Newsletter

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The bill to implement the new prior notification rule was submitted to the Diet

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We have reported on the new prior notification rule in our earlier A&S Newsletters released on October 10, 2019 (URL: *https://www.aplaw.jp/Newsletter_AS_007.pdf*) and October 25, 2019 (URL: *https://www.aplaw.jp/Newsletter_AS_008.pdf*) respectively.

On the date when we released the second Newsletter on October 25, the Ministry of Finance further made announcement to clarify more details of the prior notification rule.

This Newsletter is intended to update the contents of our October 25 Newsletter referring to our observation of the additional details of the prior notification rule clarified by the MOF announcement made on October 25.

For the convenience of our valued readers, paragraph 1. and sub-paragraph 2. (1) of this Newsletter reviews the framework of the new prior notification rule that was discussed in the October 25 Newsletter. Most of our updates are reflected in the rest of the paragraphs in this Newsletter.

1. The bill to implement the new prior notification rule was submitted to the Diet

On October 18, 2019, the Abe administration submitted to the Diet a draft bill that amends the prior notification rules under the Foreign Exchange and Foreign Trade Act (the "FEFTA") applicable to inward investments by foreign investors.

According to the Ministry of Finance (the "MOF"), which is the government agency in charge of these amendments, the amendments contemplated in the bill would require, unless an exemption applies, foreign investors to file a prior notification if they plan to buy 1 percent or more of the shares or voting rights in companies engaging in sensitive businesses, compared with the current threshold of 10 percent.

The framework of such amendments was announced by the MOF on October 8, 2019 following sign-off by the Council on Customs, Tariff, Foreign Exchange and Other Transactions.

Overseas investors negatively reacted to the proposed amendments warning that the amendments would discourage foreign investments into the Japanese capital markets impeding Japanese companies' ability to raise capital and also undermine the positive momentum in market reforms.

In response to the criticism from the overseas investors, on October 18, the MOF made an announcement to clarify the outline of the amendments announced on October 8 and then on October 25 made a subsequent announcement to further clarify the outline of the amendments (collectively, the "MOF Announcements") [1].

According to the MOF Announcements, investment managers and certain other financial institutions are exempt from the new prior notification rule in the bill.

However, the MOF Announcements still contemplate that the exemption is NOT available to investors that undertake a director position or make proposals regarding important management matters in a shareholder meeting of the issuer corporation.

The following is a summary of the key points of the bill. You will see that in the bill, only little of the new prior notification rule is incorporated as a "done deal" and a substantial portion of the rule is yet to be specified in the Cabinet Order, Ministerial Ordinance and Official Public Notice to implement the amended FEFTA (collectively, the "Orders"). The drafts of the Orders will be made public only after the bill is approved by the Diet, with changes if any.

2. Outline of the bill

(1) The framework of the bill

According to the MOF, the bill is intended to achieve two different objectives.

One is to facilitate "portfolio investments" of foreign investors by exempting them from the prior notification requirement.

The other objective is to tighten review of foreign investments in sensitive industries that are important for the protection of the national security (e.g. nuclear power, weapons, and cyber security), public order (e.g. utilities, transportation and broad casting), public security (e.g. manufacturing biological preparations and security services) or the smooth operation of economy (e.g. agriculture, forestry and fishery, petroleum, air transport).

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[1] See Explanatory material and FAQ prepared by the MOF at: *https://www.mof.go.jp/english/international_policy/fdi/20191021.html*

To these ends, the bill contemplates to (A) reduce the threshold for prior notification from the current 10 % to " no less than 1 %" which threshold shall be specified in the Cabinet Order; but (B) introduces exemptions from the prior notification requirement which exemption shall be specified in the Cabinet Order (see our discussion in 2. (2) below) whilst (C) clarifying that the exemption is not available if the investor (i) has a previous record of being subjected to an administrative order of the Japanese government due to an offence of the FEFTA or otherwise falls in a "watch" list category as specified under the Cabinet Order (according to the MOF Announcements, state-owned enterprises would be included in this category); (ii) intends to invest in the industries that are important for the national security as specified in the Cabinet Order (according to the MOF Announcements, such industries would include nuclear power, weapons, electricity and telecoms OR (iii) does not agree to abide by certain conditions which shall be specified in the Cabinet Order (according to the MOF Announcements, such conditions would include agreement to refrain from assuming a director position, making a proposal to assign or close an important business at the shareholders' meeting or having access to confidential technology-related information.).

The amendment (B) will facilitate portfolio investments of foreign investors including those that intend to cross the "no less than 1 % " threshold but do not intend to engage in the activities that may influence management of the issuer companies.

The amendments (A) and (C) will enable the government to scrutinize the proposed investments in smaller proportions and, in an extreme case, suspend the investment if the issues identified during the review process are not resolved. [2]

(2) General exemption from the prior notification requirement applicable to acquisition crossing the 1% threshold

Regarding the exemption (B) mentioned in (1) above, the MOF Announcements make it clear that under the Cabinet Order, investors that do not fall within any of the disqualifying categories (C) (i) through (iii) above will be eligible for exemption from a prior notification requirement that otherwise would apply to them if their holdings cross the "no less than 1 % " threshold in a company within a sensitive industry.

Conversely, the exemption (B) mentioned in (1) above will be denied if the investor crossing the "no less than 1 % " threshold falls within one of the disqualifying categories.

As an exception to this rule to deny the exemption, the MOF Announcements state that ,foreign fund managers engaging in investment management activities and financial institutions trading for their own proprietary accounts (collectively, the "Managers") will be exempt from the prior notification requirement regardless of the industries in which their proposed investments are made, even if the investee companies engage in the business in the industry of (C) (ii) category.[3]

However, like other foreign investors, the MOF Announcements also indicate that this exemption available to the Managers will be denied if they make the proposals that are mentioned in (C) (iii) above. It means that the Managers that fall within either of the disqualifying categories (C) (i) or (iii) above will be denied the exemption from the prior notification requirement applicable to the investments that cross 1 % threshold, though the disqualifying category (C) (ii) is irrelevant

(3) Another prior notification requirement applicable to "consent" to important management matters

It is also notable that the bill tightens current prior notification requirement applicable to a foreign investor that (a) has no less than 1/3 of the voting shares of an issuer corporation and (b) grants its consent to a change in a business objective of the issuer corporation.[4]

The bill contemplates to (A) lower the current threshold of a holding ratio from 1/3 to "no less than 1 %" which shall be specified in the Cabinet Order and also (B) expand the scope of the activities subject to the prior notification to include granting consent to a proposal on matters that have material impact on the management of the business of the issuer corporation as specified in the Cabinet Order as well as the consent to a change in a business objective of the issuer corporation as stipulated in the current FEFTA. According to the MOF Announcements, those matters would include a proposal on assumption of a director position by the investor and a proposal to assign or close an important business at the shareholders' meeting.

Given the wide scope of the matters that trigger a prior notification, if the Japanese government intends to reduce the threshold from 1/3 to 1 % in the Cabinet Order, it appears to be a significant change. According to the MOF Announcements, the exemption similar to the one available to the Managers discussed above regarding their investments crossing "no less than 1 %" threshold are unlikely to be made applicable to this prior notification requirement under the Orders.

(4) Deregulations relating to investments by a fund formed as a partnership

Under the current FEFTA, each of the General Partner and limited partners of a fund that is formed as a Japanese partnership (Kumiai) under the Japanese laws or a similar partnership formed under a foreign jurisdiction is deemed to hold shares of a Japanese listed company held in the portfolio of the fund in proportion to its equity interest in the fund and is obligated to file prior notification if its deemed shareholding reaches the 10 % threshold.

This is because such a partnership is not regarded as a legal entity under Japanese laws and is regarded as a pass-through entity for the purpose of determination of legal ownership of its assets under Japanese laws.

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[2] In reality, there is only one case where a proposed foreign investment was suspended by the government as per the FEFTA. It was the case where TCI (The Children's Investment) was subjected to the government order to suspend its proposed purchase of additional shares of J Power in 2008 to increase its holdings in excess of the 10 % threshold.

[3] The exact categories of the Managers eligible for exemption are not clear yet. Presumably, registered Managers will be eligible, but those that are not registered by a competent authority may not be eligible.

[4] "grants its consent " in this context is in the current practice interpreted as voting to affirm a proposal to amend the articles of incorporation of the issuer company to change a business objective of the corporation in a shareholder meeting.

The bill releases them from their filing obligations and, instead, obligates their fund to file prior notification. This proposed amendment will apply to a foreign fund if the foreign fund is formed as such a partnership similar to a Japanese partnership (Kumiai) and its shareholding as a whole reaches the threshold which will be no less than 1 % as specified under the Cabinet Order. A fund formed as a partnership is regarded as a foreign fund for the purpose of application of this rule and will be subjected to such new filing requirement if no less than a half of its equity interests are owned by foreign investors or its General Partner is a foreign investor.

3. Next Steps

As briefly discussed in 2. above, only a little of the new prior notification rule is incorporated in the bill as a "done deal" and a substantial portion of the rule is yet to be specified in the Orders.

The Managers that engage or may engage in activities to make proposals to issuer corporations should closely follow the discussion in the Diet of the bill.

If they wish to engage in a dialogue with the MOF, METI and/or other government agencies to discuss the contents of the bill and Orders, we believe that key subject matters would include, among other things, the following three issues:

(a) the scope of the disqualifying category 2.(1) (C) (iii) that make the exemption unavailable to the Managers

Foreign Managers may wish to discuss if the investor's "agreement to refrain from assuming a director position" in 2.(1) (C) (iii) would/could be limited to the case where the issuer company's business falls in a (C) (ii) industry AND the investor is a competitor or otherwise a strategic investor as opposed to an investment fund or other portfolio investors seeking investment return only as opposed to acquisition of technology or business of the company.

Foreign Managers may also wish to discuss if "making a proposal to assign or close an important business at the shareholders' meeting" in 2.(1) (C) (iii) would/could be limited to the case where the proposal to "assign or close an important business" is about the business of the issuer company in (C) (ii) industry AND the assignment is to, or the closure is effectively for the benefit of, an enterprise of a certain country specified in a list designated by the relevant Ministerial Ordinance pursuant to the FEFTA with respect to which export of a sensitive product or technology important for the national security is subjected to strict scrutiny.

For the sake of clarity, it may also be sensible to discuss if "making a proposal to assign or close an important business at the shareholders' meeting" could be limited to the ones that require an affirmative voting of a special majority in a shareholder meeting under the Japanese Company Act (i.e. no less than 2/3 of voting rights at present at a shareholder meeting).

(b) the scope of matters and threshold of a holding ratio that triggers a prior notification requirement in case a foreign investor grants a consent to matters that have material impact on the management of the business of the issuer corporation (see our discussion 2. (2) above)

Issues that the foreign Managers may wish to discuss on this subject will be substantially similar to those discussed in (a) above except that the Managers may wish to discuss that for the sake of clarity the "consent" at issue would/could be limited to an actual (not only potential) affirmative voting by the investor of its own shareholder proposal submitted at a shareholder meeting.

(c) the request for a list of listed corporations in sensitive industries with respect to which foreign investments may be subjected to a prior notification requirement.

Currently, there is no such list. It is usually difficult for foreign investors to determine applicability of the prior notification requirement based on the analysis of the type of business that a target company engages in.

The MOF Announcements promise that the MOF will announce such a list. Assuming that such a list will not be updated on a daily or weekly basis, foreign investors may wish to discuss if they could rely on the list and not be subjected to penalty if they proceed with a contemplated investment relying on the list, even if that list is outdated and the target company actually engages in a business in a sensitive industry.

Akio Kawamura > *View profile*
Attorney (Bengoshi), Japan
Partner
E: akio.kawamura@aplaw.jp

Ryuichi Nozaki > *View profile*
Attorney (Bengoshi), Japan
Partner
E: ryuichi.nozaki@aplaw.jp