9 April 2020

Research Division
International Bureau
Ministry of Finance
3-1-1 Kasumigaseki, Chiyoda-ku
Tokyo 100-8940, Japan

Re: Public consultation on the draft rules and regulations of the Foreign Exchange and Foreign Trade Act (FEFTA)

Dear Sirs,

We write in response to the consultation on the above matter published by the Ministry of Finance on 14 March 2020, and subsequently republished with amendments on 25 March 2020. Our comments in this letter respond to the English-language explanatory document which accompanies the consultation. We note with some concern that the draft rules and related implementing measures which give legal effect to the rules—in total, seven separate documents—are available only in Japanese. Given that the rules when made will only apply to foreign investors, and that therefore the public consultation is likely to be of most relevance to those investors, the absence of English-language versions of the draft legal instruments will inevitably limit the ability of some foreign investors to participate in, and contribute to, the consultation exercise.

Overall assessment

It appears that some steps have been taken to lessen the operational impact of the new rules on some types of foreign investor. For other kinds of foreign investors, the rules appear to have become, in some respects, tighter than those outlined to foreign investors in informal meetings and webinars earlier this year. While a reduction in the operational burden of the rules for some investors is very much welcome, our view remains that the new rules still represent a step backwards for corporate governance in Japan. The consultation seeks to draw a parallel between the approach envisaged by the FEFTA implementing rules, and the approach to the screening of foreign investment that has been adopted in the US and in some European countries. While recognising that a number of countries have in recent years taken steps to enhance scrutiny of inward investment in public companies, we believe that the proposed FEFTA regime would be unique in subjecting the exercise of some fundamental shareholder rights, such as nominating closely-related persons as directors and making certain shareholder proposals, to ongoing regulatory approval at the level of a mere 1% shareholding. As a consequence, we continue to be concerned about the underlying principle and overall regulatory approach that has been adopted in the new FEFTA regime.

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Specific comments

There are a number of areas in the new regulations that would benefit from further clarification and detailed explanation.

Foreign financial institutions

We note that the draft rules contemplate a "blanket exemption" from the prior-notification requirement for a range of foreign financial institutions. We would suggest that some further guidance is needed in order that foreign investors might accurately understand the scope and application of the blanket exemption. In particular, it would be helpful to have some clarification on the following points:

- The consultation document describes the blanket exemption as being available to foreign financial institutions "which are subject to regulations/supervisions under financial regulatory laws in Japan or other jurisdictions". However, in December 2019, the Ministry of Finance delivered a presentation to foreign investors in which the exemption was described as applying to foreign investors that are subject to the laws of Japan "or equivalent legislative frameworks of foreign countries". We note that the concept of equivalence does not appear in the consultation document in relation to the blanket exemption. Given this apparent change of policy, and its fundamental importance to determining the availability of the exemption, investors would welcome confirmation that it is indeed the intention that any foreign investor may avail of the exemption provided that it is subject to either regulation or supervision in its home jurisdiction.

- It is not fully clear to us whether the blanket exemption is available in the case of an investment held by, and in the name of, a fund vehicle, as opposed to one held by an asset management company. The consultation refers to one type of investment vehicle, whose English-language rendering is unclear. Investors would welcome confirmation as to whether all or only some forms of fund vehicle are eligible for the blanket exemption. To the extent that the concept of "equivalence" might have been retained, an explanation of its application in the context of fund vehicle eligibility would also be helpful. However, given the multiplicity of fund vehicle types and structures, we would ask that you consider adopting a simplified approach in such cases. To that end, we would suggest that a "look-through" approach be adopted, such that the eligibility of a fund vehicle should be determined by looking-through the vehicle to its investment manager and determining eligibility by reference to the status of the investment manager.

- We feel that there might be a need to further clarify the scope of the blanket exemption and the "regular exemption", and to explain the possible interaction between each in certain circumstances, as follows:

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- First, while recognising that the policy intent is that pension funds and sovereign wealth funds should look for exemption under the regular rather than blanket exemption regime, it is nevertheless the case that some such funds are regulated financial institutions in their own right. For example, some pension funds have established and own investment management entities, licensed and supervised by the regulators in the jurisdictions in which they conduct investment business, to invest on behalf of the pension fund in question. It is not clear to us whether a regulated investment management business of this kind would be able to access the blanket exemption or whether it falls to be treated as an extension of the pension fund and therefore that it is the regular exemption regime that is applicable to it.

- Secondly, in respect of its shareholding in any given public company, a regulated investment manager might have the right to determine how to exercise the voting rights attached to some, but not all, of the shares that it holds in that company. In other words, it might be the case that some of the investment manager's clients have retained the right to make decisions about voting, but others have not. It appears to us that this gives rise to a situation in which the regulated investment manager can avail of the blanket exemption only in respect of the shares over which it exercises voting control. As a result, the shares held in its name but subject to voting control by its client will need to be notified to the Bank of Japan by the client where they constitute more than 1% of share capital, unless an exemption is available. It is entirely possible that the client will not be a regulated financial institution, and will not be able to access the blanket exemption in its own right. As a consequence of the Ministry's policy decision that the obligation to notify should flow from the right-to-vote shares, it may be that some parts of the shareholding held by an investment manager will be subject to the blanket exemption regime, some to the regular exemption regime, and some that are unable to be brought within any kind of exemption. We have serious doubts about whether this arrangement is operationally feasible for both investment managers and their clients.

- The English-language explanatory document does not appear to address the case in which a listed or unlisted foreign corporate (which is not a regulated financial institution) acquires a shareholding in excess of 1% of a public company and retains the right to exercise the voting rights attached to those shares. It appears that the listed foreign corporate would be unable to access any type of pre-notification exemption. Were that to be the case, many foreign investors would question why an exemption is apparently to be made available to a foreign financial institution regulated in any country, but no exemption is to be available to a listed non-financial foreign corporate in any country. It would be helpful to receive confirmation as to the position of listed non-financial corporates under the new FEFTA rules in circumstances in which those corporates retain voting power over their shares.

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Definition of foreign investor

We note that the implementing rules would change the definition of "foreign investor" currently used in FEFTA. It appears that this is to be achieved by importing into FEFTA the definition of a "subsidiary" from Japan's Companies Act. However, the consultation document does not explain why this change is either necessary or appropriate. Given that this will introduce additional complexity into the operation of FEFTA and expand the number of investors classified as "foreign", some explanation would be appreciated by investors. In the absence of a reasoned explanation, investors might well conclude that the change of definition is intended to capture some specific foreign investors and their investment holding structures that have until now been outside the scope of FEFTA.

In addition, we question the legal appropriateness of a legislative change which converts existing non-foreign investors who already hold in excess of 1% of a company's issued share capital but are not presently subject to FEFTA into foreign investors who are subject to FEFTA. In our view, the new, expanded definition of "foreign investor" should apply only in respect of foreign investors whose shareholding crosses the 1% threshold after the new FEFTA rules come into force. Alternatively, the rules will need to provide appropriate transitional relief for investors with existing holdings in excess of 1% but who were not classified as "foreign" when they made their investments.

Sovereign wealth funds and public pension funds

The consultation sets out the terms of an exemption regime for "sovereign wealth funds and public pension funds". It appears that to access the regular exemption a fund will need to be accredited by the Ministry and a memorandum of understanding will need to be concluded with each fund. We find the terms of the proposed regime to be excessively complicated, impractical and lacking in transparency. We make the following points:

- First, the consultation document provides that the "decision of an accreditation and signing of MOU will not be made public". Funds in most parts of the developed world, especially public pension funds, will be unable to comply with such a requirement. As a matter of governance and transparency to their members, it will not be possible, nor in our view would it be desirable, for a public pension fund to conceal its status as an accredited investor or the fact that it had entered into a legal agreement with the Government of Japan in relation to pension fund assets.

- Secondly, as a practical matter, we see no way in which accreditation and agreement of an MOU can be achieved by June 2020 with every fund which currently holds more than 1% of the issued shares of a Japanese company. We therefore do not see how funds will be able to access the regular exemption when the new rules are fully implemented in June. Investors would welcome guidance from the Ministry about its intended timetable for accrediting and agreeing an MOU with all funds. We believe that a lengthy transitional period would be appropriate during which the current FEFTA rules would continue to apply.

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- Thirdly, as noted above, the policy decision to attach the notification obligation to the controller of the voting rights creates operational difficulties for both funds and their investment managers where each is subject to a different FEFTA exemption regime. In addition, the more restrictive terms of the regular exemption, together with its apparent unavailability by June 2020 could prompt some funds to delegate to their investment managers decisions about the exercise of voting rights. It would be an unwelcome outcome of the FEFTA revision if the difficulty of obtaining accreditation and of operating the regular exemption prompted some pension funds to pull back from hands-on investment stewardship.

- Fourthly, in respect of investments in core sectors, it was disappointing to see that the Ministry proposes to introduce two additional eligibility conditions ("d" and "e") for access to the regular exemption. The proposition that, in addition to refraining from the activities specified in (a) to (c), a foreign investor must also agree to refrain from making written proposals to the board and from certain other activities, is likely to be unacceptable to many foreign investors. The effect would likely be to shut down any form of substantive dialogue between the foreign investor and the investee company. As a practical matter, it is therefore unlikely that foreign investors in core sectors will be able to use the regular exemption. In turn, this may well mean that fewer foreign investors will be willing to invest in companies operating in core sectors. Moreover, the language of the additional conditions, especially (e), is expressed in such broad and vague terms that it will be very difficult for a foreign investor to know for certain how to comply with those conditions. Even if a foreign investor were in principle willing to accept constraints on its ability to interact with investee management, it would be difficult for it to know exactly what sort of activity is or is not permitted under condition (e).

- Lastly, what is the position of private pension funds under the new FEFTA rules, and specifically the regular exemption? In respect of the regular exemption, the consultation document refers only to "public" pension funds. In both the US and the UK a very substantial proportion of pension fund assets invested overseas are held by pension funds operated by large corporates for the benefit of their retired employees; these are not in any sense "public" pension funds.

We urge the Ministry to reflect on the practical issues associated with the implementation of the new rules for pension funds/sovereign wealth funds and strongly suggest that:

- Pension funds and sovereign wealth funds which receive accreditation should be allowed to access the blanket exemption in respect of investments in designated business sectors other than core sectors;

- The regular exemption should be reserved for pension funds and sovereign wealth funds in respect only of their investments in core sectors; and

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- Condition (e) should be removed or its scope significantly narrowed, so that foreign investors will be able to maintain a dialogue on governance matters with investee management in core sectors.

Transitional measures

The consultation document does not, as noted, address transitional arrangements. We have highlighted above a difficulty with rolling out the accreditation scheme for funds in order that they may access the regular exemption from June 2020. In addition:

- Foreign investors (including those that are "foreign" both before and after the new rules are implemented) require clarity about grandfathering arrangements (if any). That is to say, if, when the new rules are implemented in June, a foreign investor holds more than 1% of the issued shares of company in Japan but cannot avail of a notification exemption, how should that investor proceed?

- Given that many foreign investors in Europe and North America are operating remotely under measures in their countries designed to address the coronavirus epidemic, there might be operational challenges in both configuring and testing compliance monitoring and reporting systems needed to implement the new rules. As noted above, we see a particular systems challenge associated with position calculations for an investment manager which holds shares in a company, over only some of which it has voting power. We would ask the Ministry to consider whether Q2 2020 is still an appropriate time to implement the new FEFTA reporting regime.

- Following on from the above point, investors would also welcome clarity about the Ministry's own business continuity arrangements in the event of a wider coronavirus epidemic in Japan leading to the sort of mandatory home-working that has been seen in other countries. The processes set out in the new FEFTA rules involve review and approval by the Ministry at various stages (for example, granting of accreditation and screening of certain actions). Investors would welcome confirmation that the Ministry has arrangements in place to allow these processes to function smoothly in the event of a lengthy lockdown or similar arrangement in Tokyo.

We would be happy to discuss any of the points in this letter with you further.

Yours truly,



Jamie Allen, Secretary General

**Christopher Mead, Deputy Secretary General, ACGA, also contributed to this letter.*

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