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Publication of Draft Regulations to Implement the Amended Foreign Exchange Act – regarding Notification Requirements on Inbound Equity Investments in Listed Shares –

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Following the enactment on November 29, 2019 of the amendments to the Foreign Exchange and Foreign Trade Act (the “**Amended FX Act**”) which tighten the rules with respect to inbound equity investments, the government announced on March 14, 2020 a set of draft amendments to the regulations promulgated thereunder (i.e., the relevant Cabinet Order, Ministerial Ordinance and Notices) to implement such amendments (collectively, the “**Draft Regulations**”). The Draft Regulations are open to public comments until April 12, 2020.

The key change in the Amended FX Act is the lowering of the threshold with respect to the prior notification requirement in connection with the acquisition of ownership interests in Japanese listed companies that engage in certain regulated businesses (the “**Regulated Businesses**”) from the current 10% to 1%*. The Draft Regulations include provisions for exemptions from the notification requirement, clarify the scope of Regulated Businesses and provide important guidelines regarding the implementation of the Amended FX Act.

This newsletter provides a brief summary of the key elements of the Draft Regulations.

1. Current Framework and Major Changes set forth by the Amended FX Act

Overview

Under the current FX Act (prior to the Amended FX Act going into effect), foreign investors (“**Foreign**

*Unless indicated otherwise, all percentages are on either a volume or voting right basis.

Investors) are required to provide prior notification (the **“Prior Notification Requirement”**) to the Japanese government (the **“Relevant Ministries”**), via the Bank of Japan (**“BOJ”**), prior to the acquisition of 10% or more of ownership interests in a Japanese listed company (the **“Regulated Investments”**).

For FX Act purposes, “Foreign Investors” include, among others, (i) individuals who are non-residents of Japan; and (ii) corporations or other entities established in foreign jurisdictions (including Japanese branches of foreign companies) with their principal offices outside of Japan. The Regulated Businesses covered by the FX Act pertain to industries involving national security, public infrastructure, public safety and certain protected domestic sectors, such as agriculture.

The main change effectuated by the Amended FX Act is the lowering the threshold for the Prior Notification Requirement in the event of a planned acquisition of shares in a listed company, which is included in the category of Regulated Businesses, from 10% to 1%. The Amended FX Act expands the scope of the Regulated Investments, requiring a Foreign Investor having at least 1% of ownership interest in a Japanese listed company to give prior notification to the BOJ in case such Foreign Investor intends to provide its consent to any material change to the corporate objectives or other matters having a material effect on the management of the company. The Amended FX Act also expands the definition of a “Foreign Investor” to include certain types of limited partnerships¹.

Key Points of the Draft Regulations

The key points of the Draft Regulations include, among others, (i) clarification of the scope and conditions for the exemption from the Prior Notification Requirement; (ii) expansion of the scope of the Regulated Investments; and (iii) expansion of the definition of a “Foreign Investor”.

2. Exemptions from Prior Notification Requirement

The Draft Regulations provide a set of fairly complex exemptions from the Prior Notification Requirement.

There are two types of exemptions: (i) a **“Blanket Exemption”** for certain **“Financial Institutions”**; and (ii) a **“Regular Exemption”** for investors other than “Financial Institutions” and restricted investors (as described below; the **“Restricted Investors”**). In addition, the scope of the exemption under (ii) above varies depending on the type of the Regulated Business.

“Financial Institutions” include the following²:

- (a) Domestic and foreign securities firms;
- (b) Domestic and foreign banks;

¹ Please see our newsletter dated November 1, 2019 (link attached), providing a summary of the proposed amendments to the FX Act: https://www.amt-law.com/asset/en/pdf/bulletins10_pdf/EN_191105.pdf

² Since even Japanese stock companies may be deemed “Foreign Investors” for purposes of the FX Act (see Section 4 below), the definition of “Financial Institutions” includes certain domestic financial institutions, as listed above.

- (c) Domestic and foreign insurance companies;
- (d) Domestic and foreign asset management companies;
- (e) Domestic and foreign trust companies (including trust banks) which have investment discretion;
- (f) Domestic and foreign Investment corporations; and
- (g) High frequency (or high speed) traders³.

The Regulated Businesses are divided into the following two categories: (i) sectors that are essential to the activities and security of the state (the “**Core Sectors**”); and (ii) designated sectors other than the Core Sectors (the “**Non-Core Sectors**”).

“Core Sectors” include the following:

- Weapons, aircraft and space industries, nuclear facilities and “dual-use technologies”.

“Non-Core Sectors” include the following:

- Heat supply, broadcasting, public transportation, biological chemicals, security services, agriculture / forestry / fisheries, leather manufacturing and air and maritime transportation.

The following are divided into “Core Sectors” and “Non-Core Sectors”, depending on the specifications of the business that they are engaged in:

- Cybersecurity, electricity, gas, water supply, railways and the telecommunication and oil industries. (For example, cybersecurity businesses providing programming services specifically designed to protect important infrastructure are included in “Core Sectors” while other cybersecurity businesses are deemed “Non-Core Sectors”.)

Blanket Exemption

Subject to compliance with certain conditions (as described below; the “**Exemption Conditions**”), Financial Institutions benefit from an unlimited Blanket Exemption with respect to investments in both “Core Sectors” and “Non-Core Sectors”. Please note, however, that a post-facto report (a “**Post-Investment Report**”) is required to be filed with the BOJ whenever the investment equals or exceeds 10%.

The “Exemption Conditions” require that the Financial Institution:

- does not appoint itself, or a person closely related to it (a “**Closely-related Person**”) ⁴, as executive (e.g., director or corporate auditor) of the Japanese company;
- does not submit proposals to sell, cease, or make changes to, material operations relating to the Regulated Business at shareholders’ meetings of the Japanese company; and

³ Those registered pursuant to the Financial Instruments and Exchange Act

⁴ A “Closely-related Person” is broadly defined to include, among others, the Foreign Investor’s officers and employees, its affiliates’ officers and employees, its main contractors and any person deemed as such during the previous one year period. The scope of the persons included in the definition differs depending on whether the relevant nomination was made by the Foreign Investor itself or a third party.

- is not given access to non-public technical information relating to the Regulated Business nor does it propose to the Japanese company a change of the internal rules, agreements, etc. relating to the management of such information.

Regular Exemption

A Regular Exemption is available to all Foreign Investors other than (i) Financial Institutions (who benefit from the Blanket Exemption), and (ii) Restricted Investors. State-owned enterprises (such as sovereign wealth funds (SWFs) and foreign government pension funds) may benefit from a Regular Exemption upon obtaining an authorization from the Japanese government (see below).

The exemption is applied in a different manner depending on whether the investment is in “Core Sectors” or “Non-Core Sectors”, as follows:

- Subject to compliance with the “Exemption Conditions” (same as above), investments in “Non-Core Sectors” benefit from an unlimited exemption from the Prior Notification Requirement. Please note, however, that Post-Investment Reports must be filed with the BOJ when an investment reaches or exceeds the 1%, 3% and 10% thresholds, respectively.
- Subject to compliance with the “Exemption Conditions” (same as above) and certain additional conditions (as described below; the “**Additional Exemption Conditions**”), an investment in a company classified within the “Core Sectors” is exempt from the Prior Notification Requirement where such investment is lower than 10%. Please note, however, that Post-Investment Reports must be filed with the BOJ when an investment reaches or exceeds the 1% and 3% thresholds, respectively.

The “Additional Exemption Conditions” with respect to “Core Sectors” require that the Foreign Investor:

- does not participate in the Japanese company’s committees in charge of determining matters that are material to the business of “Core Sectors”; and
- does not submit written proposals to board of directors’ meetings of the Japanese company that set deadlines relating to business activities classified as “Core Sectors”.

A Regular Exemption is available to SWFs or foreign government pension funds which are not considered to pose a risk to the national security and were granted a special authorization (accreditation) from the government of Japan. The government will consider whether (i) the purpose of the investor’s activities is only financial return, and (ii) its investment decisions are made independently from the government of the jurisdiction where it is established. Such SWFs or pension funds are also required to enter into a memorandum of understanding (MOU) with the Japanese government.

Restricted Investors

No exemption is available to a Foreign Investor having been sanctioned during the previous five years for a violation of the provisions of the FX Act.

No exemption is available to SWFs and foreign government pension funds which have not been granted the above-mentioned authorization by the Japanese government.

The following table illustrates how the exemptions apply:

Type of Foreign Investor	Sector to be invested in	Exemption
Financial Institutions	Non-core Sectors & Core Sectors	Blanket Exemption: - subject to the Exemption Conditions, an unlimited exemption from the Prior Notification Requirement is available - Post-Investment Report when investment equals or exceeds <u>10%</u>
General investors (including SWFs and foreign government pension funds which have been granted an authorization by the Japanese government)	Non-core Sectors	Regular Exemption (1) : - subject to the Exemption Conditions, exempt from the Prior Notification Requirement - Post-Investment Reports when investment reaches or exceeds <u>1%, 3% and 10%</u> , respectively
	Core Sectors	Regular Exemption (2) : - subject to the <u>Exemption Conditions plus Additional Exemption Conditions</u> , exempt from the Prior Notification Requirement for investments below <u>10%</u> - Post-Investment Reports when investment reaches or exceeds <u>1% and 3%</u> , respectively
Restricted Investors	Non-core Sectors & Core Sectors	No exemption is available (*State-owned enterprises which have not been granted an authorization by the Japanese government may not benefit from any exemption.)

Although the Draft Regulations, as a whole, are fairly complex, the broad range of applicable exemptions renders their impact with respect to the lowering of the Prior Reporting Requirement threshold reasonably moderate.

“List” of Japanese Companies

The regulator Q&A released on October 25, 2019⁵ states that the government shall publish and update

⁵ Available 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

from time-to-time a list of Japanese companies that are:

- not subject to the Prior Notification Requirement and only require a Post-Investment Report;
- subject to the Prior Notification Requirement, but may benefit from an exemption; and
- subject to the Prior Notification Requirement and no exemption is available to them.

Though the Draft Regulations are silent regarding the list, the general understanding is that the Japanese government is currently collecting information from the companies thereon in order to determine each such company's category.

3. Post-Investment Notification

Where, by virtue of an exemption indicated above, the investment by a Foreign Investor is not subject to the Prior Notification Requirement, a Post-Investment Notification must be filed, within 45 days from the date on which the relevant Regulated Investment was made⁶, with the Relevant Ministries, via the BOJ. As mentioned above, the threshold for such filing is 1%, but additional reports are required when the investment reaches 3% and 10% (when Prior Notification Requirement does not apply), respectively.

SWFs and foreign government pension funds may be subject to different thresholds or other reporting requirements, as agreed in the MOU with the Japanese government.

4. Expansion of the Definition of “Foreign Investor”

The Draft Regulations propose an expansion of the definition of a “Foreign Investor” to include a broader range of subsidiaries of foreign companies or non-resident individuals. More specifically, under the current FX Act, only Japanese companies (and their direct subsidiaries) having at least 50% of their voting rights held by a foreign company or a non-resident are deemed “Foreign Investors”. However, the Draft Regulations adopt the boarder definition of “subsidiary” under the Companies Act of Japan. Such definition includes companies controlled, via direct or indirect holding of voting rights or through other measures, by a parent company.

A partnership (including a foreign partnership) is recognized as a Foreign Investor when (i) its general partner (GP) is a Foreign Investor, or (ii) the majority of its funding is contributed by partners that are Foreign Investors.

5. Expansion of the Scope of Regulated Investments

The Amended FX Act provides that any Foreign Investor holding 1% or more of the ownership interests a Japanese listed company must file a prior notification with the BOJ in case it intends to provide its

⁶ Currently, this Post-Investment Notification has to be filed by the 15th of the month following the month in which the investment (or provision of consent) occurred.

consent to any material change to the corporate objectives or other matters having a material effect on the management of the company.

The Draft Regulations clarify that (i) where a Foreign Investor holding at least 1/3 of the voting rights of a company (including the voting rights held by Closely-related Persons) provides its consent to a material change to the corporate objectives of the company (only when the objectives following the change include any Regulated Business), such consent shall be deemed a Regulated Investment, and (ii) where a Foreign Investor holding at least 1% of the voting rights of a company (including voting rights held by Closely-related Persons) provides its consent to (a) the appointment of a director or corporate auditor affiliated with such Foreign Investor, and/or (b) certain agenda items, such as the sale or transfer of all or part of the company's material business or the sale or transfer of all or part of its subsidiary's shares in connection with the Regulated Business (only if the Foreign Investor proposed, or caused another shareholder to propose, such agenda items), such consent shall be deemed a Regulated Investment.

In any of the above cases, in the absence of an applicable exemption indicated in Section 2 above, the Foreign Investor shall be required, prior to taking the relevant action, to file a notification with the BOJ.

Please note that the definition of "Regulated Investment" includes cases where a Foreign Investor is granted a discretionary authority by its client to invest on its behalf in shares of a Japanese listed company as well as exercise voting and other shareholder rights, provided the client does not retain such authority. However, as indicated in Section 2 above, an asset management company classified as a "Foreign Investor" which has a mandate to invest in Japanese equity is likely to qualify for an exemption from the Prior Notification Requirement. In the case of a partnership that is a Foreign Investor, unless it delegates the discretionary investment activities to an asset management company that is exempt therefrom, a GP of a partnership that is deemed a Foreign Investor is likely to be subject to the Prior Notification Requirement on behalf of such partnership.

6. Enforcement

The Amended FX Act and the relevant Cabinet Order, Ministerial Ordinance and Notices are scheduled to enter into effect no later than May 29, 2020.

The supplemental provisions of the Amended FX Act provide that the increased reporting requirements thereof would apply to any Regulated Investments made 30 days following the date on which the amendment goes into effect. Any investments made prior thereto would only be subject to the current requirements.

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