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Investment Opportunities and Barriers in Japan: The Regulation of Direct Investment

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I. INTRODUCTION: FEATURES OF JAPANESE INDUSTRY AND ITS GROWTH

When considering investment opportunities and barriers to such opportunities in Japan, one must first have some understanding of the historical situation surrounding the development of industry and legal policy in Japan following World War II.

As a result of the war, Japanese industry in the early postwar years was virtually destroyed, requiring complete reconstruction. One of the purposes of the Allied occupation which began in August 1945 was the formulation of a policy of economic democratization. The Allies dissolved the *zaibatsu*[1] and eliminated the previous excessive concentration of economic power, while simultaneously using the precedent of American law to establish an Antimonopoly Act and a Securities and Exchange Act within municipal law. The policy of economic democratization also extended to commercial law and led to the amendment of corporate laws based on American precedent.

The industrial world experienced some confusion at the time, due to the change from the previous German-style legal system to a system styled after American practice, but the changes met the overall approval of Japanese industry. One factor behind this approval was the expectation that the unification of corporate laws and the extension of identical treatment to foreign and domestic corporations alike would result in the influx of foreign capital to Japan.

The expectations of industry were disappointed, however, as the bulk of American capital flowed to the European continent, and Japanese industry was instead forced to rebuild by its own independent efforts.

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1. The *zaibatsu* were the giant conglomerate corporations. The four largest prewar *zaibatsu* were Mitsubishi, Miteui, Sumitomo, and Yasuda. Following the war, these conglomerates were dissolved and reconstructed after undergoing reformation.

The Japanese government simultaneously implemented policies for the promotion of domestic industry, focusing on financial and tax law, thus extending protection to Japanese industry and nurturing its regrowth. These were the origins of Japan's policy of industrial protection.

In the mid-1950s major Japanese companies began forming corporate groups (*kigyō shūdan*) from the former *zaibatsu*, centering on banking institutions. Through such horizontal industrial affiliations (*keiretsu*), these groups formed linkages which extended mutual aid in the areas of finance and product manufacturing and distribution. Such organizations later developed into vertical affiliations as well.

What would have happened had American capital been introduced to Japan following the amendment of corporate law in the early 1950s? The Japanese economic structure would likely have become more internationalized, and the Antimonopoly Act, the Securities and Exchange Act, and corporate laws would have been promulgated and implemented in forms more closely resembling their American precedents at an earlier date.

American capital did not flow into Japan. Japanese industry was rebuilt through a combination of its own efforts and strong government protection. At the same time—the Antimonopoly Act, the Securities and Exchange Act, and corporate laws—laws which had been initially modeled after American precedent, were revised numerous times, and thus, assumed a form extremely favorable to Japanese corporations.

Currently, Japanese corporations are fully able to compete on a par with other world businesses, and their activity overseas is nothing short of remarkable. Under these conditions, the previous protection extended to domestic corporations can no longer be justified. Free competition has come to be recognized as the fundamental principle of global economic life, a fact amply demonstrated by the recent revolutions within the societies of Eastern Europe. How corporations are treated when their economic activity is confined within the borders of a single nation is one matter, but once those corporations extend their activities to other countries, fair and free competition is possible only when the same conditions are extended to corporations of all other countries as well.

With this background, I would now like to address investment opportunities and barriers with respect to direct investment in Japan.[2]

2. There are problems of taxation of capital gains and disclosure for noninvestment corporations associated with international indirect investment. I wish here to narrow the focus of discussion to the issue of direct investment alone.

II. BARRIERS TO DIRECT INVESTMENT IN JAPAN AND PROBLEMS REGARDING ITS LEGAL REGULATION

A. Methods of and Problems Relating to Foreign Access to the Japanese Market

There are a variety of methods whereby foreign corporations can gain access to the Japanese market, but the most direct methods are probably the establishment of a new subsidiary or joint venture corporation, and capital investment in already existing companies (including mergers and acquisitions). The establishment of a subsidiary or joint venture corporation has not resulted in any particular problems between Japan and other countries. At present, IBM and nearly 3000 other companies are active in Japan as foreign capitalized corporations. In contrast, participation in pre-existing corporations is accompanied by inevitable stock transfers, resulting in a variety of problems. In particular, the development of business groups and *keiretsu* through the Japanese custom of mutual shareholdings is said to create barriers not only to commercial transactions, but to acquisition of securities as well, representing a problematic obstacle to direct investment in Japan.

Barriers to direct investment in Japan can be divided into two types: (1) problems of formal legal regulations and their application; and (2) problems of informal legal regulations and their application, and problems of informal barriers. Problems of legal regulations and their application have been examined from a variety of perspectives within the Structural Impediments Initiative (SII) talks, and the Japanese government has already indicated its willingness to proceed toward the solution to those problems.

In contrast, while the informal barriers have been a focal topic at the SII talks, no agreements have been reached regarding a comprehensive means of removing such barriers. Within this context, the purpose of the present conference is precisely to broach these types of issues, to raise our mutual consciousness regarding them, and thereby to hopefully proceed toward solutions. I want to divide our discussion into the two areas of problems of legal regulations and their application and problems of informal barriers.

B. Direct Investment in Japan: Problems of Legal Regulations and Their Application

The problem of legal regulations and their application to direct investment in Japan can be divided into individual areas dealing with the

Foreign Exchange Control Act, the Antimonopoly Act, the Securities and Exchange Act, the Commercial Law Act, and various other business laws. Some of these laws are applied with identical contents to foreign and Japanese corporations alike, while others are applied differently to foreign and domestic corporations. Further, the contents or application of some of the Japanese laws are stricter or more lenient than their American law counterparts. So long as no logical rationale exists for the differences in contents and application of such restrictions, the conditions of investment in the two countries will differ, resulting in unequal treatment and true barriers to direct foreign investment.

1. Foreign Exchange Control Act

The current Foreign Exchange Control Act (and Foreign Exchange Control Ordinance) provides general regulations which are capable of broadly restricting direct investment by foreign corporations (article 26 of the Law) and limiting technical cooperation (assumed to be accompanied by capital cooperation—article 25 of the Law).

With respect to direct investment in Japan, these restrictions concern advice regarding changes in or cessation of the investment (assuming the prerequisite of preparatory notification—article 22, paragraph 3 of the Law; article 12 of the Ordinance; and article 20 of the Ministerial Ordinance); and the granting of permission in the case of technical cooperation (article 25 of the Law).

The existence of these regulations has been discussed at the SII talks, and the Japanese government has agreed to abolish some of the regulations within the next Diet session. Those restrictions are to be replaced by new provisions which will be applied only to issues concerning the preservation of national security and related matters as noted in article 3 of the Organization for Economic Co-operation and Development's (OECD) Code of Liberalization of Capital Movements, and to areas subject to reservations under the same OECD code. Further, serious consideration is to be given to whether items currently subject to reservation will continue to be so reserved. A concurrent topic will be clarification of the standards employed in the application of the law. Concepts like "national security" as used within the Foreign Exchange Control Act are of ambiguous scope, and there is the danger that even greater restrictions could be placed on direct investment in Japan, depending on how those concepts are interpreted.

2. Antimonopoly Act

The Antimonopoly Act is aimed at maintaining and preserving the competitive order within Japan, and is not specifically designed to restrict direct investment from abroad. Further, the law is applied not only to foreign corporations, but to Japanese corporations as well. However, since its enactment, the law has been amended numerous times at the behest of Japan's industrial world. Consequently, the law itself has gradually lost its clout, and its application has been relatively lenient. A good deal of disparity has thus arisen between Japan and the United States in the contents and application of antimonopoly regulations, effectively producing conditions of inequality between the two nations.

3. Securities and Exchange Act

The most convenient method for foreign corporations to gain access to Japanese corporations is by purchasing stock (or equity) in an existing Japanese company. The stock can be purchased through the securities market, but takeover bids (TOB) are a more effective method. Japan's takeover bid system is different from that practiced in America, involving previous notification, shorter term for the takeover bid, and added procedural complexity for foreign corporations. Takeover bids tendered by foreign corporations are also subject to application of the Foreign Exchange Control Act. Since these differences have been regarded as effective restrictions in takeover bids, the Securities and Exchange Act was amended on June 15, 1990.

Japanese law has adopted the same five percent rule used in American law with regard to disclosure of large volume shareholdings.

4. Commercial Law Act

The Commercial Law Act stipulates that articles of incorporation can be used to restrict the transfer of stock shares (article 204, paragraph 1 of the Law). These stipulations are fundamentally directed toward small, closely held corporations, and are not provided for listed corporations (see the Initial Listing Requirements of Tokyo Stock Exchange, article 4, item 9; and Continued Listing Requirements of Tokyo Stock Exchange, article 2, item 9). As a result, such regulations cannot be called restrictions of direct investment to Japan.

5. Other Special Laws

The Japan Telegraphic Corporation Law (article 4, paragraph 1) and the Kokusai Denshin Denwa Corporation Law (article 4, paragraph 1) limit stockholdings to Japanese citizens and Japanese corporations. Similarly, the Japan Airlines Corporation Law (article 2, paragraph 3) limits maximum stockholdings by foreign nationals to one-third of the total stock, while the Broadcast Act (article 53, paragraph 1) limits maximum stockholdings by foreign nationals to one-fifth the total stock. The purpose of these restrictions is ostensibly related to "national security," but some doubt remains as to whether all of these restrictions can be interpreted in that way, and some reconsideration is in order.

III. INFORMAL BARRIERS TO DIRECT INVESTMENT IN JAPAN

A. Stockholder Stability and the Closed Nature of Corporate Society

As noted above, legal barriers to direct investment in Japan are being gradually eliminated. However, the SII talks have shown that even when foreign corporations wish to use vehicles such as mergers and acquisitions to gain access to the Japanese market, the uniquely closed nature of Japanese corporate society—in particular, customs like mutual shareholdings—result in informal barriers to such access.

The custom of mutual shareholding is perceived as a means of establishing a stable body of stockholders for a corporation, and is considered an effective method in the context of corporate groups and *keiretsu*.[3] Accordingly, Japanese corporations have, without exception, used this method to enhance stockholder stability and increased the number of uncomplaining corporate stockholders.[4] As a result, the ratio of corporate stockholders for listed companies in Japan has, in recent years, risen to approximately seventy-eight percent.

The primary aim of mutual shareholding as practiced by Japanese corporations and managers is to strengthen the managerial base through a stabilization of stockholders. Corporate stockholders raise few waves regarding dividends and the amount of capital gains. By increasing the number of such stockholders, it becomes possible for the company's managers to gain the shareholders' confidence, thus stabilizing the posi-

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3. Mutual shareholding is the practice whereby two or more companies, for purposes of business cooperation or stabilization of corporate management, hold mutual shares of the other's stock. Several patterns of mutual shareholding exist, but the generally used method is the third-party share allotment, in which the other company is made the recipient.

In the case of six major corporate groups, the proportion of stock held by another single company is approximately one to two percent, but the total stock held by all companies in the group rises to around ten percent.

4. According to a survey of stock distribution carried out by the National Conference of Stock Exchanges, the percentages of shares held by different kinds of stockholders in 1989 were: 22.6% by individual investors; 42.3% by financial institutions; 3.7% by investment trusts; 2.0% by securities companies; 24.8% by business corporations; 0.7% by government and local public bodies; and 3.9% by foreign nationals.

tion of the managers themselves. This further makes it possible to implement corporate policy from the perspective of long-term profitability, thus stabilizing the overall direction of management. Second, capital cooperation between corporations makes it possible to strengthen relationships with companies with which a corporation has cooperative relationships in other areas of its operation. Third, mutual shareholding is effective as a means of mutual corporate financing. Finally, the formation of corporate groups and *keiretsu* facilitates financing and operating cooperation between companies, allowing use of common brands and otherwise enhancing a corporation's competitiveness.

As mentioned earlier, the practice of mutual shareholding has its origin in the immediate postwar period of corporate rebuilding, when it was looked to and functioned importantly as a means of mutual assistance. At the same time, however, the practice also has a background in Japan's unique cultural ambiance.

There has been criticism of the practice of mutual shareholding, even from within Japan.[5] There is the danger of a "hollowing" of corporate capital; that is, there is a danger of inviting the creation of corporate capital lacking in substance. This practice may also promote control by managers uninvolved in actual investment, which in turn may result in a disregard for the rights of minority stockholders. Mutual shareholding may lessen the effectiveness of monitoring functions designed to supervise the activities of managers. Further, the reduction of floating stock may lower the functionality of the securities market and invite interference with securities loans. The long-term holding of stock may lead to a stagnation or fixation in the amount of corporate capital available. Finally, the formation of corporate groups and *keiretsu* may impede fair competition.

The problem of *keiretsu* has been raised within the SII talks from the standpoint of the third and sixth points noted above. The Japanese government is now formulating a number of related policies for study by the Japanese Fair Trade Commission.

In any case, it cannot be denied that the existence of corporate groups through the practice of mutual shareholding is an impediment to direct investment in Japan. Transactions between industrialists against

5. The Corporate Law Act and Antimonopoly Act have put restrictions on the practice of mutual shareholding. These restrictions can be divided into the three areas: (1) the prohibition of a subsidiary receiving stock of a parent company, Corporate Law Act 211/3; (2) restrictions on the holding and acquisition of stock and the exercise of voting rights, Corporate Law Act 241, such as the prohibition of financial corporations from holding more than five percent of issued stock, Antimonopoly Act 11; and (3) disclosure restrictions.

the background of *keiretsu* relations which are formed through mutual shareholding are an obstacle to free competition, resulting in an overall exclusionary effect with regard to foreign corporations which seek to export to Japan, develop markets, or invest in Japan.

B. Corporate Acquisitions and Japanese Business Customs

In Japan, there is no resistance to the entry of capital from foreign corporations. For the last several years, actual performance in the area of direct investments in Japan show that investments have been virtually doubling each year.[6] Two of the signs most frequently seen on Japanese streets are those for McDonald's and Kentucky Fried Chicken, and most gasoline stations are those of Esso (Exxon), Mobil, and other foreign-capitalized companies. There are also a number of foreign corporations which have been mistakenly thought to be established on Japanese capital.[7] In short, there is no resistance to friendly corporate acquisitions, even when that acquisition is done by foreign corporations. In such cases, the custom of mutual shareholdings does not represent a barrier to direct investment in Japan.

There is a strong current of opposition, however, against hostile takeovers.[8] This opposition is not limited to such takeovers when conducted by foreign corporations, but by Japanese corporations as well. The activities of the *kaishimeya* (a term which has much the same connotation as the English "greenmailer") have long been subject to the same harsh censure as that directed toward a hijacker. Particularly when acquisitions are made by the method of leveraged buy outs, the excessive debt required by the purchase, stagnation of repayment, and subsequent corporate dismemberment and release of employees has caused high degrees of suspicion of and opposition to hostile takeovers. Such opposition is evident not only among Japanese managers and investors, but among employees and labor unions as well.

6. According to the annual report issued by the Ministry of Finance's International Finance Bureau for 1989, direct foreign investments in Japan over the previous five years had increased at an annual rate of 200%. The absolute monetary figure of such investments, however, remained only one-tenth the total invested from Japan to the United States; as the final report of the Structural Impediments Initiative talks indicates, even greater efforts are required in this area.

7. *See* FOREIGN AFFILIATED COMPANIES IN JAPAN — A COMPREHENSIVE DIRECTORY (Tokyo 1989).

8. In a survey of corporate managers conducted by the *Nihon keizai shinbun*, 70% of respondents indicated that hostile corporate takeovers were not appropriate within the context of Japanese culture, customs, and labor management relationships. NIHON KEIZAI SHINBUN, Sept. 28, 1989.

In the background to this opposition is a fundamental difference in the way in which the Japanese view the question "Whose company is it?" In Europe and the United States, the concept that the corporation belongs to the stockholders is firmly in accord with capitalist principles, with the result that stockholder profit becomes the standard for corporate decision-making. In contrast, no matter what the theoretical ideal may be, the reality in Japan is that a consciousness exists to the effect that the corporation "belongs to a certain community, composed of stockholders, managers, employees, and even customers."[9] This communal consciousness likely has been fostered as the result of the way in which corporate executives are produced in Japan. The great majority of executives in major Japanese corporations rise from the ranks of common employees of the same companies. Even when a person reaches the position of company director, that person still maintains his status as an employee of the company.[10] It is natural that such executives retain a consciousness that the company is an entity which has nurtured them, and which they themselves have nurtured. Accordingly, the most general standard of corporate decision-making used by corporate managers is that which springs from the perspective of the profit of the corporation itself.[11]

Evidence of this tendency can be seen for example, in the case of the recent attempted purchase of the Chūjitsuya and Inageya supermarkets by the Shuwa Company. In this case, the individual company labor unions of both target corporations issued resolutions against the proposed purchase, and the Zenaen union association of which they were members expressed its support for the resolutions. In short, contrary to the situation in Europe and the United States, there is opposition in Japan to the transfer of corporate ownership through the will of stockholders alone.

While the structure of authority within this so-called "closed" soci-

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9. According to a survey of department chiefs in 100 listed companies conducted by the *Nikkei shinbun*, the question "Whose company is it?" was answered by 77% of respondents with the answer "the employees' "; 65% answered "the managers' "; 59% said "the stockholders' "; 26% responded "the customers;' " and 23% said "society's as a whole." The high figure given for "the employees" was likely a result of the fact that this survey was directed toward employees, but the overall pattern of responses indicate a recognition that the company belongs to a certain community, one which includes the company's customers. NIKKEI SHINBUN, Apr. 23, 1990.

10. In Japan, company directors may simultaneously be employees; most managing directors without representation rights hold the joint positions of employee and director.

11. According to the survey mentioned *supra* note 7, 77% of those surveyed responded to the question "What does your corporation emphasize most heavily?" with the answer "accumulation of profits for the purpose of expanding business." This is a clear expression of the concept that the profit of the corporation itself is serving as the standard of value.

ety is said to constitute informal barriers to investment, factors internal to the system itself are beginning to bring about change.

First, the internationalization of the Japanese economy is causing increased competition among domestic corporations, forcing companies into an inevitable fight against time. Specifically, the leisurely development of a given area of business over a long period of time is not feasible in today's rapidly changing industrial environment. Japanese managers are being forced to consider corporate acquisitions from the perspective of more effective management tactics in restructuring.[12] In fact, the number of corporate acquisitions (mergers and transfers of operation) in Japan is increasing each year.[13] This is evidence that there is no resistance to corporate acquisitions when they are executed in a friendly way.

Second, while corporate investors—particularly insurance companies and other institutional investors—have conventionally been viewed as stable stockholders supporting the status quo of managerial control, such investors are now beginning to complain about the low rate of dividend return on their shareholdings. Looking for more effective investments for their capital, they are starting to question corporate management itself.

Third, as new stock is issued to raise capital, the distribution of that stock is beginning to be more widely spread, resulting in changes in composition within the ranks of stable stockholders. When new issues are distributed to previous stable stockholders, a large capital burden is placed on the recipients, and that cost is increasing.

IV. PROSPECTS AND FUTURE TOPICS FOR INVESTMENT IN JAPAN

The preceding has been a discussion of features of Japan's industry and legal policies. Along with a simple review of historical facts, I have addressed the issue of legal restrictions and informal barriers (business customs) placed on direct foreign investment. Legal restrictions on direct investment in Japan have at last begun to be dismantled as the result

12. According to a survey of managers conducted by the *Nihon keizai shinbun*, 82% of respondents indicated they considered mergers and acquisitions to be an effective tool in management strategy. NIHON KEIZAI SHINBUN, Sept. 28, 1989.

13. The annual report issued by Japan's Fair Trade Commission in 1989 showed that 1336 notifications of mergers were recorded in 1988, an increase of ten percent over the previous year. Further, statistics for the past five years indicate growth in mergers at an average annual rate of seven percent. Transfers of operation have the same effects as mergers, and 1028 cases of such transfers were recorded last year, a figure representing 1.5 times the number of similar cases five years ago.

of outside pressure from foreign nations. Signs of change are also beginning to appear in these Japanese business customs considered to be informal barriers to investment.

When it comes to the question of whether the Japanese market environment has become an easy one for direct investment by foreign corporations, one must admit that problems still exist. The Securities and Exchange Act has been amended and takeover bid restrictions have been revised, but there remains an excess in the corporate holding of stock, particularly by financial institutions. An increase of floating stock is also desirable from the perspective of the overall health of the securities market.

Further, securities companies and banks have recently begun acting as mediators in corporate merger and acquisition activities with considerable success in that area.[14] But legal provisions are still insufficient; once such provisions are in place, the merger and acquisition market is expected to be more firmly established, resulting in the facilitation of even more direct investment from foreign countries. At the same time, liberalization of the strict restrictions on corporate mergers is also a matter for consideration, and a strengthening of stockholder rights is desirable from the perspective of investor protection. For example, the general Japanese practice of suppressing profit dividends at a low level and augmenting them with share dividends cannot be considered a desirable practice from the investor's standpoint.

Such considerations are necessary in order to remove barriers to direct foreign investment in Japan and enlarge the scope of opportunities. They are also necessary to give greater global universality to Japanese corporate society and to modernize Japanese corporate structure. Based on a recognition of these current conditions, the issue of revising and reforming the opportunities and barriers to investment from abroad will be reported on and studied at the next conference.

14. In Japan, a growing level of arbitration in corporate acquisitions is being performed by so-called city banks, intermediary institutions of securities companies, general trading companies, and foreign securities companies. For more details about this business, see NIKKEI SANGYŌ SHINBUN No. 4786.