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Proposed Amendment to Foreign Exchange Act to Increase Notification Requirements on Inbound Equity Investment in Listed Shares

Kunihiko Morishita / Ryu Umezu / Michi Yamagami / Koji Kawamura

On October 18, 2019, the Cabinet submitted a bill to the Diet to revise the Foreign Exchange and Foreign Trade Act so as to tighten regulations on inbound equity investment.

The key change in the proposed amendment will be a lowering of the "prior notification" requirement threshold for acquisition of ownership in Japanese listed companies that engage in certain regulated business from the current 10% to 1%.

Both the European Union and the United States have tightened regulations intended to prevent the transfer of sensitive advanced technologies to competitor countries by way of foreign investments. The Japanese government has been spurred to urgency by a sense that Japan could be seen as the "only loophole" in a comprehensive transfer-regulation regime.

The new amendment will also contain a framework to provide exemptions to the notification requirement, which will be promulgated via Cabinet Order (or other methods) at a later time. According to reports, "portfolio investments" as well as transactions by foreign financial institutions and foreign asset management companies will likely be exempted from the notification requirement. However, as the draft Cabinet Order containing the exemptions has yet to be published, the full extent of these exemptions are not yet clear.

The government hopes to enact the amendment during the current extraordinary Diet session ending December 9, 2019 and have it enter into effect in 2020, within six months from the date of publication of the amendment.

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1. Current Regulatory Framework for Acquisition of Listed Shares

Under the current Foreign Exchange and Foreign Trade Act ("**FX Act**"), foreign investors ("**Foreign Investors**") are required to notify ("**Notification Requirement**") the Japanese government (the "**Relevant Ministries**"), via the Bank of Japan ("**BOJ**"), in advance if they intend to acquire 10% or more of shares in a Japanese listed company on either a volume basis or voting right basis[1] (the "**Regulated Investments**").[2]

"Foreign Investors" for these purposes include:

(i) individuals who are non-residents[3] of Japan;

(ii) corporations or other organizations established in foreign jurisdictions (including Japanese branches of foreign companies) and which have their principal office outside Japan;

(iii) corporations in which the proportion of aggregate voting rights held by persons falling under categories (i) and/or (ii) above, either directly or indirectly,[4] is 50% or more; and

(iv) corporations or other organizations in which the majority of either officers (i.e., directors or other similar officers) or representative officers are individuals who are non-residents of Japan.

The industries covered by these provisions of the FX Act are those involving national security (e.g. weapons, aircraft, nuclear power, and space technologies), public infrastructure (e.g. gas, water, power, telecommunications, and railways), public safety (e.g. vaccine manufacturing and security services), and certain protected domestic industries, such as agriculture. In August of 2019, the government added 20 IT related industries, including semi-conductors, to this list (together, the "**Regulated Industries**").

After the Foreign Investor notifies the BOJ of its intent to make a Regulated Investment in a Regulated Industry, the Relevant Ministries will conduct a review and issue a report within 30 days of the filing of the notification. The Relevant Ministries have the power to suspend a Regulated Investment if it is likely to have detrimental effects on national security, public order, public safety, or significant adverse effects on the management of the Japanese economy.

In practice, it has been extremely rare – at least to date – for the BOJ or other Relevant Ministries to intervene. Only one order for a suspension of investment has been made since the current FX Act was passed. In 2008, a British investment fund was prevented from buying further shares of J-Power Corp, which owned nuclear power plants. The rationale for this suspension order was that there was a risk

[1] Inclusion of acquisition of listed shares on a voting rights basis is currently only dealt with by the most recent amendment to a relevant Cabinet Order which took effect as of October 28, 2019.

[2] Certain other types of action by a Foreign Investor (such as acquisition of shares in unlisted Japanese companies) are also subject to the Notification Requirement. For the sake of brevity, we will focus on acquisition of shares in listed companies in this Legal Update.

[3] As defined in the FX Act.

[4] Via ownership of not less than 50% of intermediate entities.

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that the financial condition of J-Power Corp could be significantly impaired, leading to potentially detrimental effects on construction and maintenance of a nuclear power plant.

2. Proposed Changes to the FX Act

(1) Lowering the Notification Threshold to 1%

The main change in the proposed amendment ("**Amendment**") relates to lowering the threshold for the Notification Requirement in the planned acquisition of shares in a listed company in the Regulated Industries. Currently, the Notification Requirement triggers when a foreign investor plans to acquire 10% or more of listed shares on either volume basis or voting right basis.

The Amendment lowers the threshold to acquisition of 1% of listed shares. The apparent rationale behind the 1% threshold is that, under Japanese company law, shareholders of 1% or more of voting shares in a joint stock company (*kabushiki kaisha*) are entitled to make proposals regarding the running of the company, such as requesting the addition of certain matters to the agenda of shareholders meetings (the so-called "right of proposal").

(2) Expanding the Scope of Regulated Investments

Any Foreign Investor who already has at least 1% of voting rights in a Japanese listed company will be required to give prior notification to the BOJ if the Foreign Investor intends to give consent to any material change to corporate objectives, or to other matters having a material impact on the management of the company. The full extent of this requirement will be laid out in a future Cabinet Order.

(3) Expanding the Definition of "Foreign Investor"

The Amendment will also expand the definition of "Foreign Investor" to include certain types of limited partnerships.[5] Under current regulations, each general partner and limited partner of a limited partnership is individually subject to the Notification Requirement. The Amendment will change the regulatory focus so that each limited partnership (as opposed to each individual partner) will be a regulated party if:

(i) 50% or more of the limited partnership's funds are from overseas investors;[6] or
(ii) the majority of the general partners in the limited partnership are overseas investors.

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[5] Limited partnerships formed under Japanese law or foreign law are included in this definition.

[6] That is, non-resident individual investors and other investors to be defined in a Cabinet Order, not to be confused with Foreign Investors. The same applies in item (ii) of this list.

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3. Exemptions

The Amendment will grant a suite of exemptions to the Notification Requirement. The full nature and extent of these exemptions have not yet been published. When finalized, it is likely that they will be promulgated in supplementary regulations, such as a Cabinet Order.

According to the explanatory materials published in the Cabinet dated October 25, 2019,[7] exemptions which have been announced (but have not yet been fully defined) include investment by foreign securities companies on their own accounts (i.e. excluding transactions on a customer's account) and investment by foreign banks and insurance companies, as well as transactions conducted by foreign asset management companies. However, it is possible that the exact nature of these exemptions will change before they are finalized and published.

The first regulator Q&A on this topic was also released on October 25, 2019.[8] This Q&A, as well as the explanatory materials discussed above, clarified that in many circumstances, a Foreign Investor will qualify for exemptions under a so-called "portfolio investment" exemption if the Foreign Investor:

- does not appoint itself, or a person closely related to itself, as an executive;
- does not submit proposals to shareholders meetings of the Japanese Company to sell, cease, or make changes to, important business operations; and
- is not be given access non-public technical information which may be critical to public safety, national security, etc.

This Q&A also states that Sovereign Wealth Funds and pension funds which are not deemed to pose a risk to national security will be eligible for exemptions, despite being Foreign Investors.

If a company or person falls into any of the exemption categories, they shall be completely exempted from the Notification Requirement.

4. Pending Issues

Many of the pending issues relating to the Amendment are definitional in nature. Perhaps most importantly, the Cabinet has not yet fully defined the "portfolio investment" exception. The portfolio investment concept may restrict the exercise of the rights of shareholders. This ambiguity is potentially problematic as companies may plan to restructure their activities and investments in Japan to take advantage of the exemptions, but are unable to do so until the definition is clarified.

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[7] They can be found at the following link (Japanese only):
https://www.mof.go.jp/international_policy/gaitame_kawase/press_release/kanrenshiryou_191018.pdf

[8] It can be found at the following link (Japanese and English):
https://www.mof.go.jp/international_policy/gaitame_kawase/press_release/faq_191025.pdf
https://www.mof.go.jp/english/international_policy/fdi/faq_191031.pdf
The Q&A also addresses issues relating to Activist Investors and the basic intent behind the Amendment.

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The published Q&A states that the government will publish and update[9] a list of listed companies that are:

- not subject to the Notification Requirement and require only a post-investment report;
- subject to the Notification Requirement, but for which an exemption might apply; and
- subject to the Notification Requirement, and for which no exemptions are applicable.

It is highly likely that the government will consult with interested parties and seek public opinions before conclusively stating its position.

While the Amendment and its exemptions have yet to fully take form, active involvement in the consultation process with regulatory authorities by industry players may help shape future Cabinet Orders relating to the Amendment into something that successfully balances Japan's national security requirements with the interests of Japanese companies and Foreign Investors.

[9] This would require significant volume of screening if an exhaustive list of all listed companies is required; there is some doubt as to the practicality of this plan.

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- Authors:
  Kunihiko Morishita（kunihiko.morishita@amt-law.com）
  Ryu Umezu（ryu.umezu@amt-law.com）
  Michi Yamagami（michi.yamagami@amt-law.com）
  Koji Kawamura（koji.kawamura@amt-law.com）

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