



European Business Council in Japan  
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Position Paper

Foreign Direct Investments

INTRODUCTION

The European Business Council in Japan (EBC) believes that attracting more foreign capital and firms is the key to reviving the Japanese economy. Achieving this requires an improvement of the regulatory environment, an argument which the EBC has repeatedly put forward and substantiated in the 29 sector-focused chapters of our annual White Paper Report.

The EBC is encouraged by the fact that the Government of Japan (GOJ) is increasingly receptive to our arguments on the relationship between regulatory reform and FDI. Resolving the regulatory impediments identified by the EBC - unclear administrative practices, unique Japanese standards and testing for consumer goods, and too rigid (some times even several parallel) testing/certification processes- would definitely cause a much welcome surge of both FDI and trade to Japan.

The EBC fears, however, that the GOJ is losing focus by including a growing number of issues in the FDI discourse without acting to provide the necessary legal tools for foreigners to get involved in the first place. **Efforts should be concentrated on facilitating cross-border M&A** as it is the single largest component of FDI into Japan and represents 60% of global FDI.

Types of cross-border reorganisations that are legally recognized and the applicable tax rules will, in large, determine the level of new FDI. This makes the current, largely negative, debate and the apparent sudden loss of confidence in policies on the part of the GOJ so distressing.

The EBC was disappointed that the triangular cross-border merger scheme slated for inclusion within the recently enacted corporate law was delayed for one year. The recent resurgence of Japanese corporate interest in cross-shareholdings as a protective measure is also a matter of concern. The EBC recommends that the GOJ as well as the Japanese public use this one-year postponement period to re-focus on the fundamentals and find rational ways to quickly move forward.

If Prime Minister Koizumi's goal of doubling FDI is to become a reality, the GOJ should now take resolute steps or risk losing the confidence still held by foreign investors in Japan.



## DETAILED COMMENTARY

In the context of the current debate we would like to stress that:

### *1. FDI is indispensable for the Japanese Economy*

Increased inflow of FDI would mean increased influx of capital, new jobs, increased productivity and, consumer welfare in Japan. It would enrich the Japanese Economy as foreign firms bring new management skills, R&D, marketing methods. New business approaches and, equally important, access to fresh capital to develop new services and/or products, give a novel dimension to competition and stimulate domestic companies to become even more innovative.

Just as the Ministry of Economy Trade and Industry (METI) concluded in its annual report on international economy and trade 2004, "Towards a new value creation economy", Japan's high value-added products and products with competitive advantages tend to be concentrated in certain specific sectors. If jobs and knowledge are to stay and be nurtured further in Japan, access to international capital and know-how in all sectors of the economy is indispensable.

It is, for instance, difficult to imagine how the Japanese Pharmaceutical industry can survive in the long-run without further consolidation and partnership with foreign manufacturers. According to a survey by the *Pharmaceutical Executive* in May 2002, among the top 20 manufacturers in the world, there are 9 European, 10 American but only one Japanese manufacturer (Takeda Pharmaceutical Co. on position no. 15).

Although the recent merger between Sankyo Co. and Daiichi Pharmaceutical Co probably has added a second Japanese manufacturer barely in the top 20, the Japanese presence is still extremely weak. The aggregate Japanese spending on R&D is equivalent to only 7.7% of total world expenditures and aggregate sales representing only 9.3% of world sales (compared to 39% in R&D and 34% of world sales for their European counterparts). Given the fact that drug development for the global market is a risky and increasingly expensive process that requires combining scientific excellence and economy of scale, partnership with leading foreign companies (that possess both R&D means and knowledge of the Global market) seems indispensable for the industry.

### *2. Foreigners invest in Japan to do business here*

When following the debate in Japan it is easy to forget that FDI is a commitment to participate in the management and operation of domestic companies. FDI, per definition, occurs when a foreign company acquires sufficient equity to do so and has nothing whatsoever to do with short-term speculative investments.

Europe is the biggest investor in Japan with 5.3 trillion yen invested between 1998 and 2003, surpassing the U.S with roughly 1.8 trillion yen. We invest in Japan because we believe in the possibilities of doing business here. Companies without a long-term commitment and staying power seldom invest in the first place.



### *3. Easing the FDI infrastructure would lead to more crucial European- Japanese Strategic Partnerships*

The EBC is firm in the belief that making it easier for Europeans to invest in Japan would lead to many new sensible European- Japanese global partnerships, bringing the European market closer to Japan and the Japanese market closer to Europe. When Renault bought 36.8% of the shares in Nissan 1999, it marked the start of a highly successful partnership that within four years took Japan's by-then fourth largest automobile manufacturer from the brink of bankruptcy to the most profitable firm in the global auto industry in 2003.

An ambitious, culturally sensible and sensitive integration on all levels of two highly complementary organisations proved to be a formula for success. The manufacturers were both, in their own rights, midrange in their respective markets, but are now, together, the fourth biggest manufacturer in terms of sales on the global market, speedily approaching the number 3 position.

Judging from our daily experience of doing business in Japan and taking the sheer size of our economies into consideration, the EBC is convinced there is potential for many more successful European- Japanese Strategic Partnerships in the global market.

The EBC urges the GOJ to consider this potential and facilitate the FDI infrastructure for European companies who are willing to invest further in Japan.

### *4. FDI is not the prolonged arm of cultural imperialism but an essential part of a sound global economic integration*

As Europeans, we recognise well the fears on the part of many Japanese that FDI is threatening the unique and Japanese culture and way of life. Similar arguments have been frequently utilised in Europe as well, but fears that FDI would dilute local cultures have proved wrong in the European context. The creation of an internal market and a common currency has caused a perpetual acceleration of cross-border M&A and FDI from both within Europe and from other parts of the world. But national and business cultures have largely remained unaffected. We have learned that, while enhancing competition and efficiency, the market entrants adapt largely to the local tastes and practices of their new customers and employees.

France is a good example. The last 15 years have fundamentally changed the ownership structure of industry in France. Today, 30% of its GDP is now generated by foreign companies and approximately 150,000 new jobs have been created by new FDI to France during the last 5 years. Contrary to the predictions of many, this has occurred with no fundamental change in the French way of life.

The EBC would like the GOJ and Japanese public to consider that we in Europe maintain a high degree of cultural diversity, while at the same time, we are enjoying the fruits of increasing FDI to our countries. FDI has in many ways revolutionized our economies, but **despite that**, we have been able to keep many local industries and, with them, local cultures vivid.

It is our firm belief that Japan could profit in a similar way from opening up Japan to foreign investors without risking any of its cultural heritage. As foreign investors enter Japan to provide



products or services to Japanese customers for profit, it is highly unlikely that they will neglect local preferences and practices.

*5. Foreigners are not particularly keen to engage in hostile Take-Over-Bids (TOB) in Japan*

The current debate in Japan gives the impression that foreigners are eager to engage in “hostile” take-overs of Japanese companies. That is far from the truth. Friendly transactions are preferable to hostile bids. The diligence and cooperation of the management along with the good-will of employees and customers are essential to the success of any business. A hostile take-over would put all of these benefits at risk and is seldom advisable from a business perspective. In Japan, these universal business concerns are even greater. Most European investors would not even consider attempting to manage a company in Japan without the co-operation of its Japanese management.

*6. The triangular merger scheme is a welcome first cautious step for M&A with Japanese Entities*

The stock of FDI in Japan is exceptionally low at below 2 per cent of GDP, (compared to 22.7% in Germany, 12.9% in the U.S., 36.2% in China). Corporate governance practices, defensive influence of main banks and cross shareholdings have historically been working against foreigners interested in investing in Japan. Progress has been seen over the years - the main banks have gradually been exercising less influence on companies, there has been a tendency for cross-shareholding to become less prevalent, and more companies perceive the prospects of partnerships/mergers with foreign entities more favorably.

While business practices/attitudes are changing, much more needs to be done on the regulatory side. The EBC has long argued that a key obstacle to FDI is the fact that foreign companies are not permitted to use their stocks for mergers and acquisitions in Japan, in contrast to wholly Japanese companies. The EBC believes that the introduction of a full cross-border stock exchange scheme with the same tax deferrals as for M&A between domestic entities would be the ideal measure. The EBC recognises, however, that there are difficulties in making significant changes in one leap in Japan. Accordingly, the EBC fully supports the triangular merger scheme as the first important, cautious step in the right direction.

*7. It is hard to understand why the introduction of the triangular merger scheme was postponed when it cannot be used for hostile TOB*

The postponement of the triangular cross-border merger scheme within the new corporation law came as a disappointment to the EBC. The reason for the postponement seems to be a sudden fear that domestic companies are not prepared to face foreign “hostile” take-over bids. This is indeed perplexing as the proposed triangular merger scheme requires consent of the boards of the merging companies prior to any swap of stocks.

In other words, only “friendly” transactions can take place under the triangular merger scheme in the new law.

It is, finally, important to note that only companies that can issue new stocks are able to engage in stock-exchange transactions under the new scheme. The EBC maintains that investors with these



capabilities are precisely the kind of long-term investors that benefit Japan as they bring new capital, products and technology.

## MOVING FORWARD

With the decision of postponement taken, the EBC believes it is imperative for the GOJ to use the time to regain the confidence of foreign investors. The triangular merger scheme should not be changed and, more importantly, bold steps should be taken to deal with the following related crucial M&A issues:

### *A) Tax Deferral*

It is critical that triangular mergers and cross-border share exchanges receive tax deferral with the same conditions on applicability and eligibility as the conditions for the stock swaps that are currently permitted between domestic companies. Proper tax deferrals for cross-border M&A are absolutely essential in attracting FDI. The EBC urges the GOJ to make a swift confidence-boosting decision on this issue.

### *B) Defensive Measures & Corporate Governance*

The new corporate code opens the door to an array of defensive measures against hostile take-overs. While understanding the desire to have such mechanisms available, the EBC is concerned that some of the proposed poison pills will be introduced without proper protection of shareholders' rights. A formal board decision with proper minutes should be required before launching a defensive measure and a trigger should always be reversible within a certain period of time. A clear formula for calculating appraisal rights should be provided as well.

Finally, it is essential that the GOJ does not give in to pressure to include comprehensive defensive measures of the Delaware type to prevent greenmailing. Within the Japanese context, these measures would risk a virtual stranglehold on the M&A market and, therefore, on FDI.

### *C) Legal Lucidity*

The EBC appreciates the work done by the METI Committee on Corporate Value to produce guidelines for judging whether a corporate board's decision to trigger a defensive measure is rational or merely a means to entrench itself further. We support largely the conclusions within the Guidelines and believe that the concerns on corporate governance are well taken. They should be considered valid starting point to address the pressing need to improve the functioning of corporate governance and securities markets in Japan.

The EBC is, however, deeply concerned that there is no guarantee the guidelines will be followed. As the Corporation law it self draws no clear line between the use and abuse of defensive measures, the recommendations proposed by the METI Corporate Value Study group should be given clear legal and binding authority.