1. Creating a friendly and open Environment for Foreign Direct Investment (FDI)

Direct investment in Japan is still extremely limited compared to the EU and USA. There has been a significant pick-up since FY 1998, but, it is not clear whether this is the beginning of a sustained trend or merely a once and for all step adjustment. Indeed a decline in the inflow of direct investment has occurred in FY 2001, albeit in keeping with global trends, and seems likely to persist in FY 2002. However, foreign direct investment has made most headway in Japan in sectors where deregulation has progressed (like financial services and telecommunications), suggesting that if regulatory reform and economic restructuring can be advanced on a broader basis in Japan correspondingly more foreign direct investment will follow. In particular, the EU draws attention to the fundamental benefits which could be obtained in terms of levelling the playing field for new market entrants, domestic and foreign, through a tougher enforcement of competition policy (see below, 2.1 competition policy).

Keidanren has well stated the benefits of direct investment inflows in a recent paper ("Towards the Creation of International Investment Rules and Improvement of the Japanese Investment Environment", 16 July 2002): "In many cases, investment in Japan entails the cross-border shift of not only capital, but also valuable corporate management resources such as new business models, new technology and materials, and new management know-how. Such investment also creates jobs here in Japan and stimulates intra-company cross-border transactions which expand economic ties between Japan and the home country. Investment in Japan will also help to prevent the feared hollowing-out of industry, as well as stimulating domestic competition, increasing economic efficiency and advancement of industry. The resulting virtuous cycle created in Japan as an investment host will boost the domestic economy".

1.1. Investment

The same Keidanren paper also pinpoints the steps which the Japanese authorities should take to stimulate more direct investment. It points out that:

"More specifically, the following steps need to be taken:

(1) improving the efficiency and reducing the cost of energy, physical distribution, telecommunications, and social capital formation;
(2) lowering the effective corporate tax rate and reforming tax systems, including tax breaks for investment;
(3) creating more flexible corporate laws;
(4) simplifying and speeding up administrative procedures while eliminating arbitrary decisions;
(5) assisting creative efforts by local municipal governments such as special regulatory reform zones; .
(6) simplifying, rationalizing and speeding up customs clearance procedures at ports and customs;
(7) promoting the outsourcing of state-run programs to the private sector;
(8) developing capital markets and other institutions;

(9) bringing Japan's technical regulations and standards and its conformity assessment procedures into line with international standards; and, toward promotion of investment in Japan;
(10) expanding and improving central and local government external PR efforts; and
(11) establishing a system for the one-stop provision of investment-related information.

Keidanren also points out the urgent need to simplify and accelerate procedures for visas, work permits and other entry and stay-related procedures (including for transfers within companies) so as to provide access to the best human resources companies can get, regardless of nationality.

Needless to say, the EU totally agrees with the views expressed by Keidanren on investment. The EU would recommend the high cost threshold for investors in Japan and the transparency and predictability of the investment environment as the two key areas for active reform.

Nevertheless, the EU welcomes the significantly more pro-active attitude being taken by the Government of Japan towards the promotion of FDI. This more positive stance is symbolised by PM Koizumi's powerful message of welcome at the December 2001 EU-Japan Summit for increased investment in Japan by EU companies. Furthermore, increased political commitment has been demonstrated through the Council on Economic and Fiscal Policy's designation of FDI promotion as a basic economic revitalisation strategy. The announcement that the Japan Investment Council (JIC), chaired by the Prime Minister, will report in March 2003 on further measures to increase FDI, and that the Business Forum created by JETRO will also issue recommendations in December 2002, are additional positive signs.

Increasing two-way investment is one of the key aims of the EU-Japan Action Plan adopted at the EU-Japan Summit in 2001. The EU equally appreciates the growing cooperation of the Japanese authorities, for instance in organising the successful Investment Symposium in December 2001, and notes too similar cooperation with the US authorities. These are good foundations on which to build. Moreover, Japan deserves credit for major reform steps over the last five years:

- Starting in 1997, far-reaching changes in the Commercial Code which have allowed the creation of holding companies, streamlined merger procedures, allowed domestic share exchanges in order to facilitate corporate restructuring, improved bankruptcy rules, and strengthened corporate governance and accountability.
- Starting in 2000, a series of revisions in accounting standards in order to bring Japan nearer to international practice by introducing consolidated, tax effective and mark-to-market accounting.
- Initial steps to improve labour mobility by introducing defined contribution portable pension plans (October 2001), gradually expanding the job categories covered by fee-charging employment agencies, and increasing the maximum duration of termed contracts.
- From 1999, moves to increase transparency and accountability in the regulatory process through the public comments procedure and the No-Action Letter system.

1.1.1 Overcoming the high-cost threshold

For a number of reasons there is, on international comparisons, a high cost threshold for a foreign investor entering the Japanese market. In this context, continued moves to make the real estate market more liquid and transparent are important, but the EU wishes to point out three practical steps that could be taken:

(i) Greater simplification and coordination in the process of registration/approval as a designated foreign investor in Japan;

(ii) Improved co-ordination of the work of the national and local bodies responsible for investment promotion. The December 2001 EU-Japan Investment Symposium pointed to best practice among EU investment promotion agencies, and the concept of a "one-stop shop" where a foreign direct investor can find not only all the information he needs to have, but also facilitation in the sense of easy and simple registration and access to services, site, qualified labour sources, etc. To give a specific example, it is noteworthy that in the Kansai area the local prefectures have no single, coordinated approach to attracting FDI despite the acute need of the region for new investment. In particular, there is a need to improve, on the one hand, the means of channelling enquiries from potential investors to regions whose profile matches their needs, and, on the other hand, better to support regions in identifying the potential investors to whom their strengths make them most attractive.

(iii) Remove restrictions on M&A methods used by foreign companies, notably tax-neutral share-for-share exchanges. Such mergers/acquisitions techniques, common practice in other major markets, are not yet possible in Japan. This is a matter of concern precisely because M&A is one of the main ways in which foreign companies can enter a market, and is a major channel for foreign investment. In this context, the EU welcomes and supports METI's recently announced proposals to allow, in a tax-neutral manner, the use as consideration by a 100% Japanese subsidiary of its foreign parent company's shares when merging with/acquiring another Japanese company (so-called "triangular merger" model).

Moreover, there is still room for the friendliness and openness of the local business environment for potential investors to be improved. Major concerns brought to light in this area by businesses operating in Japan include the following:

- The recent introduction of a consolidated taxation system, with effect from April 2002, is most welcome and addresses a long-standing EU concern. However, a number of issues remain to be addressed if the system is to deliver its full potential in promoting investment and corporate restructuring. EU firms request that the 2% surtax (unknown in the EU) levied on firms using the system be removed, that the 100% ownership rule for application to subsidiaries be reduced to a 50% threshold, that the expiry of companies' pre-consolidation losses, the obligatory taxable revaluation of assets on entry to the consolidated group, and the obligatory integration of all 100% subsidiaries to be eligible for consolidation be abolished, and finally that local taxes be included in the consolidation.

- Access to high-quality legal advice on multi-jurisdictional questions is artificially restricted by the fact that Japanese and foreign lawyers are still prohibited from practising together in Japan in a single integrated law firm. This is out of step with practice in the majority of industrialised countries (see section 1.2 below). The EU urges the rectification of this situation in legislation already planned to go before the Diet in the ordinary session of 2003.

Priority reform proposal:

a. The EU urges the Government of Japan further to reinforce its strategic political approach to encouraging FDI by addressing as a priority the following issues:

(i) "Mainstreaming" pro-investment measures throughout government policy-making, for instance by taking a broad cross-sectoral approach to investment under the Three-Year Regulatory Reform Programme, and in the work of the CRR.

(ii) Simplifying and better co-ordinating the rules for registration/approval as a designated foreign investor in Japan;

(iii) Creating a "one-stop shop" for potential investors, possibly an "Invest Japan" style organisation, which would provide a single point of access for information and facilitating the process of establishment in Japan, and mediate actively to match the needs of investors with the strengths of potential locations.

(iv) As proposed by METI, change the applicable laws so as to allow, from April 2003, tax-neutral share-for-share M&A by foreign companies.

b. Take action to address industry's concerns with regard to the conditions for implementation of the new consolidated taxation system (see above).

c. The EU urges Japan to remove its few remaining non-security related restrictions on foreign investment.

1.1.2 Transparency and Predictability

An area of continuing concern is the transparency, accountability, predictability and independence of the regulatory process. Transparency means diffusion of information, i.e. making available relevant information for all interested operators in order to ensure fairness as well as economic efficiency, and is closely linked to the principle of legal security. A business survey conducted for the European Commission on global factors in deterring investment concluded in April 2000 that 71% of big EU companies regarded lack of transparency in legislation and regulations as the most frequent hindrance to investment. The problem is all the greater for SMEs. Unnecessary difficulties for companies making their way through the regulatory process result in a considerable penalty in time and money. There has been significant progress in this area in recent years, the two most notable developments being the introduction in April 1999 of the Public Comments Procedure, and in April 2001 of government-wide guidelines obliging each ministry to set up a "No Action Letter"

system. However, the European Union remains concerned that, though welcome in intent, these procedures are often implemented in such a way as to prevent them from delivering their full potential. The following are amongst the most important concerns regularly voiced by businesses operating in Japan:

- Regulators in many areas of economic activity in Japan lack independence**.** For example, Japan's telecommunications sector lacks an independent regulatory authority. In harbour transport, for instance, the Ministry of Land, Infrastructure and Transport (MLIT) delegates certain regulatory functions, including many with a bearing on free competition, to the Japan Harbour Transport Authority. This body represents all the major waterfront businesses except the shipping lines, but operates a "prior consultation" process for changes in shipping operations, which effectively binds the shipping lines. The EU echoes the concerns of the CRR, expressed in its July 2002 Interim Report, that a dedicated model of regulatory oversight is required for liberalising sectors dominated by state-owned monopolies, such as energy and postal services, and urges Japan to establish independent regulators in these sectors.

- Fundamental conflicts of interest such as the above, coupled with historically weak overall competition policy enforcement by the Japan Fair Trade Commission (JFTC) contribute to a business environment which all too often unfairly favours incumbent operators over new entrants.

- Steady progress is being made in Japan towards streamlining administrative procedures and practices, but the European Union remains concerned by the continued prevalence of administrative guidance, both written and oral. In the process of regulatory reform, it is vital that regulations are not simply replaced by administrative guidance. The Public Comments Procedure, introduced in April 1999 to allow all interested parties to comment on administrative measures and draft regulations is a vital part of this process. The European Commission has made considerable use of this procedure in order to offer comments in such diverse areas as motor vehicle standards, construction standards and telecommunications policy. Significant improvements in the quality of consultation with regulatory authorities over recent years are reported by EU companies.

  However, in order to achieve the intended aim of ensuring better regulation through timely prior consultation, the Public Comments Procedure needs to become an integral part of the regulatory process. While ministries and agencies are complying with the letter of the procedure, all too often only little time is left before finalisation of the report or regulation in question for well-substantiated comments to be properly taken into account. One example was the consultation procedure launched by METI's Industrial Structure Council on the subject of planned legislation on End of Life Vehicles (ELV). Between 25 July and 27 August 2001, METI received 301 comments on the draft Second Report of the ELV Working Group of the Industrial Structure Council. The final version of the report was published virtually unamended on 10 September 2001. Another illustrative example occurred recently in the financial sector, where the public comment period on new FSA rules against short-selling ended on Monday 9 September 2002, only for the rules to enter into force substantially unchanged barely a week later. Such experiences give rise to legitimate doubts as to the

sincerity with which the procedure is being implemented.

- The "No Action Letter" (NAL) system has the capacity to save companies time and money by giving advance guidance on planned business situations. However, MPHPT statistics show that only nine NALs have been issued since the inception of the system. In order to bring its intended benefits, the system needs to be implemented in a pro-active and consistent manner. In particular:

  - Each administrative body has established its own "No Action Letter" (NAL) guidelines. This leaves open the risk of inconsistent application in terms of the criteria for the receiving of requests, including scope of application, and the degree to which a given ministry feels itself to be bound by its replies to requests. In addition, the system is restricted in application so-called "new business", rather than also permitting the clarification of regulatory issues involving existing products and services.
  - Replies given by administrative bodies are not binding, thus giving rise to doubts about their reliability as the basis for major business decisions.
  - There is no clear obligation to publish replies, thus depriving administrative bodies of a useful means of establishing, over time, a published body of reliable precedent.
  - There is no clear appeals procedure in cases where a company feels that the reply it receives does not fit the facts of the case it has presented. The EU is concerned to have been informed of cases where officials have orally discouraged the submission of NALs.

Similar observations apply to the *kaito bunsho* system used by the National Tax Authority (NTA).

- The principles of transparency and accountability should apply not only to systems such as public comments and NALs established by law, but also to relations with the regulator in the course of day-to-day business. It is unfortunate, for instance, that FSA should often fail to answer in writing written requests for regulatory clarification when it would not tolerate the conduct of business in this manner between financial services providers and their clients. Equally, while the publication of FSA inspection manuals has improved matters considerably, the conduct of inspections should be subject to basic standards of fairness. This would include consistent inspection methods, objective choice of items targeted for inspection, and the respect for procedural rights such as presumption of innocence and the right against self-incrimination. The NTA is another example where EU firms continue to report numerous cases of arbitrary and inconsistent treatment.

Although the EU recognises that increased transparency requires long-term changes in administrative culture, awareness-raising activities in government such a government-wide code of conduct and improved training would be constructive steps.

Priority reform proposals:

a. *With regard to the Public Comments procedure, the EU urges the Government of Japan to build on progress in implementation by:*

(i) *enforcing and monitoring its use by ministries and agencies, and in particular ensuring that a reasonable period (at least six weeks) is allowed for comments to be made; and*

(ii) *ensuring that ministries, agencies, and, where applicable, advisory councils, allow sufficient time properly to reflect considered public comments in draft regulations and reports. All public comments submitted should be published.*

b. *With regard to the "No Action Letter" (NAL) system (and, similarly, the NTA's* kaito bunsho *system), the EU urges the Government of Japan to:*

(i) *Monitor centrally the implementation of the system in order to ensure that consistent criteria for the receivability of requests, including scope of application, are applied. The scope of application of NALs should be increased to cover also regulatory issues involving existing and not just "new" products and services;*

(ii) *Make NALs binding on the issuing body;*

(iii) *Create a clear obligation on the issuing body to publish NALs, in anonymous form where necessary, in order to create over time a reliable body of precedent;*

(iv) *Establish clear guidelines allowing companies to appeal against a NAL if they feel that it does not properly reflect the facts of their case.*

1.2 Legal Services

Clients nowadays expect to be able to get advice on international business from a single, fully integrated, international law firm. Clients want to deal with integrated law firms because they know from experience that it gives them cost-effective access to expertise developed in whichever international business centre is at the cutting edge in their field of interest, and with the same high level of service which they are used to in other markets. This is particularly true for cross border investment transactions. The fact that in Japan they cannot do so has serious and wide-ranging economic consequences. On the one hand, Japanese companies are at a competitive disadvantage because they do not have in their own home market the level of access to or quality of legal advice that is available to them in all other major industrialised countries – advice which is needed to support Japan's business sector and Japan's efforts to restructure its financial services area. On the other hand, potential foreign investors in Japan are deterred because they are unable to get the advice necessary to make crucial business decisions, be it acquiring a Japanese company, establishing a joint venture, or organising an initial public offering.

1.2.1. Joint Enterprise, Freedom of Association

The opportunities for foreign lawyers to practice in Japan are limited due to a restrictive regulatory regime. While this is a clear problem for foreign, including European, law firms, it also severely restricts the opportunities for young Japanese lawyers to gain experience of supplying international legal services in what is an increasingly global market place.

Current rules prohibit a *bengoshi* from being in a true partnership with a foreign lawyer licensed in Japan (*gaikoku-ho jimu bengoshi* or "*gaiben*"). Partnership does not affect the independence and professional responsibility of individual lawyers. In other jurisdictions, which permit such relationships between lawyers qualified in different jurisdictions, neither the independence of individual lawyers nor the quality of the professional service rendered to clients has been adversely affected

The compromise reached in 1995 by creating the so-called "joint enterprise scheme", and further amended in 1998, does allow joint work on specific cases by a Japanese lawyer and a *gaiben*. However, it does not allow them to enter into relationships of partnership. The suggestion that such a prohibition is needed in order to ensure the ethical integrity and independence of Japanese lawyers is unjustified, and the restrictions to which it gives rise are protectionist in nature. Experience in countries which do allow partnerships between domestic and foreign lawyers does not support such concerns, which are capable of being addressed by the legal system itself. By imposing a structure specifically designed to keep the foreign and Japanese firms in the joint enterprise apart, the current system prevents the provision of a seamless service, and has the effect of creating a professional legal environment which is not in the interests of clients, both foreign and Japanese persons and firms.

Further improvements are therefore needed, in order to guarantee full freedom of partnership with Japanese lawyers (*bengoshi*).

The European Union appreciates the opportunities for change offered by the Judicial Reform Council's final recommendations (June 2001), especially as they state that "from the position of actively promoting tie-ups and co-operative work between Japanese lawyers and gaikoku-ho jimu bengoshi, conditions for designated joint enterprises (defined under the current system as joint enterprises between Japanese and foreign lawyers with the purpose of conducting legal service which includes public relations elements under legally bound conditions) should be deregulated. The review of the ban on foreign lawyers employing Japanese lawyers should be discussed continuously as a future issue while paying close attention to international debate."

The European Union urges the Japanese government to take advantage of the momentum provided by the process of judicial reform which is now underway, in order to solve this nagging problem once and for all. Indeed, the Internationalisation Study Group set up by the government's Judicial Reform Promotion Headquarters clearly marked its preference for partnership to be permitted between registered foreign lawyers and *bengoshi*, reaching a majority view in favour of the following key changes:

(i) abolishing the prescribed purposes for which a joint venture between *bengoshi* and *gaiben* can be established;

(ii) abolishing the general prohibition of joint ventures between *bengoshi* and *gaiben;*

(iii) abolishing the general prohibition on profit sharing between *bengoshi* and *gaiben;* and,

(iv) abolishing prohibition of employment of *bengoshi* by *gaiben.*

The European Union urges the Government of Japan to ensure that these majority views are fully respected in the legislation on this issue due to be presented to the 2003 ordinary session of the Diet. The revisions required to the existing legal framework are relatively modest and could be dealt with quickly and simply. Minimum requisites for a reformed system permitting partnerships would include absence of restrictions on scope of business, freedom from petty bar association restrictions on questions such as naming of the partnership, and the ability to benefit without discrimination from becoming a legal corporation (*bengoshi houjin*). The process of registration as a *gaiben* should in addition be as quick and streamlined as possible – focussing on professional credentials and integrity.

Priority reform proposal:

Take action through the legislation due to be presented to the Diet in its 2003 ordinary session, and in full respect of the majority views of the Internationalisation Study Group, to guarantee full and unrestricted freedom of association between Japanese lawyers (bengoshi) and licensed foreign lawyers (gaikoku-ho jimu bengoshi) by removing all restrictions on partnership between foreign and domestic lawyers.

1.2.2. Qualifying experience needed to be licensed in Japan

Experience in the country of principal qualification is a requirement for a *gaiben* license. This condition is not imposed on Japanese lawyers, and represents an unnecessary regulatory barrier to those with less than three years of experience. Such a requirement is to be distinguished from continuing education requirements which exist in some jurisdictions, but which are imposed by the supervisory authorities of the home country, and not by supervisors of the host country. Progress was made in 1998, in that the experience required to be registered as a *gaiben* was reduced from 5 to 3 years, while at the same time the period spent in Japan that would count toward meeting that requirement was cut from 2 years to 1 year. Also, the place of experience, which used to be limited to the home country, was expanded to include periods during which legal services relating to the licence applicant's home country law were provided in other countries.

Priority reform proposal:

Full abolition of the post-qualification experience requirement before a licence can be granted as a designated foreign lawyer authorised to practice in Japan.

1.3. Employment Agencies

Despite a considerable widening in recent years of the job categories which can be handled by fee-charging employment agencies, Japanese regulations continue to place limits on the coverage of both recruitment agencies, whether for permanent or temporary jobs, and interim employment agencies (or temporary staff despatching agencies, *haken gaisha*). The EU welcomes the announcement under the Three-Year Regulatory Reform Promotion Programme that further expansion will be sought of the job categories with which employment agencies can deal under the Manpower Dispatching Business Law (e.g. adding financial sector salespersons to the list of 26 job categories where dispatching for three years rather than just one is permitted).

Remaining restrictions limit the business activities of such agencies, reduce the accessibility of suitable staff for employers, particularly for foreign business employers, and reduce labour flexibility. Recruitment agencies are still not allowed to deal with construction and port transport workers. The negative list for *haken gaisha* includes port transportation, construction, medical services, securities, etc., and manufacturing. The latter ban is of particular concern, since it covers a large number of potential workers. The EU recommends that the review currently underway in the Labour Policy Council should lead to the removal of lingering restrictions, notably in the manufacturing sector, and notes that the Council for Regulatory Reform has called for the decision on this matter to be brought forward.

Priority reform proposal:

Elimination of all restrictions on the job categories which can be handled by either recruitment or interim employment agencies.