land transport	X		X
Fishing	X		
Mining and minerals	X		
Petroleum	X		
Water resources and power exploitation			X
Alcoholic beverages			X

Source: OECD, Controls and Impediments Affecting Foreign Direct Investment
(Paris:1987)

Culture

The relatively stringent foreign ownership restrictions in Canada's cultural industries are part of a larger package of measures designed to preserve Canada's cultural identity. Under Canada's Baie-Comeau policy, investment by non-Canadians in Canadian-controlled businesses (takeovers) or in the establishment of new businesses in the **book publishing** and distribution sector is regarded favourably if the investment is through a Canadian-controlled joint

venture. Investment in foreign-controlled businesses in Canada is allowed if control is transferred to Canadians at fair market value within a reasonable period of time, normally two years.²⁹⁸

Under the FTA, Canadian authorities agreed to follow certain practices in the case of an indirect U.S. acquisition of a Canadian enterprise in the book publishing sector. Specifically, the federal government is to purchase a Canadian subsidiary from a U.S. investor at fair market value in the event of a forced divestiture. This provision was included in the Canada-U.S. Free Trade Agreement to protect U.S. investors from forced divestiture at "fire sale" prices.

Among other cultural activities, FDI (takeovers) in Canadian-controlled **film distribution firms** is regarded favourably if it is through a Canadian-controlled joint venture; investments in foreign-controlled businesses are subject to government discretion; and investments to establish new businesses must be directly linked to the importation and distribution of proprietary products.

Broadcasting and Telecommunications

Foreign ownership in Canadian broadcasting and cable operations is limited to a maximum of 20%. Under the *Broadcasting Act*, the Canadian broadcasting system must be effectively owned and controlled by Canadians so as to "safeguard, enrich and strengthen the cultural, political, social and economic fabric of Canada". A licence to operate a broadcasting station can only be granted to a Canadian citizen or to a Canadian corporation whose chairman and directors are Canadian citizens and whose shares are 80% owned by Canadians.²⁹⁹

The Federal Telecommunications Policy Framework of 1987 limits foreign ownership to 20% for telecommunication carriers authorized to own and operate interprovincial and international telecommunications network facilities. Situations where foreign ownership exceeded the 20% limit prior to the introduction of the policy were grandfathered in the legislation.

²⁹⁸ Ibid.

²⁹⁹ Ibid.

Petroleum

In March 1992, the federal government announced the elimination of its policy on oil and gas acquisitions, which prohibited the sale of Canadian-controlled oil and gas assets valued in excess of Cdn\$ 5 million unless the companies were in financial difficulty. Under this policy, foreign takeovers of oil and gas companies that were already foreign-controlled were permitted subject to a negotiated increase in Canadian ownership and/or improvement in Canadian investment spending.

With the elimination of this policy, the government no longer prohibits the sale of Canadian-controlled upstream oil and gas companies to foreign investors. In addition, the ICA was amended to allow U.S. investments in oil and gas to be subject to the same review thresholds as those which generally apply to U.S. investments in other sectors under the terms of the FTA. Accordingly, the review thresholds for oil and gas acquisitions by U.S. investors have been raised from Cdn\$ 5 million to Cdn\$ 150 million.³⁰⁰

Mining and Minerals

The Canadian Uranium Industry Policy of 1987 governs foreign participation in specific properties. Non-resident ownership of a uranium mining property is limited to 49% at the stage of first production. Higher levels of foreign ownership may be allowed if it can be established that the property is in fact Canadian-controlled. Exemptions to this rule may be granted to foreign investors who can establish that Canadian partners cannot be found.

Banking

Apart from requiring prior authorization to invest in the Canadian banking sector, other foreign investment limitations apply. Foreign direct investment in banking activity in Canada falls outside the purview of the ICA and is covered by other statutes. The *Bank Act* regulates certain acquisitions of control and new business establishments by banks and foreign bank subsidiaries in Canada. The Act restricts any person (domestic or foreign) and any shareholder associated with such a person from owning more than 10% of the

³⁰⁰ Energy, Mines and Resources News Release, Ottawa, March 25, 1992.

shares of a Schedule A bank (whose shares are widely held). In addition, foreign ownership of Schedule A banks is limited to 25% of the outstanding shares.

Foreign banks operating in Canada through their subsidiaries may do so as Schedule B banks (whose shares are narrowly held). The *Bank Act* governs the incorporation of wholly owned subsidiaries by one or more banks. The domestic assets of foreign bank subsidiaries are not permitted to exceed 12% of the total domestic assets of banks in Canada. They must have authorized capital of at least \$5 million, of which at least 50% must be deposited with the central bank. At least half of the directors must be Canadian citizens normally resident in Canada. Foreign bank subsidiaries and other domestic Schedule B banks are restricted from owning more than 10% of the voting shares of a non-banking corporation incorporated in Canada. Last but not least, the *Bank Act* governs the acquisition of control of a foreign bank subsidiary subject to review and approval by the Minister of Finance. The *Bank Act* is administered through the Office of the Superintendent of Financial Institutions.

Under the Canada-U.S. FTA, U.S. investors in banking and U.S. bank subsidiaries receive national treatment in Canada. U.S. investors are permitted to own collectively more than 25% of the shares of a Schedule A Canadian bank. The 10% limit on individual shareholders means, however, that a U.S. bank will not be allowed to control a Canadian Schedule A bank. In addition, U.S. bank subsidiaries operating as Schedule B banks in Canada may have assets valued in excess of 12% of the total domestic assets of banks in Canada.³⁰¹

Insurance

Foreign ownership in Canadian-controlled and federally incorporated life insurance companies is limited to 25% of the capital. Under the terms of the FTA, U.S. investors are exempt from this ceiling; however, a single foreign shareholder, including any U.S. citizen, is not allowed to own more than 10% of the capital. The transfer of control of Canadian-owned insurance companies to non-residents is prohibited. The amount of initial deposit is higher for foreign investors establishing a branch than for domestic insurance

³⁰¹ OECD (March 1991), op. cit.

companies. Foreign branches are also required to maintain assets in Canada at market value instead of book value.

Transportation

Canada maintains restrictions on foreign ownership in the air and marine industries. Under the *National Transportation Act* of 1981, the operation of domestic air services and scheduled and non-scheduled international air services from a base in Canada requires that the airlines be at least 75% Canadian-owned, and controlled in fact by Canadians. The Canadian nationality requirement can be relaxed to 49% by Order-in-Council. Cabotage is reserved to national airlines on the basis of bilateral agreements.

In maritime transportation, cabotage is reserved to national ships, but any company incorporated in Canada may apply to register the ship under the Canadian flag; certain offshore activities in coastal waters (e.g. dredging) is not permitted to non-national vessels.

Among the measures affecting land transportation, trucking cabotage is reserved to Canadian nationals using Canadian equipment.

Fishing

Federal foreign ownership restrictions exist in the fish harvesting sector. Under the Commercial Fisheries Licensing policy for Eastern Canada, which went into effect in 1990, Canadian firms must relinquish their fishing licences if foreign ownership exceeds 49%. Foreign-owned firms may buy out the minority shareholding rights held by another foreign subsidiary with respect to a Canadian firm that owns fishing licences, provided these foreign firms are nationals of the same country.

Monopolies

Last but not least, FDI is prohibited in a number of private, public, or public/private monopolies. The major public monopolies that restrict FDI include postal service and satellite communications; hydro-electricity; automobile insurance and health insurance plans in some provinces; and provincial jurisdiction over the sale of alcoholic beverages.

Provincial Government Restrictions

In addition to the broad number of federal statutes, various provinces have enacted laws to restrict foreign equity participation in sectors considered vital to provincial economies.³⁰² The Canadian constitution provides individual provinces, not just the federal government, with jurisdiction to act on certain matters that typically fall within the domain of international obligations relating to investment. For example, under the 1985 OECD Code of Liberalization of Capital Movements, the federal government agreed to carry out the provisions of the Code to the fullest extent possible, consistent with the constitutional system of Canada. This in effect left the provinces "unbound" to the code, although subject to so-called "best efforts" by the federal government.

Many of the provincial restrictions on FDI pertain to financial industries. The main provincial regulations in the financial sector affecting FDI relate to the issue and admission of **foreign securities** to capital markets and provincially chartered **life insurance and trust companies**. For example, in Alberta, Ontario, and Manitoba, non-Canadians cannot individually own more than 10%, or 25% collectively, of trust companies operating under provincial charters granted by these provinces. These provincial regulations override the FTA provisions concerning U.S. investments, so that a U.S. resident is treated like any other non-Canadian in the case of trust companies.

In December 1990, Quebec adopted new rules that significantly liberalize foreign ownership of Quebec **chartered insurance companies**. Non-residents can now acquire, without authorization, 30% of the voting shares of a Canadian-controlled, provincially chartered insurance company or up to 50% of the voting shares with authorization from the relevant provincial Ministry. In exceptional circumstances, acquisitions of more than 50% of the voting shares may also be permitted. There are no foreign-ownership restrictions applying to provincially chartered insurance companies in other Canadian provinces.

A number of provinces (Nova Scotia, Prince Edward Island, Saskatchewan, Manitoba, and Alberta) restrict foreign ownership and

³⁰² For example, the *British Columbia Land Act*, the *Manitoba Corporations Act*, the *Ontario Mortgage Brokers Act*, the *Saskatchewan Farm Ownership Act*, and so on.

acquisition of **real estate property**, mainly mining, agricultural, shoreline, or recreational lands. Investments in real estate in these provinces are reserved for Canadian citizens or residents of the province.

A few other examples of provincial laws that regulate FDI activity in certain sectors are as follows: a nationality requirement for obtaining a **fishing** licence in British Columbia; the Canadian ownership requirements for licensing of **oil and gas production** in Nova Scotia; Canadian citizenship or Canadian control as a criterion for approving the acquisition of **mining** property in British Columbia; and nationality or ownership and other conditions for leasing **mining property** in the Northwest Territories.

The Antitrust Framework and Merger Policy

In June 1986, new antitrust legislation in Canada called the *Competition Act* was proclaimed into force, replacing the old *Combines Investigation Act* (CIA) which had been in force since 1910. The most significant changes effected by the recent amendments related to mergers. Under the CIA, the criminal prohibition against the formation of mergers that would lessen competition to the detriment of the public had not resulted in any contested conviction over its long history. The new merger provisions of the *Competition Act* in effect repealed the criminal prohibitions and replaced them with new civil law provisions.³⁰³

The Director of Investigation and Research at the Bureau of Competition Policy, Consumer and Corporate Affairs Canada³⁰⁴, is responsible for administering the merger provisions of the *Competition Act*. The Director is empowered to examine a merger or

³⁰³ Under the CIA, the criminal provisions relating to mergers required that public detriment be proved beyond reasonable doubt. That was so onerous that the legislation proved virtually ineffective. Mergers under the *Competition Act* are now therefore adjudicated under civil law provisions. Note that in addition to mergers, certain other issues are also reviewable under non-criminal provisions of the Act. However, antitrust activities such as price fixing, market-sharing arrangements, bid-rigging, and other specified offenses are subject to the criminal provisions of the Act.

³⁰⁴ Effective June 25, 1993, most of the department of Consumer and Corporate Affairs was merged with parts of Investment Canada and the department of Communications and the department of Industry, Science and Technology. Competition legislation remains unchanged.

proposed merger to determine, on the basis of eight enumerated factors, whether "competition is, or is likely to be, prevented or lessened substantially" in the market place.³⁰⁵ If the Director is satisfied that the merger is likely to produce the above results, he or she is authorized to apply for remedial orders to the Competition Tribunal (the "Tribunal"), a quasi-judicial body established under the *Competition Tribunal Act* to adjudicate the non-criminal provisions of the *Competition Act*. It is the Tribunal, on application by the Director that ultimately rules on contested mergers. As discussed below, the Director may negotiate a possible resolution with the parties to a merger in the form of a consent order which would be submitted to the Tribunal for approval.

The merger review provisions of the *Competition Act* apply equally to domestic-owned and foreign-owned businesses in Canada. At the same time, there is no discrimination in the merger review process between domestically-owned and foreign-owned enterprises. Moreover, a transaction approved under the ICA is not excluded from the application of the provisions of the *Competition Act*.

The Act states that in assessing the competitive effects of a merger or proposed merger, the Director cannot come to a decision that is based solely on market share or concentration factors. While market share and industry concentration are important, the legislation makes it clear that certain qualitative and quantitative factors specifically identified in the Act must also be taken into account in reaching a decision.³⁰⁶ When the Director applies for remedial orders from the Tribunal in respect of disallowing all or part of a merger that is found to be anti-competitive, the Tribunal, like the Director, may take into account the factors cited in the Act in coming to its own decision. Furthermore, the Tribunal may not make such an order if the merging parties can demonstrate that there would be efficiency gains from the merger sufficient to offset the effects of lessening competition.

³⁰⁵ Section 92 of the *Competition Act*, R.S., c. C-23, s.1 (1986).

³⁰⁶ The assessment of the competitive effects of a merger must be made with reference to eight factors enumerated in section 93 of the *Competition Act* – namely, (i) effectiveness of foreign competition; (ii) failing business; (iii) availability of acceptable substitutes; (iv) barriers to entry; (v) extent of effective competition remaining; (vi) removal of a vigorous and effective competitor; (vii) change in innovation in a relevant market; and (viii) any other factor relevant to competition that would be affected by the merger.

Table 7-4
The Merger Review Process in Canada

Under the 1986 *Competition Act*, a merger is defined as a direct or indirect acquisition, or establishment, by one or more persons, of control over a significant interest in the whole or a part of the business of a competitor, supplier, customer, or other person. All mergers, whether or not they exceed the pre-notification thresholds, are subject to examination by the Director if they have, or are likely to have, the effect of preventing, or lessening substantially, competition in a definable market. For large mergers that exceed certain threshold levels, the Act requires that the party or parties proposing the deal notify the Director about the merger prior to completing the transaction. Prior notification of mergers are subject to two threshold tests as follows:

- ▶ Under the **size of parties threshold**, the parties to the transaction, with their affiliates (those corporations joined by a 50% plus voting-share link), must have gross assets in Canada or gross revenues from sales in, from, or into Canada in excess of Cdn\$ 400 million (US\$ 343 million); and
- ▶ if the takeover bid is for voting shares or involves an acquisition of assets, then the **size of transaction threshold** requires that the corporation whose shares are being acquired have gross assets in Canada or gross revenues from sales in or from Canada in excess of Cdn\$ 35 million (US\$ 30 million). The acquisition of voting shares must also result in the acquiring party holding voting shares that exceed a specified percentage of share ownership. For publicly traded companies,
 - ▶ the threshold is 20% of the outstanding voting shares (or 50% if 20% is already owned);
 - ▶ for all other companies, the threshold is 35% (or 50% if 35% is already owned).

A merger must meet **both thresholds** in order to be notifiable. Once notification is given, the parties to the merger are required to wait from seven to 21 days, depending on the type of filing, before completing the merger. Notifiable mergers may be filed with the Director either in "short" or "long" form. In the latter case, a transaction can proceed 21 days after notification is filed; the "short" form has a seven-day waiting period, although the Director may demand that a "long" form be filed, in which case the parties must wait 21 days from the day of submitting the "long" form before consummating the transaction. In practice, the waiting period has proved to be too short a time period for the Director to review larger and complex transactions, thereby necessitating an extension of the deadline with the acquiror's consent.

(continued)

The Director may use the information supplied to challenge the proposed transaction before the Competition Tribunal if the proposed merger is likely to prevent or lessen competition substantially in the marketplace. If the Tribunal also finds the merger to be anti-competitive it may make a remedial order disallowing all or part of the merger pursuant to section 92 of the *Competition Act*. The Tribunal may prohibit the merger, or in the case of a completed merger, dissolve the merger or order divestitures of shares or assets. There is also authority for the making of other remedial orders but only with the consent of the affected party. There is a limitation period of three years, after which no application can be made by the Director to the Tribunal against a merger that has been substantially completed.

The *Competition Act* contains provisions that require prior notification and a waiting period for **large** business acquisitions, amalgamations, and joint ventures. The notifiable transactions provisions (pre-notification) of the Act came into force in July 1987. Under the pre-notification provisions, all mergers that exceed two general types of threshold levels must be notified to the Director in advance of completing the transaction. Under the law, only the acquiring party must notify, which contrasts with the situation in the United States, where the acquired party must notify as well. The salient features of the merger pre-notification process is described in Table 7-4.³⁰⁷

Parties to a proposed merger can apply to the Director for an Advance Ruling Certificate (ARC). Once granted, and provided that the merger is completed within one year, the Director cannot proceed to challenge the merger solely on the basis of the information provided, upon which the certificate was originally issued. In addition, an ARC legally exempts notifiable mergers from being notified to the Director; at the same time, it provides the merging parties with the assurance that the merger will not be challenged under the statutes and a remedial order sought within the three-year limitation period under the legislation.

An ARC is usually granted if, in the Director's opinion, there are no sufficient grounds to apply to the Tribunal in respect of the

³⁰⁷ Clifford, J.F.; Kazanjian, J.A.; and Rowley, J.W. "Canada" in J. William Rowley and Donald J. Baker, eds., *International Mergers: The Antitrust Process*, U.K.: Sweet & Maxwell (1991), p. 653.

merger for which an ARC is being sought.³⁰⁸ In general, the criterion for awarding an ARC depends on whether the gains in efficiency likely to result from the merger will be greater than, and offset, the anti-competitive effects of the merger.

The Bureau encourages consultations between the Director and the parties proposing mergers or acquisitions prior to implementing a transaction (whether notifiable or not). The Director has been very aggressive in seeking negotiated settlements as opposed to proceeding to the Competition Tribunal. The Bureau has stressed that the Director seeks a consultative approach to resolving merger issues – a process that is made relatively easier and less adversarial under the civil law merger provisions of the *Competition Act*.³⁰⁹ Through such discussions, the parties are encouraged to submit to the Director, in appropriate cases, written undertakings for divestiture upon, or after, the completion of proposed mergers, in order to eliminate or reduce the anti-competitive impact of a merger.

An important aspect of the merger provisions is that an acquisition may be subject to substantive review even when the transaction does not meet the notification threshold. In effect, the Act applies to mergers of all sizes and all parts of Canada. Small, non-notifiable mergers that substantially affected competition in local market areas have been challenged by the Director in the past. In addition, the substantive review provisions may give rise to extraterritoriality considerations; that is, they may apply to certain acquisitions in countries outside Canada where the effect of the transaction would be to lessen competition substantially in relation to a Canadian market. This situation would arise, for example, if the parties outside Canada had subsidiaries operating in Canada.

Informal Barriers to Direct Investment

Relative to other industrialized countries, Canada has few informal barriers to FDI. In general, the market for corporate control does not support many hostile takeovers of publicly quoted

³⁰⁸ Consumer and Corporate Affairs, "Merger Provisions - *Competition Act*", *Information Bulletin No. 1.*, Bureau of Competition Policy, Ottawa, June 1988.

³⁰⁹ *Ibid.*

companies.³¹⁰ In Quebec, takeover barriers can be significant because of the existence of strong ownership linkages between the province's financial and commercial sectors. In particular, the linkages can be most effective in deflecting unfriendly takeover bids for so-called Quebec-based "heritage" companies. Relative to other G-7 countries, however, Canada is of the Anglo-Saxon tradition and thus more open to takeovers than most European countries. Last but not least, the presence of state-owned enterprises in the economy, as in other countries, tends to limit foreign participation in certain economic activities.

Ownership Barriers to Takeovers of Publicly Traded Companies

Publicly quoted Canadian companies operate in a market structure that generally results in few hostile takeover bids and, at the same time, generally undermines the success of contested bids. This reality applies to most bids, regardless of whether they are initiated by domestic or foreign companies. First, the number of potential takeover targets is constrained by the relative size of the stock market. In 1989, there were only 1,146 domestic-controlled companies listed on the Toronto Stock Exchange (TSE) – Canada's largest stock exchange – with a market capitalization of about Cdn\$ 337 billion (US\$ 291 billion).³¹¹ The presence of foreign companies on the TSE accounted for 60% of the capitalization in 1989. Relative to other stock exchanges, the TSE is not only small in size, but it typically consists of a large number of small to medium-sized companies.³¹² Second, the shares of publicly quoted Canadian companies are not widely held. For example, of the 400 largest

³¹⁰ For an analysis of recent hostile takeovers in Canada, see M. Patry and M. Poitevin, "Hostile Takeovers: The Canadian Evidence", in *Corporate Globalization Through Mergers and Acquisitions*, Investment Canada Research Series, University of Calgary Press (1991), pp. 123-51.

³¹¹ With only 68 foreign companies listed on the exchange, the average capitalization of those companies was almost US\$ 6 billion – about 24 times greater in size than the typical domestic company. Compilation is based on data from *Fédération Internationale des Bourses de Valeurs, Activities and Statistics Report* (1989), p. 25; and Montreal Exchange, *Montreal Exchange Guide to World Equity Markets* (1990), and Euromoney Publications PLC, GT Management PLC, and the Montreal Exchange, p. 72.

³¹² The average value per domestic quoted company in Canada (about US\$ 253 million in 1989) indicates that, unlike the German, French, and Italian markets, the pool of potential targets in Canada is typically composed of a large number of small to mid-sized companies.

public companies in Canada, 382 are controlled by dominant shareholders.³¹³

Table 7-5
Takeover Barriers: Ownership and Control of Listed Companies in Canada

In Canada, the relatively small size of the stock market provides few takeover prospects for foreign investors. First, there is only a small number of potential targets on the stock exchanges compared with other countries. Second, the scope for hostile bids in Canada is further reduced by a relatively high level of share concentration. The salient features of the stock markets can be characterized as follows:

- ▶ In 1989, the Toronto Stock Exchange (TSE) - Canada's largest exchange - listed 1,146 domestic-controlled companies with capitalization of about US\$ 290 billion, or about 55% of GDP. In comparison, the London Stock Exchange and the New York Stock Exchange listed 2,357 and 1,544 domestic companies with market capitalization equal to 97% and 55% of GDP, respectively, in 1989.
- ▶ The TSE is dominated by the presence of large foreign multinationals as opposed to Canadian-owned companies. Almost 60% of the TSE capitalization in 1989 was accounted for by 68 foreign-controlled firms, or less than 6% of all listed companies on the stock exchanges; the average market capitalization of foreign-controlled firms was in fact 25 times greater than that of a typical Canadian firm listed on the TSE.
- ▶ A substantial number of public companies in Canada are controlled by a single shareholder or a group of shareholders. For example, some data suggest that almost 96% of the 400 largest companies in Canada are controlled by dominant shareholders. Many public companies have non-voting or subordinate voting shares that are publicly traded on the TSE and other Canadian exchanges. Family, or family groups, control many public companies through their holdings of a relatively small number of voting common shares even though the significant majority of the common equity is held by the public in the form of non-voting or subordinate voting shares.
- ▶ Only 14% of the companies included in the 300 Composite Index of the TSE in 1990 were widely held; comparable data for the United States indicate that over 63% of the leading companies had widespread shareownership.¹

(continued)

³¹³ Price Waterhouse, *Doing Business in Canada* (1989), pp. 62-63.

As many public companies in Canada have a controlling shareholder or shareholder group, it is common practice to "lock-up" these shares through a pre-bid agreement. A lock-up agreement commonly requires the shareholder to deposit his or her shares to the bid and not to cooperate with competing bidders. In return, the bidder agrees to make a takeover bid upon the terms and conditions stipulated in the agreement.

In sum, the structural characteristics of the stock market generally do not support the success of hostile takeover bids in Canada. Nevertheless, hostile bids tend to be more frequent in Canada than in other economies such as Germany and Japan, but are less common than in other Anglo-Saxon countries, notably the United Kingdom and the United States.

¹ Ron Daniels, "Mergers and Acquisitions and the Public Interest: Don't Shoot the Messenger", in *Corporate Globalization Through Mergers and Acquisitions*, Investment Canada Research Series, University of Calgary Press (1991), p. 212.

A particular feature of the Canadian capital markets is that many Canadian companies have issued non-voting or subordinate voting equity that is publicly traded on the TSE and other Canadian stock exchanges. This characteristic of the stock market has allowed many Canadian public companies to remain controlled by a family or other founding group through the holding of a relatively small number of voting common shares even though a significant majority of the common equity is held by the public in the form of non-voting or subordinate voting shares.³¹⁴ Given that a substantial number of public companies in Canada are in fact controlled by either a single shareholder or a small group of shareholders, it is not uncommon for an offeror to negotiate with the controlling shareholder for the purchase of his securities, prior to commencing a takeover bid. Typically, this entails negotiating a lock-up agreement with the controlling shareholders that allows the bidder to make an offer on stipulated terms and conditions; in return, the controlling shareholders agree to tender into such a bid. The bidder must, however, ensure that the agreement does not give the controlling shareholders greater consideration for their securities than other security holders; otherwise, the agreement will have violated the interests of minority shareholders, which are protected by law.³¹⁵

³¹⁴ Ottenbreit, Davis, and Woods, "Canada", op. cit., pp. 196-97.

³¹⁵ See Graham P.C. Gow and McCarthy Tétrault, "Regulation of Take-Over Bids in Canada", in *Mergers and Acquisitions in Canada*, annual edition (1990).

Thus the relatively high concentration of control in publicly traded companies precludes the success of most hostile takeovers in Canada. The friendly agreed-bid tends to occur more frequently than contested takeovers, although the latter type of acquisition is more prevalent in Canada than in most other European economies.³¹⁶ The ownership barriers to takeovers are summarized in Table 7-5.

It has been noted that publicly quoted companies on Canadian stock exchanges that are the target of a large hostile takeover bid can take advantage of the pre-notification provisions of the *Competition Act* to stall for time (see the section on the merger review process in this chapter). The takeover defence is made possible by the fact that the pre-notification provisions of the *Competition Act*, unlike merger legislation in the United States, requires that only the acquiror – the party proposing the merger – files a notifiable transaction with the Director of the Bureau of Competition Policy and submits associated information. In effect, this statutory requirement places no obligation for disclosure on the target company and thereby gives it the ammunition to withhold relevant information from the acquiror.³¹⁷ The outcome could well be that by not cooperating with the bidder, the target has the potential to delay the contested bid up to a point where the acquiror is frustrated and withdraws the bid. Alternatively, the target may, itself, request that the acquisition be challenged.

Government / Business Linkages in Quebec

In Quebec, the strong alliance which exists between government and business interests can work to obstruct hostile takeovers of so-called Quebec-based "heritage" companies. These important business, financial, and government linkages have been broadly labelled as "Quebec Inc." - a universal banking model with overtones of what has typically been associated with "Japan Inc."³¹⁸

³¹⁶ Some authors have also noted that the Anglo-Saxon type of hostile bid tends to be less common in Canada than in the United States and the United Kingdom. See A.E. Safarian, "Rapporteur's Report", in *Corporate Globalization Through Mergers and Acquisitions*, Investment Canada Research Series, University of Calgary Press (1991), pp. 244-45.

³¹⁷ International Mergers (1991), op. cit., pp. 682-83.

³¹⁸ Thomas J. Courchene, ed., *Quebec Inc.: Foreign Takeovers, Competition/Merger Policy and Universal Banking*, Queens University, School of Policy Studies, (Kingston:Pathways, 1990), pp. 8-14.

The control of Quebec's so-called "heritage" enterprises is largely affected through a bank-dominated, credit-based financial system.

In this system, the assets of a few large financial institutions are used to acquire important Quebec heritage companies, thereby consolidating a controlling interest in those enterprises and ensuring that their ownership, including head-office functions, continues to reside in Quebec. In the process, takeovers of the heritage companies that threaten Quebec's economic interests can be effectively blocked by government and business. In short, Quebec's financial institutions are often supportive of government initiatives, and together they act as allies to protect provincial business interests.

At the core of Quebec Inc. is the Caisse de depot et placement du Quebec, Canada's largest pension fund source. The Caisse was created in 1965 to invest the contributions of Quebec residents to the Quebec Pension Plan. It also controls funds from Quebec government's no-fault automobile insurance plan. The other powerful financial institution is the Caisse Populaire, the network of government-influenced depositor-owned credit unions, which dominates banking in Quebec. The independent Caisse Populaire was started at the turn of the century by Alphonse Desjardins, and its branches now form an association called Mouvement Desjardins.

The evolution of Quebec Inc. represents a formidable force in the context of Quebec's internal capital / financial market. With assets of about \$34 billion, the Caisse is Canada's single largest pool of capital and Canada's biggest and most influential stock market investor. It is estimated that the Caisse's stockholdings represent 2.5% to 3% of total market capitalization in Canada and that it alone accounts for 20% of trading in the Montreal Stock Exchange.³¹⁹

The Caisse has shown support for government initiatives to keep ownership of Quebec-based heritage companies in provincial hands. In part, this philosophy reflects the aspirations of the government and commercial interests to maintain a distinctive Quebec business culture in the province. While a percentage of its pension funds and the proceeds from the government-operated auto

³¹⁹ *Globe and Mail*, "Fear, Envy of Caisse de Depot renewing criticism of its power", Barrie McKenna, August 28, 1989, pp 1-9. On a North American scale, the Caisse ranked 47th among pension fund managers.

insurance plan are invested in Treasury bills, government bonds, mortgages, and other fixed-income securities, the Caisse also has 28% of its total investments in the shares of Canadian firms.³²⁰

In the early 1980s, the Caisse purchased significant stakes in leading Canadian companies based in Quebec, including: Alcan Aluminium Ltd. (a Montreal-based multinational aluminium products company); Canadian Pacific Ltd. (a transportation and resource company); Power Financial Corp. (a financial services arm of Power Corp.); Domtar (a forest products company); Vidéotron Ltd. (a cable and television company); Provigo and Steinberg (a food wholesaling and retailing company). According to one source, the Caisse now owns in excess of 10% of the equity of about 10 of Canada's largest companies.³²¹ The Caisse often insists upon board representation if its shares in a company are high, further leveraging its influence and virtually eliminating the success of hostile takeovers.

Other Barriers

Performance Requirements

In some cases, foreign investment proposals that involve a takeover of a Canadian-owned firm are required to meet certain "performance requirements" in order to receive approval by Investment Canada. In many cases, such undertakings are already contemplated in the foreign investors' business plans. Other "voluntary" commitments, however, are sometimes informally negotiated between the investor and Investment Canada in the course of reviewing the proposal. Additional undertakings are sought by the Agency in order that the takeover can be deemed to be of "net benefit to Canada" – the legal criterion whereby a takeover proposal is to be allowed or rejected. While these legal limitations exist on the extent and nature of the performance requirements that can be demanded of foreign investors, such undertakings have the potential to deflect takeovers, especially if the demands upon foreign investors are significantly different from those contemplated in their business plans.

³²⁰ *Christian Science Monitor*, "Quebec Wields Financial Power State Capitalism", March 27, 1991, p. 7.

³²¹ *Globe and Mail*, "Fear, Envy of Caisse de Depot", op. cit., August 28, 1989.

In practice, the Agency appears to have demanded performance requirements in relatively few cases. The vast majority of acquisitions reviewed and approved by the Agency have not been subject to any performance requirements. Since the inception of Investment Canada in 1985, almost 90% of the takeover proposals reviewed and approved required no modification to the original plans as they were sufficient to ensure "net benefit" to Canada; only one-tenth of the acquisitions reviewed and approved required additional undertakings in order to qualify under the net benefit test.³²² The majority of undertakings sought in connection with takeover proposals have involved the oil and gas sector. In general, they called for increased Canadian ownership levels and commitments on investment spending by the foreign acquiror. The new legislation in respect to liberalizing FDI regulations in the oil and gas industry is likely to result in fewer undertakings in the sector.

The remaining cases where undertakings have been sought have involved mostly high-profile, technology-intensive Canadian companies. Foreign undertakings in this sector are mainly to ensure that Canadian firms remain internationally competitive. Some of the undertakings typically obtained from foreign investors include, among others: assurances that the investor has, and is prepared to commit, the resources required for the Canadian business to grow as an internationally competitive enterprise, including financial, research, technological, production, marketing, and management resources; a commitment to significant levels of R&D spending in Canada; a commitment, where appropriate, to world product mandates for specified products and services (from R&D through manufacturing and marketing); a commitment to provide quality employment opportunities for Canadians; and assurances that any transfer of technology between the Canadian business and the investor, or its affiliates, will be on an arms-length basis.³²³

³²² OECD, *Canada: First Examination of Position under the Code of Liberalisation of Capital Movements* (Paris:August 1991), pp. 32-33.

³²³ For undertakings related to high-technology acquisitions, see Steven Globberman, "Foreign Acquisitions of Canadian High-Technology Firms", in *Foreign Investment, Technology and Economic Growth*, Investment Canada Research Series, University of Calgary Press (1991), pp. 263-64.

Table 7-6
Informal Barriers to FDI in Canada: Use of Performance Requirements

Investment Canada reserves the right to screen certain takeovers and in the process to consider performance requirements which are generally sought in order that certain investment proposals will be attractive enough to qualify under the "net benefit" test of the Investment Canada Act. More often than not, the types of undertakings that foreign investors ultimately give are already contemplated in their business plans. Subject to legal limits, however, other forms of undertakings may sometimes be sought for particular takeovers (e.g. high-technology and other controversial acquisitions) in order to offset political sensitivities towards the takeover or redress other concerns.

Under the Canada-U.S. FTA, many acquisitions by U.S. investors are no longer reviewed by the Agency; therefore, the opportunities for imposing performance conditions have been significantly reduced. In addition, the FTA explicitly prohibits the use of certain performance requirements i.e. local content, local equity, import substitution, or export-level requirement. Earlier, the United States had successfully won a GATT case involving Canada's practice of extracting commitments from foreign investors to favour Canadian suppliers. The FIRA panel found that undertakings to purchase goods of Canadian origin constituted discrimination in favour of domestic production, and this practice was in violation of the GATT national treatment standard; however, export requirements and local manufacturing requirements were not found to be inconsistent with Canada's GATT obligations.¹

The restrictions on performance requirements under the FTA do not cover some excluded business sectors (financial services, transportation services, and specific cultural activities). Other types of undertakings – e.g. those related to research and development spending – are legally binding under Canadian law, and foreign investors can be held to those commitments. The vast majority of undertakings in the past have involved oil and gas industry acquisitions. Acquisitions of publishing firms and technology-intensive industries are generally subject to stringent performance requirements.

Under the proposed NAFTA, no country may impose specified performance requirements in connection with any investments in its territory – namely, specified export levels, minimum domestic content, preference for domestic sourcing, trade balancing, technology transfer or product mandating. These disciplines, however, do not apply to any NAFTA country's government procurement, export promotion, or foreign aid activities.

¹ General Agreement on Tariffs and Trade, "Basic Instruments and Selected Documents", *Canada - Administration of the Foreign Investment Review Act*, Report of the Panel adopted on February 7, 1984, 13th Supplement (Geneva: March 1984).

The investment provisions of the 1989 Canada-U.S. FTA called for the elimination of certain performance requirements by Canada

for U.S. investors, and third-country investors when U.S. interests would be affected (Table 7-6). In particular, Investment Canada can no longer impose several kinds of requirements on a U.S. investor as a term or condition of permitting investment in Canada or in connection with the regulation of conduct or operation of a business enterprise located in Canada. These include requirements to export a given level or percentage of goods and services; to substitute Canadian goods and services for imported goods and services; to purchase goods or services used by the investor in Canada from suppliers located in Canada or to accord a preference to goods or services produced in Canada; or to achieve a given level or percentage of Canadian content.

It is important to note that the restrictions on the use of performance requirements under the FTA investment provisions are not applicable to investments in any of the excluded businesses noted earlier (e.g. financial services, transportation services, or specified cultural activities). In addition, other types of performance requirements, such as research and development commitments, are legally binding under Canadian law once an investor "volunteers" to meet such performance criteria.

The North American Free Trade Agreement, which was negotiated in September 1992 but awaits ratification by the governments of the United States and Mexico, and Royal Assent in Canada, calls for more extensive prohibitions on the use of performance requirements. Various performance requirements that were prohibited under the FTA are also included in NAFTA. In addition, NAFTA does not allow undertakings in connection with investments (establishments, acquisitions, expansions) that require foreign investors to transfer technology, a production process, or other proprietary knowledge to persons in the host country. An exception to this rule is allowed, however, when the requirement is imposed, or the undertaking is enforced, by a court, administrative tribunal, or competition authority for antitrust reasons. Furthermore, NAFTA also forbids conditions to be imposed on foreign investors that require them to provide persons in the host country with world product mandates – i.e. with the right to act as the exclusive supplier of the goods it produces or the services it provides to a specific region of the world.

State-Owned Enterprises

In 1984, the Conservative government launched a privatization program of federally owned companies, and a number of provinces have also privatized businesses that they once owned. The policy has been to review the government's corporate holdings and to divest itself of those investments that no longer serve public policy objectives. Despite an ambitious privatization program, government-owned enterprises continue to play a significant role in the Canadian economy.

Since the privatization program was launched in 1984, the government has sold about \$Cdn 5 billion (US\$ 4.3 billion) of an estimated Cdn\$ 50 billion of public-sector assets. Out of 170 Crown corporations owned by the state in 1984, 20 have been wholly or partially sold to private investors. Most of these corporations were sold to other enterprises instead of being offered to the public through stock sales.

Major privatizations of federally owned companies include the sale of Canadian Arsenals (a small arms manufacturer) to Montreal-based SNC Group, the sale of Teleglobe Canada (an overseas telecommunications services company) to Memotec Data, and the divestiture of Canada Development Corporation (a holding company) to the general public. In 1988, Air Canada, one of the largest state-owned enterprises, was privatized in two stages, and at present it is wholly owned by public shareholders. Foreign ownership in Air Canada was restricted to a maximum of 25% of the airline's equity. In late 1990, the Canadian government launched its single largest privatization to date with the sale of Petro-Canada, the federally owned oil company. The sale of Petro-Canada assets will be accomplished in four or five phases, and foreign ownership, as in Air Canada, will be collectively limited to 25% of the privatized assets.

Major privatizations at the provincial level include the sale of Alberta Government Telephones in 1990, British Columbia's divestment of B.C. Steamship Company, Alberta's sale of Pacific Western Airlines, and Saskatchewan's disposal of the Potash Corporation of Saskatchewan.

In general, restrictions on foreign ownership of privatized industries, if any, are developed on a case-by-case basis. For Crown

corporations privatized by virtue of special legislation, the foreign ownership thresholds, if any, are specified in the enabling privatization legislation. To date, five of the industries privatized by legislation have restrictions on foreign ownership. In three cases (Canada Development Corporation, Air Canada, and Eldorado Nuclear), limits were placed on both individual and aggregate holdings; in two other cases (Canadian Arsenal and Teleglobe), limits were placed on the aggregate holdings. The foreign ownership thresholds established for Air Canada and Teleglobe reflect those which generally apply to the telecommunications and air transport sector.

In those cases where privatizations are achieved without specific enabling legislation, foreign ownership restrictions may exist by virtue of general laws or policies pertaining to the particular sector. For example, the divestitures of Fishery Products International and Pêcheries Canada, and those of North-West Tel and Terra Nova Tel, involved sectoral restrictions on foreign ownership that applied because of general sectoral restrictions in fisheries and telecommunications.

Case Studies on FDI in Canada: A Brief Review

Since 1985, the general tenor of Canadian policy towards foreign investment has become progressively liberal. At the same time, the policy has also sought to ensure that foreign investments do bring economic benefits to Canada. Despite a formal screening mechanism in place to review large foreign takeovers, not a single takeover proposal reviewed by Investment Canada has been rejected so far. This is testimony to the fact that foreign investment proposals under Investment Canada have been treated more favourably than under the FIRA regime, when a large number of takeovers were rejected and others possibly deterred because of restrictive practices.³²⁴

³²⁴ During the 11 years of the FIRA administration, 3,116 acquisitions and 3,048 new businesses were reviewed under the old Act. A substantial number of applications were rejected (11.3% of all applications in 1982 were rejected), and many more were withdrawn. In contrast, Investment Canada has not rejected one of over 4,600 acquisitions reviewed under the ICA between June 1985 and September 1992.

Most barriers to FDI are primarily informal in nature. Takeovers of high-profile Canadian companies, in particular high-technology firms, have often required foreign investors to submit significant plans and undertakings to Investment Canada to demonstrate that the investment will bring "net benefit" to Canada. The extent and nature of undertakings that the Agency can seek from foreign investors is, however, limited by international obligations in regard to national treatment standards (see case study on FIRA and GATT below). By and large, most undertakings by foreign investors entail action that is already included in the foreign investors' business plans.

The following cases outline a number of high-profile foreign acquisitions in Canada that were resolved by Investment Canada. Each case also gives an account of the foreign investor's undertakings in respect of the takeover.

Connaught BioSciences / Institut Mérieux

In 1989, Institut Merieux, a French state-owned enterprise was allowed to acquire Connaught Biosciences, a Canadian-owned public company traded on the Toronto, Montreal, and New York stock exchanges. Connaught BioSciences, through its two operating subsidiaries, Connaught Laboratories and BioResearch Ltd., was engaged in the health care products field and was an internationally reputed vaccine maker. The deal was one of the most controversial takeovers in Canada, marred by public and media criticism. It produced counter bids from other competing pharmaceutical companies. Mérieux eventually outbid its rivals and succeeded in acquiring Connaught. It had to submit substantial undertakings to Investment Canada in order to receive the Agency's approval. These undertakings were given in fulfilment of the Agency's concerns regarding the implications of the takeover for the development of industrial biotechnology in Canada, and the implications for Connaught BioScience's ability to become a major world player in the vaccine business from a Canadian base.

At about the time of the first public bid, Institut Mérieux accounted for 12.6% of the shares of Connaught BioSciences. The Caisse de dépôt et placement du Québec was the Connaught's largest shareholder, holding 20% of the shares, while Ciba-Giegy/Chiron was the other major shareholder, with 9.4% of the shares. On April 13,

1988, Mérieux launched a hostile takeover bid for approximately 20% of Connaught's shares at Cdn \$32, and announced that it had entered into a shareholder's agreement with the Caisse that gave each other first right of refusal on the sale of Connaught's shares. That agreement also gave the Caisse a "put" option that required Mérieux to purchase the Caisse's shares at a 15% premium over market price if asked by the Caisse. The Ontario and Quebec Securities Commission put a "cease-trade" on Mérieux's bid, on grounds that the "put option" in the shareholder's agreement discriminated against other shareholders.

On September 11, 1989, Ciba-Geigy of Switzerland and Chiron of the United States announced a friendly, cash takeover bid for all of Connaught BioSciences' shares at Cdn\$ 30 per share. The market reacted positively to the bid as the share price soared Cdn\$ 5 in one day. On September 15, Ciba-Giegy/Chiron filed an application for review with Investment Canada. On September 25, Mérieux countered the Ciba-Giegy/Chiron offer by abandoning a merger proposal agreement with Connaught and, instead, offering a \$37-per-share cash takeover bid for 100% of Connaught's share, conditional upon acquiring at least 51% of the shares. The bid was endorsed by Connaught's Board of Directors.³²⁵ There were three other alternative Canadian bids to acquire Connaught, all of which failed to materialize.

Investment Canada rejected Mérieux's initial proposal, as it did not confer "net benefit" to Canada. It subsequently allowed the Mérieux proposal to go through, but only after Mérieux agreed to make further representations in support of its original proposal. Among the major undertakings, Merieux gave the following assurances: to spend not less than \$160 million (in 1988 Canadian dollars) on R&D in Canada over the 1990-94 period; under a previously announced agreement with the University of Toronto, Mérieux agreed to spend, as part of its outreach programs to universities, institutes, and granting councils in Canada, \$15 million on R&D on vaccines and related immunobiological topics during a 10-year period beginning in 1990; to build a Biotechnology Centre at Willowdale, Ontario, at a cost of between 30 and 40 million dollars, which would become fully operational within five to seven years; to offer up to 49% of its voting shares for sale to Canadian investors; to

³²⁵ Investment Canada, Press Release, December 13, 1989.

appoint "resident Canadians" to the board of directors of Institut Mérieux; BioResearch would be sold within 12 months and would be offered first to Canadians; and to provide technology transfer with respect to proprietary production technology on the microcarrier culture and purification process.

Lumonics Inc. / SHI Acquisition Corp. (Sumitomo)

This case involved a Japanese takeover of a high-technology Canadian public company that was suffering financial losses and a decline in share prices. In May 1989, Investment Canada approved the acquisition of Lumonics Inc., one of the world's largest producers of laser products, by SHI Acquisition Corporation, a wholly owned subsidiary of Japanese conglomerate, Sumitomo Heavy Industries. Lumonics was directly, and through its subsidiaries, engaged in developing and manufacturing lasers (pulsed gas, pulsed solid state, and liquid dye lasers) for industrial, medical, and scientific applications. Roughly 75% of its operations were located outside Canada at the time.

Lumonics expressed an interest in being acquired by Sumitomo since it had commercial dealings with the Japanese company and because Sumitomo was in a position to integrate Lumonic's laser systems in its own machinery and mechanical systems, thereby having the potential to increase significantly Lumonic's sales in Japan and Southeast Asia.

In approving the deal, Investment Canada negotiated a series of undertakings with Sumitomo covering Canadian identity and representation, autonomy, employment, world product mandates, R&D, technology transfer, and existing commitments to the Canadian government. Noteworthy among the undertakings by Sumitomo was a comprehensive world product mandate given to Lumonics for all laser and laser-based products and systems, whether current or new, covering all functions related to lasers. In addition, Lumonics had to have a high degree of autonomy in setting its own R&D budget and program, and it could spend more than the amounts embodied in the undertakings by Sumitomo as its sales revenues grew.

Westinghouse Canada Ltd. (WECAN) / Asea Brown Boveri Inc. (ABB)

This transaction (1989) involved a takeover proposal by ABB (a wholly owned subsidiary of ABB Ltd. of Switzerland) to acquire part of the operations and assets of the power transformer division of WECAN in London, Ontario (a wholly owned subsidiary of Westinghouse Electric Corporation of Pittsburgh, Pennsylvania) and essentially all of the assets of Transelectric Technology Inc. (TTI) of Guelph Ontario, a manufacturer of power transformers and related equipment (TTI was established by WECAN).

The transaction raised many complex issues related to competition, since it would have given ABB an effective monopoly in the large power transformer segment and almost three-quarters of the medium transformer segment. The Director of the Bureau of Competition Policy (CCA) expressed his intention to challenge the deal before the Competition Tribunal. The competition concerns were eventually resolved through a Consent Order, which was ratified by the Tribunal. They included the impact that both the FTA and ABB's commitment to seek a combination of tariff remissions and accelerated tariff reduction would have in reducing barriers to entry and facilitating increased foreign competition. In addition, ABB also gave a number of undertakings to Investment Canada before it was approved.

Conclusion

The passage of the *Investment Canada Act* in June 1985 signaled a major shift in policy towards foreign investment in Canada. The policy today actively seeks to promote foreign investment that is of "net benefit" to Canada. Investment Canada exempts from review all new business establishment by foreigners, except those in cultural activities. Non-reviewable investments are only subject to a notification requirement. While large takeovers are scrutinized by the Agency, the process remains, by and large, transparent with strict review deadlines. None of the foreign investments reviewed by the Agency have been blocked so far.

In 1989, the Canada-U.S. FTA marked a significant step not only towards liberalizing bilateral trade in goods, but it also included comprehensive measures to free bilateral investment barriers between

the two countries. The review thresholds concerning U.S. investors were substantially raised; most takeovers only require notification to Investment Canada. The U.S. takeovers in certain industries (cultural, transport, and uranium) are subject to the same thresholds as apply to non-U.S. investors.

As in most industrialized countries, Canadian sectoral restrictions on FDI under the OECD Capital Movements Code are found in banking and insurance, air and maritime transport, energy and mining, telecommunications, fisheries, broadcasting and cable. Cultural industries are specially protected from foreign investment in order to preserve Canada's national heritage. In addition, various provincial measures restrict foreign investment in real estate, the securities market, and other activities in their respective jurisdictions. Canada's merger policy, which was strengthened in 1986, applies equally to foreign and domestic mergers and acquisitions, and it seeks to prohibit takeovers that prevent or lessen competition substantially.

In Canada, relative to the other G-7 countries, there are few informal barriers to FDI activity. The concentrated ownership of most quoted companies generally limits the scope for hostile takeovers. "Quebec Inc." represents a serious threat to the success of hostile takeovers, in particular of Quebec heritage companies. Among other informal barriers, reviewable takeovers are sometimes subject to so-called voluntary performance requirements to qualify under the test of "net benefit". Many of the undertakings are often already included in the business plans of the foreign investors, therefore requiring only minor modifications. Such undertakings are an important factor in assessing takeovers of high-technology firms. State-controlled enterprises continue to play a significant role in certain key areas of the economy despite the major privatization drive launched in 1984. In recent years, foreign investors have participated in the privatization of several large enterprises, although they were subject to limited ownership of the companies' equity.

APPENDIX 1
THE EUROPEAN COMMUNITY

THE EUROPEAN COMMUNITY: POLICY INFLUENCES ON FOREIGN DIRECT INVESTMENT

Introduction

The European Community (EC) has no formal policy on foreign direct investment. It has gained no specific competence in this area from either the Treaty of Rome or subsequent Community law. Member States (MS) have taken pains to reserve competency in this area to themselves. It is the Member States, not the European Commission acting for the Community, that have individually adhered to FDI-related international obligations in multilateral fora, such as the OECD, or in bilateral arrangements, such as bilateral investment treaties.³²⁶

Nevertheless, measures taken at the Community level exert an important influence upon investment decisions. Investment is clearly susceptible to a wide variety of influences, some of which are very broadly based: the economic climate, economic integration, and the 1992 Program itself. This Appendix does not propose to provide a comprehensive review; it aims, at most, to be indicative. Purposely, therefore, it adopts a narrow focus and deals only with selected measures: liberalization of capital movements, certain trade measures, EC research and development policy, merger and acquisition policy, and state aids.

Trade policy is the area in which international concern most consistently arises with respect to EC actions. Since the second half of the 1980s, the EC has made significant use of various trade instruments, particularly rules of origin, local content, and anti-dumping measures. A number of these actions have been seen by other countries as attempts to influence direct investment flows.

On a different front, EC merger and acquisition policy has exerted an influence on international capital flows. A recent EC decision led to the cancellation of a proposed international merger that was considered desirable by Canada, in whose market the

³²⁶ The situation is changing, however. At international fora, such as the OECD and European Energy Charter negotiations, the Commission of the European Communities now speaks on behalf of Member States, following consultations among the twelve members on a Community position.

acquisition was actually taking place. The application of national competition law in the current context of globalization is increasingly recognized as a situation that allows for a considerable overlap of jurisdictions and for differing judgments made in the context of individual markets. This is clearly an area that requires formal systems of consultation and cooperation. Recognizing that fact, Canada and the EC entered into negotiations on a competition law agreement; a draft agreement has been concluded and awaits final approval.

The review recognizes that a number of EC policy actions have provided for freer movement of investment flows. This is particularly true of actions taken to liberalize capital movements and to control state aids. In addition, there appears to be less need for foreigners to locate research-linked (i.e. particularly costly/expansive) investment in the EC in order to participate in the Community's high-tech R&D projects. The possibility now exists for organizations that are located and/or pursuing research outside the EC to participate in such projects. The prerequisite is a formal Science and Technology Agreement between their home government and the European Community.

Liberalization of Capital Movements

Liberalization of the treatment accorded foreign direct investment in the European Community Member States was given impetus by the adoption of a new EC directive on the liberalization of capital movements. This directive, which came into effect July 1, 1990, dictates the free circulation of capital movements between Member States. It requires the abolition of all barriers to capital movements and affirms the right of freedom of establishment. Furthermore, with respect to capital transfers to third countries, it requires that Member States endeavour to extend the same degree of liberalization as is demanded in the case of transfers between Member States. The response of Member States to this directive, in conjunction with other influences relating to the benefits of freer investment flows, has led to substantial changes. The OECD accords substantial influence to the directive, stating:

[The directive] induced thoroughgoing changes in the regulatory framework of the new member States, together with some unprecedented regulatory changes in one other member State (France).

Other less sweeping but still significant changes were also made by member States whose regulatory framework for inward direct investment was already markedly liberal (Denmark, Ireland and Italy). The process is continuing in that some of the measures decided upon have not yet been implemented and/or other liberalisation measures are still under consideration, such as the installation of an integrated market for services, in particular financial services. In addition, plans to remove monopolies and de-regulate certain sectors are still in preparation, both at national and EC levels.³²⁷

Trade Policy Measures

The case for addressing trade policy measures as influences on foreign direct investment has been particularly well made in recent studies by the United Nations and the Organisation for Economic Cooperation and Development.³²⁸ The UN concludes that a very large part of FDI is affected by trade measures. It applies to certain trade measures the designation "investment-related trade measures" (IRTM), thereby implicitly drawing a parallel to TRIMs (trade-related investment measures), a number of which are scheduled to be banned as trade-distorting under the Uruguay Round multilateral trade negotiations.³²⁹ Specifically, the UN states:

One instrument of regional integration arrangements that can be a particularly important IRTM are rules of origin, especially their local content components ... The investment impact of such trade measures is obviously to encourage investment and production in the consuming market, presumably at the expense of economies from which exports are displaced.... Clearly, local content requirements on imports and rules of origin significantly affect investment decisions.³³⁰

³²⁷ Organisation for Economic Cooperation and Development, *Foreign Direct Investment: Policies and Trends in the OECD Area* (Paris: OECD, forthcoming), p. 34, para. 28.

³²⁸ United Nations Centre on Transnational Corporations, *World Investment Report - Transnational Corporations as Engines of Growth* (New York: United Nations, 1992). Organisation for Economic Cooperation and Development, *Investment Incentives and Disincentives: Effects on International Direct Investment* (Paris: OECD, 1989).

³²⁹ UNCTC, *World Investment Report* (1992), *op.cit.*, p. 268.

³³⁰ *Ibid.*, p. 270.

The OECD makes a similar statement in a study of investment incentives and disincentives:

Account must also be taken of measures ... such as trade protection measures (tariffs, quantitative restrictions, voluntary export requirements and so on), or the threat of protection. In certain cases, such measures appear to be among the most powerful forces determining the choice of establishment over exports as a means of supplying a given market and, in consequence the location of international direct investment....³³¹

Since the second half of the 1980s, the EC has made significant use of various trade instruments, particularly rules of origin, local content, and anti-dumping measures. These measures have for the most part targeted Japan and a number of Southeast Asian countries. Some of these actions have been seen by members of the international community as directed primarily towards eliciting additional foreign direct investment by the Asian countries in the EC and only secondarily as retaliation against trade actions.

Rules of origin set the guidelines that establish the economic nationality of a product. Within the EC the origin of a product is important in determining its right to move freely within the customs union without becoming subject to customs duties or other import restrictions applied to goods from non-EC states.

Although there are various methods used to determine origin, in 1968 the EC adhered to the notion that "last substantial process" would determine origin. In other words, where two or more countries are involved in the manufacture of a product, origin is attributed to the country in which the last substantial operation was carried out.

In February 1989, however, the EC Commission appeared to shift its basis for determining origin from "last substantial" to "most substantial" process. In a case related to integrated circuits, the Commission ruled that the assembly process - the last of a three-stage manufacturing process and the only stage realized within the EC -

³³¹ OECD, *Investment Incentives and Disincentives* (1989), p. 47.

was not significant enough to confer EC origin upon integrated circuits.³³²

In a similar decision, the EC rejected U.S. certificates of origin for photocopiers assembled in California. The Commission argued that the processing incorporated into Japanese inputs imported to the United States significantly exceeded the processing involved in the assembly of the inputs by a U.S. subsidiary. The U.S. processing was therefore held to be insufficient to qualify as the last substantial transformation in the production of the photocopiers.³³³

These actions were seen by a number of trading partners as an attempt to influence direct investment flows.³³⁴ Foreign subsidiaries whose products had, to that point, qualified as "European" seemed faced with the possibility that the designation could be withdrawn if the "most substantial" process were determined to take place outside the Community. The uncertainty created by the EC origin ruling encouraged foreign firms to provide higher levels of processing – and therefore investment – within the EC in order to protect the European designation of their products.

Prompted by the EC's action in this matter, the United States submitted a proposal to the Non-Tariff Measures Negotiating Group of the Uruguay Round that standards be adopted governing the regulation and application of rules of origin. Negotiations on the issue have made slow progress, however. Involved parties have only arrived at a preliminary agreement to refer the issue to the Customs Cooperation Council for further study.

³³² The Commission declared that two of the three stages involved in the manufacture of integrated circuits were found to be "so significantly less important than the remaining stage that they cannot individually or collectively constitute a substantial operation and thus cannot meet the requirement of being the last substantial operation in the manufacture of integrated circuits" (Commission Regulation No. 288/89).

³³³ Commission Regulation No. 2071/89.

³³⁴ At the conclusion of the 1991 GATT Trade Policy Review of the EC, the Chairman emphasized "...the large element of discretion in the use of rules of origin by the European Communities which, it appeared to some participants, was calculated to influence decisions to invest and produce in the Communities." See GATT, *Trade Policy Review - The European Communities*, vol. 2, (1991), p. 5.

Local-Content, Anti-dumping, and "Screwdriver Plant" Legislation

Japan's trade and investment links with the EC grew significantly during the latter half of the 1980s. The inflow of investment from Japan rose from US\$ 5 billion in 1987 to US\$ 7 billion in 1988 and almost US\$ 14 billion in 1989. New investment was concentrated in the manufacturing sector, in contrast to earlier investment focused in service industries. In addition, Japan's share of the EC import market doubled during the 1980s, rising to more than 10 percent.

The extent of Japanese expansion into the Community caused sensitivity problems, particularly in the automotive and consumer electronics sectors. These have been areas of great sensitivity, where Member States and sectoral groups have periodically exerted substantial protectionist pressure.

A number of Japanese investments were perceived to have been put in place to derive benefits from the expanding EC market while making a minimum economic contribution in terms of employment, technology transfer, or value-added. Some foreign producers, facing anti-dumping charges on final products exported to the EC, opened up operations in the Community. These operations were used to assemble cheap imported components and became known as "screwdriver operations". Given its EC origin, the resulting final product was originally not subject to anti-dumping duties even though its price may have been close to the price of the imported product that would have been faced with anti-dumping charges.

In response to this situation, the EC expanded the application of anti-dumping actions to products produced within the Community. Punitive measures could be applied if, among other conditions, imported inputs exceeded 60 percent of total product content.³³⁵

Several GATT members maintained that this action effectively placed a local-content performance requirement on foreign

³³⁵ Application of levies was subject to two other conditions. Assembly or production of the dutiable product must have been carried out by a firm related to, or associated with, a manufacturer whose exports of the like product had already been subjected to a definitive EC duty. Furthermore, the assembly or production operation must have been begun or substantially increased following initiation of an anti-dumping action against said manufacturer.

investment and referred the matter to GATT. Local-content requirements are one of the TRIMs banned by the Uruguay Round. In 1990 a GATT panel found the EC practice inconsistent with GATT provisions.

The EC disagreed with the panel's findings and requested that the matter be taken up in the context of the Uruguay Round negotiations. At present, the EC continues to impose undertakings negotiated with firms found to be at fault.

In commenting on EC action, the Office of the U.S. Trade Representative notes:

The [EC anti-circumvention] regulations do not explicitly require that 40 percent or more of the value of all parts be of EC origin to avoid duties. However, industry representatives have indicated increased sourcing of inputs from within the EC has been essential to obtaining the Commission's consent to a negotiated settlement in lieu of imposing duties. It thus appears EC anti-circumvention provisions are being used for purposes that extend beyond the mere enforcement of anti-dumping measures.³³⁶

A review of EC activity in respect of overall anti-dumping activity indicates that the EC pursued some 160 investigations between 1985 and 1989, mostly against exporters from Japan, Korea, and China.³³⁷ The EC's aggressive use of this instrument led the GATT, in its 1991 review of EC trade policy, to note that the EC ranked among the most intense users of anti-dumping measures worldwide.³³⁸

The response of Japanese firms to EC actions has been examined by a recent UNCTC study which cites JETRO (the Japan External Trade Organization) figures showing that the number of Japanese manufacturing plants in Europe increased by 40 percent

³³⁶ Office of the United States Trade Representative, *Barriers to Foreign Trade* (1989), p. 63.

³³⁷ GATT, *Trade Policy Review, The European Communities* (1991), *op.cit.*

³³⁸ *Ibid.* The Chairman noted in his closing remarks that "Several [GATT members] considered that these procedures were used as an elastic instrument of industrial policy rather than a legitimate defence against dumping, and they suffered from a lack of transparency" (p. 5).

from 1987 to 1988.³³⁹ The study also reports that Japanese firms made a concerted effort to increase local content. Honda reportedly increased the local content in its Italian production of motorcycles to 90 percent. In instances where European suppliers could not provide sufficient quality and reliability, European-based Japanese producers persuaded their traditional Japanese suppliers to establish "linked" investments in Europe or to undertake licensing or technical assistance arrangements with local European firms.

Merger and Acquisition Policy

Competition policy can exert an important influence on foreign direct investment via treatment of proposed mergers and acquisitions. Increasingly there has been recognition internationally of the need for cooperation and coordination among countries in the area of competition law, given an economic environment characterized by the globalization of multinational enterprises.

Since September 1990 when the EC Merger Regulation entered into force, the Commission has had prior authority to approve, disapprove, or modify any proposed concentration of companies that would create an undertaking of "European dimension"³⁴⁰. This situation is considered to exist in the case of any takeover, merger, or joint venture where:

- total worldwide annual gross revenues amount to ECU 5 billion or more (for banks, the reference point is 1/10th of assets, for insurance companies, gross premiums);
- aggregate EC revenues of at least two of the companies involved exceed ECU 250 million; and

³³⁹ "The European Community as a Host for Japanese Transnational Corporations: A Case-Study", in United Nations Centre on Transnational Corporations, *From the Common Market to EC 1992* (Washington: United Nations, 1992), p. 94.

³⁴⁰ See: Council Regulation (EEC) No. 4064/89 of 21 December 1989 on the control of concentrations between undertakings.

- two-thirds of each of the companies' annual gross revenues are derived from more than one of the 12 Member States.³⁴¹

When the above criteria are met, jurisdiction within the Community falls to the Commission, and its decisions are binding.³⁴²

Companies initiating a merger or acquisition must inform the Commission within one week after an agreement is signed or a tender offer is launched. The Commission then has one month in which to approve the transaction or to decide to investigate further. If it chooses the latter, it has four months after receipt of the application within which to issue its decision. Meanwhile, the transaction may not legally be completed.

In its first two years, the Commission's Merger Task Force reviewed 136 notifications.³⁴³ Of that total, only 10 were deemed to require the longer, four-month investigation. Of the latter, two were allowed to proceed in their original form; one was withdrawn; and the rest were cleared after modification. Only one proposal was blocked. That was the proposed acquisition of DeHavilland aircraft manufacturing company of Canada by a consortium comprised of France's Aérospatiale and Italy's Alenia. The EC Commission rejected the proposal on the grounds that the takeover "would create a powerful and unassailable dominant position in the world market for turbo-prop (commuter) aircraft, with the world's number one producer buying the world's number two".³⁴⁴

Canadian competition law allowed for a different possibility. For Canada the situation hinged upon the efficiency gains that the merger would have generated in Canada and upon the fact that

³⁴¹ This measure is applied to determine the existence of a distinct national or regional market. A distinct market is recognized when one-third or more of the revenues of the companies involved in the merger are derived from one MS. In such a case, jurisdiction over the merger falls to the national government.

³⁴² The Merger Regulation requires that the first two measures be reviewed within four years of the regulation's adoption, i.e. by September 1994. There is speculation that the worldwide revenue threshold may be reduced to ECU 2 billion and the EC revenue threshold to ECU 100 million.

³⁴³ *Financial Times*, January 19, 1993.

³⁴⁴ Press Release by the European Commission, dated October 2, 1991.

DeHavilland risked the possibility of going out of business in the absence of a merger with Aérospatiale and Alenia. Under such circumstances, Canada's *Competition Act* would allow a merger that could otherwise be challenged on grounds of a substantial lessening of competition.³⁴⁵

The efficiency-gain argument is also recognized by EC law. Article 85, which prohibits all agreements that restrict competition in intra-Community trade, allows for specific exceptions where the degree of restriction is not unreasonable and is outweighed by the beneficial effects. Considerable internal EC debate has centred around the related question of whether and to what extent the Commission might use the exception clause to pursue Community industrial-policy goals. Germany and the United Kingdom basically reject such an orientation, while Italy and France favour its use. These opposing arguments were made forcefully during consideration of the DeHavilland case. The Commission's final decision, influenced by Competition Commissioner Sir Leon Brittan of the United Kingdom, rejected the industrial-policy argument. The underlying policy issue, however, remains a matter of long-term debate within the Community.

The DeHavilland case is an instance of parallel regimes applying to the same case arriving at different conclusions in the context of their individual markets. The potential for such an occurrence also existed in a number of previous cases. There have been earlier instances in which large mergers involving exclusively non-EC firms (generally U.S.) were reviewed under the terms of the Community Merger Regulation.³⁴⁶ These cases involved large companies whose worldwide and EC-generated revenues were sufficiently high to be of "a European dimension" and thus trigger EC M&A review thresholds despite their lack of physical presence in the European Community. Those particular mergers were judged not to impede effective competition within the Community. They were

³⁴⁵ DeHavilland's sales in Canada are a small fraction of its worldwide sales. In the Canadian market, therefore, the negative effects of a lessening of competition would have been greatly outweighed by the positive welfare effects associated with company viability and continuing employment that a merger would have helped to ensure.

³⁴⁶ See U.S. International Trade Commission (USITC), *The Effects of Greater Economic Integration within the European Community on the United States: Fourth Followup Report*, April 1992, p. 10-4.

allowed to proceed, and conflict between European competition law and foreign economic interests never actually arose until the DeHavilland case.

The number of jurisdictional conflicts will probably increase rather than decrease as firms continue to globalize. In recognition of that fact, the EC has already negotiated agreements to increase cooperation in antitrust matters with the EFTA countries and the United States. Similar negotiations have almost been completed between Canada and the EC.³⁴⁷ The draft Canadian-EC Agreement would provide for:

- clearly defined provisions regarding notification of enforcement activities that might affect the interests of the other party;
- a commitment to engage in substantive consultations upon the request of either party;
- consideration of the other party's interests in enforcement decisions;
- cooperation and coordination in the enforcement of the parties' competition laws; and
- exchange of information as allowed by law.

R&D Policy

About 95 percent of the spending on research and development in the EC is done at the national and company level. International attention is centred, however, on the Community-level R&D program initiated in the 1980s. This program has drawn considerable attention and has gained importance quickly because of its concentrated focus and the support that it brings to bear on R&D in leading-edge technologies. The program was conceived of as a way to strengthen Europe's position vis-à-vis the United States and

³⁴⁷ Finalization, however, awaits the resolution of a suit filed by France in respect of the EC-U.S. treaty. France has charged the EC Commission with failure to carry out necessary internal EC consultations prior to signing the treaty with the United States. See USITC, *Fourth Followup Report* (1992), p. 10-5.

Japan in the development and application of research in critical areas of technology. Resulting Community efforts have focused on three areas: new materials, electronics, and biotechnology. Projects geared to leading-edge technology are specifically directed at target-oriented basic research or precompetitive technological research and development.

The European Commission exercises authority over Community-level programs and has wide-ranging influence over project identification and funding. Community R&D work is organized within the context of Framework Programs (FPs) that establish research objectives and approve specific projects.³⁴⁸ These programs aim to develop cooperation among Member State organizations (firms, universities, and other research institutes) on high-technology research that demands large-scale financial resources. The first such program, established in 1984, was quite modest. The second FP was budgeted at ECU 5.4 billion; the third, at ECU 5.7 billion. More recently, prompted by the intensity of international competition in high-tech areas, the EC decided to increase its funding substantially. Accordingly, the budget for the fourth FP – scheduled for the period 1994-98 – is expected to be set at ECU 13.1 billion (\$21 billion).

The approach aims not only to promote interaction between large firms but to encourage participation by small and medium-sized firms as well. Funding of projects within FPs is shared by the Commission and participating organizations. The Commission pays up to 50 percent of the costs of EC firms and up to 75 percent of the costs of EC universities. Foreign-owned or -controlled subsidiaries located in the Community are considered EC organizations and benefit from the shared-cost provisions.

The Programs have successfully fostered linkages and strategic alliances across Member States. Although still accounting for only a small percentage of total R&D expenditures within the Community, EC Framework Program R&D is increasingly gaining esteem. Now that the Programs have matured, participation in projects is seen as a mark of worth, distinguishing participating organizations. Intra-EC

³⁴⁸ Some research programs at the Community level – such as EUREKA and the European Space Agency – exist outside the of Framework Programs; however, these are few in number.

cooperation is expected to continue to grow as the EC continues to expand, as the influence of the Single Market becomes more pronounced, and as greater industrial competitiveness results from intra-European R&D collaboration. Accordingly, concern has grown among non-EC countries; they want to ensure that their organizations are not shut out of the possibility of cooperating in EC Framework projects.

Under EC regulations, Framework R&D projects must involve a consortium including two or more organizations (one of which must be a firm) from two or more EC countries. Legal provision for resulting collaborations has been made under the "efficiency gains" clause of Article 85 (cited above) and under Regulation 19, which gives the Commission the power to grant antitrust exemptions on a block or group basis, provided that certain criteria are satisfied. Under these conditions, there is no requirement for a case-by-case review. In these instances, the EC Commission judges the beneficial value of efficiency gains to outweigh significantly the restrictive or anticompetitive effects of such collaboration within the EC market.

Third-country, EC-based subsidiaries or organizations can qualify as participants if they satisfy a number of requirements: they must pursue research in Europe; find European consortium partners; agree that research results will be exploited first in Europe; and guarantee confidentiality of all project-related information, including confidentiality from the foreign parent. To this point, a number of foreign-owned subsidiaries have participated in Framework projects. Most of these firms have been large U.S. companies (about 25 in total); but there has also been participation by a few Japanese firms, and Canada has been represented by Bell Northern Europe/STC and Bombardier/Shorts.

Participation by organizations located outside the EC is also possible if reciprocity exists in terms of access by EC organizations to R&D programs conducted in the non-member state and if a formal science and technology (S&T) agreement exists between the EC and an organization's home state.³⁴⁹

³⁴⁹ Science and technology agreements establish, for example, the areas marked for cooperation between the states, the types of activity to be undertaken, legal procedures to be followed in establishing consortia, funding arrangements, and dispute-resolution guidelines. They also determine the regulation of issues such as the geographical location of intellectual property rights, the degree of protection during and following a joint project, and the particulars of commercial and scientific applications.

The Community offers two options with respect to S&T agreements: participation either at the program level or on a project basis.³⁵⁰ Under either option, participation costs must be covered entirely by the foreign company or government; the EC does not share costs in these instances. Program-level participation permits involvement in the whole range of projects comprising a program. It requires contributing to the full cost of the program on a relative GNP basis³⁵¹ but includes rights to intellectual property (IP) resulting from research in all projects within that program. Project-level participation allows for costs to be paid on a project-by-project basis, which is considerably less costly; but IP rights are limited accordingly. The entrée offered by the S&T Agreements to participation in EC Framework Programs is a very important one. It particularly benefits small and medium-sized businesses situated outside the EC and countries whose budgets could not easily cope with the cost of full program participation.

The EC first negotiated S&T agreements in specific areas with EFTA countries in 1987-88. These agreements have now been superseded by the agreement establishing the European Economic Area, which became effective January 1, 1994. In 1989, Canada and Australia formally indicated their interest in entering into negotiations to establish S&T agreements with the Community. They were the first countries outside the European Economic Area to pursue such agreements. The EC-Australia agreement has now been concluded, and negotiations between Canada and the Community opened in November 1993.

State Aid

"State aid" refers to various investment inducements that Member States use to attract new investment, either domestic or foreign.³⁵² The use of state aids by Member States is, in the

³⁵⁰ The Fourth Framework Program, for example, has about 12 separate programs covering certain sectors, each with an assigned portion of the full budget. Each of these programs funds a large number of projects within that sector.

³⁵¹ This is a fairly costly undertaking. Industry Canada (IC) estimates that participation costs in a small program would amount to approximately \$30 million.

³⁵² This category excludes aid to the agricultural sector; the latter is administered under the Common Agricultural Policy.

Commission's own words, "massive".³⁵³ In 1988-90, Member States spent, on average, more than ECU 89 billion (approximately \$124 billion) annually for that purpose. This is equivalent to 2.0% of GDP. Forty percent of all aid went to the manufacturing sector and was generally directed at troubled industrial sectors rather than growth sectors.

The Commission receives authority from Articles 92 and 93 to oversee state aid and revoke any measures that distort inter-Community trade. Article 92 of the EEC Treaty in fact contains a general ban on aid. State aids are only approved where they are deemed to be in the common interest – for example, to provide help for depressed regions, small and medium-sized enterprises, and for research and development.

The Commission has taken a strong stance, insisting that the use of state aids must be strictly contained to avoid producing competitive distortions that would offset the very benefits sought in creating the unified internal market. Decisive action by the Commission is gradually both moderating and redirecting those expenditures. In its 1992 Survey, the Commission noted that aid disbursements shifted somewhat during the period 1988-90 from sector-specific to more horizontal and regional support purposes.

The Commission has faced substantial resistance from Member States, which regard the aids as essential tools of industrial and regional policy. Nevertheless, the Commission has undertaken vigorous enforcement action, particularly with regard to prior-notification requirements and corporate reimbursement of illegal assistance. For instance, the Commission ordered the U.K. government to recover the equivalent of \$90.5 million in state subsidies paid illegally to British Aerospace PLC at the time of its 1988 takeover of Rover Group PLC. Similarly, Renault was ordered to pay back half of the \$2.55 billion in French government subsidies it received in 1988. Recent legislation underscores the continuing commitment of the Commission to eliminate distorting aids and to reduce overall aid levels. As of January 1993, Member States are now required to submit annual reports detailing all expenditures on direct and indirect subsidies.

³⁵³ Commission of the European Communities, *Third Survey on State Aids in the European Community in the Manufacturing and Certain Other Sectors* (Luxembourg: 1992).

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