24 October 2019

Mr. Kenji Okamura
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Ministry of Finance
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By post and email c/-: yukihiro.takahashi@mof.go.jp

cc: Mr. Kenichi Habu, Head, Legal Office, MOF
cc: Ministry of Economy Trade and Industry; Financial Services Agency ; Japan Exchange

Re: Amendment Bill of the Foreign Exchange and Foreign Trade Act

Dear Sir,

We are writing on behalf of the members of the Asian Corporate Governance Association (ACGA) to express our deep concerns about the direction and substance of recently proposed amendments to the Foreign Exchange and Foreign Trade Act (FEFTA).

Announced on 8 October 2019, the new proposals envisage significant changes to the current FEFTA regime. Whereas previously foreign investors were required to file a "pre-acquisition notification" if they intended to acquire 10% or more of a listed company in a restricted sector, the new threshold will be reduced to 1%. In addition, foreign investors intending to influence management on a range of governance or business issues would need to file a pre-notification of their intentions.

We understand that the aim of the Amendment Bill is to strengthen the country's national security and we consider this a legitimate objective. In its current form, however, we believe the Bill will prove highly detrimental to Japan's capital market and corporate governance. We urge the Ministry of Finance (MOF) to reconsider the amendments and undertake a thorough consultation with foreign institutional investors before finalising them. While we recognise that certain exemptions for foreign asset managers have been introduced since the original announcement, important parts of the new regulation require urgent clarification.

About ACGA

By way of background, ACGA is a not-for-profit membership association founded in 1999 that works to improve corporate governance around Asia-Pacific. Our operations are supported by a regional and global membership of institutional investors, financial service firms, listed companies, and auditors. ACGA has 115 member firms, three quarters of which are investors with more than US$30 trillion in assets under management globally. They are significant investors in the Japan market, have been supportive of the current government's corporate governance reforms, and many are signatories to the Japan Stewardship Code.

Member survey
Over the past week ACGA has sought comment from our investor members on the proposed FEFTA amendments. We have received written responses from 39 member firms—close to 45% of our 90 investor members—representing both asset owners and managers (active and passive) from the following jurisdictions: Australia, Canada, Hong Kong, Japan, Netherlands, Norway, Singapore, Sweden, the United Kingdom, and the USA. Their responses reflect a high degree of consensus around the following points:

1. **Corporate governance downgrade:** The pre-notification requirements for foreign asset managers seeking to "influence management" will not only undermine enthusiasm for investor stewardship, but contradict the government's efforts in recent years to champion better governance through the Stewardship and Corporate Governance Codes. Progress towards improved corporate governance in Japan will likely slow if management teams are subject to reduced shareholder engagement and influence. Meanwhile, the perception of Japan as a market with steadily improving corporate governance will suffer.

2. **Reduced willingness to invest:** The amended FEFTA is likely to have a chilling effect on foreign investment in Japan, since a large number of portfolio positions previously viewed as acceptable and non-strategic would now be subject to scrutiny when an investor reaches the 1% threshold, which all agree is unreasonably low and will produce unintended consequences. While the MOF announced a broad exemption for foreign asset managers and others on 18 October 2019, this would only apply to investors who commit to not trying to influence management. All of which would add considerably to administrative costs and complexity, not to mention legal and regulatory compliance costs and risks. As one member noted: "This could increase the visibility of other market participants to our investment ideas (which could reduce the value of our ideas), add administrative friction to our investment process, and increase our operational and compliance costs. These regulations could make Japanese investments less attractive than opportunities in other jurisdictions."

   Meanwhile, one of the biggest losers from the new bill may be the small and medium enterprise (SME) sector, which makes up a majority of all issuers in Japan. "These companies are inefficiently priced because, in part, global investors have difficulty conducting their due diligence and buying shares. 60% of public companies in Japan have zero sell-side analyst coverage. If global funds are restricted from owning more than 1% ... due to the new filing and pre-clearance requirements, these smaller companies might be considered uninvestable for global funds", said another member.

3. **Valuations and market liquidity:** Foreign investors account for around 30% of equity ownership in Japan and 60-70% of daily trading. If they are deterred from investing, this would almost certainly have a negative impact over time on company valuations and market liquidity. A veteran fund manager warned: "In terms of the impact on investment plans in Japan, we have already seen some of our clients raise concerns such that this may be a reason for them to take money out of Japan."

4. **Lack of clarity on "no intention to influence management":** On the one hand, there is an urgent need to clarify the scope of this concept, which currently includes "not being a director, not having access to non-public technologies or business information, and not proposing sales or divestment of businesses." It appears this is not a complete list. What other items might be added in the detailed regulations? Will it, for example, also include writing letters to companies and voting in favour of shareholder proposals?

   At the same time, most members view this provision as an unwarranted intrusion on their rights as shareholders and duties under the Stewardship Code. The issue of core and non-core operating assets is fundamental to many discussions between companies and their shareholders. Nominating candidates to the board of directors is a legal right of any shareholder. And simply owning 1% of a company gives an investor few powers within that company and little influence. You may be able to make a shareholder proposal, but to have it pass at a meeting requires the support of up to another 49% of shares voted.

5. **Lack of clarity on affected sectors:** The list of restricted sectors is extremely wide and includes, among others: weapons, aircraft, space technology; information technology, internet, software; electricity, gas; communications, broadcasting; transportation; public-safety businesses; agriculture and related. Yet it is not clear if companies that do even a small amount of business in a restricted sector will be included. What percentage of sales must be reached before a company is considered part of a restricted sector?

6. **Lack of consultation:** Members were surprised at the speed with which the Amendment Bill was announced and approved by the Cabinet, with no prior consultation of market participants and apparent disagreement among capital market institutions in Japan.

7. **Other exemptions / non-exemptions:** It is not clear to active investment managers why passive investors (ie, portfolio investors holding index investments) should be exempt from the new rules or enjoy expedited processing. This would appear to penalise active managers. Meanwhile, it is not clear to public pension and investment funds if they would be classified as foreign government-controlled entities and therefore non-exempt. While such funds may have the state as their ultimate owner, they are professionally managed and typically operate independently of government.

Recommendations
Based on feedback from members and our own analysis of the Amendment Bill, ACGA would like to make the following recommendations:

1. **Public consultation:** We would urge the MOF to consult widely on the impact of the amendments before sending them to Parliament. This bill has the potential to do considerable damage to Japan's reputation for sound capital market management and constructive corporate governance policy.

2. **Remove "influencing management"**: This concept is extremely broad and undefined. It will impede fund managers who are trying to do the right thing by engaging with companies on their governance or performance. It is likely to generate a great deal of ill will. And since the goal of all Japanese corporate governance reform of the past seven years has been the enhancement of corporate value in the context of a more responsible shareholder environment, this provision is especially counterproductive.

3. **Review the 1% threshold; maintain 10%; assess materiality**. A low threshold such as 1% will result in a large volume of reporting from foreign portfolio investors who pose little or no threat to national security—with a commensurate amount of vetting having to be done by the MOF or METI. Japan already has a 5% threshold for large-shareholder reporting, hence the government would become aware through this channel of any new foreign investor that may pose a threat to national security by taking a stake in a restricted business. This could act as an early warning mechanism, with the ultimate sanction being a government order to divest if and when the investor reached 10% (as allowed under the current FEFTA rules). In other words, there may be no need to amend the current 10% rule. A more targeted focus on the intentions and materiality of large foreign investments in sensitive areas of the economy may prove more productive for Japan in the long run. Meanwhile, 10% puts Japan in good company with Germany.

4. **Clarify the scope of restricted sectors:** There is an urgent need to clarify in detail which sectors are included in the restricted list and whether firms with any level of business in these sectors will be included.

We would be pleased to discuss further the points raised above with the MOF.

Yours truly,

Jamie Allen
Secretary General