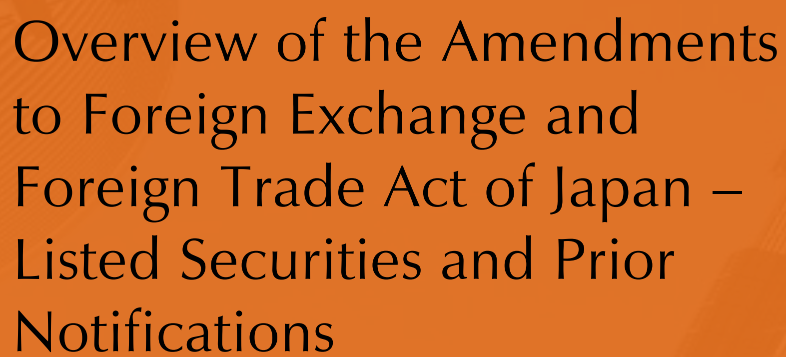

Overview of the Amendments to Foreign Exchange and Foreign Trade Act of Japan – Listed Securities and Prior Notifications

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Introduction

From its initial promulgation on November 29, 2019 to its eventual enactment on May 8, 2020, the amendments to the Foreign Exchange and Foreign Trade Act of Japan (Act No. 228 of 1949, the "**FEFTA**") has gone through substantial changes in its proposed scope and effect. The aim of the amendments to the FEFTA (the "**Amendments**") is to provide additional surveillance by the Japanese government on investments by foreign investors into Japanese companies which may pose risks to the national security of Japan whilst still ensuring that foreign investors are not unduly restricted with respect to their investments into Japan.

The Amendments became effective as of May 8, 2020 and are currently subject to a thirty-day transition period with the Amendments being fully effective on June 7, 2020.

This client alert ("**Client Alert**") is not intended to be a comprehensive summary of the full scope of the Amendments. Instead, this alert will be a first of a series of client alerts issued by Withers' Japan Investment Funds team on the Amendments, with each client alert covering a specific aspect of the Amendments as applicable to foreign fund managers.

This client alert will be an overview of the application of the Amendments to foreign fund managers trading listed securities and the circumstances which may require a foreign fund manager to submit a "prior notification of stock purchase" to the Bank of Japan in relation to its contemplated investment into Japanese companies ("**Prior Notification**"). However, this alert will not cover the new rules applicable to foreign investors in connection with post investment notifications nor the rules and regulations in relation to the investments by foreign investors in unlisted equities. In subsequent client alerts, we do hope to cover the various issues around the Amendments.

For the purposes of illustrating the analysis regarding whether a foreign entity may be subject to the reporting rules under the Amendments with respect to Prior Notifications, as well as which exemptions may be available, please kindly refer to the diagram flowchart at the end of this Client Alert.

A. The Default Rule on Prior Notifications

Under the Amendments, as a default rule, a foreign investor (a "**Foreign Investor**") may be required to submit a Prior Notification to the Japanese government via the Bank of Japan, when the Foreign Investor makes a Foreign Direct Investment in a Japanese listed company ("**Listed Company**") that operates within a Designated Business Sector.

1. The Foreign Investor

The definition of a Foreign Investor includes, but is not limited to: (1) companies domiciled outside of Japan;[1] (2) subsidiaries of a Japanese company; and (3) Japanese companies where 50% or more of the shares are held by non-Japan-resident individuals or foreign companies.

As a matter of default, the legal owner of the shares of the Listed Company will be subject to this analysis as to whether such entity is a Foreign Investor. As such, for foreign fund managers ("**Fund Manager**"), the relevant investment fund managed by the Fund Manager which also holds the shares ("**Investment Fund**") will be subject to this analysis, provided, however, an Investment Fund may be removed from this analysis as further discussed in Part A.2 below (please see with respect to "Foreign Direct Investments – New Threshold"). However, as Investment Fund typically

[1] This would include foreign companies which have a Japan branch where the Japan branch also engages in a Foreign Direct Investment (as defined below).

delegates its investment management authority to a Fund Manager (including the rights to vote on the shares), it is necessary to consider the applicable reporting obligations to the Fund Manager and each managed Investment Fund.

2. Foreign Direct Investment – New Threshold

The full scope of activities engaged in by a Foreign Investor that is classified as "**Foreign Direct Investments**" is quite broad, but for the purposes of this Client Alert, we will focus primarily on the acquisition of shares.

Prior to the Amendments, an acquisition of shares of a Listed Company was deemed to be a Foreign Direct Investment, if the shareholding of the Foreign Investor would be 10% or more after the acquisition. In such cases, the Foreign Investor may be required to submit a Prior Notification if the Listed Company is engaging in a business in a Designated Business Sector (as further discussed in 3. below).

However, the Amendments lowered the foregoing 10% shareholding threshold with respect to making a Prior Notification to 1%.

(1) Calculation of Shareholding

In addition to the lowering of the threshold, the manner of calculation of the 1% threshold was also further amended. Under the Amendments, each shareholding of a Foreign Investor is calculated as the aggregate of the respective shareholding of the following entities:

1. the Foreign Investor;
2. each Closely Related Person of the Foreign Investor; and
3. any party that has been delegated both investment authority and voting authority from a subject that falls into 1 or 2 above.

It is important to note that within the scope of parties caught within the definition of "**Closely Related Persons**" includes parent company, subsidiaries, and other affiliated entities (including their respective directors), provided that any Japan residents or Japan domiciled entities may be excluded.

(2) Fund Managers and Investment Funds

At this point in the Client Alert, we will briefly discuss Foreign Direct Investment analysis as applicable to Fund Managers and Investment Funds.

As discussed above, as a general matter, the Investment Fund, as the legal owner of the shares of the Listed Company, will be deemed to be the subject of this analysis regarding the Prior Notification. However, under the Amendments, if the Investment Fund has delegated both investment management authority with respect to sale or purchase of the shares of the Listed Company as well as the rights to exercise the rights of the shares (including voting rights) to the Fund Manager, the Investment Fund will not be deemed to engaging in Foreign Direct Investment even if the Investment Fund will exceed the 1% threshold. Instead, as a result of the delegation of authority by the Investment Fund, it will be the Fund Manager that will be deemed to be engaging in the Foreign Direct Investment.

In other words, provided that the Investment Fund has fully delegated both its investment management authority as well as the voting rights with respect to the shares to the Fund Manager, only the Fund Manager may be required to submit the Prior Notification irrespective that the Fund Manager is not the legal owner of the shares.

As a cautionary point on practical aspect of this analysis, we do recommend that attention be paid to investment fund structures or documentation whereby the Fund Manager is not granted full investment authority and/or voting rights with respect to the shares held by the Investment Fund. If the Investment Fund retains any such authority or if such authority is shared between the Investment Fund and the Fund Manager, the Investment Fund may be deemed to be engaging in a Foreign Direct Investment and subject to the filing requirements of a Prior Notification subject to the other requirements being met.

3. Designated Business Sector

The scope of businesses which falls under a "**Designated Business Sector**" has been revised under the Amendments. While the scope of businesses are still related to the national security of Japan or matters of public, the scope includes industries such as broadcasting, public transportation and agriculture.

It is important to note that if the Listed Company's business is not related to the industries classified as a mentioned in the Designated Business Sector, as a default rule, the Foreign Investor will not be required to submit a Prior Notification in connection with its acquisition of shares in such Listed Company.

B. Exemptions to the Prior Notification Requirement

1. Conditions to Rely on the Exemptions

While the application of the Amendments appear to be more demanding due to the lowering of the threshold from 10% to 1%, the Amendments also introduced various avenues by which a Foreign Investor may be exempt from having to submit a Prior Notification. However, to be able to rely on any of the prescribed exemptions set forth in Part B.2 below, the Foreign Investor must meet the following two conditions.

(1) Disqualified Foreign Investor

Certain types of Foreign Investors will be disqualified from relying on the exemptions due to their own status ("**Disqualified Foreign Investors**"). Disqualified Foreign Investors will include, but not be limited to, Foreign Investors that have been sanctioned due to a violation of the FEFTA in the past five (5) years or the investors that are foreign state-owned entities or controlled by foreign governments, etc.

(2) The Passive Shareholder Requirements

A second condition for a Foreign Investor to rely on an exemption from the Prior Notification requirement is that the Foreign Investor must meet the following three requirements with respect to its shareholding in the Listed Company (collectively, the **"Passive Shareholder Requirements**"):

(i) The Foreign Investor or any of its Affiliates[2] will not become a director or a corporate auditor of the Listed Company.

(ii) The Foreign Investor will not make any of the following types of shareholder proposals at the general shareholders meetings of the Listed Company with respect to any of its businesses in a Designated Business Sector:

(a) a transfer of the entirety of the business of the Listed Company;

(b) a merger or company split of the Listed Company whereby the Listed Company will be absorbed into the second company;

(c) the dissolution of the Listed Company;

(d) a transfer of a part of the business of the Listed Company;

(e) a transfer of all or a portion of the shares in a subsidiary of the Listed Company;

(f) a consolidation-type merger;

(g) an absorption-type split (where the Listed Company is a splitting party) of the Listed Company;

(h) an incorporation-type de-merger; and

(i) an abolition of business of the Listed Company.

(iii) The Foreign Investor will not have any access to, or otherwise request access to, non-public information regarding the Listed Company's technologies in relation to business in any Designated Business Sector.[3]

If the Foreign Investor does not meet the Passive Shareholder Requirements, it will not be permitted to rely on any exemption from the Prior Notification.

Based on discussions with numerous clients, there is some question as to whether any action must be taken by the Foreign Investor for the purposes of evidencing its compliance with the three requirements of the Passive Shareholder Requirements. While there is no explicit commentary or guidance issued by the Japan regulators on this point, ultimately this remains a fact driven determination (i.e. did the Japan Investor meet each of the tests below at the time of the acquisition of the shares). That being said, some foreign fund managers have elected to adopt guidelines in relation to their Japan investments on the requirements set forth above.

[2] The concept of Affiliates may include individual and the specific definition will vary depending on how the specific proposal for the appointment of director is made.

[3] This will include the Foreign Investor making a proposal to the Listed Company to amend its policies and procedures regarding the management and control of non-public information regarding the Listed Company's technologies.

2. The Three Exemptions to the Prior Notification Obligation

Through the analysis set forth in Part A above, as a matter of default, many fund managers may be required to submit Prior Notifications of their investment activities in Japan companies. However, the Amendments provide broad exemptions to the Prior Notification requirements for those foreign investors that meet the requirements set forth in Part B.1 above.

Exemption #1. The Foreign Financial Institution Exemption.

The first exemption is applicable to certain types of foreign financial institutions that are regulated in their home jurisdiction (the "**Foreign Financial Institution Exemption**"). As we believe many fund managers will qualify under this exemption, this alert will detail the key aspects of this specific analysis.

To qualify under this exemption, the foreign investor must be a foreign financial institution that is licensed or registered in either its home jurisdiction or Japan and, in addition, under such license or registration, such foreign financial institution must be duly supervised and regulated by the relevant financial authority of the application jurisdiction (a "**Foreign Financial Institution**").

Those foreign investors, relying on the Foreign Financial Institution Exemption will be exempt from having to submit a Prior Notification with respect to its acquisition of shares in Listed Companies.

A Foreign Financial Institution will include, but is not limited to, the following types of entities:

(1) Type 1 Financial Instruments Dealers (and foreign equivalent entities)

(2) Discretionary Investment Managers and Qualified Investor Discretionary Investment Managers (and foreign equivalent entities)

(3) Article 63 Exemption Filers that engage in a "self-management" business (and foreign equivalent entities)

(4) Banks (and foreign equivalent entities)

(5) Insurance companies (and foreign equivalent entities)

(6) High Speed Traders registered with the Japan regulators

We anticipate that most Fund Managers should qualify as a Foreign Financial Institution due to the registration or license in their home jurisdiction. For example, the scope of "discretionary investment managers", would include, but not be limited to, the following types of foreign registrations and/or licenses:

(1) investment advisers registered with the U.S. Securities and Exchange Commission;[4]

(2) authorized fund managers or alternative investment fund managers registered with the United Kingdom Financial Conduct Authority;

[4] Please note that in its public comments, the Japan Ministry of Finance specifically excluded Exempt Reporting Advisors registered with the U.S. Securities and Exchange Commission.

(3) Type 9 License Holders with the Securities & Futures Commission of Hong Kong; and

(4) Licensed/Registered Fund Management Companies with the Singapore Monetary Authority of Singapore.

Exemption #2. The Non-Core Business Exemption

A Foreign Investor that does not qualify for the Foreign Financial Institution Exemption may still be exempt from the Prior Notification requirement depending on whether the Listed Company engages in a businesses within the Core Business Sector.

The scope of businesses within the "**Core Business Sector**" is more limited than the scope of businesses in the Designated Business Sector and includes business sectors such as the manufacturing of military armaments, electricity and power, and cybersecurity.

If the Japan listed company does not engage in any businesses in the Core Business Sector, similar to the Foreign Financial Institutional Exemption, the Foreign Investor will not be required to submit a Prior Notification.

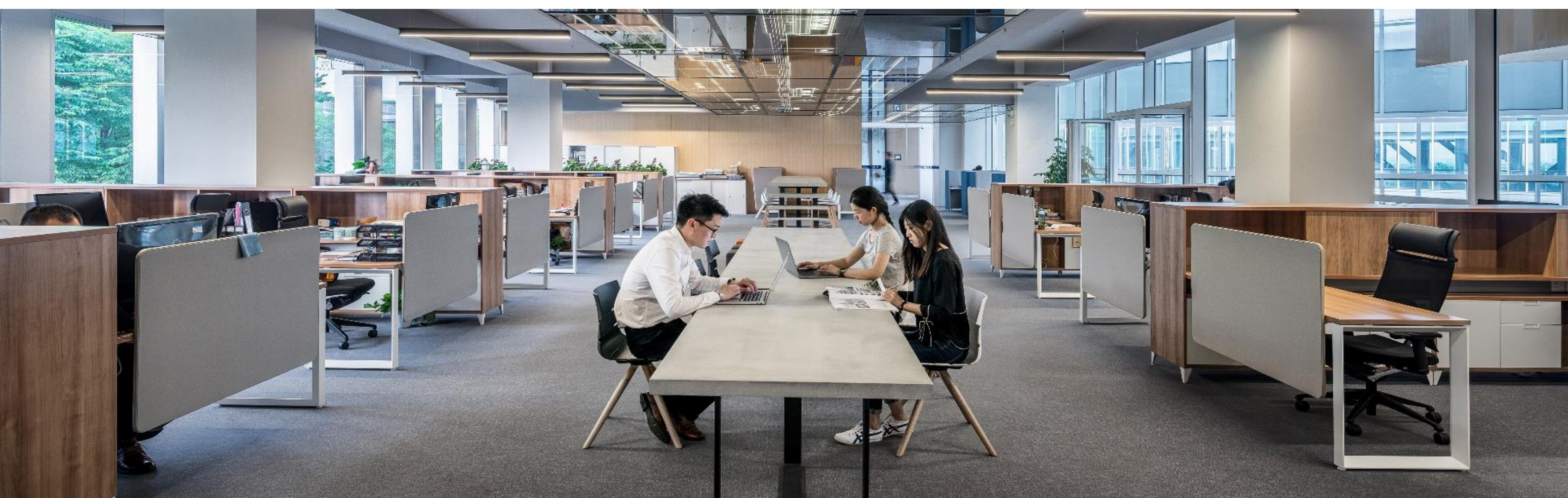
Exemption #3. The Core Business Exemption

Lastly, if the Listed Company engages in a business within a Core Business Sector, the Foreign Investor may still seek a partial exemption from the Prior Notification Requirement, if the Foreign Investor can satisfy the following additional conditions (the "**Core Business Passive Shareholder Requirements**"):

1. neither the Foreign Investor nor any designated person of the Foreign Investor will attend the board of director meetings of the Listed Company (or committees of a similar nature); and

2. neither the Foreign Investor nor any designated person of the Foreign Investor will make shareholder proposals (or similar proposals) to the board of directors of the Listed Company and/or to individual board members which may require a response or action in relation to a business of the Listed Company within the Core Business Sectors.

If the Foreign Investor can meet the above additional requirements, the Foreign Investor will not be fully exempt from the Prior Notification requirement but will only be required to submit a Prior Notification if its shareholding will exceed 10% or more subsequent the contemplated acquisition.



4. Classification of Listed Company

As discussed herein, the proper identification of whether a Listed Company engages in a business within a Designated Business Sector and/or a Core Business Sector is a critical part of the entire analysis. In order to facilitate the proper analysis by Foreign Investors as to their reporting obligations, on May 8, 2020, the Ministry of Finance of Japan published a list of all Listed Companies into the following categories:

(1) Listed Companies engaging in business a within a Designated Business Sectors but not a Core Business Sector;

(2) Listed Companies engaging in a business in Core Business Sectors; and

(3) Listed companies that businesses does not engage in a business within a Designated Business Sector.

This publication by the Ministry of Finance is intended to only be a guide and it is unclear whether the Ministry of Finance will be updating such list on a periodic basis. In the publication, the Ministry of Finance advises against full reliance on such list and recommends that each Foreign Investor properly review the information in relevant Articles of Associations (or similar constitutional document) of the Listed Company to confirm whether such Listed Company engages in a business within a Designated Business Sector or a Core Business Sector.

C. Summary of the Prior Notification Analysis

In many ways, the analysis regarding the application of the Amendments is quite complex in that there are numerous exemptions which may be available to a foreign investor with two outcomes from the exemptions. The flowchart below is intended to summarize each step of the analysis tree for a foreign investor as described in this Client Alert.

For ease of reference, we have include a simplified summary for the conclusions that may be applicable to many of fund managers that trade Japan Equities.

Foreign Financial Institutional Exemption

- Passive Shareholder Requirements? Yes
- Foreign Financial Institution? Yes

No Prior Notification will be required irrespective of shareholding or whether the Listed Company is a Core Business.

Non-Core Business Exemption

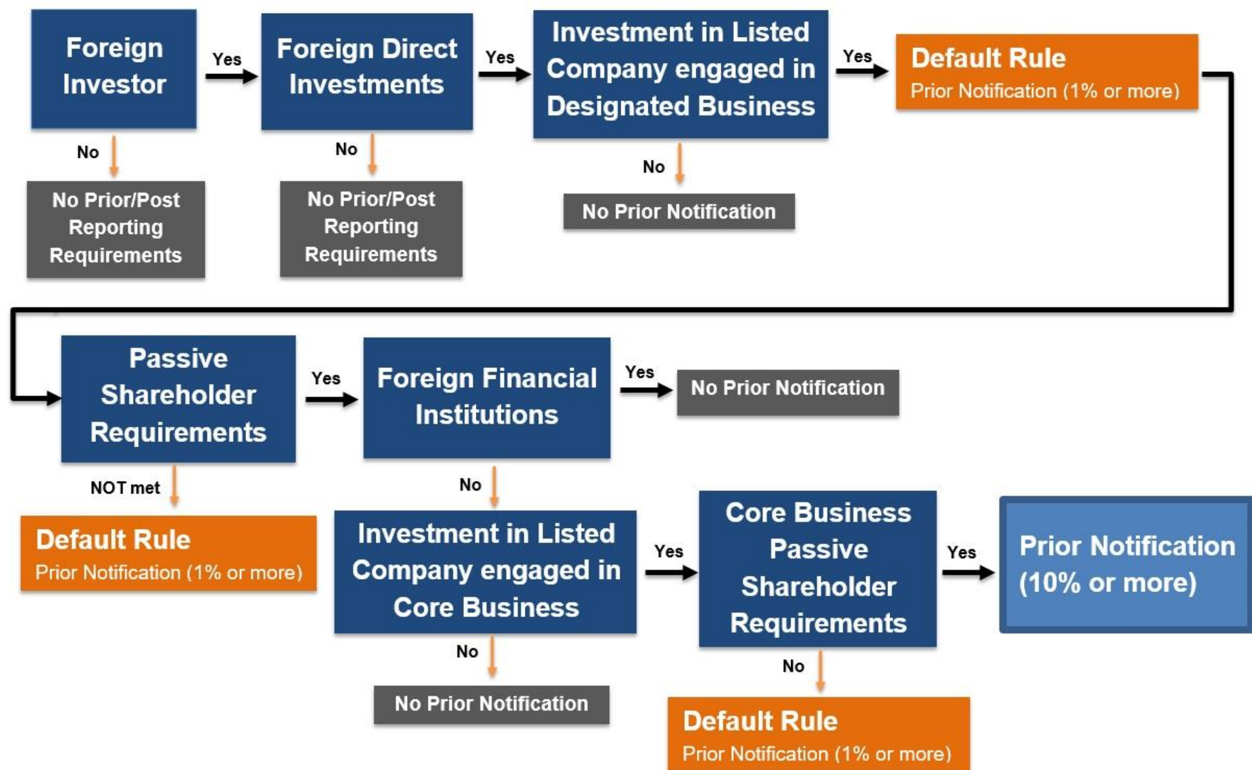
- Passive Shareholder Requirements? Yes
- Foreign Financial Institution? No
- Core Business Sector? No

No Prior Notification will be required irrespective of shareholding.

Core Business Exemption

- Passive Shareholder Requirements? Yes
- Foreign Financial Institution? No
- Core Business Sector? Yes
- Core Business Passive Shareholder Requirements? Yes

No Prior Notification will be required irrespective until shareholding exceeds 10% or more.



This Client Alert is not intended to be a comprehensive summary of the Amendments. Instead, as many foreign fund managers that trade Japan equities will seek to avoid having to submit a Prior Notification, this first Client Alert has focused on this specific aspect of the analysis.

Contacts

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