December 26, 2019

Regarding the Amendment to the Foreign Exchange and Foreign Trade Act

Shigeharu Suzuki,
Chairman & CEO, Japan Securities Dealers Association
Member, Council on Customs, Tariff, Foreign Exchange and Other Transactions and Sub-council on Foreign Exchange and Other Transactions

It is our understanding that the recent amendment to the Foreign Exchange and Foreign Trade Act had been made with a view to preventing, for national security reasons, the leakage of information on critical technologies, as well as properly minimizing the possibility of situations that can pose risks to national security.

On the other hand, it is worth noting that the proportion of ownership of shares by foreign investors in the Japanese equity market is around 30%, and that their transaction amounts comprise approximately 60% of the total equity market. As such, careful attention must be paid to the fact that foreign investors play a significant role in supplying growth funds for listed companies in Japan.

We highly appreciate the fact that the recent amendment does include certain measures aimed to promote sound foreign direct investment to Japan and mitigate the impact to the Japanese equity markets and economy, such as the introduction of an exemption to the prior-notification requirement for the foreign investors that are compliant with certain criteria.

However, market participants including the securities firms that are members of the Japan Securities Dealers Association are still raising voices of concern regarding the recent amendment.

Going forward, we understand that the details of this amended Act including the criteria for compliance to be exempted from the prior-notification requirement will be specified through Cabinet Office Ordinances and Notifications. In this process, we hope that the relevant authorities will remain in close communications with market participants, and that thorough considerations are made such that the enforcement of this amended Act does not exceed the bounds of its original intentions; that it does not greatly reduce the willingness of foreign investors to invest in Japanese listed stocks; and that it does not negatively impact stock prices, financial capital markets, and the smooth operation of the Japanese economy.

Appendix

December 26, 2019

Points of Concern from Market Participants Regarding the Amendment to the FEFTA

The Japan Securities Dealers Association (hereinafter, "JSDA") has endeavored to bolster communications between market participants and the policymaking authorities since the amendment bill to the Foreign Exchange and Foreign Trade Act (hereinafter, "FEFTA") was submitted for review at the Diet. For instance, the JSDA has relayed requests received from market participants to relevant authorities such as the Ministry of Finance (hereinafter, "MoF"), and conducted workshops featuring the relevant authorities to help securities firms gain a better understanding of the amended FEFTA.

Due to the efforts of all related parties, the recognition and understanding of the issues at stake have overall improved. However, at the moment, there remain lingering points of concern within market participants, the outline of which is described below.

1. Impact on Foreign Investors' Investment Attitudes

In the FEFTA, a threshold for the prior-notification requirement is set for foreign direct investments (hereinafter, "FDI") in certain business sectors through acquisition of listed stocks. Under the amendment, in order to appropriately respond to threats to national security, the threshold has been lowered from 10% to 1%.

Meanwhile, in order to further promote investment deemed to pose no risks to national security, a system has been introduced for portfolio investments (which account for a large portion of FDI). In the system, prior-notification may be exempted under the condition that the investments are not by state-owned enterprises or not to industries where such investment would pose national security risks, and instead they will be subject to a post-investment report requirement if the acquisition ratio exceeds 1% (hereinafter, "General Exemption System").

The General Exemption System is a measure that takes into consideration the potential impact on FDI for foreign investors. However, even under the General Exemption System, depending on the industry to which foreign investors invest, a prior-notification and

screening are still necessary, and after the acquisition ratio exceeds 1%, foreign investors may still be required to submit frequent post-investment reports in response to changes in the acquisition ratio. Given such an investment environment, there was a strong concern that foreign investors—whose presence in Japan is very prominent—may be deterred from investing in Japan or stop investing altogether.

Moreover, transactions conducted by foreign securities firms that are registered as Financial Instruments Business Operators in Japan using their proprietary accounts play an important market intermediary role in the Japanese equity market, and there was also the concern that this role would be largely restricted.

On October 23, 2019, the MoF posted on its website "Clarification of the Prior-Notification Exemptions and Burden Mitigation Measures," where it was outlined that foreign financial firms such as foreign securities firms and foreign asset management firms will be exempted from the prior-notification requirement, irrespective of the business sectors of the stocks to which they intend to invest. It was also explicated that the threshold for the post-investment report that is applied for these exempted firms will be retained at the current 10% (hereinafter, "Blanket Exemption System").

As a result, for large-scale foreign investors such as pension funds, which often outsource asset management to asset management firms, as well as for foreign securities firms who perform important market intermediary functions in the Japanese equity market, the impact of the new rules has been reduced greatly, to the relief of many market participants.

However, from the viewpoint of the impact on the investment attitudes of foreign investors, the following are some concerns that still have yet to be addressed.

(1) Impact on foreign investors classified as state-owned enterprises that conduct their own asset management without outsourcing to an asset management firm

According to the "Frequently Asked Questions on the Amendment Bill of the Foreign Exchange and Foreign Trade Act" (hereinafter, "FAQ") that was issued by the MoF on October 31, 2019, although sovereign wealth funds (hereinafter, "SWFs") and public pension funds both fall under the definition of state-owned enterprises, if they are deemed to pose no risk to national security, they would be eligible for exemption from the prior-notification requirement.

SWFs and public pension funds come in different forms. From the perspective of promoting sound FDI, if they undergo the proper prior authentication procedures, are recognized as posing no risk to national security, and are deemed as conducting investments in the same form as that of foreign asset management firms, then it could be thought of as desirable for a more flexible response—for instance, by applying the Blanket Exemption System to such SWFs and public pension funds rather than only the General Exemption System.

(2) Impact on private investors equivalent to foreign asset management firms or foreign securities firms

While such foreign investors as hedge funds, family offices, and high frequency traders do not fall under the scope of foreign asset management firms, much like (1) above, if they undergo the proper prior authentication procedures, are recognized as posing no risk to national security, and are deemed as conducting investment in the same form as that of foreign asset management firms, then a more flexible response by applying the Blanket Exemption System rather than only the General Exemption System may be thought of as desirable.

2. Impact of Publishing the Categorization List

In the FAQ, it was mentioned that the authorities will be creating and publishing a list of listed companies under each category of 1) companies for which only post-investment report is required; 2) companies for which prior-notification is required but exemption is applicable; and 3) companies for which prior-notification is required and exemption is not applicable. This list would be useful information for creating an environment in which foreign investors can invest with peace of mind.

However, if foreign investors feel that there are too many companies that fall under category 2) and 3) (especially 3)), there is the concern that the investors will be deterred from investing in Japan writ-large.

Moreover, it is assumed that foreign investors will be determining whether or not a prior-notification is necessary based on the list provided. Given this, as was raised during the November 21 session of the House of Councillors' Committee on Financial Affairs, it is deemed desirable that the operations of this list are made with a consideration of the

purpose of contributing to the peace of mind of foreign investors.

3. Impact to Fundraising for Japanese Listed Companies

(1) Fundraising via public offerings by listed companies as well as block trades of stocks for said companies in 2. above have a short time frame until the investment decision has been made. As such, it has been pointed out that, if foreign investors are not permitted to avail of the Blanket Exemption System, they may be unable to apply for and acquire more than 1% of the stocks of listed companies for which exemption from prior-notification is not applicable (i.e. category 3).

Moreover, it has been noted that, even if fundraising via public offerings is conducted by the listed companies for which exemption from the prior-notification requirement is applicable, there is the possibility that foreign investors, in consideration of the ratio of voting rights, may be disincentivized from applying for and acquiring their stocks due to the lowering of the threshold from 10% to 1%.

(2) From this perspective, it would be considered wise to limit the companies classified into categories 2) and 3) in the list above (especially 3)) to only those that are deemed truly necessary to be classified as such from the viewpoint of national security. In addition, it could be thought of as desirable to apply a more flexible response to those foreign investors that have been recognized as posing no risk to national security through the proper prior authentication procedures, such as applying the Blanket Exemption System, as mentioned in 1. above.

4. Relationship with Corporate Governance Reforms

(1) Corporate governance reforms as a growth strategy

Under the Japan Revitalization Strategy issued in June 2013, the Cabinet approved that "principles for a wide range of institutional investors to appropriately discharge their stewardship responsibilities, with the aim of promoting sustainable growth of investee companies through constructive dialogue with them" would be drafted from the point of view of promoting the sustainable growth of Japanese companies. This led to a full-fledged corporate governance reform, which is still currently in progress.

The improvement of corporate governance is a possible reason for foreign

investors who manage their assets globally to turn their asset allocation toward Japanese stocks. Among the public comments received when the "Stewardship Code" and "Corporate Governance Code" were drafted, there were some comments in English that indicated that foreign investors were very welcoming of the move, noting that the Japanese equity market would become more attractive to foreign investors as a result.

The JSDA, with the advice of the Cabinet Office, MoF and Financial Services Agency, in collaboration with Japan Exchange Group, also conducts promotional activities for foreign investors on the attractiveness of the Japanese capital markets at the world's crucial financial centers. This experience has informed us that the Japanese corporate governance reforms are received very positively amongst overseas market participants.

(2) Handling of the recent amendment to the FEFTA

Under the recent amendment, new items such as becoming a board member" and "transfer or disposition of important business activities", are scheduled to be added as part of the actions after stock acquisition deemed to lead to the leakage of information on critical technologies as well as disposition of business activities pertinent to national security, for which prior-notification will be required.

Additionally, those who intend to apply for the General Exemption System or Blanket Exemption System must comply with the following criteria: 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.

In terms of the relationship between these amendments and the corporate governance reforms, the FAQ has made clear the following points:

- Execution of shareholder's right and their engagement with invested companies which are conducive to increasing enterprise value is welcome from the viewpoint of corporate governance.
- The only thing that foreign investors need to do to take advantage of exemption

is to express in their post-investment report their intention to comply with conditions 1) and 2) above.

- In the case that, despite their intentions to comply with 1) and 2), foreign investors take said actions, prior-notification and screening for these actions will be conducted only from the viewpoint of preventing leakage of information about critical technologies as well as disposition of business activities for national security reasons. The Amendment Bill does not impose any restrictions to shareholder's right or engagement with invested companies that do not relate with the aforementioned objective.
- The authorities will conduct screening in a way that is in full respect of corporate governance; for instance, by publishing the factors to be considered in screening and ensuring transparency.
- In light of the importance of corporate governance, no other restrictions than 1) and 2) will be imposed to shareholder's right or engagement with invested companies.

(3) Concerns of foreign investors and Japan's response

However, the concerns that this amendment is restricting the execution of shareholders' rights and their engagement with invested companies and going against the tide of corporate governance reform have not been assuaged.

It is deemed desirable that policymaking authorities proceed to establish the details of and appropriately manage the amended scheme in line with the principles expressed in the FAQ, sustaining the confidence in Japan's revitalization strategy and preventing negative impacts on stock prices and financial capital markets, and to sufficiently conduct explanations (in English) for foreign investors to easily understand the details.

5. Ensuring Understanding of the Amended FEFTA's Scheme by Foreign Investors and a Preparation Period Prior to Enforcement

(1) In the amendment to the FEFTA, despite the fact that many important items of the details of the scheme are currently still under consideration, the period between the

promulgation of the amendment and its enforcement has been designated as only up to six months.

If enforcement of this amendment occurs without foreign investors' proper understanding of the scheme or enough information (in English) necessary for their preparation to invest in the Japanese equity market, as well as without a sufficient "get acquainted" period and sufficient time for their practical response, there is a concern that around the time of enforcement, investment will shrink or be withdrawn altogether, especially by those foreign investors who currently already hold more than 1% of stock.

(a) Request for more clarity about the details of the amendment in writing (within the legal documents or explanatory documents)

Within the relevant authorities, we recognize and appreciate that there has up until now been marked efforts to clarify the details of the amendment through explanatory documents or Q&A sessions at the Diet, and are grateful that there has been dialogue with market participants.

However, there are many items that are currently under discussions by the relevant authorities, as well as aspects of the amendment that have not been put down in writing, such as the definitions of important terms including "state-owned enterprises", "closely-related persons", and "important business activities"; the threshold for post-investment reporting after exceeding the 1% threshold; and clarification on the important rules to be followed such as prohibited items and items for compliance.

Moreover, the explanations provided in the dialogues with market participants thus far have not been officially recorded and published.

Looking ahead to the enforcement of said amendment next year, in order to ensure transparency, foresight, and a sufficient "get acquainted" period, it is thought of as desirable to make clear in writing (within the actual text of the legal documents or explanatory documents) as soon as possible the details of the established scheme, as well as the answers to the many questions received from market participants.

(b) Request for information provision in English

At present, the information that foreign investors residing outside Japan can access

is the MoF's "Exemption from the prior-notification requirement" document published on October 23, 2019 and the "FAQ" document published on October 31, 2019. Although these documents are available for viewing in English, they are arguably not sufficient to fully understand the details of the amendment, nor are they enough to grasp the kind of scheme to expect as well as what kinds of responses in practice are required. As such, there still remain great concerns about the said amendment amongst market participants.

In order to increase the level of understanding of foreign investors residing outside Japan, it is deemed desirable for more publicized materials to be available in English, and for the relevant authorities to keep in close communications with said foreign investors, based on the circumstances of the most recent discussions related to the amendment.

(c) Possibility of needing more time for practical response to the amendment to the scheme (i.e. changes in thresholds, etc.)

For foreign investors unable to take advantage of the Blanket Exemption System, the change of the threshold to 1% will require a significant review of the previous practice which was premised on the 10% threshold. This would apply to not only the areas of the scheme that have been directly altered, but also to areas that have not been changed, as it is expected that it would become necessary to reconfirm the interpretation of laws and regulations, which in the past was in practice deemed unnecessary to be alert due to the high enough threshold (10%). As a result, it has been pointed out that there is the possibility that to respond to such changes, more time would be needed for a sufficient understanding of and preparation for the scheme.

(2) Hence, given the above concerns, it is thought of as desirable to have in place responses to (1) (a) through (c) above, in order to ensure that foreign investors who invest in the Japanese equity market can continue their investments without facing confusion at the time of the enforcement of the amendment. Moreover, given the necessity of securing a sufficient "get acquainted" period, it would be desirable to have in place appropriate transitional measures in response to the details of the scheme going forward.

6. Digitalization of Notification and Reporting Procedures, and Responses in English

At the moment, the prior-notification and post-investment report procedures are conducted in paper format and in Japanese. After the enforcement of the amendments to the FEFTA, the frequency at which prior-notification and post-investment reports are conducted may increase due to the threshold being lowered to 1% as well as the addition of "becoming a board member" and "transfer or disposition of important business activities" as part of the actions after stock acquisition for which prior-notification will be required, if foreign investors are not permitted to avail of the Blanket Exemption System. Moreover, in the instance that stock acquisition has been executed after the prior-notification has been made, an execution report would also be necessary.

The actual increase in practical burden on investors will depend upon the details of the scheme to be established going forward; however, in the instance that the scheme is established such that frequent notifications and reports will be necessary, in order to make the procedures more efficient, it is deemed desirable to digitalize the procedures and make them available in English as well.