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Revision of Prior Notification System under the Foreign Exchange and Foreign Trade Act: Disclosure of Draft Amendments to Cabinet Orders, Ministerial Ordinances and Public Notices (Breaking News)

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I. Introduction

On November 29, 2019, the Partial Amendment of the Foreign Exchange and Foreign Trade Act (such amendment, the "**Amendment**", and such act, the "**Act**") was enacted, revising the prior notification system under the Act; but details of the revision were left to be elaborated in subsequent cabinet orders, ministerial ordinances and public notices. On March 14, 2020, the draft orders, ordinances and notices related to the Amendment (the "**Draft Orders**") were announced and the Draft Orders were subjected to public comments.[1]

The Amendment aims to achieve a "pragmatic investment system" by further promoting foreign direct investment ("**FDI**") in Japan that is conducive to sound economic growth and by ensuring minimal review of FDI that could pose risks to national security. The Draft Orders were designed in accordance with such aims and system.

This newsletter provides an overview of the Draft Orders and other relevant regulations, and examines notable points on investment and fundraising with regards to listed companies.

[1] https://www.mof.go.jp/international_policy/gaitame_kawase/press_release/20200314.htm

II. Revision of Prior Notification System

The Amendment focuses on the amendments of the prior notification system under the Act in the following respect:[2]

A. Reduction of the threshold for acquiring shares and voting rights of listed companies that fall under the scope of FDI (10% → 1%);
B. Establishment of a prior notification exemption system for share acquisitions;
C. Addition of the following types of transactions to the scope of FDI: (i) agreement regarding "matters that may materially influence management of the company" and (ii) "acquisition of business from residents, etc."; and
D. Clarification of notification and reporting obligations upon stock or voting right acquisitions by partnership funds.

The Draft Orders reflect the foregoing amendments and mainly revises the Act in respect of the items set forth below. The central focus of the revisions are to clarify the scope of application and requirements for the exemption system described in item B above (see items 1 to 5 below). In addition, the revisions clarify details to item C above (see item 6 below); and published materials on the Draft Orders[3] mention that a list will be published prior to the enforcement of the Act setting forth details regarding the listed companies which require prior notification and which operate in the "core sectors" (see item 8 below). Section III below details each of the following eight items.

1. Expansion of the scope of the regular exemption and clarification of requirements;
2. Clarification of the foreign financial institutions that are eligible for the blanket exemption;
3. Clarification of the scope of closely-related persons;
4. Clarification of the significance of access to confidential technology-related information;
5. Clarification of the businesses which require prior notification and which operate in the "core sectors";
6. Clarification of prior notification requirements for certain actions;
7. Expansion of the scope of subsidiaries that are deemed to be foreign investors; and
8. Policy for publishing a list of listed companies which require prior notification and which operate in the "core sectors".

[2] For more information, see January 2020 (vol. 44), November 2019 (vol. 43) and July 2019 (vol. 42) issues of CAPITAL MARKETS BULLETIN; set forth respectively in (Link), (Link) and (Link).
[3] See https://www.mof.go.jp/international_policy/gaitame_kawase/press_release/kanrenshiryou_20200314.pdf , published by the Ministry of Finance, March 14, 2020.

III. Draft Amendments to Cabinet Orders, Ministerial Ordinances and Public Notices Orders

1. Expansion of the scope of the regular exemption and clarification of requirements

The Amendment and the published materials stipulate the introduction of a prior notification exemption system for share acquisitions as follows:[4]

(1) (i) Foreign financial institutions, such as foreign banks, are uniformly exempted irrespective of the industry in which they operate if they satisfy certain requirements (the "**blanket exemption**"), and (ii) foreign investors that do not fall under the foregoing are exempted if they satisfy certain requirements (the "**regular exemption**").

(2) Any persons that have been punished for violating the Act or state-owned enterprises generally are not eligible to use the prior notification exemption system.

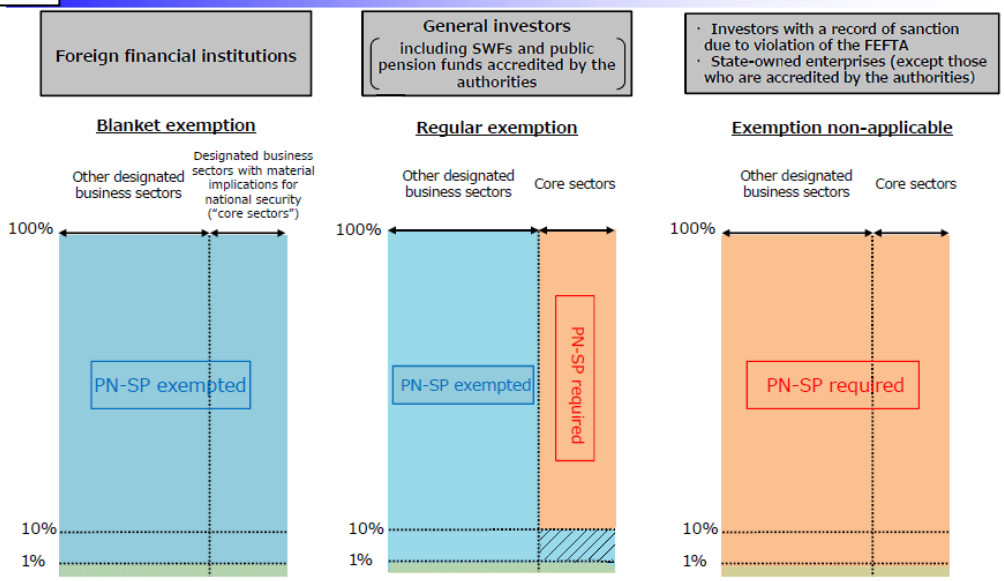
Reflecting the above, the Draft Orders were revised with regard to the following matters (see Chart 1):

(1) For the regular exemption, even if the issuer is in a core sector (and therefore the exemption is not available generally), a new system is introduced whereby the prior notification exemption will be applied to acquisitions of less than 10% of voting rights if certain additional criteria are met.

(2) It is clarified that sovereign wealth funds (SWFs) and pension funds owned by foreign governments, for which the exemption system cannot be used in principle, are eligible for the exemption if they meet certain requirements.

[4] See "Related Data, October 25, 2019" published by the Ministry of Finance (https://www.mof.go.jp/international_policy/gaitame_kawase/press_release/kanrenshiryou_191018.pdf).

(Chart 1) Exemption Scheme for Prior-notification of stock Purchases (PN-SP)



(compiled in part by excerpting from materials published by the Ministry of Finance on March 14, 2020)

(1) Additional criteria

Under the regular exemption system, in principle, exemptions are not available and prior notification is required for foreign investors if the issuer of the shares to be acquired by the foreign investors is in a core sector. In this regard, the Draft Orders have introduced a system to exempt investors from prior notification if they satisfy the following additional criteria even if the issuers are in core sectors.

First of all, under the Act, the following criteria must be complied with in order for the foreign investors to be exempted from the prior notification (such criteria apply to both the blanket exemption and the general exemption):

(i) The foreign investor or its closely-related persons will not be appointed as directors or statutory auditors of the issuer.

(ii) The foreign investor will not submit to the issuer's general shareholders' meeting any proposal regarding the transfer or disposition of the issuer's business in designated business sectors.

(iii) The foreign investor will not access confidential technology-related information regarding the issuer's business in designated business sectors.

In addition to the foregoing three criteria, the Draft Orders prescribe the following two criteria to allow exemption for investments by a foreign investor into an issuer which operates in the core sectors if each of the ratio of shareholdings and ratio of voting rights held by the foreign investor after the investment do not reach 10%:

(iv) With respect to a business in a core sector, the foreign investor (or whoever it designates) will not become a member of the issuer's committee with important decision-making authority.

(v) With respect to a business in a core sector, the foreign investor will not make any proposal in written form to the board of directors or equivalent organizational body of the issuer that requests for a response and/or action by a certain deadline.

However, some aspects of such additional criteria remain unclear. For example, the scope of criterion (iv) is unclear with respect to whether an appointment of an external manager by an investment fund to attend the issuer's board meeting falls under the scope of "whoever it designates" such that such appointment conflicts with this criterion.

Also, for criterion (v), since the requirement is to not send written documents (including emails) and set deadlines, it seems relatively easy to put pressure on the issuer in ways that do not conflict with this requirement. As such, there may be attempts to circumvent this requirement, and how this criterion will be applied and complied with in practice should be closely watched.

(2) Certification system

Regarding the scope of applicability for the prior notification exemption system, the Amendment and published materials set forth the policy that foreign investors who are state-owned or otherwise state-related are, in principle, not eligible for the exemption system and thus require prior notification. The Draft Orders provide that the regular exemption system is available for state-owned enterprises that meet certain requirements.

Specifically, SWFs and public pension funds that pose no risk to national security may use the regular exemption by obtaining individual certifications from the Ministry of Finance who shall decide whether certifications are granted by examining the following matters and concluding MOUs with such funds:

(i) Whether the investment activities of such funds are purely for the purpose of economic returns; and

(ii) Whether investment decisions of such funds are made independently of foreign governmental (or other state-related) intervention.

Note that the certification results and MOU contents are expected to remain confidential. Therefore, when a company is receiving investments from a state-related

investment fund or when a securities firm is allocating shares in an offering to such fund, the company cannot know with certainty if the fund is eligible for the regular exemption (unless the confidentiality is lifted and the certified state-related fund is permitted to disclose the fact that it has obtained the certification).

2. Clarification of the foreign financial institutions that are eligible for the blanket exemption

The types of foreign financial institutions listed below are eligible for the blanket exemption, which is an exemption that can be applied regardless of the business sector the issuer is operating in, even if it is a core sector. The blanket exemption is applicable for investments where these institutions (i) acquire at least 1% of the shares and voting rights of listed companies, etc., or (ii) acquire voting rights, etc. and some joint voting rights, etc.

Foreign Financial Institutions Eligible for the Blanket Exemption
● Securities firms
● Banks
● Insurance companies
● Asset management companies
● Trust companies
● Registered corporate-type investment trusts
● High-frequency traders

In addition to the cases where licenses are granted to operate as such types of financial institutions in Japan, foreign financial institutions that are licensed in foreign jurisdictions under regulations and supervisions by the relevant authorities based on the local laws and regulations that amount to the corresponding laws in Japan are eligible for the blanket exemption without restrictions on investment into the issuer and quantity of securities.[5] In practice, there would be an issue of which specific regulations and supervision by foreign authorities could be considered to "amount to the corresponding laws in Japan" that would satisfy such requirement.

[5] However, high-frequency traders are only exempted when they are licensed under the Financial Instruments Exchange Act of Japan and are not exempted when they are licensed under any other foreign law or regulation.

3. Clarification of the scope of closely-related persons

The concept of "closely-related persons" is adopted in the exemption criteria for the prior notification upon investments and the prior notification upon certain other actions (see below the section 6 labled "*Clarification of prior notification requirements for certain actions*"). The scope of the concept is clarified in the Draft Orders and detailed in Chart 2 below.

(Chart 2) Definition of "Closely-related Persons"

Scope of "closely-related persons" of a foreign investor	①Nomination is made by the foreign investor itself [1/]			②Nomination is made by a third party [2/] (including the investee company)		
	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 [3/]	○	○	○	○	×	○
Its other family companies such as uncle/aunt companies, cousin companies, brother/sister companies, or nephew/niece companies [3/]	○	○	○	○	×	×
The foreign investors' business partners [4/]	○	○	○	×	×	×
Persons who receive substantial amount of financial rewards and/or other assets from the foreign investor [4/]	○			×		
Persons who were in the status of the above categories in the previous one year [4/]	○			○		
Spouse of the foreign investor (if natural person) [3/]	○			○		
Lineal ascent or descent of the foreign investor (if natural person) [3/]	○			○		
Persons (or their closely-related persons) who have agreement with the foreign investor to jointly exercise voting rights [3/]	○			○		

1/ This includes the case where nomination is made by a third party on behalf of the foreign investor.
2/ On-the-spot nomination at a shareholder's meeting is not subject to the prior-notification requirement.
3/ Same as the FEFTA's definition of "closely-related persons" used to calculate the total shares of investment in a single listed company.
4/ Same as the definition under the Tokyo Stock Exchange guidelines of the persons not eligible for becoming an independent board member due to conflicts of interest.
5/ 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.

(excerpt from materials published by the Ministry of Finance on March 14, 2020)

Under the definition of closely-related persons, note that there is a difference in the scope of this term depending on whether it is the foreign investor itself (who may be obligated to provide notification) proposing the nominations or it is a third party proposing the nominations; for example, employees of the foreign investor are included in the former situation whereas it is not included in the latter situation.

4. Clarification of the scope of "access to confidential technology-related information"

The criteria for exemption from the prior notification exemption system include restrictions on "access to confidential technology-related information". The Draft Orders state that the following actions constitute such access:

(1) Acquisition of information relating to technology managed by departments

operating significant business of the issuer ("**confidential technical information**");

(2) Request for disclosure of confidential technical information; and

(3) Request for change of rules on the treatment of confidential technical information.

Among the above actions, item (1) is not breached if the issuer voluntarily discloses such information. Also, with regards to the scope of confidential technical information, information about employment terms or remuneration of board members and the financial information of the issuer do not constitute confidential technical information.[6]

In practice, among other occasions, it is necessary to examine whether receiving information in the course of due diligence of the issuer before an M&A transaction or an investment falls within the scope of the above-mentioned actions. It seems it can be construed that due diligence by securities firms conducted upon offerings of stocks and corporate bonds do not fall under "access to confidential technology-related information" since investors themselves do not acquire the information, but the language of the Draft Orders is not fullyclear on this point.[7,8]

5. Clarification of the businesses which require prior notification and which operate in the core sectors

Among the sectors for which prior notification is necessary (i.e., the designated sectors), when issuers operating in businesses that are "truly necessary for national security" (the "**core sectors**") are involved, there are cases where compliance with additional criteria are necessary to procure the applicability ofthe general exemption system; regardless, the exemption will not be available for transactions resulting in holdings of 10% or more (see above the section labeled *"1. Expansion of the scope of the regular exemption and clarifiction of requirements"*). Therefore, whether or not the issuer operates in a core sector is relevant in determining the availability of the exemption system and the criteria for eligibility in the exemption system.

[6] However, the information that constitute "financial information" is not entirely clear because basically all business activities of the issuer should be reflected in its financial statements (e.g., royalties in licensing agreements, and unit prices of and interests in particular products or services reflected in sales and costs).
[7] In a due diligence review, the scope and method of information disclosure is itself a matter to be negotiated (the purchaser usually requests disclosure of a large amount of information, while the seller and issuer usually attempt to limit this amount). When confidential technical information is disclosed through negotiation, the disclosure can be considered "voluntary" in light of the fact that the issuer ultimately decided to do so, whereas it can also be said that the disclosure cannot be truly "voluntary" given that the issuer is exposed to pressure (sometimes from the seller) that it must do so in order to be funded. As such, there is difficulty in distinguishing the disclosures based on the issuer's subjective view.
[8] The Public Notice also provides certain exceptions to the above criteria, such as when the information is requested in the course of a due diligence review.

In this regard, the Draft Orders provide that the following businesses fall under the scope of core sectors:

Scope of "Core Sectors"	
Sector	Segments Necessary for National Security <applicable legislation>
Weapons	All
Aircrafts	All
Space	All
Nuclear facilities	All
Dual-use technologies	All
Cybersecurity	• Cybersecurity-related services (e.g. network security monitoring, software) • Service providers of programs designed for critical infrastructure
Electricity	<Electricity Business Act> • General electricity transmission and distribution utilities • Electricity transmission utilities <Armed Attack Situations Response Act> • Electricity generation utility companies that own power plants with maximum generation capacity of 50,000KW or more
Gas	<Gas Business Act> • General/Specified gas pipeline service providers • Gas manufacturers <Oil Stockpiling Act> • LP gas companies that own storage facilities or core cylinder filling stations
Telecommunications	<Telecommunications Business Act> • Telecommunication carriers that provide services across multiple local municipalities
Water supply	<Water Works Act> • Water supply companies supplying to more than 50,000 people • Bulk water supply companies with capacity to supply over 25,000m^3 per day

Railway services	<Armed Attack Situations Response Act> • Railway service companies operating public facilities/infrastructure
Oil	• Oil refinery, oil storage business, crude petroleum and natural gas production

6. Clarification of prior notification requirements for certain actions

The Amendment newly added the following as a new category to FDI: "consent given in regard to matters specified by a Cabinet Order as having a material impact on the management of the company".

Pursuant to such addition, the Draft Orders stipulate that the following two actions by foreign investors fall under the scope of FDI, and are subject to prior notification upon such action:

Actions Subject to Prior Notification
(1) Providing consent at the shareholder's meeting of the issuer to nominate the foreign investor itself or its closely-related person as a board member of the issuer[9]
(2) Providing consent at the shareholder's meeting of the issuer to propose the transfer or disposal of the issuer's significant business[10]

These actions overlap with items (1) and (2) of the compliance criteria of the prior notification exemption system described above in the section labeled *"1. Expansion of the scope of the regular exemption and clarification of requirements"*. In other words, in cases where foreign investors are eligible for the prior notification exemption by stating that they will not engage in either of these actions at the time of their share acquisition, but they subsequently change and intend to engage in such actions afterwards, then such foreign investors will not be allowed to engage in these actions unless they submit prior notification thereof.

The examination by the authorities in this notification process will be conducted solely by considering the objective of the Act, i.e., to prevent for national security reasons the leakage of confidential technology-related information and disposition of business

[9] Prior notification is required when consenting, regardless of whether the proposal for nomination is made by the foreign investor or a third party. Also, if the nominee is neither the foreign investor itself nor its closely-related person, prior notification is not required.
[10] Prior notification is required only when consenting to a proposal made by the investor itself.

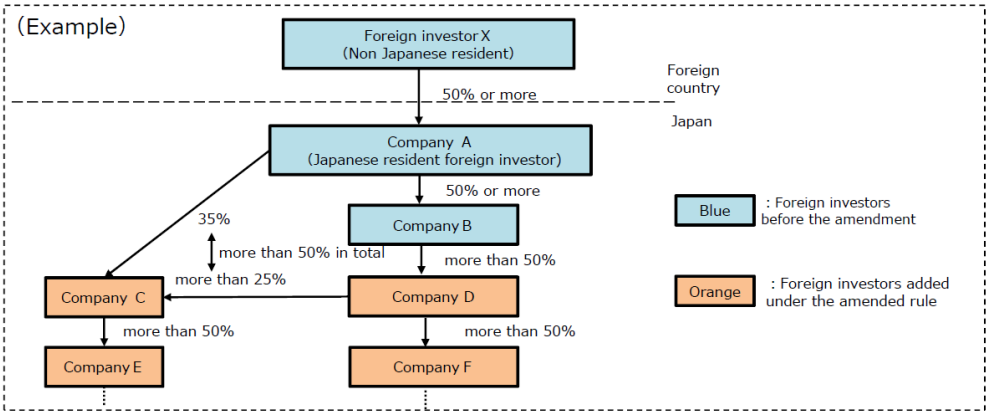
activities in designated business sectors. If there are no national security concerns, the authorities will notify the investor of clearance of the examination within five business days. In addition, the Diet and other governmental bodies have indicated they are contemplating amending the factors to be considered by the authorities in such examination.

7. Expansion of the scope of subsidiaries that are deemed to be foreign investors

The scope of "foreign investors" subject to the prior notification system has been redefined in the Draft Orders. A major update is the expansion of such scope as described in Chart 3 below.

(Chart 3) Definition of "Foreign Investor"

- Before the amendment, "foreign investor" includes companies located in Japan with 50% or more ownership of foreign investors, as well as direct subsidiaries of such companies.
- Under the amended rule, all companies that are defined as subsidiary companies under **Japan's Companies Act** are regarded as foreign investors.



(exerpt from relevant materials published by the Ministry of Finance on March 14, 2020)

8. Policy for publishing a list of listed companies which require prior notification and which operate in the "core sectors"

Whether an issuer operates in businesses which require prior notification or operates in the "core sectors" is a prerequisite for determining whether an investor is eligible for prior notification exemption. However, the classification announced by the authorities is highly complicated and detailed such that it will be likely that various cases will arise in which such determination will be difficult.

In this regard, published materials on the Act state that the authorities will prepare and will update lists of listed companies that classify them into (i) companies that do not require prior notification, (ii) companies which require prior notification but the exemption is applicable, and (iii) companies which require prior notification and the exemption is not applicable (i.e., operate in the core sector). The same policy is also stipulated in the Draft Orders and the relevant materials.

Regarding these lists, it has been announced in the course of the deliberation on the Act in the Diet and other occasions that “the decision of which to classify the issuer will in principle be a matter for the foreign investor to decide” and that “in order to facilitate the decision of foreign investors, lists will be prepared and published based on public information such as articles of incorporation and corporate questionnaires.” It was also announced that “the lists of listed companies will be published in late April.” However, there are various unresolved issues, such as the timing of publication, scope of companies covered, frequency of updates, and the treatment of cases where an investment is made without prior notification assuming the list was correct but it is found after the investment that a notification was actually necessary. Therefore, we need to closely moniter future developments.

IV. Conclusion

The draft cabinet order and ministerial ordinance is currently open for public comment until due April 12, 2020. It is expected that the cabinet approval on the cabinet order and the publication of the list of listed companies will be made in late April 2020 and then the cabinet order, the ministerial ordinance and public notice will be issued in late April 2020 to early May 2020; and finally, the Amendment and the finalized ordinances and notices will be enforced in May 2020. We will have to wait and see how the authorities will respond to the public comments and how they will finalize the draft of the ordinances and notices, and the list of listed companies. In any case, the implementation of the Draft Orders will have an impact on the shareholders' meeting of companies that close their accounts in March 2020 and also on investment and fundraising based on full-year accounts. Although the scope of the regulations can be read to be quite broad, an overly conservative interpretation of the regulations would have a chilling effect on foreign investors' investments in listed companies and fundraisings. Therefore, it is necessary to approach the amendments to the system reasonably based on accurate understandings of the purpose and intent of the regulations.