Skadden

As Shareholder Activism Grows in Japan, New Amendment Places Limits on Foreign Investors

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Investors in Japanese-listed companies have traditionally taken a passive approach to their investments, in part because Japanese business culture have long held an unfavorable view toward investors making demands or voicing strong opinions to companies. In recent years, however, the Japanese market has become increasingly receptive to direct and open engagement between market participants and listed companies. This change may be due in part to the gradual recognition by the public that investors, particularly foreign investors, exerting pressure on management teams and boards of directors can add corporate value. The dominant catalyst, however, has been the Japanese government's efforts to improve the corporate governance practices of listed companies, as reflected by the introduction of the Stewardship Code in 2017 and the Corporate Governance Code in 2018, which require Japanese-listed companies to actively engage in dialogue with their shareholders to enhance value.

In this climate, Japan is experiencing unprecedented growth of shareholder activism, and listed companies can no longer disregard the demands of activist investors. In June 2019, when the majority of Japanese-listed companies held their annual general meetings, a record 54 companies received shareholder proposals, on issues ranging from suboptimal balance sheets to management transparency. Notably, a few of the proposals were either approved or nearly approved — both of which are unusual outcomes in Japan. While the large number of shareholder proposals may reflect investor frustration with substandard corporate governance or the sluggish pace of change at listed companies, it also shows that active engagement, from private discussions to public proposals, is taking place between investors and companies.

However, despite the rise of shareholder activism, Japanese-listed companies still are not very sophisticated when dealing with activist investors. For example, most Japanese-listed companies lack any planned communication protocols or the experience necessary for active and constructive engagement with activist investors. The amendment of the Foreign Exchange and Foreign Trade Act (FEFTA) appears to be intended to help these companies avoid becoming targets of foreign activist investor campaigns.

Foreign Exchange and Foreign Trade Act

FEFTA has long regulated foreign investments in Japanese businesses by requiring certain prior notification processes, preclosing approvals from the Japanese government and/or post-closing reporting when acquisitions of significant minority equity stakes of listed companies are made, depending on the industry of the target company. The act subjects a broad range of industries related to national security to these requirements. In addition, other laws regulate specific industries, such as the Banking Act and the Insurance Business Act. A key requirement under FEFTA is a prior approval process that is triggered by an equity investment, representing 10% or more of voting rights, into a Japanese-listed company engaged in

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sensitive business important to national security. In most cases, companies receive prior approval within 30 calendar days; however, approval may take more time if the investment is for a controlling interest and the target company operates in a highly regulated industry or controls businesses determined to be important to national security, such as military, defense, nuclear power and aviation.

Japan will be tightening certain reporting requirements under the act pursuant to a recent amendment that was passed by the Japanese legislature in November 2019 and is expected to become law by May 2020.

Key Changes to the Act

Under the amendment:

- Foreign investors seeking a 1% voting interest in Japanese-listed companies engaged in sensitive businesses will be required to undergo a prior notification process and obtain preclosing approval with the Japanese government. The ownership threshold of listed companies in nondesignated sectors remains at 10%; coverage of designated sectors is subject to ongoing review by the relevant authorities.
- A new provision will require foreign investors to undergo a prior notification process before making certain changes to management of a target company engaged in a sensitive business, such as the nomination of new board members or proposals of transfers or dispositions of important business units of the target company.

The Exemption

Some foreign activist investors consider the amendment a reflection of Japan becoming less hospitable to foreign investors and believe their campaigns to improve shareholder returns will be more difficult. These investors contend that the amendment will make it practically impossible to increase their stakes in certain investments quietly. They also believe that a subtle intent of the amendment was to establish a monitoring mechanism on activist activities.

In response to such concerns, and as part of the Japanese government's efforts to mitigate the negative impacts in corporate governance practice and the M&A market in general, the amendment also includes an exemption from the prior notification process and preclosing requirement for passive investments, such as stock acquisitions made through portfolio investments by an asset manager and certain other safe harbors. However, it is clear that foreign activist investors will no longer be able to amass a voting interest equal to or greater than 1% while avoiding the scrutiny of the Japanese government.

The Ministry of Finance also explained that, in order to improve clarity as to whether a notification process is necessary for a given situation, it will categorize all listed companies into one of the following three groups:

- Companies subject to post-investment reporting only;
- Companies for which prior investment notification is required but exemption is applicable; or
- Companies for which prior investment notification is required and exemption is not applicable.

Requirements for the Exemption

In order to be eligible for exemption from the prior notification process and preclosing requirement, the following criteria must be met:

- Neither the investor nor a closely related person of the investor may become an officer or a member of the board of directors of the target company;
- The investor shall not propose to transfer or dispose of an important business unit of the target company at any annual general meeting; and
- The investor shall not have access to nonpublic information about the target company's technology that is important to national security.

The exemption is not available for (i) state-owned enterprises; (ii) companies that have previously violated relevant regulations of the act; or (iii) companies that are in the business of manufacturing weapons or producing/providing nuclear power, electricity or telecommunications services/technology.

Until the amendment is promulgated and further administrative proceedings take place, a degree of uncertainty will remain as to how the exemption applies to various situations. For example, how a shareholder proposal to elect an independent director would be treated remains unclear.

Relationship to CFIUS

While the amendment does not result in the Japanese government explicitly targeting a particular country or class/type of investor under the revised reporting rules, the change may enable closer monitoring of foreign inbound investments. This political move by the Japanese government is in line with a similar step taken by the United States through the enactment of the Foreign Investment Risk Review Modernization Act (FIRRMA), which strengthened the powers of the Committee on Foreign Investment in the United States (CFIUS) and allowed enhanced scrutiny of ownership in sensitive industries critical to national security by foreign investors. We believe that the primary purpose of the amendment is to prevent the transfer of technology from Japan to China and certain other countries — as Japan often aligns with U.S. policy in this area — and that the Japanese government seems unlikely to intervene in inbound investments from companies from the U.S., Europe or other close allies. According to the Ministry of Finance, the 1% threshold for advance screening will be the second lowest (after

the United States) among the G7 countries, and with respect to post-investment reform, the amendment still falls short of the regimes in the U.S., the U.K., Germany and Canada, all of which cover all business sectors and are not limited to those important to national interests.

Adopting a CFIUS-type regulatory regime regarding foreign investments may strengthen Japan's monitoring capability, safeguarding its national interests and preventing the leaking of information about critical technology. Additionally, it also may help support the argument that, by establishing robust regulatory measures that facilitate coordination with the U.S. on matters relating to investment security, Japan appears more likely to be recognized as an "excepted foreign state" under CFIUS, benefiting Japanese companies by narrowing the CFIUS process for investments in U.S. businesses. For this reason, the short-term incremental impact of the FEFTA amendment on the M&A market may actually be positive from an outbound M&A perspective.

Looking Ahead

While the potential impact of the FEFTA amendment may be significant for foreign activist investors and certain institutional investors, in particular Chinese state-backed institutions, we expect the overall impact on corporate governance and deal activity in Japan to be relatively limited. The amendment, according to the Ministry of Finance, does not impose direct restrictions on the FEFTA proposal rights of minority shareholders or their ability to engage with companies pursuant to the Companies Act, as long as such actions (or campaigns) do not relate to the amendment's objective, *i.e.*, protecting against the leakage or transfer of sensitive technology. A short-term dip in investments by foreign activists, whether in the form of passive investments or full-fledged campaigns, is possible, but the long-term impact of the amendment is likely to be mitigated as the Ministry of Finance provides detailed guidance in due course.

It is likely that the amendment primarily reflects the Japanese government's geopolitical motivations and is intended to be used as a tool to implement foreign policy, not to counter efforts the government recently has made to improve corporate governance practices and promote investments. The Japanese M&A market has grown significantly in the past few years, especially since 2012, when the Liberal Democratic Party under the leadership of Shinzo Abe implemented its new economic policy and pushed for corporate governance reform. In addition, the markets understand that Japan's opening to foreign investors has benefited the stock market, and the Japanese government is unlikely to reverse this direction and force foreign investors to leave the overseas investor-dependent market. The limited intent of the amendment is to put in place necessary safeguards so that critical technology and information are not transferred in a manner that is inconsistent with Japan's national interests.