Daiwa Institute of Research

28 November 2019 (No. of pages: 10)

Japanese report: 11 Nov 2019

Revision of Foreign Exchange Law Regarding Inward Direct Investment

Concerns that portfolio investment could be impeded are limited

Financial and Capital Market Research Dept.
Yuki Kanemoto

Summary

- The amendment bill of the Foreign Exchange and Foreign Trade Act (referred to below as the foreign exchange law) which strengthens inward direct investment regulations was enacted on November 22. The inward direct investment regulations require foreign investors to submit a prior notification in cases where they plan on acquiring 10% or more shares of a company listed on the stock exchange when said company is a member of a particular industry. A government examination is also required under the regulations.

- While the amendment bill, expected to go into effect in spring next year, calls for the expansion of the range covered by regulations according to the foreign exchange law where the level of acquisition of shares of a listed company requiring submission of a prior notification would be lowered to 1% or more from the current 10% or more, the proposal at the same time calls for introduction of an exemption of portfolio investment etc. from the requirement to submit a prior notification.

- The FAQ which was publicized by the Ministry of Finance on October 25 clarifies the standards which must be followed by investors in order to be eligible for exemption from prior notification. The ministry also announced its plan to publish a list of issues requiring prior notification. Publication of the FAQ for the most part relieves concerns that portfolio investment could be impeded by the new regulations.

- This reconsideration of the regulations has been criticized as placing too many restraints on activist investors, and while the FAQ claims that this is not the case, it is indeed possible that situations could occur where the government refuses to give its approval to an activist investment. Further clarification of examination criteria is therefore desirable.

1. Introduction

The amendment bill of the Foreign Exchange and Foreign Trade Act (referred to below as the foreign exchange law) which strengthens inward direct investment regulations was enacted on November 22. Reportedly, the amendment bill is intended to go into effect in the spring of 2020.

The foreign exchange law stipulates regulations associated with inward direct investment. It requires foreign investors to submit a prior notification in cases where they plan on carrying out direct investment in certain industries. The government reviews cases of inward direct investment, and where necessary may make a recommendation for a change in the investment or order the investor to halt said investment. Inward direct foreign investments which require the filing of a prior notification include 10% or more shares of companies listed on the stock exchange, as well as shares of non-listed companies.

According to the revision of the foreign exchange law, the level of acquisition of shares of a listed company requiring submission of a prior notification is lowered to 1% or more from the current 10% or more. At the same time, it includes the introduction of a system for exemption of portfolio investment from the requirement to submit a prior notification of inward direct investment.

When major points in the revision of the foreign exchange law were announced by the Ministry of Finance's Council on Customs, Tariff, Foreign Exchange and Other Transactions, foreign investors and people associated with the stock exchange voiced concerns that new rulings on prior notification would reduce the willingness of foreign investors to invest. Therefore, the Ministry of Finance then clarified the applicability of the exemption program[1] and measures to reduce the burden on investors on October 18 and also publicized "Frequently Asked Questions on the Amendment Bill of the Foreign Exchange and Foreign Trade Act" (referred to below as FAQ)[2] on October 25.

In this report we provide an explanation of regulations associated with inward direct investment and the revision of the foreign exchange law.

2. Inward Direct Investment Regulations

The foreign exchange law requires foreign investors[3] to submit prior notification in cases where they plan on carrying out direct investment[4] in certain industries. Industries included under the definition of "certain industries" are listed below. (Foreign Exchange Law, Article 27(1), Notification of Inward Direct Investment, Article 3(2), Mandate Associated with Inward Investment, Article 3(4), Establishment of Industries by the Minister of Finance and the Minister in charge of business associated with inward direct investment as stipulated in Article 3(4))

(1) National safety related: weapons, aircraft, nuclear power, space industry, industries manufacturing products which can be diverted to military use, cyber security.*
(2) Public services and systems related: gas & electricity, heat, communications, broadcasting, water, railways, transportation.

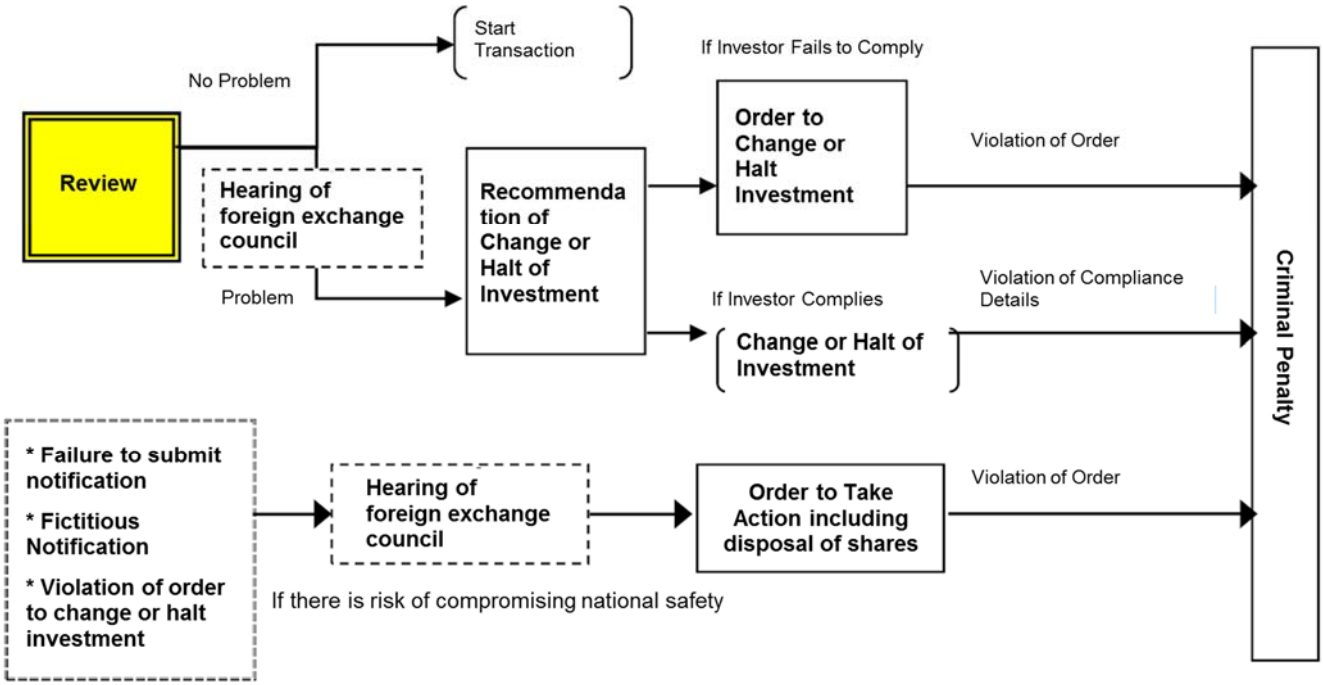
[1] See Ministry of Finance website (https://www.mof.go.jp/english/international_policy/fdi/kanrenshiryou_191021.pdf).
[2] See Ministry of Finance website (https://www.mof.go.jp/english/international_policy/fdi/faq_191031.pdf).
[3] Applicable to a non-resident individual, a corporation established in accordance with foreign laws, or companies in which ownership of 50% or more is held by a non-resident individual or a corporation established in accordance with foreign laws (Foreign Exchange Law, Article 26 (1)).
[4] Includes acquisition of shares of unlisted companies and acquisition of 10% or more of total number of issued shares of companies listed on a stock exchange, consent given in regard to the substantial change of the business purpose of a corporation, and the undertaking of discretionary investment management pertaining to shares of a listed company (10% or more of total number of issued shares).

(3) Public safety related: biologics manufacturing industry, security guard industry (4) Industries that are fundamental to running the Japanese economy: agriculture, forestry and fisheries, oil, leather related industries, air transport, and shipping.

*Added to list of industries on August 1, 2019 in accordance with revision of the notice establishing industries (May 2019).

The Minister of Finance and the Minister in charge of business shall carry out a review of inward direct investments for which prior notification has been received and complete said review within 30-days in principle, and where necessary may make a recommendation for a change in the investment or order the investor to halt said investment (Chart 1).

Procedural Flow of Inward Direct Investment Review Process **Chart 1**



Source: Ministry of Finance; compiled by DIR.

The foreign exchange law also requires a foreign investor carrying out direct inward investment to make a follow-up report to the Minister of Finance and the Minister in charge of business. Cases in which the follow-up report is required differ from those under the prior notification requirement, and are not limited to the industries listed in table shown above (Foreign Exchange Law, Article 55-5 (1)).

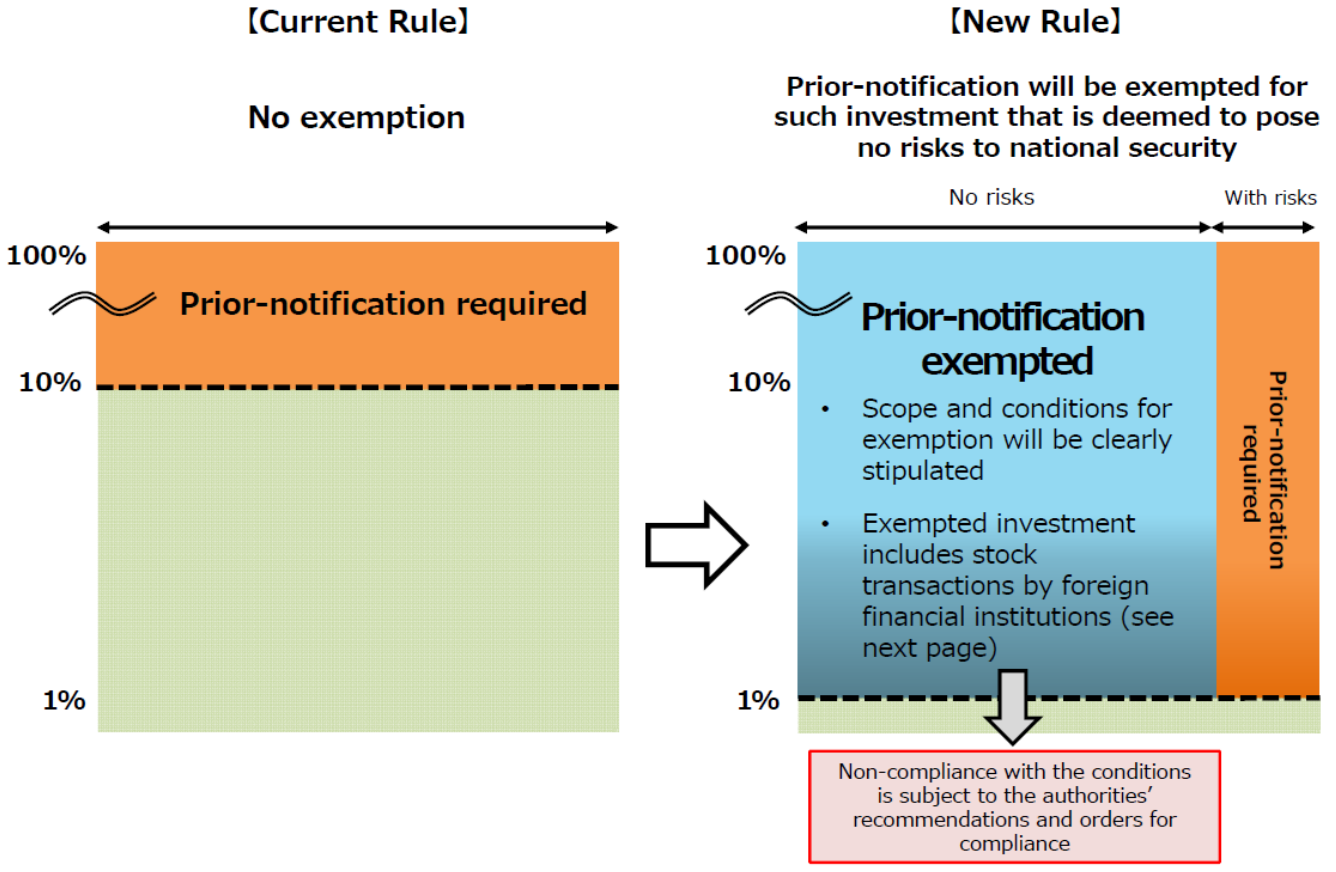
3. Revision of Foreign Exchange Law

(1) Main points of the revision

The main points of the revision are listed in the table below[5].

(1) Introduction of system of exemption from prior notification (a) Portfolio investment to be exempt from prior notification. (2) Reconsideration of investment level requiring prior notification (a) Acquisition of shares of a listed company in certain specified industries: requirement level changed from 10% or more to 1% or more. (b) Prior notification requirement extended to actions and decisions affecting exercise of influence on corporate management, such as accepting an appointment of corporate officers and transfer or acquisition of important businesses.

Prior Notification Requirement Exemption Process (Illustration) **Chart 2**



Source: Ministry of Finance.

As was mentioned previously, the amendment bill is intended to go into effect in the spring of 2020.

[5] Also included in the proposal are programs to promote and strengthen information sharing with domestic and foreign offices of government agencies, and means of lightening the administrative load in the prior notification process for investment associations and investment funds of various types.

(2) Prior notification exemption program

(a) Scope of prior notification exemption program

Exemption from prior notification is applicable to portfolio investment. Plans are to establish this concretely in the detailed regulations of the foreign exchange law and it is not yet clear at this time.

The prior notification exemption program does not apply to investors who have violated the foreign exchange law in the past, or state-owned enterprises, etc.. Additionally, exemption does not apply to investment in industries listed as requiring prior notification where there is great risk of compromising national safety. The major examples are the manufacture of weapons, nuclear power, electrical power, and communications.

In addition, standards have also been established which must be followed by investors receiving exemption from prior notification as illustrated in the below chart.

(1) The foreign investors or their closely-related persons will not become board members of the invested company;
(2) The foreign investors will not propose transfer or disposition of important business activities of the invested company to the general shareholders' meeting; and
(3) The foreign investors will not access non-public information about the invested company's technology that can impact national security.

The foreign investors need only indicate that they are following standards (1) and (2) in the above list in the post-investment report regarding the exercise of one's rights as a shareholder in order to receive an exemption from prior notification[6]. If they are unable to uphold these standards, the ministry will send a follow-up notice recommending or ordering the investor to comply with the standards.

To explain further regarding number (2) in the above list of standards, which states that "the foreign investors will not propose transfer or disposition of important business activities of the invested company to the general shareholders' meeting," this does not apply to a proposal for the appointment or dismissal of officers, or making a proposal at general business meetings (outside the official shareholders' meeting). Nor does the rule apply to voicing approval or agreement to proposals of other shareholders made at the shareholders' meeting. The above standards therefore do not impede or inhibit other general shareholder behaviors or actions.

(b) Measures to reduce burden on foreign banks, etc.

The burden on investors such as foreign banks is reduced as illustrated in the below chart.

(1) Stock transactions by foreign securities firms using their proprietary accounts will be exempted from the prior-notification requirement, irrespective of the business sectors of the stocks.
(2) Stock transactions by foreign banks, insurance companies, and asset management companies will be exempted from the prior-notification requirement, irrespective of the business sectors of the stocks.
(3) Threshold for post-investment notification that is applied for exempted firms will be retained at the current 10% for foreign securities firms, foreign banks, insurance companies, and asset management companies.

[6] Foreign securities firms, foreign banks, insurance companies, and asset management companies making use of the exemption from prior notification are not obligated to submit a post-investment notification unless they have acquired 10% or more of a company's shares as mentioned below. For this reason it may be assumed that neither prior notification nor post-investment report are required of those foreign investors who are exempt from prior notification if, for example, 3% of a company's shares are acquired. (At the same time of course standards (1)-(3) must be followed.)

According to (1) in the above list, transactions carried out by foreign securities companies on their own account such as block trades for supplying liquidity in the market are exempt from the requirement to submit a prior notification. As for the requirement of follow-up reporting, already included in the current regulations, the range according to the current regulation will be maintained in the case of foreign securities companies, foreign banks, foreign insurance companies, and foreign asset management companies as stated in (3) in the above list.

Furthermore, number (2) in the above list shows promise of being effective in reducing the burden on foreign asset management companies. However, in order to be eligible for this exemption, the foreign asset management company must uphold the established standards of investment described above. In other words, foreign asset management companies which plan to accept an appointment as an officer of a company being invested in, or to propose transfer or disposition of important business activities of the invested company to the general shareholders' meeting, will not be eligible for exemption from prior notification.

(c) Clarification regarding SWF and publication of a list of listed companies of each category

In regard to sovereign wealth funds, the FAQ clearly states that "If SWFs and pension funds are deemed to pose no risk to national security, they are eligible for exemption from prior-notification." Furthermore, the FAQ also states that "If SWFs and pension funds invest in listed companies through financial institutions eligible for exemption and do not become shareholders of the listed companies, those SWFs and pension funds do not need to submit prior-notification."

The FAQ also states that the authorities will publicize and update a list of listed companies for which prior notification is unnecessary, as well as listed companies for which prior-notification is required but exemption is applicable, and listed companies for which prior-notification is required and exemption is not applicable. At this time, foreign investors must investigate for themselves in order to find out whether or not a particular stock issue requires prior notification. Publication of a list of this sort will be extremely beneficial.

Furthermore, the FAQ also clarifies the fact that there are no plans to add more industries to the list of industries requiring prior notification in association with the current revisions to the law.

(d) Other issues

Other issues include the following. SWFs and pensions may not receive exemption regarding investments in industries other than those which are "deemed to pose no risk to national security." It is assumed that this includes investments of 1% or more in the following industries: manufacture of weapons, nuclear power, electrical power, communications, etc. Therefore, SWFs and pensions which plan on acquiring shares in any of these industries must handle the investment so as to avoid the ratio of shares or voting rights reaching 1% or more.

4. What to Watch for in the Future

(1) Do these reconsiderations target activist investors?

This reconsideration of the regulations has been criticized as excluding activist investors. However, the FAQ answers to the question "Is the Amendment Bill targeting so-called activists?" that "No, it isn't. The Amendment Bill aims to further promote sound foreign direct investment while preventing leakage of information on critical technologies and disposition of business activities for national security reasons." Gaining the government's approval is not based on whether or not the foreign investor is an activist investor. Government decisions are based on whether or not an investment brings about "leakage of information on critical technologies and disposition of business activities for national security reasons."

However, it is indeed possible that situations of "leakage of information on critical technologies and disposition of business activities for national security reasons" could occur where the foreign investor is an activist. The reason is that an activist investor intends to influence management decisions of the company being invested in. And this could in turn directly or indirectly influence the handling of technical information held by the company being invested in, or its business activities.

The recommendation that the ratio of acquisition of shares of listed companies be lowered from 10% or more to 1% or more came from the interim report of the Ministry of Economy, Trade and Industry's Industrial Structure Council, Trade Committee[7]. The report, dated October 8, 2019, cites the following examples of exercising influence on the management decisions of invested companies as problematic cases of certain foreign countries.

- Investment fund O acquired approximately 1% of the stock shares of company A. Then, after acquiring said shares, demanded that the business strategy of company A be changed, and that they be allowed to assign a new managing director. Ultimately, the top executive of company A resigned, and the managing director of fund O was selected as board director of company A.
- Company P acquired approximately 1% of shares in company B, and then began criticizing the business strategy of company B, requesting a conference with the CEO of company B. As a result, company B decided to consider selling a business unit that had originally been slated for expansion, finally selling off that part of their business the following year.

(2) Issues and measures associated with examination criteria

(a) Issues associated with examination criteria

As was mentioned in part (1), attaining government approval for an investment is not based on the question of whether or not the foreign investor is an activist investor. According to the current foreign exchange law, attaining government approval for an investment (or conversely receiving an order to cease investment) is determined by the question of whether or not said direct inward investment will "impair national security, prevent public order, or interfere with the protection of public safety," as well as whether or not said investment "will have a significant adverse effect on the smooth operation of the Japanese economy" (Foreign Exchange Law Article 27 (3) & (5)). However, these standards are abstract and do not clearly state whether or not each individual investment will be granted government approval.

In principle, the details of government examinations regarding direct inward investments are not made public. However, in 2008, the government issued an order to cease investment in The Electric Power

[7] The report suggests that, considering the fact that there are examples of foreign countries having strong influence on management decisions of invested companies by virtue of exercising shareholder's proposal rights where a ratio of 1% or more of shares is held, the threshold for ratio of shares held requiring submission of prior notification should be reduced to the level of 1% or more.

Development Co., Ltd. (J-Power), a listed company in an industry requiring prior notification of investment. The fund requesting permission to invest was The Children's Investment Master Fund (TCI) located in the British Cayman Islands. In this case, the government order to cease and desist was made public. The examination criteria applied in this case are thought to be a useful reference, and so we have included the outline of said decision as an appendix to this report.

The government considered in this case whether the acquisition of shares by the TCI Fund and its subsequent exercise of shareholder's rights would have influence on J-Power management and planning, operation and maintenance related to its key equipment and whether this in turn would have risk of influencing the nation's stable supply of electricity, as well as national policy on nuclear power and the nuclear fuel cycle. As a result of the government's examination, it was determined that said acquisition of shares "would have risk of influencing the stable supply of electricity, as well as national policy on nuclear power and the nuclear fuel cycle".

In order for the TCI Fund to gain approval for the acquisition of shares in this case, it would have been necessary for the acquisition of J-Power shares and the subsequent exercise of shareholder's rights to show no risk of influencing the stable supply of electricity, as well as national policy on nuclear power and the nuclear fuel cycle in Japan (see appendix). This would have required that the TCI Fund identify items which it would demand through its exercise of shareholder's rights from J-Power management and what kind of direct and indirect influence the demand would have, and demonstrate that those demands would pose no risk of influencing the stable supply of electricity as well as national policy on nuclear power and the nuclear fuel cycle. However, the fact is that it would be difficult to identify indirect influence and demonstrate the absence of risk.

(b) The necessity of clarifying examination criteria

It is assumed that in the TCI Fund case, especially strict examination criteria were applied due to the fact that J-Power's operations were associated with Japan's nuclear power policy. Hence it remains unclear whether the same criteria would also be applied to general cases. In reality, it would doubtless be difficult if not impossible for a so-called activist investor to obtain permission to acquire shares if these same criteria were generally applied.

If the investment in question has problems from the viewpoint of national security, it goes without saying that the government should not grant its approval. However, if the assumption that Japan's national security might be compromised is broadly applied to all industries requiring prior notification when investing, it would of course be difficult for a so-called activist investor to acquire shares, and in the eyes of foreign investors, this could have a negative effect on the process of advancing corporate governance reforms. There is danger here that foreign investors might lose interest in investing in Japan.

Under the current regulations an examination is not required if the acquisition of shares of a listed company is less than 10%. But as a result of the recent reconsiderations, acquisitions of 1% or more will now require a government examination in principle. This may also lead to an increase in the number of cases which must undergo examination. It has therefore become even more important than in the past to avoid this process exceeding a reasonable range and becoming a limiting factor as regards inward direct investment.

It would also be more efficient from the viewpoint of government resources available for the carrying out of examinations if there is more clarification in regard to examination criteria. Moreover, since a broad range of government agencies in addition to the Ministry of Finance takes part in the examinations performed in accordance with the foreign exchange law, it is desirable that uniform criteria be applied. (Depending on the industry, the examination process could potentially include the Ministry of Economy, Trade and Industry, the Ministry of Health, Labour and Welfare, the Ministry of Internal Affairs and

Communications, the National Police Agency, the Ministry of Land, Infrastructure and Transport, the Ministry of Agriculture, Forestry and Fisheries, and the Ministry of the Environment, etc..)

Considering the above factors, further clarification of the examination criteria may be required. In relation to this point, factors which are taken into consideration in the examination of inward direct investment were publicized jointly by the Ministry of Finance and related ministries in August, 2017[8]. It is hoped that the examination criteria will be further clarified in the future by preparing and publicizing a revised version of factors taken into consideration in examinations in light of these recent considerations and by disclosure of information associated with concrete examples of direct inward investment cases which did receive approval.

[8] Factors taken into consideration in the examination of inward direct investment include the following: (1) maintaining the production and technical foundations of industries associated with national security (weapons, aircraft, space industry, and nuclear power), (2) preventing the leakage of sensitive technology associated with machinery considered to be essential to national security, (3) maintaining public activities during normal times and emergencies, (4) maintenance of public safety, (5) in regard to Japan's deferred industries as stipulated by Article 2b of the Code of Liberalization of Capital Movements by the OECD, the maintenance of a stable supply and sufficient stockpile of food and fuel, national land conservation and the continuation of the production activities of domestic industries in the interests of the smooth operation of Japan's economy, (6) attributes of foreign investors and related companies, funding plans, past investment behavior and performance, etc., and (7) any other factors which should be taken into consideration in the examination.

Appendix: Outline of Government Examination of the TCI Fund Acquisition of Shares of the Electric Power Development Co., Ltd. (J-Power)

This case is in regard to the prior notification submitted by the TCI Fund in January 2008 to the Ministry of Finance and the Ministry of Economy, Trade and Industry in relation to its acquisition of 20% of the shares of J-Power, a listed company operating in an industry which requires prior notification.

In this case it was determined by the Ministry of Finance and the Ministry of Economy, Trade and Industry that, based on the past investment policy and investment behavior[9] of the TCI Fund that acquisition of stock shares by said fund could influence the management and operations of J-Power.

It was also determined that by acquiring stock shares of J-Power and exercising its shareholder rights, the TCI Fund could have influence on management and the planning, operation and maintenance related to key equipment of J-Power and in turn could influence the nation's stable supply of electricity, as well as national policy on nuclear power and the nuclear fuel cycle.

In response to these points, the TCI Fund insisted that it had no intention of hindering the stable supply of electricity in Japan, or national policy associated with nuclear power and the nuclear fuel cycle, and would make no shareholder proposals that might do so. However, the Ministry of Finance and the Ministry of Economy, Trade and Industry responded that, based on the fact that the TCI Fund had not clearly stated how J-Power management would achieve the business objective which the TCI Fund indicated, they had determined that there was risk that the investment could influence the nation's stable supply of electricity, as well as national policy on nuclear power and the nuclear fuel cycle[10]. (It is assumed that in order to demonstrate that there would be no risk of influencing the nation's stable supply of electricity as well as national policy on nuclear power and the nuclear fuel cycle, the TCI Fund had to concretely identify how J-Power management would achieve the said objective and demonstrate that there would be no risk posed as a direct or indirect result when the objective was realized.)

Considering the above, the Ministry of Finance and the Ministry of Economy, Trade and Industry issued a recommendation that the TCI Fund halt its plans on investing, but TCI rejected the recommendation. Therefore, an order to cease and desist was issued. (This is the only case in which an order to cease and desist was issued.)

[9] Concretely speaking, it was determined that the policy of the TCI Fund took aggressive actions in some situations in relation to the company being invested in in order to increase shareholder value. For instance, putting pressure on the management of the company being invested in, or in some cases making a proxy solicitation.

[10] In the process of this examination, the TCI Fund demanded that the management of J-Power take the responsibility to explain setting management indicators (or business plan) and how targets would be reached, but since they did not indicate clearly how this would be realized, it was concluded that there could be direct or indirect influence resulting from the TCI Fund's demands. For instance, construction of the Oma Nuclear Power Plant could be suspended or suffer a major delay in schedule, or the reduction of capital investment and repair costs related to core facilities, and this could influence the nation's stable supply of electricity, as well as national policy on nuclear power and the nuclear fuel cycle.