NEW JAPANESE FOREIGN INVESTMENT REGULATION COULD IMPACT THE FINANCIAL SERVICES INDUSTRY AND UNDERMINE JAPAN'S CORPORATE GOVERNANCE REFORM

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On November 22, the Japanese National Diet, the Japanese national legislature, passed an amendment bill to the Foreign Exchange and Foreign Trade Act (Act No. 228 of 1949, as amended) (the "FEFTA") to expand the scope of foreign investment review (the "Amendment"), which may have negative impacts on financial services providers and institutional investors who trade and/or invest in securities of publicly traded Japanese companies. More specifically, the Amendment may require financial institutions whose business includes trading shares of Japanese publicly traded companies and mutual funds and other funds whose investment portfolios includes shares of such companies to revisit and reconsider their trading or investment practices and, for example, assess how an institution can fit its trading or investment practice into an exemption. The Amendment may also require institutional investors to revisit certain types of shareholder engagements with Japanese publicly traded companies.

The Amendment includes a significant expansion of the advance notification requirement, which effectively functions as an advance approval requirement, for certain types of foreign investments in Japanese companies, or "inward direct investments," that includes acquisition of shares of a company listed on a Japanese stock exchange (a "Public Company"). Most notably, with respect to acquisition of shares of a Public Company, the Amendment would lower the threshold of the shareholding ratio for the advance notification (approval) requirement from 10 percent to one percent. The government explained that the rationale for one percent is that it is equal to the shareholding percentage required for a shareholder to have the right to propose an agenda item at a general shareholders meeting under the Companies Act of Japan (Act No. 86 of 2005, as amended) (the "Companies Act"), and, as such, a foreign investor "could have significant influence in terms of control over the target company." [1]

The government promised to include broad exemptions to protect the financial services sector and tried to reassure investors about its support for corporate governance; however, many investors remain concerned that the Amendment would make it difficult for non-Japanese financial services providers and institutional investors to trade shares of or invest in Public Companies and/or to engage in effective shareholder engagement with Public Companies. Many also voiced concerns that the focus on the shareholder right to propose agenda items would undermine the corporate governance of Public Companies and offset the government's recent intensive efforts for corporate governance reform.

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Key Takeaways From the Amendment

- The Amendment would lower the shareholding threshold for the *advance* notification (approval) requirement to one percent with respect to two categories of reviewable transactions, *i.e.*, (i) acquisition of shares or voting rights of a Public Company, and (ii) consenting to a material change to the purpose of a Public Company.
- The Amendment would add "acquisition or succession of *business*" (as opposed to shares) by a business transfer, corporate split, or merger as an additional category of reviewable transaction, expanding the scope of the FEFTA review.
- The Amendment would update the definition of "foreign investor" to include a new partnership fund category, which results in the fund (or the general partner) triggering the FEFTA requirements instead of each of the foreign limited partners ("LPs"); however, the new definition appears to include certain practical issues.
- Exemptions for the advance notice requirement would be provided by regulation.
- The Amendment includes no change to the *post*-reporting requirement for reviewable transactions that are not subject to the advance notification (approval) requirement, *i.e.*, the shareholding ratio of 10 percent would remain as the triggering threshold.
- The scope of the FEFTA review on private company investments would remain largely the same, although the "foreign investor" definition and procedural amendments would have other impacts.
- The Amendment would authorize the Japanese government to share information with certain friendly foreign governments.
- The Amendment would expand the government's power to intervene in the completed transaction or activity that failed to submit an advance notification and may be expanded to include, *e.g.*, divestiture orders.

The Ministry of Finance indicated that it intends to complete the rulemaking process on implementing regulation "well in advance" [2] of June 2020 when the majority of Japanese companies hold annual general shareholder meetings.

The key driving force for this unusual haste, perhaps at the significant expense of foreign financial services providers and institutional investors, is the United States' recent efforts in expanding the scope of foreign investment review by the Committee on Foreign Investment in the United States (CFIUS) and, in particular, the Japanese government's hope that Japan would be included on the so-called "White List" or designated as an "excepted foreign state." [3]

This alert discusses key takeaways from the Amendment and exemptions.

LEGISLATIVE CHANGES

Changes to the FEFTA review requirements under the Amendment are summarized below:

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1. Expansion of reviewable transactions or activities:

The Amendment would lower the shareholding threshold for the advance notification (approval) requirement from 10 percent to one percent with respect to acquisition of shares or voting rights of a Public Company by a foreign investor. [4]

The Amendment would lower the shareholding threshold for the advance notification (approval) requirement from 33.3 percent to one percent with respect to consenting to a material change to the purpose of a Public Company by a foreign investor.

The Amendment would add "acquisition or succession of business" (as opposed to shares) by a business transfer, corporate split, or merger as an additional category of reviewable transactions.

> With these changes, foreign investors such as mutual funds and institutional investors who hold and/or trade a few percent of the shares of a Public Company would be subject to the advance notice (approval) requirement for the first time. Further, as we discuss below, even if an institution is entitled to rely on an exemption, the post-execution report requirement may apply, which would be detailed in the rulemaking process and would also represent a new requirement for these types of foreign investors.

2. Update on the definition of "foreign investor":

It would update the definition of "foreign investor" to include a new partnership fund category.

The new partnership fund category under the Amendment is, essentially: a Japanese or foreign partnership fund in which (i) the amount of funds invested by foreign investors accounts for 50 percent or more of the total investments (contributions), or (ii) the general partner is, or a majority of general partners are, "foreign investor(s)." This update would result in the fund triggering the review requirement, *i.e.*, advance notice (approval) requirement and/or post-reporting requirement, under the FEFTA for all of its investors, removing the necessity for each of the foreign LPs to satisfy the requirement.

Criterion (i) applies irrespective of whether the foreign investors are actually able to exert control over the investment, *e.g.*, foreign LPs who are not generally engaged in or empowered to direct investment decisions or to control portfolio investments would be included in the calculation. As such, even if foreign LPs' investments are passive in nature, and they are unlikely to pose any national security threat, the fund would still trigger the FEFTA review requirement.

Given potential additional contributions and redemptions, under criterion (i), the "foreign investor" status of a particular fund could change over time. This would need to be resolved in a practicable manner, perhaps through regulation.

3. The advance notification (approval) requirement primarily applies to reviewable transactions that involve shares or voting rights of Public Companies engaging in certain designated types of business affecting Japan's national security, public order, public safety, or certain protected industries ("Designated Business"). Reviewable transactions that involve shares or voting rights of Public Companies engaging in no Designated Business are subject to a post-reporting requirement under the FEFTA. The Amendment

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leaves unchanged such post-reporting requirement for reviewable transactions that are not subject to the advance notification (approval) requirement, and as such, for those transactions, the shareholding ratio of 10 percent would remain as the triggering threshold.

In this regard, it is important to note that the Designated Business is determined for the purpose not only of protecting Japan's national security but also of promoting its industrial policy, which may be different from approaches taken by other countries such as the United States and, as such, industries that have historically been protected are also included. For example, the following types of business are included:

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> agriculture and forestry; fisheries; mining; certain manufacturing (leather products, petroleum products, baggage, electronic devices, semiconductors, memory disks, telecommunication devices, cell phones, or computers); utility (electricity, gas, heat, water); telecommunications and media; internet usage support business; software-related development business (other than the game industry); transportation and postal; petroleum wholesale or gas stations; the central bank, agricultural cooperatives, and fishery cooperatives; security guard services; and LNG (liquefied natural gas) storage.

EXEMPTIONS PROMISED TO BE PROVIDED BY REGULATIONS

As noted above, the government promised to promulgate regulations to provide broad exemptions. While the details are not yet available, the government listed in its paper the following exemptions:

4. **Trading activities by a foreign broker-dealer on its proprietary account.**
   Trading activities on a customer's account would be subject to the advance notification requirement, if applicable.
5. **Trading activities by a foreign bank, insurance company, or investment manager.**
   The scope of this exemption was not made clear.
6. **Passive investments** in which the foreign investor does NOT:

assume office as a board member or officer (including a person closely related to the foreign investor);

propose a transfer or disposition of important business; and

have access to national security-related nonpublic technologies or information.

The government suggested that for exempt transactions under (1) and (2), post-execution reports would be required when the shareholding ratio reaches 10 percent, which is consistent with the current FEFTA requirement. For exempt transactions under (3), however, post-execution reports would be required for investors meeting the one percent threshold.

The government emphasized that the scope of exemptions would be made clear in the regulation to avoid foreign investors having to file advance notifications when they are not sure of the applicability of exemptions. With

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respect to the third category of exemption (passive investments), the government noted that there would not be any additional restrictions on shareholder rights or shareholder engagement and that if a foreign investor later changes its approach and decides to take action that would constitute one or more of the three types of activities listed above, the investor could submit an advance notification at that time. [5] On a related but different point, whether a shareholder proposal submitted to a Public Company without filing an advance notification under the FEFTA would still be valid for Companies Act purposes remains an open question, and as such, foreign investor shareholders could, in practice, face greater scrutiny when submitting proposals.

While the government's promise to provide these exemptions was meant to help address some concerns, many stakeholders continue to criticize the focus on shareholder rights, which would undoubtedly discourage engagement by foreign shareholders, and, given that these activities would still be subject to post-execution reports, operational challenges in complying with the new FEFTA review requirements and exemptions may still arise.

The government further indicated that there would be carve-outs from the passive investment exemption as described in item (3) above:

First, a foreign investor (i) who is "under the influence of a foreign government," *e.g.*, a state-owned enterprise; or (ii) who has violated the FEFTA in the past, would not be able to rely on exemptions. We note that from the FAQ it appears that the government would allow sovereign wealth funds or public pension plans to rely on exemptions under certain circumstances.

Second, if the Designated Business of the target Public Company includes industries where involvement by a foreign investor may significantly undermine national security, such as weapons manufacturing, nuclear power, electricity, or telecommunications, the foreign investor may not rely on the passive investment exemption as described in item (3) above. [6]

In addition, in an effort to clarify and help foreign investors comply with the Amendment and these exemptions and carve-outs, the Ministry of Finance also promised that it will prepare, and update periodically, a list of Public Companies with applicable classification. In the list, Public Companies (currently, there are over 3,600 Public Companies) will be classified into three categories: (1) Public Companies where a foreign investor would be subject to the advance notification requirement; however, an exemption is available if the foreign investor satisfies certain requirements; (2) Public Companies where the advance notification requirement would apply and an exemption is not available; and (3) Public Companies that are not subject to the advance notification requirement.

CHANGES ARE IMMINENT

As noted above, the Amendment has already been enacted and will become effective within six months from its promulgation. What follows next is the rulemaking process led by the Ministry of Finance. The rulemaking process would likely be complete sometime in the spring of 2020 at the latest. A Ministry of Finance official who appears to be the lead drafter for the legislation indicated that he hopes to complete the rulemaking process "well in advance" of June 2020, when the majority of Japanese companies will hold their annual general shareholder meetings. [7] While the legislative changes are essentially a done deal, the scope of, and each requirement for, exemptions, which would be critical in defining the future trading and investment activities in shares of Public

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Companies, as well as Japan's future investment environment generally, may leave some room for further consideration and consultation with "market-related parties." [8]

Financial services industry participants and institutional investor communities who trade and/or invest in shares of Public Companies should review this development and the Amendment carefully and consider appropriate action plans and whether to revisit the current practice or operation or engage with the Japanese government to tailor the exemptions. A number of efforts by affected stakeholder groups are already underway.

NOTES

[1] Minutes of the 43rd Foreign Exchange Sub-Committee of the Custom/Foreign Exchange Council (Oct. 8, 2019).

[2] *Id.*

[3] *Cf.*, K&L Gates alert "Treasury Proposes Regulations Implementing Nearly All of FIRRMA's Provisions" (Sept. 27, 2019).

[4] Generally, under the FEFTA, shares and/or voting rights held by closely related parties are counted toward the threshold.

[5] The Ministry of Finance, Frequently Asked Questions on the Amendment Bill of the Foreign Exchange and Foreign Trade Act (last updated Oct. 31, 2019) (the "FAQ").

[6] The government indicated a possibility of different treatment if the investments are index-based investments. *Id.*

[7] Minutes of the 43rd Foreign Exchange Sub-Committee of the Custom/Foreign Exchange Council (Oct. 8, 2019).

[8] "… [W]e have starting consultation with market-related parties including foreign investors" (Mr. Mimura, Vice-Minister, Ministry of Finance). *Id.*

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