Healthy globalization through the constructive use of foreign investment

Study project
"Use of foreign investment to enhance enterprise value"

Main points of interim report

Project leader: Ryuji Yasuda

November 2008

21PPI
- Japan's Opes & Dynamic Policymaking Hub -
21世紀政策研究所
The 21st Century Public Policy Institute

Introduction

Caught in a financial crisis and worldwide economic downturn of unprecedented proportions, globalization is under threat. The lesson of history is that a depression tends to push countries down the path of protectionism and that a multipolar world order can give rise to exclusive state capitalism.

For an increasingly mature Japanese economy, however, continued, healthy globalization is a sine qua non. This is not simply because overseas market development is a source of growth for Japan's corporate sector but also because any further improvement in the value added element of Japan's already mature domestic economy will ultimately depend on the active utilization of foreign technology, services, and human resources right here in Japan.

No one country can solve the current crisis single-handedly. On the one hand, Japanese capital interests must be proactive in increasing their investment overseas and in providing capital and technology while, on the other, we must encourage inward direct investment by foreign capital interests, thereby effectively utilizing reciprocal trade and capital exchange as a means of overcoming this threat to the globalization process.

Three important principles

First, we must restore confidence in healthy globalization. For the past 10-15 years or so, the world economy has been driven, in a laissez-faire sort of way, by untrammeled borderless global competition based on market fundamentalist attitudes, and dominated by a doctrine under the terms of which the supreme goal of any company must be to maximize its shareholders' returns.

Global competition certainly stimulates industrial innovation and has in its time been the driving force of global economic growth. However, the industrial capital that generates real added value, in the shape of goods and services, has been replaced by financial capital interests (investment funds) that, for short-term gain, invest highly leveraged funds in securities, real estate, resources, and corporate takeovers throughout the world, giving rise in the process to a debt-fueled investment bubble. One costly outcome of this headlong charge has been global economic recession. It is crucially important, under the circumstances, to restore the capacity of industrial capital to generate added value and, in so doing, find our way back onto a path of healthy globalization based on social responsibility and discipline.

Second, a clear perception of Japan's national interest in a global context must be established. Globalization should not, of course, be understood to mean the creation of some sort of cosmopolitan borderless socioeconomic community into which the state's identity would be subsumed. Every country has its own national interest, which must be safeguarded against threats to both national security and public order. Globalization is the ongoing search, continued in a spirit of mutual respect for such needs, for ways in which the benefits of a global economy might be shared and national markets opened, as far as possible, to the world. In short, no country that has lost sight of its own national interest can talk realistically of globalization.

There is little to be gained from debating inward foreign investment in terms of a stark choice between "arming ourselves for a fight" and "welcoming them with open arms." So why open up to foreign investment at all? The simple fact is that, situated as it is in the midst of a process of globalization, Japan's economy needs to generate added value to grow, and if it is not also at the heart of this process, it will lose its position in Asia as well. So why place partial limits on foreign investment? The answer in this case is to safeguard Japan's national security and public order. Both these answers are born of the perception of Japan's national interest in a global context. In other words, the solution to the implied choice between arming for a fight or welcoming them with open arms is that we must be as open as possible while at the same time standing firm in defense of our interests wherever necessary.

Third, in formulating measures for the promotion of inward investment and a system for the regulation of foreign investment, we must be confident in advocating standards with global application of which Japan can be justly proud. There is certainly agreement and commitment among member countries of the Organisation for Economic Co-operation and Development (OECD) to do everything in their power to promote the free flow of capital. When it comes to their various investment promotion programs and regulatory systems, however, there is nothing even remotely resembling a single "global standard." In short, every country has standards of its own that are designed, as far as possible and in light of the basic principles, to meet its particular requirements. Japan too must compare the variety of systems and implementations in use around the world with a view to preparing its own plan for the promotion of inward direct investment, while at the same time introducing the sorts of regulatory systems that will be essential for protection of the national interest. With the European and US globalization model in disarray, now is the time for Japan to speak out.

With financial meltdown and economic recession in the offing, the question of inward direct investment is assuming increasing importance.

Investments in forward-looking value added business ventures undertaken in conjunction with foreign-affiliated companies will stimulate economic activity and boost domestic demand. This should lead over time to the forging of closer links between Japan and the rest of the world. Nurturing the growth of Asian companies that have recently established operations in Japan is also the key to strengthening Japan's links with other Asian markets. In the knowledge-based industries, it is precisely by the active cross-border exchange of knowledge, information, and human resources that we will enhance the value added element of our own economy in the current low-growth environment. We must certainly avoid anything that might slow the process of investment in Japan by foreign corporations.

As a result of the current downturn, Japanese companies are again feeling the need for funds to underpin the revitalization of their operations, as more than half have already seen their share prices fall to unusually low levels below book value. From here on, we can expect those private equity funds that survive the shakeout, along with Chinese, Asian, and Middle Eastern sovereign wealth funds, to be looking increasingly to buy into Japan. However, while welcoming the contribution of risk money from these sources, we must also ensure that investment is orderly and disclosure complete if we are to avoid a repeat of the last financial capital stampede.

In an increasingly nervous world, if we are to feel comfortable about opening our doors to foreign capital, one absolute precondition is that we must have in place a safety valve in the shape of an effective system for regulation of the sort of inward foreign investment that might otherwise have negative consequences for our national security and public order.

If we do not act soon to resolve these problems, it will be too late and globalization will be under even greater threat.

Government agencies and experts in various fields have already held discussions and submitted suggestions as to how we might best promote inward direct investment. But if we do not act soon to bring concept and reality together in a practical plan of action, there will be no advance for inward direct investment beyond the status quo. With this in mind, it would surely be no bad thing for those members of our industrial and financial business communities, who are already in the vanguard of direct investment around the world and have experience dealing directly with foreign capital interests, to give fuller expression to that experience in our current endeavor.

What we want more than anything from this project is for Japanese society as a whole, and for its industrial and financial business communities, to each make their views clear and to engage in a full-scale debate on these themes, which are destined to have such a powerful influence on the future of Japan's economy and the activities of its corporate business community.

To this end, the 21st Century Public Policy Institute has initiated an internal study project for the collection, study, and discussion of data pertaining to the formulation of a plan for "Use of foreign investment to enhance enterprise value." This report summarizes the main points of our interim report on this project.

Index

"Use of foreign investment to enhance enterprise value" study project taskforce members

Project leader	Ryuji Yasuda	Professor of Hitotsubashi University Graduate School of International Corporate Strategy
Project members	Masashi Adachi	Counsel to law firm of Paul, Weiss, Rifkind, Wharton & Garrison LLP
	Masakazu Iwakura	Partner at law firm of Nishimura & Asahi
	Shunichi Kimura	General Manager, Legal Office, Corporate Affairs Department, Tokyo Electric Power Company
	Soichiro Sakuma	General Manager, Legal Department, Nippon Steel Corporation
	Kazuhiro Takeuchi	General Manager, Corporate Planning & Coordination Dept., Sumitomo Corporation
	Katsuyuki Hasegawa	Head, Research Department-Financial Markets, Mizuho Research Institute
	Yasuhisa Abe	Director of Economic Policy Bureau II, Japan Business Federation (Keidanren)
21st Century Public Policy Institute		
	Takuya Tsujigaki	Senior Fellow
Daiwa Institute of Research		
	Susumu Okano	Executive officer
	Shigeto Kashiwazaki	General Manager, Corporate Financial Strategic Department
	Hiroharu Fukazawa	Senior Analyst, Corporate Financial Strategic Department

I . Why encourage inward direct investment?

Globalization has entered a third phase, "Globalization 3.0," in which mutually-beneficial two-way capital flows are completing the global circle.
Improving the ability of Japan's mature economy to generate added value is conditional on encouraging foreign capital to invest in Japan as well as Japanese companies investing outside Japan.

1 "Globalization 1.0" was a period when Japan looked to export to, or establish local production bases in, specific countries. The movement was one-way, and the focus was on remote points - individual locations.

2 "Globalization 2.0" was a period of localization within the context of a "glocal" strategy whereby corporations looked to create optimized global networks encompassing functions from research and procurement to production, sales, and after-sales service. The focus was on the establishment of lines - one-way links with individual locations.

3 In the context of a knowledge-based society, "Globalization 3.0" is a time in which cross-fertilization-outwards from the industrial heartlands of Japan and inwards from overseas-is facilitated by localized concentration/integration. The movement is now two-way, with the focus on areas - interaction between whole areas.

4 Under Globalization 3.0, therefore, our task is to use the growth of inward investment to realize five main goals.

- To "create regional clusters (regional aspect)," by facilitating the development of regional concentrations of domestic and overseas companies, of which Japan would be just one
- To "facilitate the integration of global knowledge, information, and human resources at a regional level" with a view to using innovation to boost added value

- To inspire corporate groups with the energy to complete a global circle linking Japan with regional hubs around the world (global industry/knowledge creation centers)
- To lose no time in occupying the center ground of the Asian circle to ensure a pole position in the future Asian regional economic zone
- To encourage inward investment by non-manufacturing industries, in other words financial and service industries, which have different characteristics from manufacturing industries

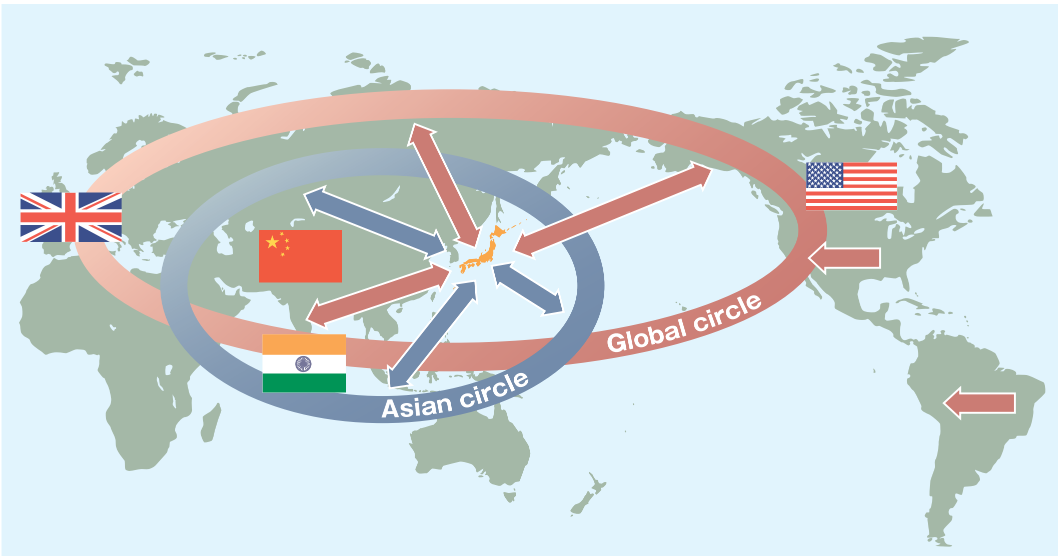
5 Simple volume growth would be difficult for Japan's mature economy. However, there is nothing to stop Japan from utilizing increased inward investment to boost added value and secure qualitative growth.

Chart Ⅰ-1: Active two-way capital flows essential for maximizing the value added element of Japan's mature economy

Targets for Globalization 3.0

Globalization 3.0

- Regional concentrations of industry, knowledge, and information
- Manufacturing industries + Finance/service industries
- Two-way flows



To encourage two-way trade and investment flows

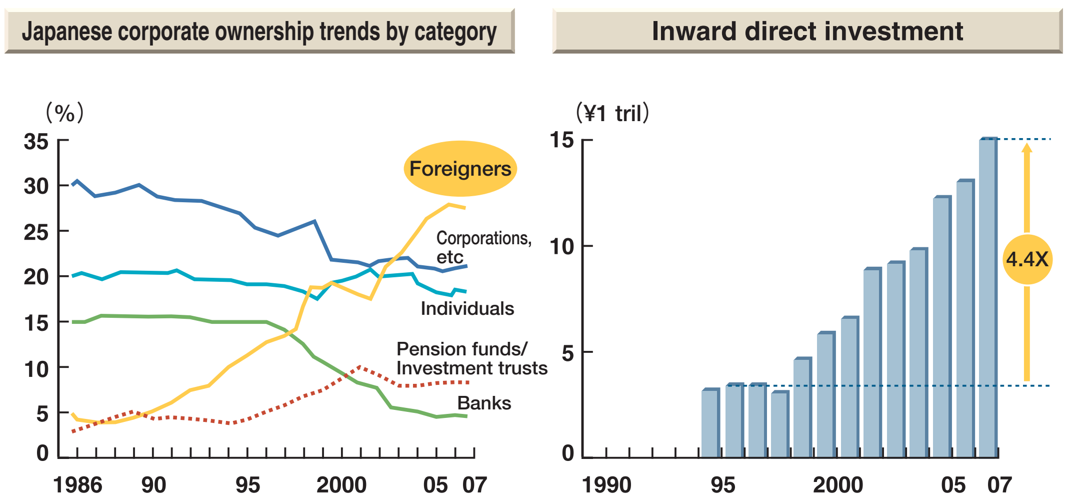
- **Establish regional industrial clusters around the world**
  Automobiles, electronics, environmental industry, pharmaceutical industry, etc
- **Create Asian circle**
  Direct investment by Asian companies in Japan
  Asian regional centers of global companies
- **Create regional concentrations of knowledge, information, and human resources for innovation**
  R&D, software development, design, information analysis, intellectual property management
- **Establish global centers for the finance and service industries**
- **Participate in global circle**
  Transformation from local into global companies

II. Is Japan still subject to "Japan bashing"?

Foreign investors are a major presence in portfolio investment the world over, and direct investment has increased more than four-fold since the mid-1990s.
Inward investment is steadily increasing.
However, the promotion of even more direct investment is a matter of some urgency for Japan. If Japan fails in this respect, it will inevitably find itself excluded from the global economic circle, it will lose its ability to generate added value and compete at a global level, and it will see its position in the Asian pecking order reduced. This should not be treated lightly.

1 Inward portfolio investment has boosted corporate Japan's foreign ownership ratio to almost 30%. On a flow (trading volume) basis, foreign investors account for more than 50% of daily turnover.

Chart II-1: Inward portfolio and direct investment in Japan has risen steadily



Source: TSE

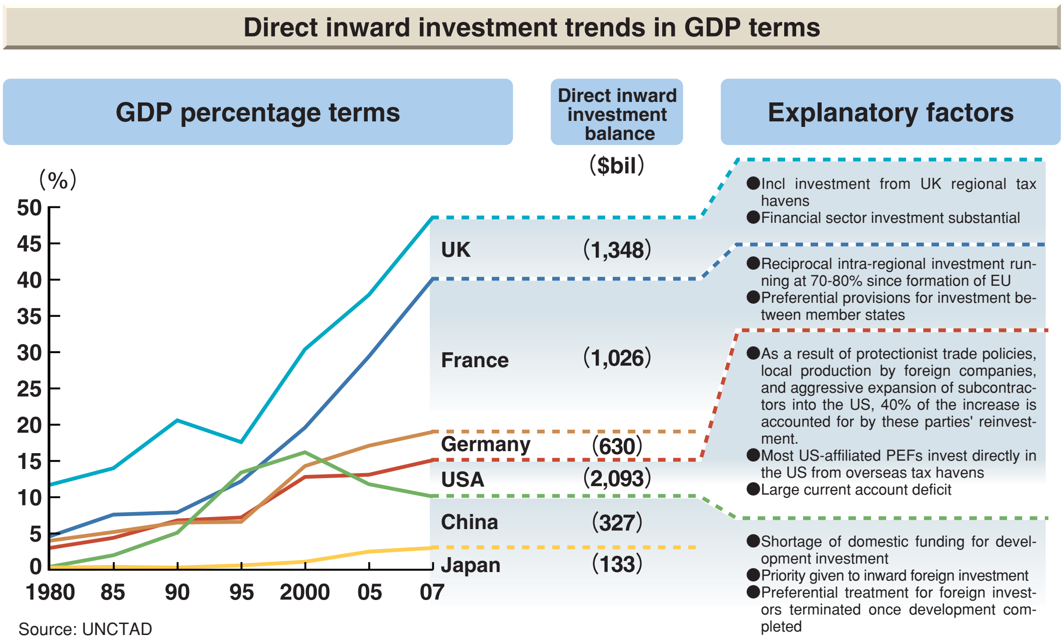
Sources: MOF, BOJ

2 Inward direct investment has increased 4.4-fold to more than ¥15 trillion since the mid-1990s. ROE, including foreign affiliates' royalty income, is high at around 15% and the number of foreign companies that have become leaders of their respective industries in Japan is not inconsiderable in the information, health care, and oil industries among others.

3 Direct investment in Japan is small in GDP terms compared with similar investment in other countries, but demands that Japan should therefore open the way to higher levels of direct investment are superficial and as such questionable, ignoring as they do the historical and regional economic context within which the current situation has developed.

4 The real reason for boosting inward direct investment is that if Japan fails to stimulate inward investment and put itself at the center of the global circle during Globalization 3.0, enhancement of the Japanese economy's value added element will be stifled and Japan will inevitably lose its relative position in Asia. There isn't much time left.

Chart Ⅱ-2: Japanese inward direct investment is certainly not great but simplistic comparisons that ignore the historical and regional economic dimensions are futile



Source: UNCTAD

Ⅲ. Could an easing of Japan's anti-foreign, insular legal system be the key?

Following ten years of deregulation, Japan currently has one of the least anti-foreign legal and regulatory systems in the world. With an overhaul of the legal system no longer central to the promotion of inward direct investment, our main task on this front is to eliminate such concerns and dissatisfaction as foreign capital interests may have regarding the prospects for a mature Japanese economy, to make Japan's economy a more attractive place for them to do business, and to secure their recognition of Japan as an indispensable base for their global activities. These tasks are more for Japan's corporate sector than for its overseas counterparts.

1 Deregulation has progressed to the extent that Japan's legal and regulatory systems are no longer anti-foreign or insular. There is consequently significantly less talk these days among foreign companies and their affiliates about Japan's legal and regulatory systems being an impediment to inward investment.

2 However, while having nothing whatsoever to do with the regulation of foreign investment, some of Japan's business structures and systems continue to be criticized by virtue of the additional costs they create and the risks they pose. This is an area in which Japanese companies will need to work together in the search for solutions.

3 Some greenmailer-type activist funds have accused Japan of being an insular market but to treat criticism of this sort as a litmus test of the openness of Japanese markets to inward investment is less than constructive.

4 There are grave concerns among foreign capital interests as to the prospects for Japan's now mature economy. It must surely therefore be our overriding ambition to turn the Japanese market into a sufficiently attractive place for doing business that all such doubts are dispelled.

Typical doubts:

- Concerns about the low growth potential of a Japanese market with an aging population
- Concerns about the relative decline in Japanese power in Asia
- Dissatisfaction with high Japanese business costs, including corporate taxes

ChartⅢ-1: Easing of Japan's legal and regulatory systems has reached a point at which they are no longer seen by foreign corporations as a significant barrier

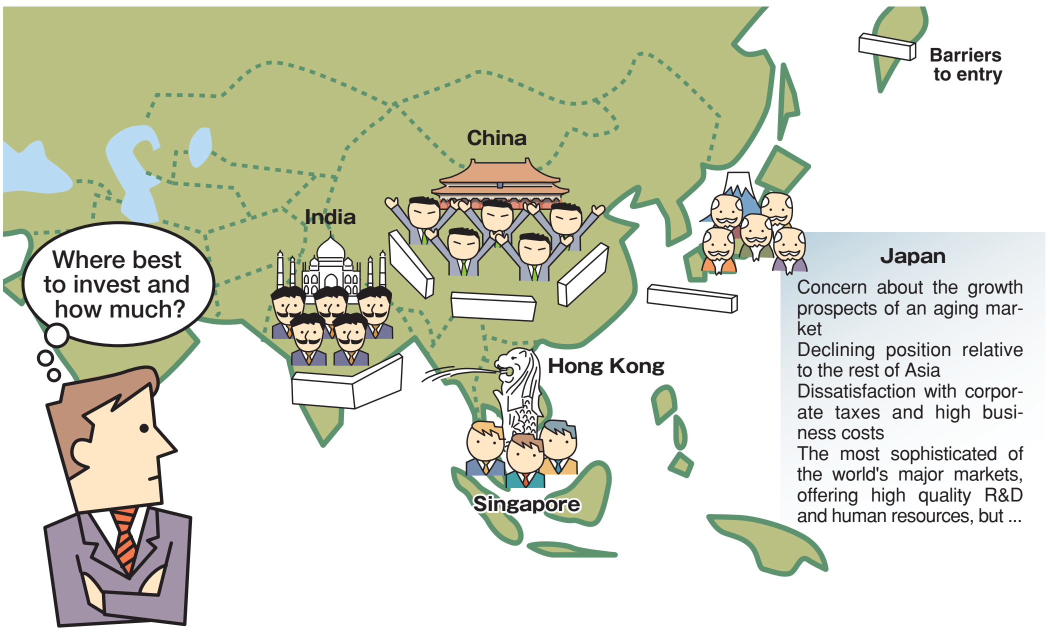
Progress of deregulation

1950	● Foreign investment legislation provides for inward direct investment under license only (prohibited in principle)
1964	● Becomes OECD member
1967-72	● Gradual increase in deregulated sectors
1979	● Foreign Exchange and Foreign Trade Control Law revised ● Inward direct investment switched to a system of advance notification (permitted in principle)
1991	● Revision in Foreign Exchange and Foreign Trade Control Law enables switch from advance notification system to ex post facto reporting system for all but four industries ● Industries approved for ex post facto reporting listed (positive list)
2002	● Industries required to give advance notification listed (negative list) to make outcomes more predictable

Impediments to business in Japan as perceived by foreign companies

Source: "Survey on Attitudes of Foreign-Affiliated Companies toward Direct Investment in Japan," JETRO (March 2008)

ChartⅢ-2: Bolstering the appeal of a mature Japanese market rather than revising its legal system is the key



Source: "Survey on Attitudes of Foreign-Affiliated Companies toward Direct Investment in Japan," JETRO (March 2008)

Ⅳ. Foreign companies or investment funds. Which should be given priority?

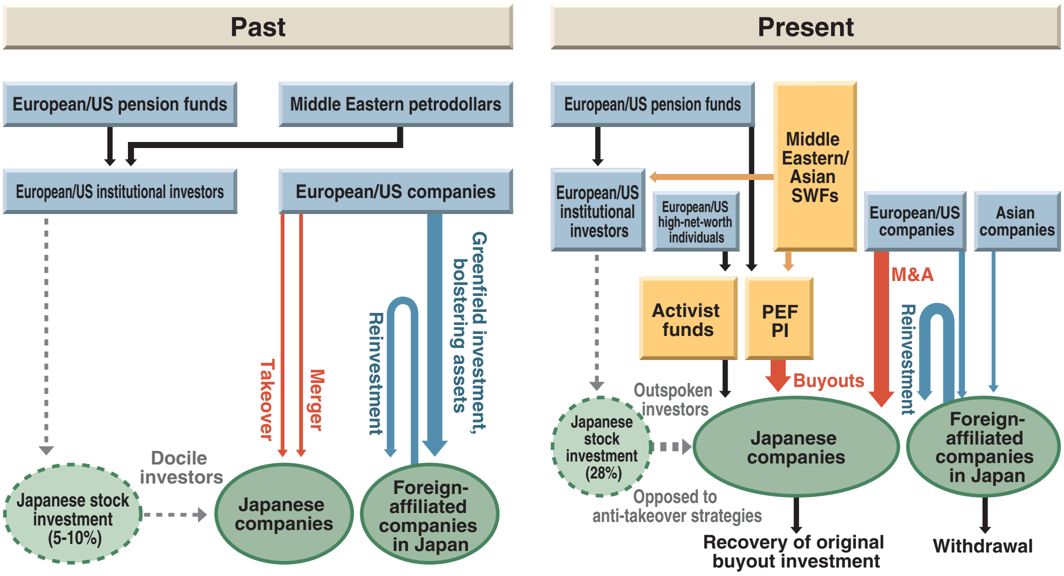
It has been argued that regardless of whether potential investors represent industrial capital interests (strategic buyers) or financial capital interests (financial buyers), as long as they are willing to invest in Japan, we should give them an unconditional welcome. However, there is a clear difference between investment for investment's sake and investment as a contribution to industry, and, in keeping with the strategic objectives of Globalization 3.0, inward investment by foreign industrial capital interests must clearly be preferred to financial capital investment.

1 Direct industrial capital investment in Japan (investment by foreign companies) has introduced new products, services, and technology along with unfamiliar business models, stimulating the Japanese economy and creating a million or so new jobs in the process. Through them, Japan has also increased its links with the rest of the world.

2 At the same time, financial capital (private equity funds [PEF]) has been a rapidly growing presence, accounting for 15-20% of the net increase in global direct investment.

- Raising risk money around the world from investors looking for high returns
- Taking advantage of ultra-low interest rates to borrow large sums to facilitate highly leveraged buyouts based on relatively limited amounts of original capital
- Fully exploiting the logic of capital, and using techniques such as restructuring to boost shareholder value
- Securing profits either by listing or selling to another company in the short/medium term

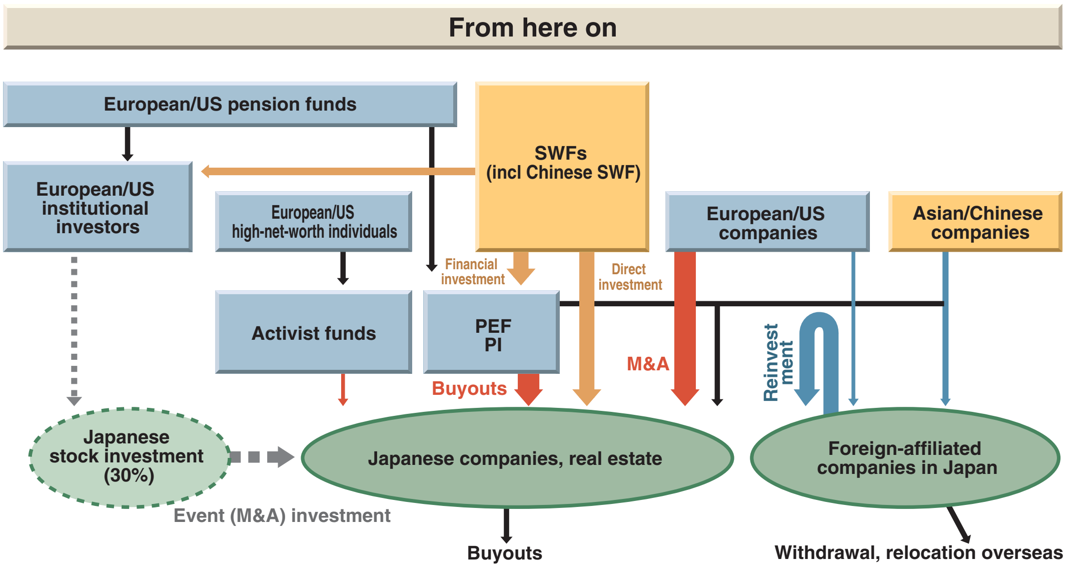
ChartⅣ-1: Inward direct investment by industrial capital interests boosts investment by reinvesting in existing foreign-affiliated companies and initiating additional investment. Financial capital, in the shape of PEFs, is also becoming a major investor



●Expansion via reinvestment in existing businesses and additional investment in greenfield sites to establish bases from which to develop Japanese markets
●Docile foreign investors

●Rapid rise in buyouts by PEFs and foreign financial institutions for the rehabilitation of Japanese companies after the bubble burst
●Increase in reinvestment and M&A by foreign companies in Japan
●Influx of activists
●Outspoken foreign investors

ChartⅣ-2: Ranks of financial capital interests to be swelled in future by SWFs (sovereign wealth funds)



●Risk of decline in greenfield investment and reinvestment
●Increase in takeover pressure on Japanese companies from foreign companies, PEFs, and outspoken shareholders working in concert
●Increased investment in Japan either directly via SWFs, or indirectly via PEFs
●Risk of decline in inward investment when exit is the logical conclusion to a successful funding operation

3 Financial capital has not only contributed to the resolution of corporate Japan's non-performing loan problems and need for corporate rehabilitation but has also helped revive flagging companies, underwritten sales of non-core subsidiaries, and enabled companies to delist. On the other hand, it has done little to further the strategic objectives of Globalization 3.0 by, for example, introducing new products and technologies into Japan and linking Japanese companies into global markets.

4 The risk money underpinning financial capital is channeled not only into PEFs but also hedge funds and funds investing in anything from petroleum resources to cereals and real estate, The resulting instability is one of the factors behind the recent financial crisis and economic turbulence, and one with respect to which we should be very much on our guard.

5 While welcoming inward direct investment in both its forms, differences between them, in terms of their respective aims and characteristics, make it essential that we should prioritize the encouragement of foreign industrial capital investment and devise a range of investment incentives for this purpose.

ChartⅣ-3: Contributions to Japan's economy: Industrial vs financial capital

Industrial capital vs Financial capital

			Industrial capital	Financial capital
			Manufacturing industries / Service industries / Finance industry	Private equity funds / Sovereign wealth funds / Activist funds
Unassisted entry	New entrant	●Greenfield investment	Encourage as a matter of priority by providing policy resources	
	Existing foreign-affiliated company	●Reinvestment ●Additional investment		
Assisted entry	M&A	●Minority shareholders ●Acquisition of management rights	Foster conditions conducive to M&A	Make best use of this double-edged sword
Investment characteristics	●Source of added value		●Increase in enterprise value based on business synergies and growth	●Increase in shareholder value based on restructuring of business and assets
	●Investment period ●Target return on investment ●Risk tolerance		●Long-term ●ROE ●Low	●Short/Medium-term ●IRR (15% or more: highly leveraged) ●High
Effect on direct investment overall			●Accumulates continuously	●Positive in case of buyout. Negative in case of successful IPO, or sale to Japanese company

V. Would foreign companies be amenable to an old-style public-sector-led approach?

Areas in which Japan's strengths could attract foreign companies, playing a useful role in pursuit of the strategic objectives of Japanese Globalization 3.0, are characterized by keywords such as regional industrial clusters, regional knowledge centers, gateway to Asia, and international financial capital center.
For foreign corporate investment, the underlying business rationale is key and a private company orientation essential. To put such a concept into practice, why not dispense with the old approach, whereby the public sector takes the lead and the private sector provides support, and replace it with an approach in which the private sector takes the lead and the public sector provides the support, thereby making it possible for Japanese and foreign companies to work together on major profit-making projects?
We would also need to consider the establishment of large-scale special economic zones and/or "virtual economic zones" more befitting the age of the Internet (health care and environment-related industries).

1 Our target in promoting inward direct investment by industrial capital interests should not be so much to secure new investment as to encourage European and US global companies already active in Japan to reinvest and/or commit additional investment to expand their activities in Japan.

2 In targeting new investment, our priority will be to attract European and US companies with new business models, and blue chip Asian companies, while in Asia consideration will be given to campaigns mounted jointly by the government, public, and private sectors.

3 Key themes will likely include Japanese characteristics that appeal to foreign capital interests, such as the "size and sophistication of the Japanese market," "high quality of human resources," "R&D and advanced technological processing capabilities," "safeguarding of intellectual property rights," and "vast financial assets," along with areas already targeted in Globalization 3.0. A number of ideas suggest themselves:

1) Regional concentrations of industries in which Japan is strong (e.g., northern Kyushu's automobile and electronics industries, and Kansai's new energy-related industries)
2) R&D-style and sensory development-style intellectual production centers based around regional concentrations of knowledge, information, and human resources (e.g., biomedical, industrial design, animation, and information analysis outsourcing services)
3) Joint development of industries that could be crucially important in a market dominated by an aging population (medical treatment, health care, financial asset management services)
4) Positioning as gateway to Asia (R&D, management, intellectual property, Asian logistics, and professional services)
5) Strengthening function as an international financial center

4 What about replacing much of the old approach with a new business approach as the driver?

- Shift the emphasis from public sector-led legal system reform to private sector-led business
- Shift the focus from foreign companies alone to foreign and Japanese companies together
- Shift away from prioritization of physical infrastructural provision to combined physical and soft infrastructural provision
- Shift from targeting small projects to targeting big ones

5 What if we were to establish large special economic zones (special regional cluster zones and special wide-area virtual zones) where domestic and overseas companies could work together on highly profitable ¥1 trillion projects led by the private sector and supported by the public sector?

Ⅵ. Are Japan's legal and regulatory systems, including takeover defense strategies, barriers to inward M&A?

Stimulating active M&A of Japanese companies by foreign capital interests is an important direct investment driver. Legal and price-related obstacles to M&A have been significantly reduced and anti-takeover strategies do not look to be a major problem. To overcome the main remaining hurdle, however, will require a change of mindset on the part of Japanese corporate managers, who will need to adopt the sort of global mentality that will allow them to be more flexible when evaluating the potential for growth in cooperation with foreign capital. While this is unlikely to be achieved overnight, the important thing is to study and learn from sound examples of successful established practice. From the standpoint of the principle of reciprocity in cross-border M&A, one area that will clearly need to be revisited is the difference between Europe and Japan with regard to the requirement placed on an offeror to acquire all the shares in the offeree company (tender offer system).

1 M&A is an important avenue for inward investment. Cross-border M&A currently accounts for approximately 70% of the net increase in global inward direct investment. In Japan, 18% of recent inward direct investment took the form of takeovers of Japanese companies by foreign corporate buyers.

2 The obstacles to M&A are not as great as they once were. First, legislation was put in place to facilitate the introduction of share swaps and a corporate demerger system, then triangular mergers were approved to simplify M&A by foreign companies wishing to use shares as consideration. Following recent stock price weakness, moreover, Japanese companies no longer look overpriced, suggesting now could well be a good time to buy.

3 With the exception of greenmailer-type activist funds, few see hostile takeover defense strategies as a significant obstacle. To avoid any unnecessary confusion, however, it may be worth prohibiting the adoption of unreasonable anti-takeover provisions and instituting instead a comprehen-

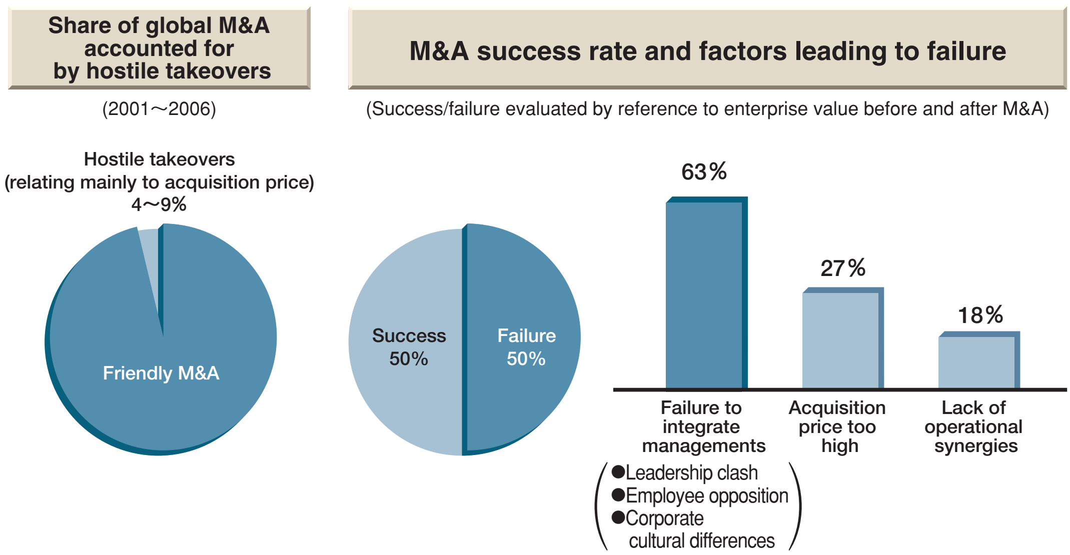
sive set of takeover and merger rules similar to the UK's City Code, which has been found effective in deterring unsuitable offerors. The City Code embodies the following general principles.

- Shareholders must be afforded equivalent treatment
- Shareholders must be enabled to make a properly informed decision
- Board members must act in good faith
- Stock price manipulation is forbidden
- An offeror must exercise all due care
- A tender offer must not hinder the conduct of an offeree company's business operations

4 With the privatization of several government organizations currently in the pipeline, it will be important for the government, when listing those that make major contributions to the public good, to emulate Europe and the US and retain control of them by, for example, providing for the disenfranchisement of majority shareholders, or retaining a golden share, or adopting a class share-based approach. To rewrite the rules after the event would inevitably create confusion among existing shareholders.

5 Many foreign companies are keen to see an increase in the number of friendly takeovers to ensure the successful post-takeover integration of their own management teams. The key in this regard will be to change the mindset of Japanese corporate managers. To this end, it is crucial for Japanese managers to cultivate the sort of global attitudes that will enable them to see realignment with a foreign company to achieve growth on a global scale as a viable option.

Chart Ⅵ-1: Foreign companies looking to friendly takeovers to assure them of success on the M&A front (= smooth integration at management level)



Sources: "Gassho Renko Senryaku (Multi-Party Alliance Strategy)" (Yoshinori Yokoyama, Keiko Honda: Toyo Keizai Shimposha), "Post-M&A Leader's Role" (David Fubini: Firstpress), "The Practice of M&A Management" (Nobumichi Hattori: Toyo Keizai Shimposha), A.T. Kearney, etc; compiled by author.

- Insist on going it alone and blow your company's future, or embrace realignment and open the way to the future?
- Degenerate into little more than a local Japanese company or become a full-fledged member of the global business community?

6 Major differences between Japanese acquisitions of foreign companies and foreign acquisitions of Japanese companies reflect a lack of balance between the two. From the standpoint of reciprocity, it is worth looking again at the differences between Japan's tender offer system and those of Europe and the US.

- If a Japanese company were to acquire 30% or more of the shares in a UK company via a tender offer, it would have to have funding in place to acquire the remainder up to 100% but could not compel minority shareholders to surrender their holdings until 90% or more of shareholders had responded positively to the tender offer. Germany has a similar system. In contrast, if a UK company is looking for an easy way to take control of a Japanese company, providing it confines its acquisitions to between 50% and 66.6% of the company's shares, it is under no obligation to buy the rest. Moreover, if it acquires upwards of two thirds of the shares, it can utilize techniques such as reverse splits to compel minority shareholders to surrender the remaining shares.

Chart Ⅵ-2: Japanese tender offer rules less rigorous than European rules. From the standpoint of reciprocity, Japan must replace the potential for partial acquisition with a requirement for full acquisition

Comparative rules for mandatory general offers

	Japan	UK	Germany	France
Persons acting in concert	When one or more persons acting in concern raise their shareholding in a company to more than one third of the whole by the acquisition, within a three-month period, of more than 5% of its shares outside the market, or more than 10% of its shares inside and outside the market	When one or more persons acting in concert look to acquire 30% or more of a company's shares	When one or more persons acting in concert look to acquire 30% or more of a company's shares	When one or more persons acting in concert look to acquire 33.3% or more of a company's shares
Disclosure	● Offeree company obliged to disclose its opinion on the offer ● Offeror obliged to disclose responses to questions ● Disclosure of price determination process, nature of involvement in management, conflicts of interest	● Offeree company obliged to disclose its opinion on the offer ● Disclosure of price determination process, nature of involvement in management, conflicts of interest	● Offeree company obliged to disclose its opinion on the offer ● Disclosure of price determination process, nature of involvement in management, conflicts of interest	● Offeree company obliged to disclose its opinion on the offer ● Disclosure of price determination process, nature of involvement in management, conflicts of interest
Partial offers	Partial offers leading to the acquisition of less than two thirds of a company's shares permitted (51%-65%)	Not permitted (Possible up to a certain level with the approval of the Panel)	Not permitted (Except where less than 30% of the shares are targeted)	Not permitted (Simplified procedure available if no more than 10% of the shares are acquired)
General offer obligatory	Yes (when at least 2/3 of the shares are acquired)	Yes	Yes	Yes
Minimum consideration	No restrictions	Highest price paid during preceding 12 months	Highest price paid during preceding 6 months	Highest price paid during preceding 12 months
Squeeze-out of minority shareholders	—	90% or more	95% or more	95% or more
Withdrawal of offer	Withdrawal rules relaxed in the event that anti-takeover measures are used	Rights of withdrawal cannot be reserved in the case of a mandatory offer	Rights of withdrawal cannot be reserved	Permissible in the event, for example, that a rival offer materializes or anti-takeover measures are brought into play

Sources: "Revisions to System of Monetary Penalties for TOB/Large Shareholding Report Violations," Jun Yokoyama (Financial Product Business series, DIR 2007), "M&A Management," Nobumichi Hattori (Toyo Keizai Shimposha 2003), annotated and compiled by Nishimura & Asahi (Law Offices)

Note: The tender offer system is part of a broader body of M&A legislation not readily susceptible to cross-border comparisons of this sort, which may not provide an entirely accurate picture. The chart is intended as a rough guide only.

Ⅶ. Are PEFs vultures or dependable risk money?

"Fund capitalism," a new financial capital force with a rapidly increasing presence in the global investment and M&A markets, is having a huge direct effect on those markets. At the heart of this development, the private equity fund (PEF), with its bright and dark sides, is very much a double-edged sword. To get the best out of a PEF by securing an infusion of risk money to realize the logic of capital and engender a short/medium-term rise in a company's share price, each fund must be used intelligently and with a clear understanding of its fundamental nature. On the other hand, with respect to the dark side implicit in such funds' lack of transparency, it is essential to secure greater disclosure and tax treatment on a par with that of industrial capital. The idea is not, of course, to rely indefinitely on foreign risk money but rather to coax the huge reserves of money lying idle in Japan into action and to nurture the development of Japanese PEFs capable of being numbered among the world's foremost PEFs.

1 PEFs, which have mushroomed around the world to the point at which they already have $2 trillion in assets under management and a further $820.0 billion as yet uninvested, accounted for approximately 20-30% of global M&A in 2006 in their capacity as what are generally referred to as financial buyers (buyers whose primary objective is to secure a return on investment by acquiring a company).

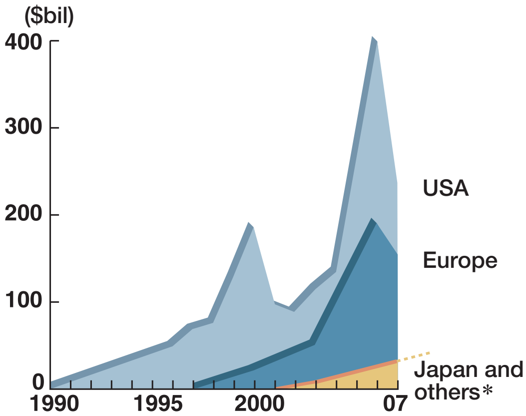
2 Exploited in the first instance by foreign capital-based PEFs, Japan's PEF market, which is still being infiltrated by domestic and overseas funds, has already swelled to what is reputed to be about ¥2 trillion in assets under management, something of a fund bubble in its own right.

ChartⅦ-1: In just a few years, the PEF market, which originated in the US, spread first to Europe and has subsequently expanded throughout the world, including Japan, such that it now encompasses a global network of funding sources and investment targets

Globalization of PEFs

PEF investment markets

Rapid growth in investment value outside the US in recent years

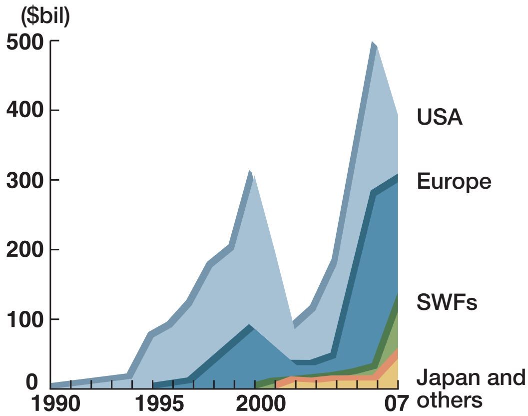


*Approx 9% in value terms (2001-07)

Source: The Private Equity Analyst; compiled by author

PEF funding source markets

PEF funding sources have spread beyond the US with Middle Eastern, Asian, and Chinese SWFs growing particularly rapidly in the past 1-2 years



Source: The Private Equity Analyst

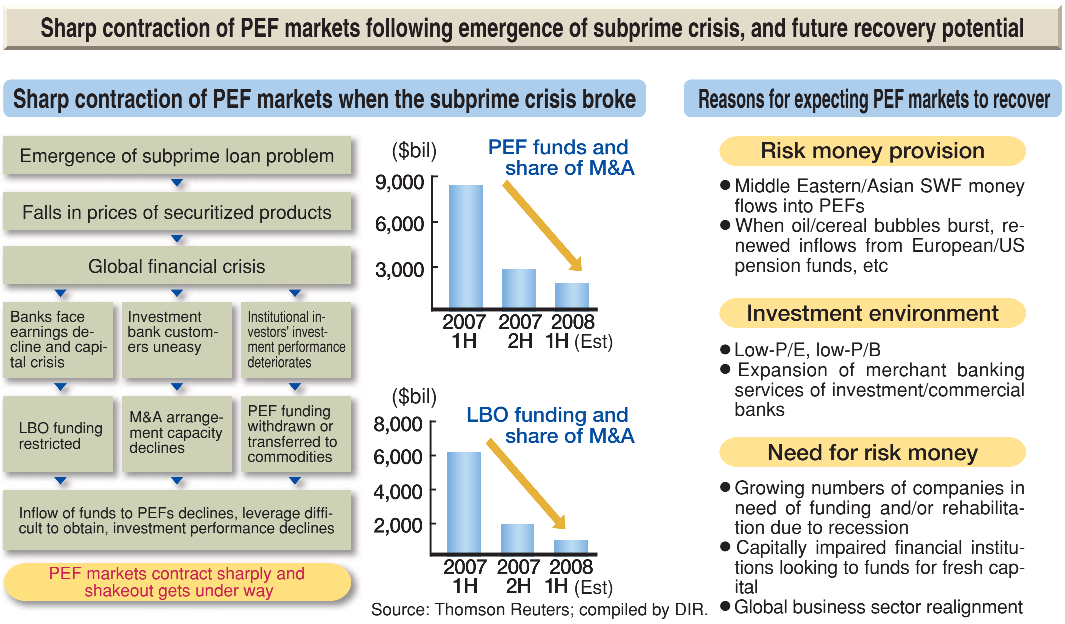
3 Large numbers of funds are invested by fund management companies, both domestic and foreign, operating out of overseas tax havens such that investments made by them in Japanese companies are treated, for statistical purposes, as inward direct investment. Conversely, when companies bought out in this way are eventually listed, for example, or sold off to a Japanese company, they count as a reduction in direct investment.

4 PEFs come in a variety of forms from rehabilitation funds to real estate funds, value-up funds, and PIPE (private investment in public entities) funds, all of which differ from one another by virtue both of their characteristics and of the ways in which they are invested. It is for this reason important to be clear in advance as to the policy objectives and characteristics of any given fund.

5 Under pressure from the global financial crisis that started towards the end of 2007, PEF markets have contracted sharply and a shakeout is under way. However, the major PEF players have been active in their pursuit of funding from the Middle Eastern, Chinese, and other SWFs (sovereign wealth funds) and with opportunities for investment in rehabilitation projects expected to increase throughout the world, we could well see a concomitant increase in Japanese corporate buyouts.

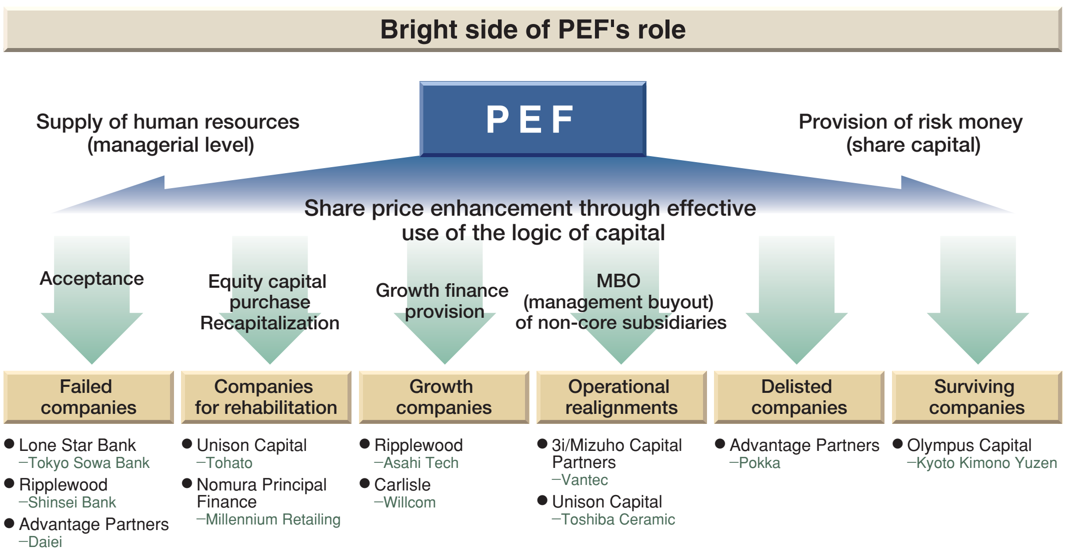
6 On the bright side, PEFs provide companies with the funds they need for rehabilitation, realignment, revitalization, and growth, and have the professional expertise to help them maximize shareholder value. Companies must have the wisdom to evaluate funds properly when choosing trustworthy PEFs and make expert use of them in their corporate business realignment and M&A strategies.

ChartⅦ-2: PEF markets contracted sharply when the subprime loan problem came to light but should recover in time



Source: Thomson Reuters; compiled by DIR.

ChartⅦ-3: PEF, a double-edged sword: The bright side

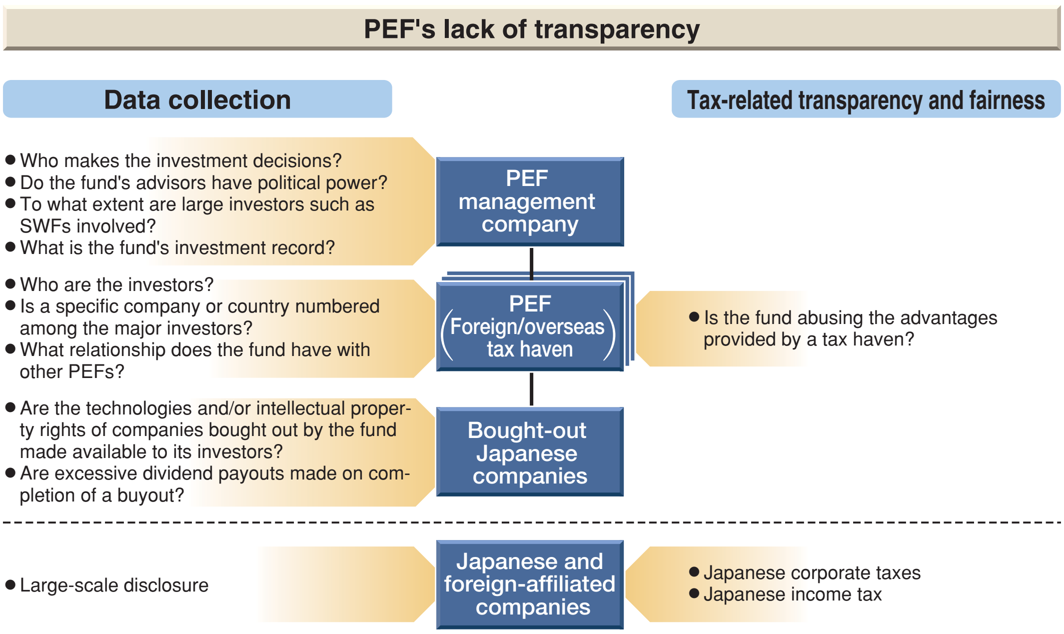


7 The dark side of PEFs lies in their lack of transparency. Disclosure is limited with the result that it may not be readily apparent that a PEF's principal subscriber is a particular company or a particular country's SWF, who its advisory members are, or what sort of investment record it has. There

are moves in Europe and the US to require fuller disclosure by PEFs and in the UK, the Walker Report, produced as the result of a private sector initiative, is already attracting attention. We need to see a similar approach adopted in Japan. One possibility would be to establish a private sector PEF data collection and rating agency.

The Walker Report, commissioned by the British Venture Capital Association (BVCA) and major private equity firms, was published in November 2007 under the title of Guidelines for Disclosure and Transparency in Private Equity. The report was produced against the background of the private equity industry's increasingly high profile, inadequate disclosure, excessive exclusivity, and criticism from a number of interested parties caught up in a process of large-scale acquisition and restructuring for the purpose of enhancing corporate enterprise value. Private equity firms licensed by the UK FSA (Financial Services Authority) and UK companies in PEF portfolios are called on to meet the basic disclosure requirements set out in this report.

ChartⅦ-4: PEF, a double-edged sword: The dark side



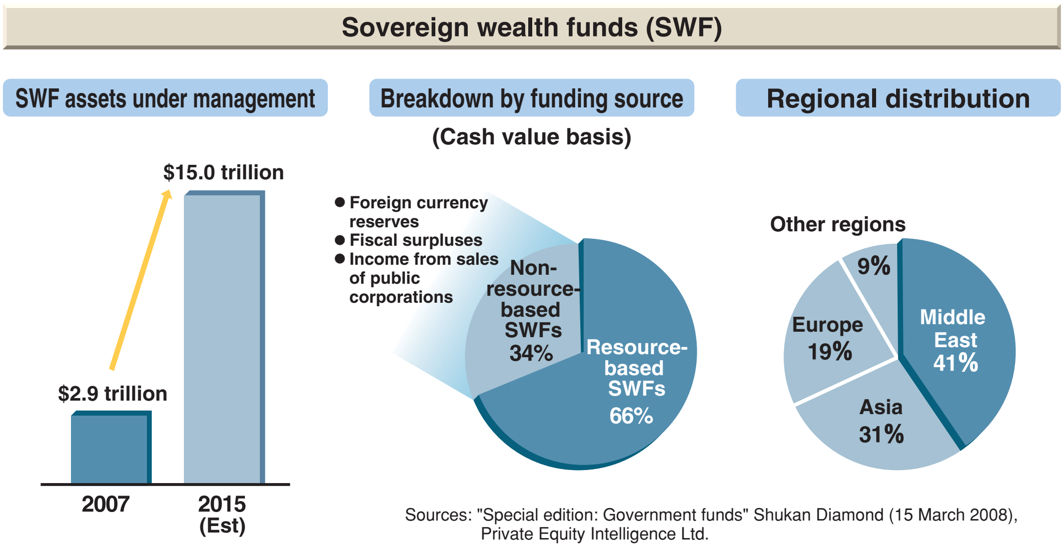
8 Another aspect of the dark side of PEFs is the lack of transparency with respect to the tax they pay and their degree of impartiality. Most PEFs avoid tax at the fund level by basing themselves in tax havens but have found themselves subject to civil actions for using elaborate schemes to circumvent taxes for the payment of which they are legally liable. If companies are to be acquired by PEFs, they must be subject to a rigorously administered tax system not overly inequitable compared with what they would have been subject to if taken over by industrial capital interests.

Ⅷ. How should Japan respond to Middle Eastern, Asian, and Chinese SWFs?

Amid the advance of fund capitalism, the impact of SWFs has also become increasingly difficult to ignore. SWFs have undergone a transformation of late from once docile portfolio investors to outspoken investors with a growing taste for strategic business investment via PEFs, or as direct investors, with the result that we can expect SWFs to have an increasing influence on inward direct investment going forward. What we need now is a framework for the ongoing collection and investigation of information pertaining both to SWFs and to PEFs that count SWFs among their subscribers, along with positive action to attract Middle Eastern SWF capital through the medium of "joint funds."

1 Investment funds (SWFs) sourced, in the case of resource-rich economies such as Russia and some Middle Eastern countries, out of resource-based income and, in the case of export-led economies such as China, out of foreign currency reserves, currently control assets to the tune of $3 trillion, a figure estimated to rise to anything from $12 to $15 trillion by 2015.

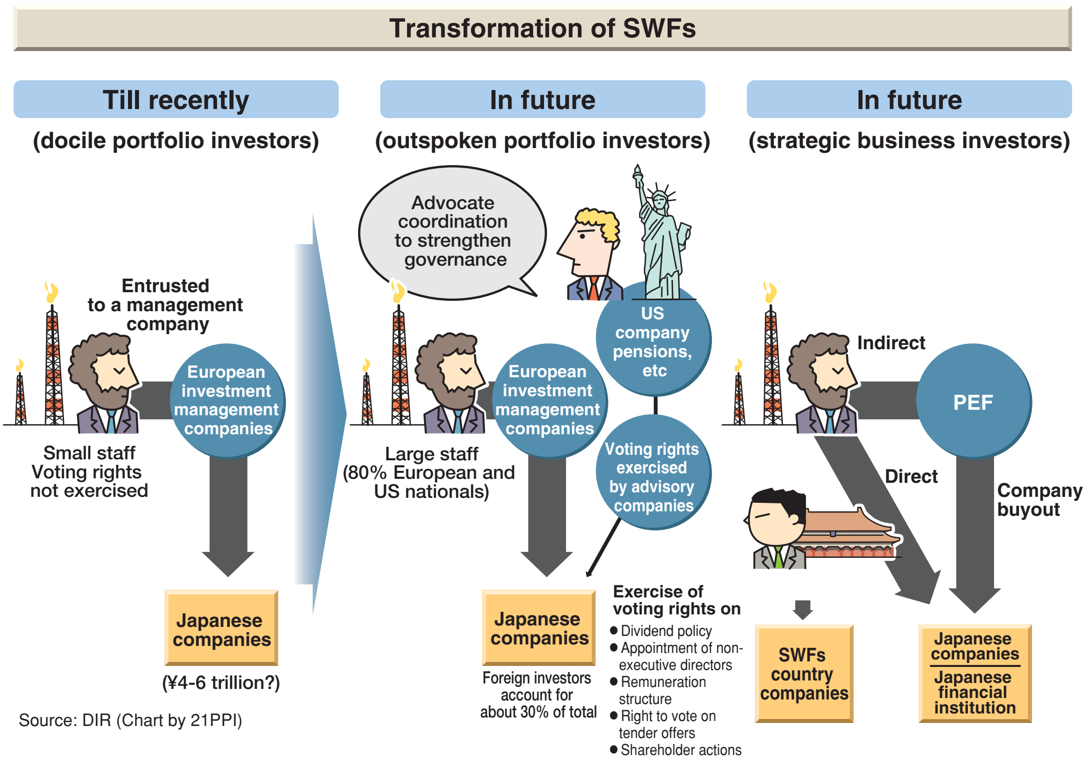
ChartⅧ-1: SWFs have $2.9 trillion in assets under management, two thirds funded out of resource-based income, and one third out of foreign currency reserves and/or fiscal surpluses. 70% of SWFs are based in the Middle East and Asia



Sources: "Special edition: Government funds" Shukan Diamond (15 March 2008), Private Equity Intelligence Ltd.

2 To date, the main focus for SWFs has been on stable long-term portfolio investment. There are signs, however, that these funds may be changing from hitherto docile portfolio investors into considerably more outspoken investors with the determination to exercise their rights as shareholders.

ChartⅧ-2: SWFs are being transformed from docile investors into increasingly outspoken investors and, in some cases, strategic business investors

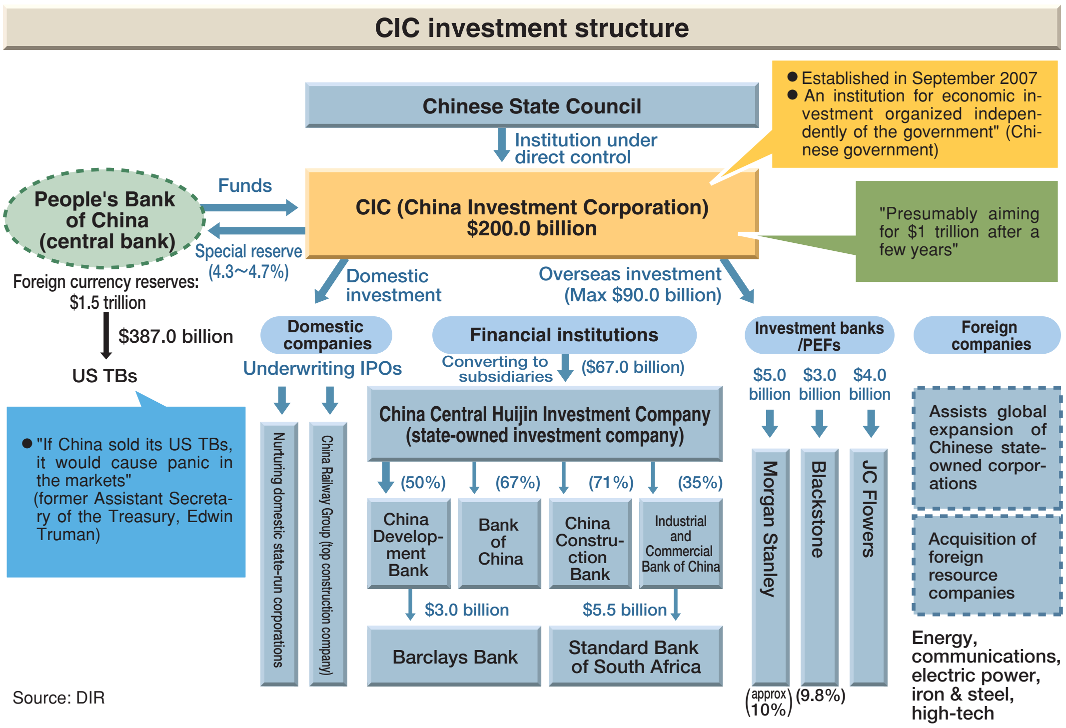


Source: DIR (Chart by 21PPI)

3 Some SWFs are also now taking on the appearance of strategic business investors. Indirect M&A through the medium of private sector PEFs and direct business investment in non-financial companies and financial institutions, based on a country's strategic objectives, are on the increase. This has become particularly evident in the case of a number of Singaporean, Chinese, and Middle Eastern SWFs.

● The CIC (China Investment Corporation) implements Chinese national strategic objectives by using $200 billion, drawn in the first instance from the country's huge foreign currency reserves, to invest both directly and via foreign PEFs, to invest in foreign investment banks, and to acquire foreign financial institutions through China's four big banks, whose capital it controls. It consequently plays an important part in extending China's global presence.

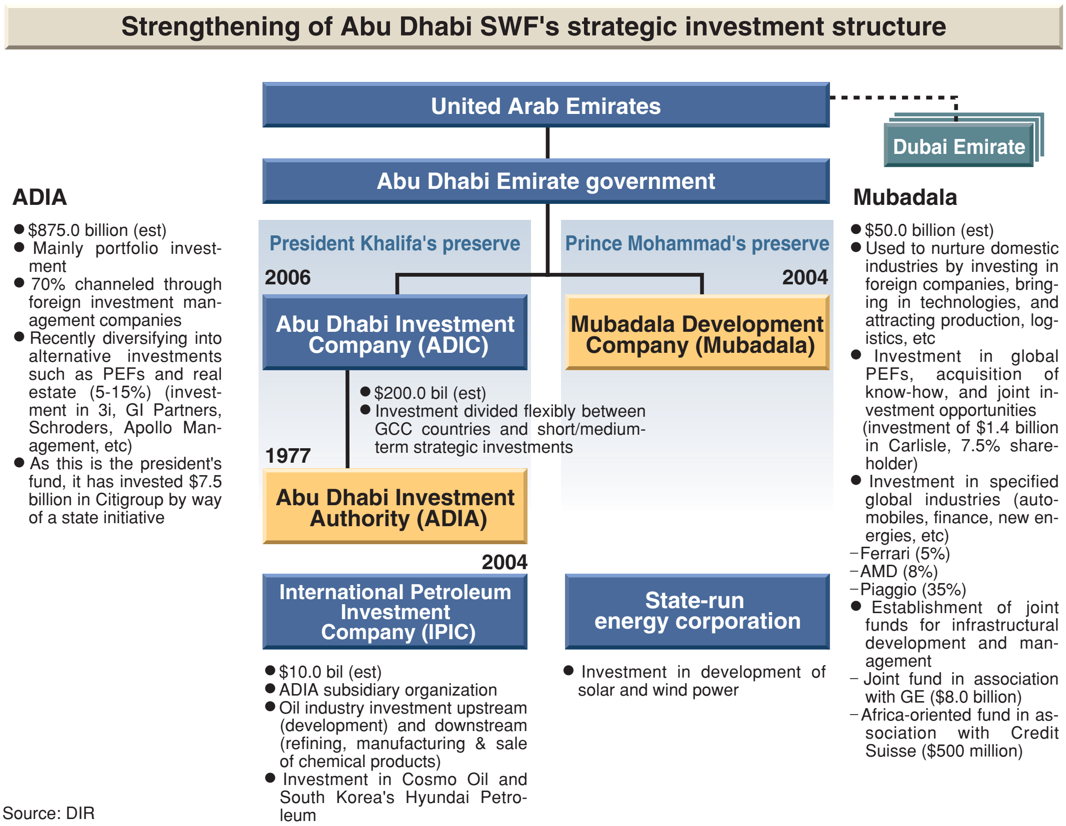
ChartⅧ-3: China's SWF: CIC (China Investment Corporation)



Source: DIR

● Operating out of the UAE (United Arab Emirates) in the Middle East, the Abu Dhabi Investment Authority (ADIA), the world's biggest SWF with assets of $875.0 billion, is no longer the docile portfolio investor it once was, having recently invested in Citibank while at the same time starting to channel funds into European PEFs. Moreover, the Mubadala Investment Company, established as an independent company with assets of $50.0 billion, is not only making strategic investments of its own and pouring vast sums into PEFs but has also recently set up a joint infrastructural investment fund in cooperation with GE.

ChartⅧ-4: UAE (Abu Dhabi) SWFs: ADIA, etc



Source: DIR

4 SWFs, once denounced as dangerous state-run funds, have come more recently to be seen as potential saviors, up to a point at least, by a Europe and US in dire financial straits. For the time being, they will probably look to secure the transparency they require through application of the IMF's manual of global best practice "Generally Accepted Principles and Practices (GAPP, Santiago Principles)."

5 Under the circumstances, Japan must not only be involved in the formulation of a voluntary code of practice for the world's SWFs but must also lose as little time as possible in establishing a framework for the collection of data both on SWFs and on the PEFs into which they also channel large sums, the ultimate object being to monitor the involvement of SWFs in Japan's securities markets, in Japanese corporate M&A, and in the effects such activities might have on Japan's national security.

6 One possible option might be to attract funding from Middle Eastern SWFs, looking for stable long-term investment opportunities, through the medium of joint funds established in association with Japanese companies, with a view not only to the rehabilitation and realignment of businesses in Japan but also to the funding of infrastructural investment and corporate buyouts throughout Asia. Collaboration based on Middle Eastern money and Japanese technology would make a great deal of sense.

IX. Is Japan adequately prepared to defend itself against foreign investments that could harm the national interest?

Finally, to safeguard Japan's national interest in terms of its security, it is only by first creating a safety valve in the shape of a framework for effective regulation of the acquisition by foreign capital interests of shareholdings in Japanese companies that we could feel secure in encouraging corporate Japan to welcome inward direct investment with open arms. There are limits to the current system of listing, advance notification, and legal sanctions, as provided for under the terms of the Foreign Exchange and Foreign Trade Control Law, and our suggested alternative would be to learn from European and US practice in these areas and take the earliest opportunity to consider the possibility of introducing a system that would enable ex post facto regulation of foreign investment in Japan. As for managing this regulatory system, the most important thing would be for the cabinet and government departments/bureaus that took on this responsibility to share a clear perception of Japan's national interest in a global context.

1 Globalization is not a first step towards the development of a cosmopolitan borderless political and socioeconomic entity. Healthy globalization must rather be built on principles for the regulation, based on mutual respect between countries, of foreign investment with the potential to harm national interests in the shape, for example, of national security.

2 The OECD "Code of Liberalisation of Capital Movements," which provides for the free flow of capital between countries, also recognizes the need for systems to regulate investment from foreign countries that could pose a threat to national security, public order, and/or public safety, and each country has duly devised a system of this sort for itself.

3 For its part, Japan has based its defense on a system of listing, advance notification, and legal sanctions. The legislation in question ensures that there is an excellent chance of securing the requisite information in advance but if anything should indeed slip through the net, effective regulation becomes highly problematic from that point on.

- Technologies, products, and businesses that affect security and public order are becoming increasingly complicated with the result that no matter how detailed an ex ante schedule may be, there is an ever-present risk that something may be missed
- Once an investment has slipped through the net, there is little that can be done that will have any real effect on it
- Even if an offense is committed, it is difficult to enforce sanctions against non-residents

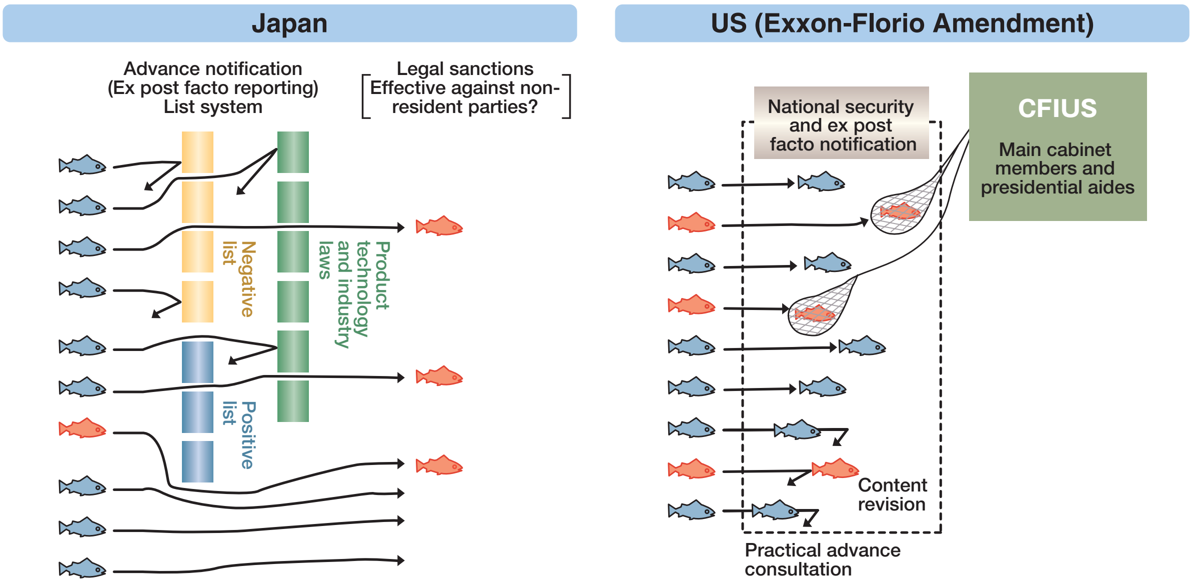
4 By contrast, the US Exxon-Florio Amendment is the exact opposite of the situation in Japan. Under the terms of this amendment, the Committee on Foreign Investment in the United States (CFIUS) can, in the event that the acquisition of shares in a US company by foreign capital interests is deemed to pose a potential threat to US national security, negotiate revisions to the acquisition plan or call an ex post facto halt to the acquisition process itself. The UK has a similar system.

5 In Europe, Germany and France use a list and advance notification-based system similar to that used in Japan. In France, however, in the event that a party contravenes the regulations, the authorities may not only impose legal sanctions but may also declare any agreement or contract relating to the investment void and order a return to the previous status quo. For its part, Germany is considering a bill to enable investment to be reversed after the fact instead of listing industries subject to regulation.

6 Given the growing potential for all sorts of foreign companies and funds to acquire shares in Japanese companies with new businesses and technologies, Japan should probably also be looking to introduce a system for the regulation of foreign capital that would enable the authorities, in extremis, to safeguard the nation's security and/or public order by either calling a halt to, or modifying the content of, such acquisitions after the fact. Not only must the legislation pertaining to this system be lucid but the authorities responsible must also be able to make a persuasive case in negotiations based on their perception of Japan's national interest in a global context.

ChartIX-1: Japan must consider a system for the effective regulation of Japanese corporate stock acquisitions by foreign companies that could pose a threat to Japan's national security

National systems for the regulation of inward investment



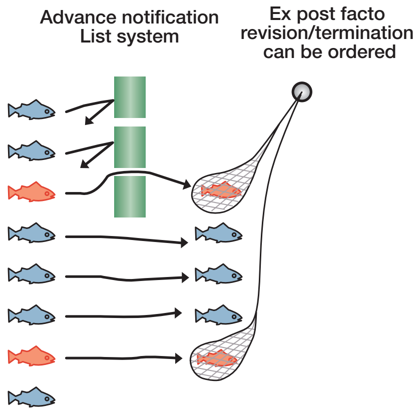
ChartIX-2: Japan must consider referring to the European and US examples by introducing a system for the ex post facto regulation of inward investment as a matter of urgency

National systems for the regulation of foreign capital interests

	Japan	USA
Legislation	● Foreign Exchange and Foreign Trade Control Law (amended in 2007)	● Defense Production Act (Exxon-Florio Amendment, amended 2007)
Jurisdiction	● Minister of Finance and other competent ministers	● President ● Committee on Foreign Investment in the United States (CFIUS)
Reasons for regulation	● National security, public order, public safety, trouble-free economic management	● National security
Specified industries	● Yes: Weapons, airplanes, space development, nuclear power, etc	● No
Target transactions	● Acquisition of 10% or more of the shares in a listed company	● In the event that a foreign company with a controlling interest in a US company may pose a threat to national security (excl cases in which investment is the sole aim and voting rights are limited to a maximum of 10%)
Duty of notification	● Yes: Advance notification	● No: Ex post facto regulation
Surveillance organization	● 30 days (max 5 months) ● Advance consultations can be arranged	● Review: 30 days ● Investigation: 45 days ● Unofficial discussions frequently held in advance
Refusal record	● Screenings: Approx 760 ● Refusals (ordered to terminate process): 1 (TCI's bid for J Power) Note: Past 3 years	● Reviews: 1,604* ● Investigations: 25 (unilateral withdrawal common in the event of a failure to reach agreement with CFIUS) ● Reports to president: 12 ● Refusals (order to sell): 1 (Chinese government agency CATIC's bid for MAMCO [1990])
Trends/ features		● Laws and regulations revised in response to bids for Unocal and others ● Special arrangements for transactions involving foreign governments

*Period since law came into force (1988) through March 2006
Source: METI, US GAO; compiled by DIR.

Germany/France



UK	France	Germany
● Company law (revised in 2002)	● Commercial and financial code (revised 2005)	● Outward trade settlement legislation (revised 2004)
● Department of Trade and Industry	● Ministry of Economy, Finance, and Industry	● Federal Ministry of Economics and Labour
● Public interest	● Maintenance of order, public safety, national defense	● National security interest
● No	● Yes: 11 strategic industries (technologies, weapons, etc with military and civil uses)	● Yes: Battlefield weapons, encryption systems, etc
● All mergers and acquisitions	● (1) Acquisition of control (majority of voting rights) of French company (2) Acquisition of branch of French company (3) Acquisition of upwards of 1/3 of voting rights (non-EU companies only)	● Acquisition of at least 25% of shares
● Yes: Advance notification	● Yes: Advance notification	● Yes: Advance notification
● 6 months (normally 30 days) ● (Particularly in cases involving defense-related matters) Unofficial discussions frequently held in advance	● 60 days ● Unofficial discussions frequently held in advance	● 30 days ● Unofficial discussions frequently held in advance
● Refusals (intervention notice): 6 (issued in each case to keep information relating to military planning secret) Note: Since law came into force (2003)	● Refusals: None Note: Since code came into force (December 2005)	● Screenings: 11 ● Refusals: None Note: Since legislation came into force (July 2004)
● As the main aim is to promote sales by auction and prevent the establishment of monopolies, UK corporate bidders may also find themselves in the firing line	● Code revised in response to a takeover bid for Danone ● Possibility considered that size of foreign government's shareholding in offeror company should be taken into account	● Legislation revised in response to takeover of HDW

21PPI

– Japan's Opes & Dynamic Policymaking Hub –

The 21st Century Public Policy Institute

Keidanren Kaikan 6th Floor, 1-9-4 Otemachi, Chiyoda-ku, Tokyo, 100-8188
TEL：+81-3-5204-1764　FAX：+81-3-5255-6279　URL：http://www.21ppi.org