



Risks in Japanese Infrastructure Investment

Executive Summary

Infrastructure development in Japan carries specific risks to investors. In this briefing, we highlight the following issues:

- ◆ **Criminal syndicates** (colloquially known as yakuza) are common throughout the Japanese construction industry. Such organizations will mostly operate behind legitimate individuals and entities, enter into legal agreements, and deliver projects on time and up to standard. However, while no illegal activity may be taking place, contracting with such groups violates Japanese and U.S. laws on doing business with criminal syndicates. Because these firms are engaged in legitimate activity, it can be difficult to find out if a firm has criminal connections, or if it contracts with other firms that do. Extensive due diligence is required to expose such connections.
 - ◆ Criminal syndicates can also become part of the contracting process through **land acquisition** and **labor recruitment schemes**. Again, while such activity is generally not illegal, it is a source of counterparty risk to firms that contract with them.
 - ◆ Firms investing in Japan should also be aware of **fraudulent discrimination complaints**. These claims are brought forward supposedly on behalf of historically marginalized peoples, but in reality can be fraud schemes by criminal organizations. Legitimate cases of discrimination do exist; however, due diligence is necessary to sort genuine complaints from fakes.
 - ◆ Japanese financial institutions often have access to sources of information on a firm's criminal connections not available to foreign firms, but may have **different standards in assessing the risk** posed by such connections. A local financial firm's acceptance of a counterparty should not automatically translate to acceptance by a foreign firm.
 - ◆ Infrastructure projects are often tied to **"pork-barrel" spending** by political parties, as well as contracts given out as local patronage. Investors should account for local relationships and political risks when considering such projects.
 - ◆ **Bid-rigging** is still common in Japan, but is currently the subject of a regulatory crackdown. Compliance with anti-monopoly laws is increasingly important.
 - ◆ **Product quality** and **fraud** can be concerns in infrastructure construction, even when employing large and well-established firms.
- "Pork-barrel" spending refers to the utilization of government funds for projects in specific districts designed to please local voters and win votes for local legislators.

Ties to Organized Crime



Organized crime syndicates in Japan are often referred to colloquially as *yakuza* and officially as “anti-social elements” (ASE). ASE are normally loosely organized into large national syndicates. They engage in much of the same criminal activity as gangs elsewhere, including gambling, prostitution, drug smuggling and fraud. For a large portion of Japanese post-World War II history, their existence was tolerated, as they fulfilled some functions in maintaining order (this included repressing communist activity during the Cold War), resolving local disputes, and mobilizing labor during the critical economic growth period of the 1960s and 70s.

However, public opinion toward ASE has soured in recent years, and the consequences of doing business with ASE-affiliated organizations have increased. Japan passed its first anti-gang law in 1992. Since 2011, “ASE-exclusion ordinances” have proliferated in Japan, obliging individuals and firms to ensure that they are not giving business or creating exit opportunities in their existing investments to those having “close contact” with criminal syndicates or their members. These ordinances impose fines or prison sentences on convicted offenders. Moreover, they mandate avoiding doing business with individuals who merely identify as members of criminal syndicates, regardless of whether they have committed any crime.

ASE are frequently encountered in infrastructure projects, as they are common in labor-heavy industries such as construction, warehousing, logistics and dock work. Many companies that operate in these sectors have overt or hidden connection to criminal organizations, or may contract with firms that do. Since the advent of Japanese anti-ASE laws, criminal organizations have begun to move away from mainstream construction and toward more dangerous contracting such as asbestos removal, where they flout safety regulations in order to offer lower prices. ASE have also started to identify much less openly with their syndicates, making detection more difficult.

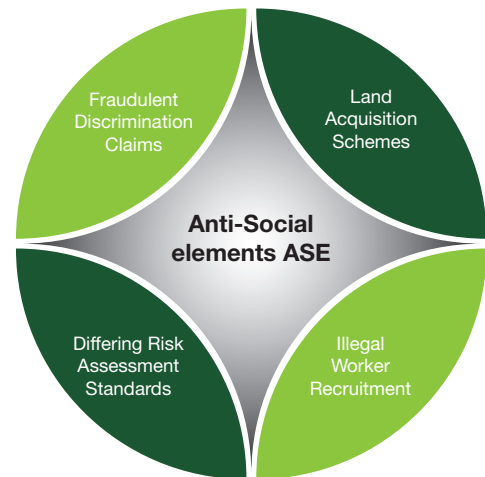
Some media articles have suggested that a large number of contracts awarded for the construction and maintenance of Nagoya Centrair Airport in 2005 went to ASE-associated firms. This was not necessarily intentional, but because these firms tended to undercut on price, they were often able to win bids in a legitimate manner.

Various branches of the United States government have repeatedly sanctioned Japanese criminal syndicates since 2011, banning U.S. firms from transacting with them. Associating with ASE has in some cases also become a source of reputational risk: several Japanese politicians in recent years have been forced to publicly return campaign donations coming from businesspeople with criminal connections.

Land Acquisition Schemes

Infrastructure projects often require the purchase of significant amounts of land. This has given rise to a type of scheme that can expose developers to compliance issues. When it is known that a piece of land will be needed for an infrastructure project, crime syndicates may purchase that land from the original owner, sometimes as payment for a debt. The syndicate then sells the land to the developer at a profit. This is particularly common with golf courses, which were built during the 1990s economic bubble and many of which subsequently went bankrupt. Criminal syndicates were employed to silence unhappy investors using unreasonable legal procedures and aggressive lawyers, and often bought the land outright to resell later.

While purchasing such land is legal in itself, Japanese and U.S. regulations forbidding transactions with criminal syndicates can expose companies to potential fines and other sanctions.



Illegal Worker Recruitment

One role frequently played by ASE is as labor brokers, who act as middlemen between laborers and employers. While not a scam in its own right (the broker in theory simply takes a commission), labor brokering has historically been one of the main ASE businesses, and a wide variety of fraud schemes have been developed around the activity. Moreover, since the passage of the Anti-Yakuza Law in 1992, it has been illegal for ASE to engage in labor recruitment, and Japanese and U.S. sanctions make it risky to transact with criminal organizations in any case.

Fraudulent Discrimination Claims

Throughout Japanese history, certain ethnic groups and social castes have faced marginalization or discrimination. After World War II, there were a number of political and social campaigns to grant these groups greater equality and legal protection.

Criminal organizations sometimes claim to be acting on behalf of such individuals to demand compensation for various types of discrimination. This is not to say that all discrimination claims are baseless; however, it is a known fraud scheme. Due diligence is necessary to sort out legitimate complaints from fake ones.

Differing Risk Assessment Standards

Japanese financial institutions and investment firms have their own methods of accessing information related to a firm's ASE connections. These methods and sources are often not available to foreign firms, even those with local offices and local staff. However, although Japanese firms may have access to better quality information, they may have different standards of what constitutes an ASE, and what sorts of ASE pose a compliance risk. In other words, acceptance by a Japanese firm does not necessarily mean that the entity in question will meet the compliance standards of a foreign firm.



Local Pork-Barrel Projects

Japanese political parties function as large patron–client networks, serving as conduits for resources to local constituencies. Such clientelism is especially prevalent in infrastructure projects, resulting in many unnecessary projects. When Japan Airlines, Japan’s flag carrier, filed for bankruptcy in 2009, analysts pointed out the number of “unnecessary” local airports and routes throughout the country. A recent article noted that the sea between the main island of Honshu and the much smaller island of Shikoku already has three bridges running across it, yet local politicians continue to push for two more. Such projects come about due to requests by local politicians to their colleagues in the central government.



Pork-barrel projects like these serve to create employment in a politician’s home constituency, allow the politician to funnel contracts to supportive companies, and are often a source of extra income to the politician, who often takes a cut of the profits. Their success often depends on political factors, making knowledge of local relationships and political risk crucial.

Patronage Contracts

Contracts for infrastructure services are also commonly awarded on the basis of local political connections. One example of this phenomenon is in the heating industry. While the market for natural gas (concentrated in large cities) is cornered by a few big firms, the distribution of propane (still the primary fuel in rural areas) is still generally done by small local firms.



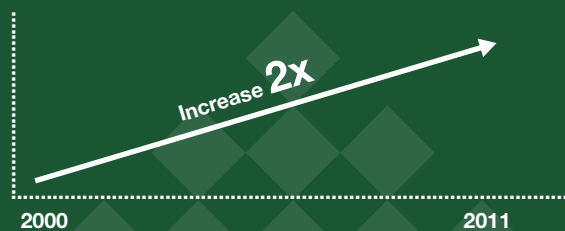
The contract for a town’s propane distribution is often parceled out to a prominent local company, often based on historical political power bases. Propane companies are a major source of local employment and an important part of local infrastructure, making these contracts lucrative both in terms of money and influence. Such patronage can be an obstacle to other firms entering the market.

Bid-Rigging

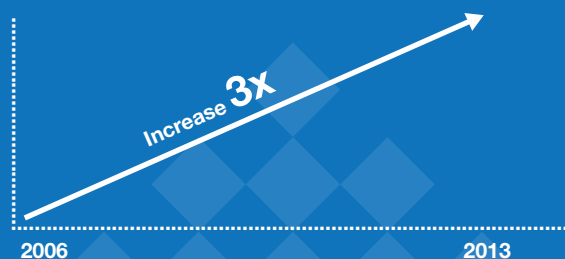
Bid-rigging is illegal under Japan's Anti-Monopoly law, but remains widespread in the construction industry.

Enforcement of the Anti-Monopoly Law has gradually increased in the past decade, however. The first company was fined for bid rigging under the Anti-Monopoly Law in 1999. The number of investigators employed by the Japan Fair Trade Commission doubled from 2000 to 2011. Total fines levied by the commission tripled from 2006 to 2013. New legislation also penalizes organizers of rigged bids.

Number of investigators employed by the Japan Fair Trade Commission.



Total fines levied by the Japan Fair Trade Commission.



While enforcement of bid-rigging laws has grown much stricter, internal compliance mechanisms within Japanese companies are still catching up. It was not uncommon even a decade ago for executives at rival firms to drink or play golf together, behavior that would be seen as evidence of collusion in other countries. Bid-rigging is also seen in some localities as way to ensure economic growth by distributing contracts among local businesses.

Product Quality

Even after screening contractors for undesirable connections, quality assurance remains an issue in infrastructure projects. Even the most prominent general contractors are not exempt. During the building of a new runway at Tokyo International Airport (Haneda), one of Japan's industry leaders in general construction was found by journalists to be illegally using industrial waste as landfill material at the construction site. It was alleged that the firm was attempting to cut costs by using materials that did not meet government standards for the project.



Blackpeak's Team in Japan

Blackpeak has extensive experience advising clients in the infrastructure sector. **Jack Clode**, co-founder of Blackpeak, oversees the business in Northeast Asia. He is one of Asia's most experienced risk advisory executives, having commenced his career in 1995 handling front-line investigations. His expertise includes due diligence, business intelligence, fraud and intellectual property. The head of our Tokyo office, **David Suzuki**, has worked with clients on addressing the challenges from Japanese anti-social elements who insert themselves into the investment process. Over a career in risk consulting spanning 20 years, he also has extensive experience conducting complex due diligence, strategic business intelligence and civil and criminal litigation support assignments on behalf of global Japanese companies in the Asia Pacific region.

Typical Scope of Work

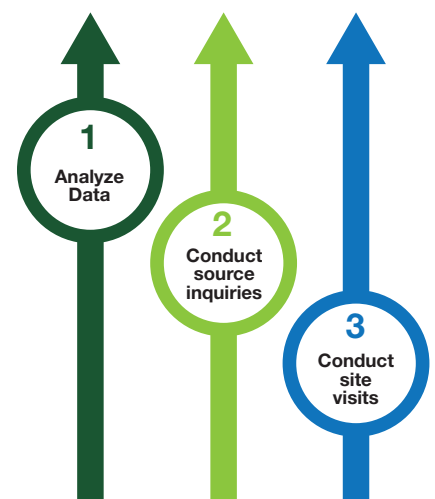
Blackpeak's due diligence investigations seek to accomplish the following:

- ◆ Summarize the target company's basic background, including formation (where and by whom), ownership structure, history and business activity.
- ◆ Detect actual or alleged labor disputes, safety issues, corruption, environmental problems, bribery, commercial disputes, significant litigation or criminal activity.
- ◆ Search for indications of undisclosed financial problems, compliance issues or detrimental information. This includes bankruptcy or foreclosure by courts or financial agents (including the government).
- ◆ Develop profiles of each key principal at the target company, with priority given to the most senior individuals. Includes checking the principals against litigation, AML and regulatory databases, as well as gathering industry knowledge on the individuals' reputation and standing within the business community. Also includes mapping relationships with politically exposed persons, marginally acceptable business persons and quasi-underworld individuals (associates of underworld individuals).
- ◆ Understand the external business affiliations and past track records of the key principals to the extent that they relate to the proposed relationship with the client.
- ◆ Detect any undisclosed influences over the target company or its principals.
- ◆ Make discreet inquiries with sources to ascertain any possible links to organized crime syndicates.

Standard Methodology

Blackpeak makes use of the following investigation methods:

- ◆ Analysis of legal and regulatory database materials, Japanese corporate and other records, local and international media, and global watch lists.
- ◆ Conduct discreet source inquiries in Japan with individuals familiar with the target company and principals. These sources should be qualified to comment on the target company and principals' reputation and business acumen, the dynamics of their government relations and any known incidents of business irregularities, fraudulent activities or corrupt dealings.
- ◆ Conduct discreet site visits to offices or factories owned by the company.



Further Information

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About Blackpeak

Blackpeak is an international investigative research and risk advisory firm dedicated to uncovering critical risk-related information for our clients worldwide.

We specialize in investigative due diligence, investigations and security, and business intelligence research. Each project is executed by our in-house team with unmatched in-country expertise, using customized investigative methodologies.

Our team members have been managing risk consulting projects for more than 20 years covering all industries across the globe.

Founded in Asia, the firm now operates from strategic locations in key financial and economic centers, including Hong Kong, Singapore, Tokyo, Shanghai, Beijing, Guangzhou, New York and Washington DC.

In 2019, Blackpeak was acquired by Acuris, the BC Partners and GIC-backed provider of global data, intelligence, research and analysis.

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www.blackpeakgroup.com

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