COVID-19: JAPANESE NEW FOREIGN INVESTMENT REVIEW GOES EFFECTIVE AS NATIONAL SECURITY CONCERNS GROW AMID COVID-19 PANDEMIC – IMPACTS ON THE ASSET MANAGEMENT INDUSTRY

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Asset Management and Investment Funds Alert

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On May 8, 2020, Japan's expanded foreign investment review requirement went effective. Upon expiry of the 30-day transition period, i.e., on June 7 and onwards, any investment or activity that constitutes "Foreign Direct Investment" (FDI) engaged by a "Foreign Investor" (Foreign Investor) will be subject to the advance notification requirement (which essentially functions as approval requirement) or must satisfy conditions for an exemption. This concludes the Japanese government's rulemaking efforts to implement an amendment bill to the Foreign Exchange and Foreign Trade Act (Act No. 228 of 1949, as amended) (the FEFTA),[1] which passed the National Diet in November 2019. While some have advocated for delaying the implementation of the FEFTA in an amended form given the COVID-19 pandemic, the Japanese government wasted no time implementing the FEFTA as national security concerns become more relevant globally in the COVID-19-influenced markets.

The regulation implementing the FEFTA provides two types of exemptions, one of which is specifically provided for non-Japanese licensed financial institutions including foreign-owned licensed Japanese institutions that themselves are Foreign Investors; however, the exemptions require compliance with descriptive conditions and do not cover all of the activities that constitutes FDI. In addition, these institutions' customers that themselves are Foreign Investors may be subject to the FEFTA. Below we discuss key considerations for complying with the FEFTA as it applies to the asset management industry.[2]

TIMELINE

November 22, 2019	Japanese National Diet passed an amendment bill to the Foreign Exchange and Foreign Trade Act to expand the scope of foreign investment review (the Amendment).[3] Key legislative changes in the Amendment included the following: ▪ The shareholding threshold for certain reviewable FDI was lowered to 1 percent of outstanding shares. ▪ The definition of "Foreign Investor" was updated to include a new partnership category. This will remove the necessity for

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	each of the foreign limited partners to satisfy the FDI requirements. ▪ Review on private company investments remain largely unchanged; however, Foreign Investors may rely on an exemption. ▪ The government authority was expanded enabling it to (i) share information with certain friendly foreign governments, and (ii) intervene in the completed transaction or activity that failed to submit an advance notification, e.g., divestiture orders. On November 29, the Amendment was promulgated.
April 24, 2020	The Cabinet approved the final Cabinet Order, Ministerial Ordinance and Public Notices implementing the Amendment (collectively, Implementing Regulation).
May 8, 2020	Amendment, the Implementing Regulation went into effect. Transition period began.
June 7, 2020	Full implementation of the Amendment begins. Transition period ends on June 6.

NEW FDI REVIEW REQUIREMENT AS IT APPLIES TO FDI IN PUBLIC COMPANIES

Who is a "Foreign Investor"?

Foreign Investors include:

- A nonresident individual;
- A corporation or other organization organized under non-Japanese laws or with a principal office outside of Japan;
- A company 50 percent or more of voting rights of which are held directly or indirectly by Foreign Investor(s);[4]
- A corporation or other organization at which a majority of directors are nonresident individuals;
- A partnership in which (i) the amount of funds invested by Foreign Investors accounts for 50 percent or more of the total investments (contribution) (that is to be determined at the time of each FDI transaction) or (ii) the general partner (GP) is, or a majority of GPs are, Foreign Investor(s).

What are reviewable FDI transactions and activities?

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Reviewable FDI transactions and activities include:

- Acquisition of shares or voting rights of a Public Company that engages in certain "Designated Business."
- Consenting to (a) a material change to the purpose or (b) "matters which have material impacts on the Public Company's operation" of a Public Company that engages in certain "Designated Business." "Matters that have material impacts on the Public Company's operation" include:
  - A proposal regarding appointment of the Foreign Investor or its "Related Person"[5] as director or statutory auditor.[6]
    - Importantly, this includes "re-appointment" (renewal of the term).
    - Appointment of director/statutory auditor of a subsidiary in which the Foreign Investor holds 50 percent or more of voting rights upon prior notification (approval) is exempt.
  - A proposal regarding transfer of the business of the Public Company or its subsidiaries, in whole or in part;
  - A proposal regarding other corporate reorganization arrangements, cessation of business, or dissolution.

What are the shareholding thresholds that trigger the FDI review requirement?

- 33.3 percent for consenting to a material change to the purpose of the target company.
- 1 percent for all other reviewable transaction and activities.[7]

When counting the shareholding ratio, a Foreign Investor must include:

- Shares/voting rights held by the Foreign Investor;
- Shares/voting rights held by the Foreign Investor's "Closely Related Parties";
- Shares/voting rights managed by the Foreign Investor and/or its Closely Related Parties pursuant to a "Discretionary Investment Management Agreement"; and
- Voting rights for which the Foreign Investor is given the right to exercise pursuant to a certain proxy arrangement.

"Closely Related Parties" include:

- Certain group companies of the Foreign Investor by way of direct or indirect ownership of 50 percent or more of voting rights (e.g., subsidiaries, second-generation subsidiaries, and so-called parent, grandparent, uncle, cousin, sister, and nephew companies);
- Directors and managing members of the Foreign Investor and entities that are Closely Related Parties;
- Entities that share 50 percent or more of directors and managing members of the Foreign Investor;
- (If the Foreign Investor is an individual) spouse, direct descendants and ascendants;
- (If the Foreign Investor is a foreign government or public entity) other government agencies;

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- Entities and individuals who have agreed to exercise voting and other shareholder rights jointly with the Foreign Investor, and Closely Related Parties of such entities or individuals; and
- GP of the partnership in which the Foreign Investor is a member, and Closely Related Parties of the GP.

"Discretionary Investment Management Agreement" means an arrangement whereby the Foreign Investor is authorized and delegated to make investments and exercise voting rights, resulting in the principal not being able to exercise such rights by itself. Importantly, a Foreign Investor who is a customer of Discretionary Investment Management Agreement is not subject to the FDI review requirement in the discretionary investment management or custody context if it completely delegates the authority to (a) invest and (b) exercise shareholder rights including voting rights to its manager and/or custodian, i.e., no reservation or instruction. If the manager or custodian itself is a Foreign Investor (e.g., foreign or foreign owned manager/custodian), the manager/custodian is subject to the FDI review requirement; however, it may be able to rely on an exemption.

What are the "Designated Business"?

"Designated Business" includes two categories: (i) "Core" Designated Business and (ii) "Non-Core" Designated Business. In this regard, on May 8, 2020, the government issued a list of Public Companies categorizing (1) Public Companies with no Designated Business, (2) Public Companies with Non-Core Designated Business, and (3) Public Companies with Core Designated Business. The list will be reviewed and updated from time to time.

"Core" Designated Business (Examples)	**"Non-Core" Designated Business (Examples)**	**Other business**
▪ Weapons ▪ Aircrafts ▪ Nuclear facilities ▪ Space ▪ Dual-use technologies ▪ Certain cybersecurity (relating critical infrastructure) ▪ Certain electricity ▪ Certain gas ▪ Certain telecommunications ▪ Certain water supply ▪ Certain railway ▪ Certain oil On May 1, the government proposed to	▪ Other cybersecurity ▪ Other electricity ▪ Other gas ▪ Other telecommunications ▪ Other water supply ▪ Other railway ▪ Other oil ▪ Heat supply ▪ Broadcasting ▪ Public transportation ▪ Biological chemicals ▪ Security services ▪ Agriculture, forestry and	All other business sectors.

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include certain pharmaceutical products and medical equipment, which is currently under public consultation.	fisheries ▪ Leather manufacture ▪ Air transportation ▪ Maritime transportation	
List (3) Public Companies with Core Designated Business.[8] Blanket Exemption (defined below) may be available. General Exemption (defined below) may be available if the Foreign Investor satisfies additional conditions.	List (2) Public Companies with Non-Core Designated Business.[9] Blanket Exemption (defined below) may be available. General Exemption (defined below) may be available.	List (1) Public Companies with no Designated Business.[10] Prior notification (approval) requirement does not apply. However, post-investment reporting requirement (10 percent or more) will apply (no change from prior to Amendment).

What are the exemptions and their conditions?

There are two exemptions: (i) "Blanket Exemption" for covered financial institutions, and (ii) "General Exemption" for other Foreign Investors including certified sovereign wealth funds and government pension plans. State-owned enterprises and other Foreign Investors who violated the FEFTA in the past will not be able to rely on these exemptions. Exemptions are not available for certain FDI activity, i.e., consenting to (a) a material change to the purpose or (b) "matters that have material impacts on the Public Company's operation" of a Public Company.

"Blanket Exemption" for covered financial institutions

- Available for Public Companies with "Core" Designated Business / "Non-Core" Designated Business
- Generally covers proprietary trading and customer account trading pursuant to "Discretionary Investment Management Agreement"
- No prior application is required to rely on the Blanket Exemption.
- However, post-reporting per transaction is required once the shareholding ratio hits 10 percent, within 45 days. The report form includes certification for compliance with conditions.

Covered Financial Institutions include:

- Type I broker-dealers and foreign broker-dealers;

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- Banks, foreign banks;
- Insurance companies, foreign insurance companies;
- Investment managers, foreign managers, including managers relying on the “QII Special Business Activities” exemption;
- Certain trust companies and trust banks, foreign trust companies and trust banks;
- Investment companies, registered foreign investment companies in a foreign country; and
- High-frequency traders registered in Japan.

The government confirmed that U.S.-registered investment advisers, U.K.-authorized fund managers and alternative investment fund managers, Hong Kong Type 9 (Asset Management) licensees, and Singapore “LFMC” and “RFMC” are covered financial institutions; however, U.S.-exempt reporting advisers are not.

Conditions

- The Foreign Investor or its Related Person may not accept the office of a board member (director or statutory auditor) of the Public Company or its affiliates.
- The Foreign Investor may not submit a proposal to a general shareholder meeting of the Public Company regarding transfer of the business of the Public Company or its subsidiaries, in whole or in part, or other corporate reorganization arrangements.
- The Foreign Investor may not obtain “Confidential Technology-related Information” (Technology Information) or engage any of the following activities that may result in disclosure of Technology Information:
    - Knowingly obtain Technology Information; however, the Foreign Investor may use such information provided by the Public Company voluntarily within the purpose and conditions of such provision;
    - Knowingly propose to disclose Technology Information to the Foreign Investor or a third party; or
    - Propose changes to the Public Company's internal rules, arrangements or contacts regarding Technology Information.
        - Certain investment banking activities (M&A advisory) are exempt with conditions.

General Exemption for other eligible Foreign Investors

- Available for Public Companies with “Core” Designated Business (with additional conditions) / “Non-Core” Designated Business
- No prior reporting is required to rely on the General Exemption.
- However, post-reporting per transaction is required 1 percent or more for Public Companies with Core Business (1 percent, 3 percent, and per transaction if 10 percent or more); 10 percent or more for Public Companies with Non-Core Designated Business (per transaction). The report form includes certification for compliance with conditions.

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Foreign Investor Eligibility

- Available for Foreign Investors generally, except state-owned enterprises and enterprises, and other Foreign Investors who were punished or imposed an administrative order under the FEFTA in the past five years.
    - Sovereign wealth funds and government pension plans (SWFs) may rely on the General Exemption, but a SWF is required to (a) enter into a memorandum of understanding with the government (such memorandum of understanding will not be made public) and (b) obtain certification by the government that is SWF is deemed to pose no national security risks. In this regard, the government will review whether (i) investment activities of the SWF is only for economic returns and (ii) investment decisions by the SWF are made independently of their governments; however, details are not available, nor specific timeline for review is provided.

Conditions

- Business with "Non-Core" Designated Business, but no "Core" Designated Business: same as Blanket Exemption conditions
- Business with "Core" Designated Business: in addition, the Foreign Investor may not:
- Attend or cause a third party to attend a committee of the Public Company that has authority to make important decisions regarding its "Core" Designated Business; or
- Submit or cause a third party to submit a written proposal (including email) regarding the Public Company's "Core" Designated Business to request a response or certain activity by a certain deadline.

How do the advance notification (approval) and post reporting work?

Advance notification (approval) – FDI not relying on an exemption	An advance notification must be approved prior to engaging in the notified FDI. If the notified FDI is not of national security or other concerns,[11] the government will notify the Foreign Investor of clearance of the screening within five business days, which had been the case for most of FDIs prior to the Amendment. However, the government may request additional information. A post-execution report is required per transaction, within 45 days from acquisition.
Blanket Exemption	10 percent or more (per transaction), within 45 days from acquisition.
General Exemption	Public Companies with Core Designated Business: 1 percent, 3 percent, and per transaction if 10 percent or more, within 45 days from acquisition. Public Companies with Non-Core Designated Business: 10 percent or more (per transaction), within 45 days from acquisition.

CONCLUSION

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The FDI review requirement under the FEFTA has broad impacts on the asset management industry, and in particular, managers and other institutions that trade and retain shares of Japanese publicly traded companies in their accounts or customers' accounts. Managers and other institutions that themselves are Foreign Investors are likely subject to the FDI review requirement or required to comply with the conditions under an exemption. In addition, if the customers are Foreign Investors, these customers may also be subject to the FDI review requirement unless they completely delegate to their managers and/or custodians the investment authority and the authority to exercise shareholder rights including voting rights without any reservation. While the Blanket Exemption and General Exemption are expected to be widely used by the industry participants and their customers, compliance with the conditions of these exemptions will potentially have significant implications on their ability to engage in shareholder engagement generally. For example, the Implementing Regulation provides that exemptions are not available for a FDI, the purpose of which is to make "continuous and stable implementation of a business in Designated Businesses" difficult. In this regard, the government indicated that this may include certain informal proposals provided through normal investor-company communications resulting in reduction of a relevant Designated Business, although the government sees that such determination would be made only in limited circumstances, e.g., circumstances that warrant the government's disapproval if a notification (approval application) was submitted.

The asset management industry participants should review and stand ready to comply with the new FDI review requirement. For further questions, please contact the authors.

FOOTNOTES

[1] For more background on the legislative changes, please see our previous alert. *See* Tsuguhito Omagari & Yuki Sako, *New Japanese Foreign Investment Regulation Could Impact the Financial Services Industry and Undermine Japan's Corporate Governance Reform* (December 9, 2019), available here.

[2] For example, the European Commission recently issued guidance to member states on the protection of EU's critical assets and technologies from acquisitions and investments by non-EU Companies. *See* Philip Torbøl et al., COVID-19: *The Commission Provides Guidance to Member States on the Protection of EU's Critical Assets and Technologies from Acquisitions and Investments by Non-EU Companies in the Context of the COVID-19 Outbreak* (May 6, 2020), available here.

[3] The bill required the Amendment be implemented within six months from the promulgation.

[4] Generally, foreign-owned Japanese companies fall under "Foreign Investors". Exceptions may apply.

[5] "Related Persons" include (i) directors, officers, managing members, and/or employees of the Foreign Investor and its certain Closely Related Parties; (ii) individuals who have received significant money or assets from the Foreign Investor; and/or (iii) other entities and individuals who have agreed to exercise voting rights and other shareholder rights jointly with the Foreign Investor, and "Related Persons" of such entities or individuals. The exact scope of "Related Persons" differs depending on whether the nomination was submitted directly or through another party by the Foreign Investor or a third party.

[6] The government indicated that "consent" may include intentional abstention that effectively enables the appointment, e.g., abstention of a large number of shares in knowing it will enable the proposed appointment.

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[7] (i) Building a position but unwinding the same within the same day may be netted, (ii) crossing 1 percent with borrowed shares would generally be counted toward the threshold; however, (iii) receiving shares by way of security assignment collateral would not be counted.

[8] As of May 8, 518 Public Companies are included.

[9] As of May 8, 1,584 Public Companies are included.

[10] As of May 8, 1,698 Public Companies are included.

[11] On March 8, 2020, the government issued the order regarding the factors to be considered in reviewing the application. *See* Ministry of Finance, JAPAN, *Factors to be considered in authorities' screening of foreign direct investment* (May 8, 2020), available here.

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