

31 March 2020 (No. of pages: 8)

Japanese report: 18 Mar 2020

Proposal of Rules and Regulations Regarding Foreign Exchange & Foreign Trade Act Announced

Exemption from prior notification now applicable to investments by SWFs in core sectors such as nuclear power

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Summary

- On March 14 the Ministry of Finance announced a proposal of an amendment to Rules and Regulations regarding the revised Foreign Exchange & Foreign Trade Act. Revisions were made to the Foreign Exchange & Foreign Trade Act in November last year. The criterion necessitating prior notification when a foreign investor acquires the stock of a listed company in a designated business sector was lowered to 1% of the company's stock. At the same time, a system of exemption from prior notification was introduced. The revisions are expected to be implemented in May.
- According to past explanations of the Ministry of Finance, exemption from prior notification was not granted to sovereign wealth funds (SWFs) or public pension funds when they invested in core sectors such as nuclear power and electric power. There was therefore concern that SWFs and other investors would hesitate to invest in any of the core sectors, thereby negatively influencing stock prices.
- This latest proposal for revision of the Rules and Regulations would provide exemption from prior notification up to a certain limit in the above described situation (however with certain additional conditions). We can therefore assume that the concerns above have been for the most part resolved.

1. Announcement of Proposal of Rules and Regulations Regarding Foreign Exchange & Foreign Trade Act

On March 14 the Ministry of Finance announced a proposal of an amendment to the Rules and Regulations regarding the revised Foreign Exchange & Foreign Trade Act (referred to hereinafter as the Foreign Exchange Act), as well as a notification revision plan and background explanation materials (available in English also). (The Ministry is accepting opinions until April 12.)¹

The Foreign Exchange Act stipulates regulations associated with inward direct investment. It requires foreign investors to submit a prior notification in cases where they plan on obtaining 10% or more of shares of a listed company in designated business sectors, which is to be reviewed by the government. Revisions were made to the Foreign Exchange Act in November last year. The criterion necessitating prior notification when a foreign investor acquires the stock of a listed company in a designated business sector was lowered to 1% of the company's stock. At the same time, a system of exemption from prior notification was introduced.

Lowering the criterion for prior notification according to the Foreign Exchange Act means that cases requiring prior notification and government review will increase. This has brought about fears that investments by foreign investors, who account for 70% of the total amount traded in stocks listed on the TSE², and 30% in ownership ratio³, will be hindered, thereby negatively influencing stock prices. However, the proposed Rules and Regulations widens the range of exemptions from prior notification, making it more liberal than past explanations of the Ministry of Finance, hence resolving these concerns.

2. Overview of the proposal of the Rules and Regulations

(1) Range of exemption from prior notification

According to the current law, foreign investors are required to carry out prior notification and undergo a government examination if they acquire 10% or more of shares of a listed company which is a member of one of the designated business sectors. Designated business sectors are listed below.

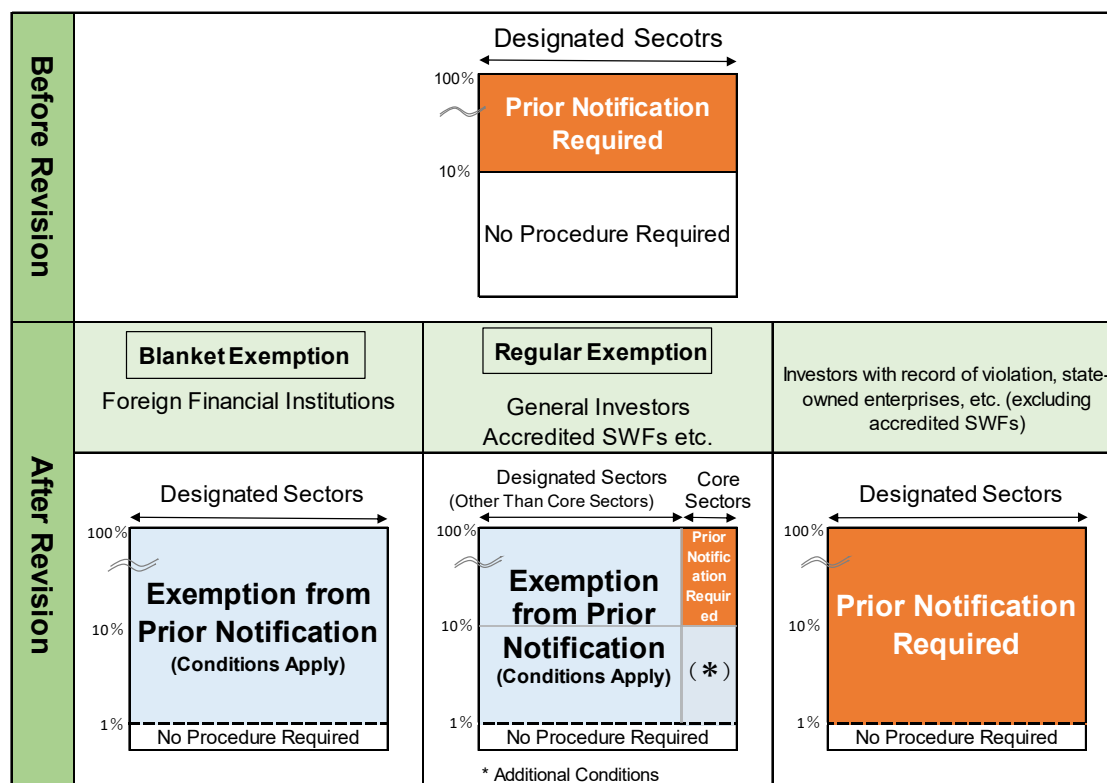
- (1) National safety related: weapons, aircraft, nuclear power, space industry, industries manufacturing products which can be diverted to military use, cyber security.
- (2) Public services and systems related: gas & electricity, heat, communications, broadcasting, water, railways, transportation.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

After the law is revised, foreign investors will be required to carry out prior notification if they acquire 1% or more of shares of a listed company which is a member of one of the designated business sectors, unless said investor qualifies for an exemption. The range of applicability of the system of exemption from prior notification depends on the type of foreign investor (Chart 1).

¹ The Ministry of Finance website, (https://www.mof.go.jp/english/international_policy/fdi/20200314.htm)

² According to the Tokyo Stock Exchange "Trading Value of TSE 1st Section Stocks by Investor Type," foreign investors accounted for 73.3% of annual trading value in 2019.

³ According to the Tokyo Stock Exchange, the Nagoya Stock Exchange, the Fukuoka Stock Exchange, and the Sapporo Securities Exchange "FY2018 Share Distribution Survey," foreign corporations had a shareholding ratio of 29.1% as of the end of fiscal 2018.



Source: Ministry of Finance material (March 2020); compiled by DIR.

Foreign financial institutions who fulfill the conditions described in (2) (a) – (c) are not required to carry out prior notification (blanket exemption). Investors who have undergone sanction in the past for violation of the Foreign Exchange Act, and state-owned enterprises are not eligible for exemption.

All others not falling under the above descriptions, such as general investors, etc. (Chart 1, lower center), are not required to carry out prior notification in acquiring 1% or more of shares of a listed company which is a member of a designated business sector other than one of the core sectors if they fulfill the conditions shown below in (2) (a) – (c). On the other hand, if a general investor acquires 1% or more of shares of a listed company which is a member of one of the core sectors, they must also fulfill additional conditions as described below in (2) (d) – (e). If they can fulfill these conditions, prior notification is unnecessary up to 10% of shares (regular exemption). This is a significant change from the old explanatory materials of the Ministry of Finance⁴, which explained that in the case of core sectors, investors other than foreign financial institutions were not eligible for the exemption from the prior notification requirement.

(2) Conditions which must be fulfilled in order to be eligible for exemption

Foreign investors must strictly uphold the following three conditions in order to be granted exemption from the requirement to carry out prior notification.

- (a) Foreign investors or their closely-related persons (explained further below) will not become board members of the investee company;
- (b) Foreign investors will not propose to the general shareholders' meeting transfer or disposition of investee company's business activities in the designated business sectors; and
- (c) Foreign investors will not access non-public information about the investee company's technology in relation with business activities in the designated business sectors (explained further below).

⁴ Ministry of Finance, "Amendment Bill of the Foreign Exchange and Foreign Trade Act" (revised Oct. 21, 2019).

However, in the case of investment in core sectors, in order for foreign investors other than financial institutions to gain eligibility for exemption from the requirement of prior notification, the additional conditions shown below must also be fulfilled.

- (d) Regarding business activities in core sectors, the foreign investors will not attend the investee companies' committees that make important decisions in these activities.
- (e) Regarding business activities in core sectors, the foreign investors will not make proposals, in a written form, to the executive board of the investee companies or board members requiring their responses and/or actions by certain deadlines.

Overview of Exemption from Prior Notification Chart 2

Type of Investor	Conditions for Exemption		
Foreign Financial Institutions	Blanket Exemption	Foreign investors who strictly uphold conditions described in (2) (a) – (c) above are exempt from prior notification. (No maximum limit)	
General Investors (Including accredited SWFs)	Regular Exemption	Designated business sectors other than core sectors	Foreign investors who strictly uphold conditions described in (2) (a) – (c) above are exempt from prior notification. (No maximum limit)
		Core sectors	Foreign investors who strictly uphold conditions described in (2) (a) – (e) above are exempt from prior notification on up to 10% of shares.
Investors who have undergone sanction in the past for violation of the Foreign Exchange Act, and state-owned enterprises (Excluding accredited SWFs)	Not eligible for exemption from requirement to carry out prior notification.		

Source: Ministry of Finance material (March 2020); compiled by DIR.

(3) Handling of SWFs, etc.

As was explained earlier, in principle, state-owned enterprises are not exempt from prior notification. However, SWFs and public pension funds which do not threaten to impair national security, are eligible for the exemption program (regular exemption), as long as they have been granted individual accreditation by the Ministry of Finance.

The Ministry of Finance carries out the following examination before granting accreditation (whether or not accreditation has been granted is not publicized).

- (1) Investment activities of the SWFs are only for economic returns; and
- (2) Investment decisions by the SWFs are made independently of their governments.

(4) The scope of foreign financial institutions

As was explained previously, procedures for foreign financial institutions are simpler than they are for other foreign investors, because foreign financial institutions are not required to submit prior notification as long as they fulfill the stated conditions. For this reason many foreign investors have shown an interest

in how the scope of what are called “foreign financial institutions” here is defined, in hopes that their own organization might gain recognition as a financial institution.

According to the proposed Rules and Regulations, “foreign financial institutions,” which are eligible for blanket exemption, are defined as follows. Foreign financial institutions are organizations which fall under the regulatory controls and supervision as financial institutions in their country of origin except high-frequency trading firms (HFT) .

- ◆ Foreign financial institutions of the types listed below, and which are regulated and supervised under financial regulatory laws in Japan or other jurisdictions are defined as “foreign financial institutions.”
- (1) Securities companies
 - (2) Banks
 - (3) Insurance companies
 - (4) Asset management firms
 - (5) Trust companies
 - (6) Registered corporate-type investment trusts
 - (7) High-frequency trading firms*

* Limited to those stipulated by Japan’s Financial Instruments and Exchange Act.

(5) Definition of terms in conditions for exemption from prior notification

a. “Closely-related persons”

As was explained earlier, it is stipulated in the conditions for exemption from prior notification that “foreign investors or their closely-related persons will not become board members of the investee company.” Since there are often cases where a foreign investor proposes the appointment of an officer to encourage more efficient management, interest has been expressed in the concrete definition of “closely-related persons” as it is used in the conditions.

According to the proposed Rules and Regulations, the scope of “closely-related persons” is stipulated as illustrated in Chart 3.

Definition of “Closely-Related Persons”

Chart 3

Scope of “closely-related persons” of a foreign investor	①Nomination is made by the foreign investor itself (includes nominations made by a third party on behalf of the foreign investor)			②Nomination is made by a third party (including the investee company) (Note 1)		
	Board member of the foreign investor	Employee of the foreign investor	Member of the foreign investor’s committee that has authority on investment decisions	Board member of the foreign investor	Employee of the foreign investor	Member of the foreign investor’s committee that has authority on investment decisions
The foreign investor (if company)	○	○	○	○	×	○
Its subsidiaries, second-generation subsidiaries, parent companies, or grandparent companies	○	○	○	○	×	○
Its other family companies such as uncle/aunt companies, cousin companies, brother/sister companies, or nephew/niece companies	○	○	○	○	×	×
The foreign investors’ business partners	○	○	○	×	×	×
Persons who receive substantial amount of financial rewards and/or other assets from the foreign investor	○			×		
Persons who were in the status of the above categories in the previous one year	○			○		
Spouse of the foreign investor (if natural person)	○			○		
Lineal ascent or descent of the foreign investor (if natural person)	○			○		
Persons (or their closely-related persons) who have agreement with the foreign investor to jointly exercise voting rights	○			○		

Source: Ministry of Finance material (March 2020); compiled by DIR.

Notes: 1) On-the-spot nomination at a shareholder’s meeting is not subject to the prior-notification requirement.

2) If the foreign investor is a state-owned enterprise, “closely-related persons” include members of the state’s central government, local governments, government agencies, central bank or political parties.

b. “Access to Non-public Information about the Investee Company’s Technology”

As was noted earlier, one of the conditions for obtaining exemption from prior notification is “Foreign investors will not access non-public information about the investee company’s technology in relation to business activities in the designated business sectors”. The definition of the phrase, “access non-public information about the investee company’s technology” is presented below.

- ◆ Obtaining confidential technology-related information managed by the investee company’s sections that conduct business activities in the designated business sectors (Notes 1 & 2)
- ◆ Requesting disclosure of confidential technology-related information (Note 2)
- ◆ Requesting a change in the investee company’s internal rules on the treatment of confidential technology-related information (Note 2)

Note 1: The case where the investee company voluntarily provides such information to the foreign investor does not constitute a breach of this exemption condition.

Note 2: The followings do NOT constitute confidential technology-related information:

- Information about employment terms or remuneration of board members and employees
- Financial information

(6) The scope of core sectors

The scope of core sectors is stipulated as shown below in Chart 4.

Scope of Core Sectors		Chart 4
Areas	Scope is narrowed to those truly necessary for national security	
Weapons	All	
Aircrafts	All	
Space	All	
Nuclear facilities	All	
Dual-use technologies	All	
Cybersecurity	<ul style="list-style-type: none"> • Cybersecurity-related service (e.g. network security monitoring, software) • Service providers of the program designed for critical infrastructures 	
Electricity	<Electricity Business Act> <ul style="list-style-type: none"> • General Electricity Transmission and Distribution Utility • Electricity Transmission Utility <Armed Attack Situations Response Act> <ul style="list-style-type: none"> • Electricity Generation Utility companies that own a power plant with maximum generation capacity of 50,000KW or more 	
Gas	<Gas Business Act> <ul style="list-style-type: none"> • General Gas/Specified Gas Pipeline Service Providers • Gas Manufacturers <Oil Stockpiling Act> <ul style="list-style-type: none"> • LP Gas companies that own a storage facility or core cylinder filling station 	
Telecommunications	<Telecommunications Business Act> <ul style="list-style-type: none"> • Telecommunication carriers that provide service across multiple local municipalities 	
Water supply	<Water Works Law> <ul style="list-style-type: none"> • Water Supply companies supplying to more than 50,000 people • Bulk Water Supply companies with a capacity of supplying over 25,000m³ per day 	
Railway services	<Armed Attack Situations Response Act> <ul style="list-style-type: none"> • Railway Service companies operating public facilities/infrastructures which are stipulated under the Armed Attack Situations Response Act 	
Oil	<ul style="list-style-type: none"> • Oil Refinery, Oil Storage Business, Crude Petroleum and Natural Gas Production 	

Source: Ministry of Finance material (March 2020); compiled by DIR.

(7) Future schedule

Future schedule (tentative) is as shown below in Chart 5.

Future Schedule (Tentative)		Chart 5
March 2020	Launch of public consultation on the proposed Rules and Regulations (for 30 days)	
End April	Authorization of the amended Rules and Regulations List of companies' classification made public (note)	
End April / Early May	Promulgation of amended Rules and Regulations.	
May	Entry into force of amended law, Rules and Regulations (applied 30 days later)	

Source: Ministry of Finance press release (March 2020); compiled by DIR.

Note: The list of stock issues is separated into categories: listed companies operating businesses in core sectors, designated business sectors other than core sectors, and business sectors other than the designated business sectors.

As indicated in Chart 5, even if the amended law is implemented in May, it will not be applied until 30-days later. Hence the 1% rule will apply to stock purchases 30-days or more after the implementation date.

3. Stock Market Influence

(1) Influence on the stock market is expected to be limited

As was mentioned previously, the old explanatory materials of the Ministry of Finance, in the case of core sectors, indicated that foreign investors other than foreign financial institutions were not eligible for the exemption from the prior notification requirement. Therefore, it was assumed that when sovereign wealth funds (SWFs) invest in core sectors, they are not granted exemption from prior notification and are required to go through the prior notification and examination procedures.

SWFs and public pension funds manage huge amounts of capital, and hence, if a company invested in is small in scale, the ownership ratio can easily exceed 1% in some cases. There was therefore concern that if complex procedures would be required each time this situation is occurred, SWFs and public pension funds might hesitate to invest in any of the core sectors, thereby negatively influencing stock prices.

According to the proposed Rules and Regulations, if an SWF or a public pension fund fulfills the conditions (including additional conditions), and obtains accreditation, they will be exempt from the prior notification requirement up to an ownership level of 10%. The above concerns have therefore been resolved, and influence on the stock market is therefore considered to be limited. The focus in the future will be the question of whether or not each SWF and similar investor will be able to obtain accreditation from the Ministry of Finance under the above mentioned examination criteria. (Note: the results of the examination process will not be made public.)

(2) Influence on corporate governance

One of the criticisms of the amendment is that it might reverse the current trend toward strengthening corporate governance. The reason is that in order to gain exemption from prior notification, foreign investors must fulfill the stated conditions, hence foreign investors, including related parties, cannot be appointed as officers of a company being invested in, and foreign investors may not propose transfer or disposition of business activities in the designated business sectors of a company to the general shareholders' meeting.

Particularly general investors including SWFs who have gained accreditation must fulfill additional conditions in order to gain exemption from prior notification in the case of investments in core sectors. Concretely speaking, as regards business activities in core sectors, the foreign investor may not participate in committees with significant decision-making authority, or make a proposal in writing to the executive board of the investee companies or board members requiring their responses and/or actions by certain deadlines.

These are conditions for gaining exemption from prior notification, but that does not mean that foreign investors are forbidden from carrying out these actions. However, for foreign investors who manage large amounts of funds, such as SWFs and public pension funds, the requirement of undergoing the above described procedures is itself a factor hindering investment. For this reason, there may be situations in which foreign investors avoid these actions or behaviors, and in doing so place constraints on dialogue between corporations and investors.