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# NO&T Japan Legal Update

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**This issue covers the following topic:**

■ Technology/M&A

**Impacts of Amendments to Foreign Direct Investment Regulations on Foreign Investment in Japanese Technology Companies.**

■ Technology/M&A

## Impacts of Amendments to Foreign Direct Investment Regulations on Foreign Investment in Japanese Technology Companies.

### I. Introduction

On May 8, 2020, amendments to the Foreign Exchange and Foreign Trade Act (the "**FEFTA**"), which regulates foreign direct investments ("**FDI**") in Japan[1], as well as its related cabinet orders, ministerial ordinances and public notifications (collectively, "**Amendments**") came into force, and will be fully implemented from June 7, 2020.

The Amendments are a continuation of recent changes that have been made to Japan's FDI regulations. In August 2019, an amendment to the Notifications on Business Sectors came into effect and expanded the scope of the sectors that require advance filings under the FDI regulations ("**designated business sectors**") to include, among others, software, data processing services, and Internet-use support sectors. Foreign investors who invest in companies engaged in business in the technology sector and technology companies themselves are no longer unaffected by the review process under the FDI regulations.

Although the Amendments include a number of changes to the FDI regime, the expansion of both the scope of the activities that are subject to the advance filings requirement, together with the expansion of the scope of the designated business sectors in 2019, has an impact not only on capital contributions and acquisitions of companies engaged in technology-related businesses, but also on their management and corporate activities after capital contributions and acquisitions.

This article provides an overview of the Amendments with a particular focus on topics relating to businesses in the technology field.

### II. Lowering of Threshold for Acquisition of Shares of Designated Business Sector Listed Companies

Before the Amendment, foreign investors who acquire shares of a listed company[2] in Japan are not subject to FDI regulations if the ratio of their shareholdings and/or the ratio of their voting rights is less than 10%. However, under the Amendments, the 10% threshold for the acquisition of shares of a listed company is lowered to 1% if the listed company is engaged in a business that falls within a "designated business sector". Accordingly, a filing under the FEFTA is required prior to a foreign investor acquiring 1% or more of the shares of a listed company engaged in a business that falls within a designated business sector.

1 Generally speaking, the FEFTA requires filings and/or notifications regarding certain activities such as the acquisition of shares of Japanese companies by foreign investors.
2 Including shares registered or designated for over-the-counter trading.

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This change under the Amendments will have a significant impact on foreign investors who wish to invest in listed companies in Japan. For example, if a foreign investor plans to make a minority investment (i.e., holding a few percent of shares) in a Japanese listed company engaged in software development or cloud services, which falls under a designated business sector, the foreign investor must make a filing with the Japanese authorities in advance of the investment in accordance with the FEFTA. As a general rule, the review period for the advance filing under the FEFTA is 30 days (which may be shortened[3]). Thus, the review period will need to be factored into the overall timeline when preparing for even a minority investment.

The acquisition of shares of an unlisted company is subject to the FDI regulations even if it is an acquisition of only one share. To be precise, advance filing is required for foreign investment in unlisted companies that operate in a designated business sector and post-fact notification is required for foreign investment in other unlisted companies. This has not been changed by the Amendments.

## III. Expansion of the Scope of Activities Subject to FDI Regulations

The FDI regulations under the FEFTA are not limited to the acquisition of shares, but also includes 'consent' given by foreign investors in relation to certain activities of Japanese companies. Prior to the Amendments, the only consent that was subject to the FDI regulations was consent at a shareholders' meeting to a proposed amendment of a company's Articles of Incorporation to add a business that falls within the designated business sectors to the business purpose of the company.

Under the Amendments, the FDI regulations will also apply to consent given by a foreign investor (in the case of a listed company, a foreign investor who holds 1% or more of the voting rights) in relation to the following matters that may have a material influence on the company's management. These changes were made primarily to prevent the outflow of technical information and the loss of business activities which involve national security.

### (i) Appointment of Foreign Investors Themselves or Related Persons as Directors or Corporate Auditors

As a general rule, a foreign investor must make a filing in advance of giving its consent to a proposal to appoint himself/herself or any of his/her 'related persons' as a director or corporate auditor of a Japanese company that engages in a business that falls under the designated business sectors. The 'consent' in this case includes exercising voting rights in favor of the proposal at a shareholders' meeting as well as providing consent to a written resolution. Since it is necessary to make the filing prior to a shareholders' meeting held to appoint directors and/or corporate auditors, the schedule for the shareholders' meeting may be affected.

It should be noted that the definition of a foreign investor's 'related persons' differs slightly between cases where the foreign investor itself, or the foreign investor through a third party, submits a proposal for the appointment of directors and/or corporate auditors, and cases where the company or other third parties submit such a proposal.

Notwithstanding the foregoing, there is an exception to this rule. A foreign investor is not required to make a filing in advance of giving consent to a proposal to appoint himself/herself or a related person as a director and/or corporate auditor of a company in which the foreign investor holds 50% or more of the voting rights and that foreign investor has made an advance filing under the FEFTA in relation to the acquisition of those shares in the company. Thus, in a situation where foreign investors have invested in Japanese companies and hold a majority of voting rights, there is no need to make a separate filing when appointing themselves or their related persons as directors and/or corporate auditors.

3 In practice, the review period is often shortened to two weeks. For cases determined on national security considerations, the review period may be further shortened to four business days after the day on which the filing is received.

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On the other hand, in cases where the above exception requirements are not met (e.g., a minority shareholder proposes to appoint its officer or employee or its related person to be a director of the company in connection with its minority investment), a filing will be required in advance of each time a director or corporate auditor is appointed.

(ii) M&A Transactions Pertaining to Designated Business Sectors

Under the Amendments, a filing must be made by a foreign investor in advance of giving consent to a proposal that it submitted to a shareholders' meeting directly or through other shareholders which pertains to any of the following activities in respect of a business that falls within a designated business sector:

- Transfer of the whole or a part of business;
- Transfer of whole or part of shares and equity of subsidiaries;
- Absorption-type merger (in the case of becoming an absorbed company) or a consolidation-type merger;
- Absorption-type company split (in cases of becoming a splitting company) or an incorporation-type company split;
- Dividends in kind on the shares of the business or subsidiary;
- Dissolution; or
- Abolition of the business.

As a result, when carrying out an M&A transaction for a business that falls under a designated business sector category, consideration should be given as to whether either or both of the buyer or the seller is required to make an advance filing in light of the above restriction under the FEFTA.

## IV. New Exemptions for Prior Filings for Share Acquisitions

Under the Amendments, while the scope of activities subject to the FDI regulations is expanded, at the same time, a new scheme is introduced that sets forth certain exemptions to the requirement to make a filing in advance of a share acquisition. It should be noted that there is no exemption for the requirement to make a filing in advance of giving consent to a proposal for the appointment of directors/corporate auditors or in respect of the M&A transactions mentioned above.

The table below provides an outline of the new exemption scheme that is available for general foreign investors who do not fall under the category of foreign financial institutions or state-owned corporations.

| | Listed Company | Unlisted Company |
|---|---|---|
| Designated Business Sectors (except for Core Business Sectors) | Exemption from advance filings (no upper limit) by observing the conditions for the general designated business sectors. | Exemption from advance filings (no upper limit) by observing the conditions for the general designated business sectors. |
| Core Business Sectors | Exemption from advance filings of share acquisition of less than 10% if additional conditions are also observed. | No exemption from advance filings. |

The outlines of 'Conditions for General Designated Business Sectors' and 'Additional Conditions for Core Business Sectors' that are referenced in the above table are set forth below:

**(Conditions for General Designated Business Sectors)**
Foreign investors and related persons are not appointed as directors (or, in the case of business equity companies, executive partners or executive officers) or corporate auditors;
Not to propose to shareholders' meeting for the transfer or abolition of a business that falls under a designated business sector; and
Not to acquire non-disclosed technology information pertaining to a business that falls under a designated business sector, or do any other actions that may lead to the outflow of such technical information.
**(Additional Conditions for Core Business Sectors)**

Not to attend the board of directors or committees with important decision-making authority regarding a business that falls within a core business sector by foreign directors themselves or by persons designated by them; and
Not to make a proposal in writing or electromagnetic records to the board of directors or committees with important decision-making authority, or to any of their members, for the response or action of the company, with a time limit, in relation to a business that falls within a core business sector.

As mentioned above, under the Amendments, parts of businesses that were traditionally understood as designated business sectors have been further designated as core business sectors, and are subject to additional exemption criteria. Among the core business sectors, businesses in the technology field include:

- Cybersecurity-related services;
- Data processing services exclusively used to provide services related to critical infrastructure businesses, such as electric power and telecommunications; and
- Data processing services exclusively used to handle certain personal information (which is limited to location information, personal identification code, sensitive personal information, and credit information) from more than one million people.

With regard to listed companies, foreign investors should take the time to check the classification of the target company. A list is published[4] by the Ministry of Finance classifying listed companies into three categories; namely, companies that operate businesses:

- that are not within a designated business sector;
- that are within a designated business sectors but not a core business sector; or
- that are within a core business sectors.

It is worth noting that in Japan, except for circumstances where an investment made is for pure investment purposes, it is not uncommon for a foreign investor acquiring shares in a company that is engaged in a business in the technology field to appoint a director or designate an observer to the board, or utilizes the technical information held by the company, even if it is a minority investment. In such cases, it would not be possible to fulfill the criteria under the exemption scheme for the share acquisition, and it would be necessary to make a filing in advance as required under the FEFTA.

## V. Limitation of Scope of Designated Business Sectors

As mentioned above, the amendments to the Notifications of Business Sectors, which came into effect in August 2019, resulted in the expansion of the designated business sectors to include businesses concerning, among others, software, data processing services, Internet-use support. As a result, the number of cases has increased where an advance filing is required for the FDI in companies engaged in businesses belonging to the technology field.

Contrary to the amendments to the Notifications of Business Sectors, the Amendments also introduce new provisions that will act to limit the scope of such expanded designated business sectors. Specifically, businesses of software, data processing services, and Internet-use support (other than those that fall within a core business sector) will not be classified as engaging in a designated business sector if they are: (a) operating incidentally as part of the same entity whose business is not within a designated business sector; or (b) operating for the purpose of servicing their parent company and their subsidiaries which operate businesses that are not within a designated business sector. These two exceptions are only applicable to businesses that do not provide their services to any person/entity outside of its own corporate group.

## VI. Concluding Remarks

The Amendments will lead to further increases in the number of advance filings made in relation to FDI involving companies engaged in business in the technology field in Japan, and due to an increased focus on ensuring national security in this area, the review of the advance filings is likely to be more stringent than before. Additionally, the Amendments are not only related to foreign investors, but also affect companies that are recipients of foreign investment or are considering entering into M&A transactions with foreign investors, and companies that already have foreign ownership interests.

4 The "List of Applicability of Prior Filings of Foreign Direct Investment under the Foreign Exchange and Foreign Trade Act of Listed Companies in Japan" is published on the website of the Ministry of Finance.

For these reasons, it is important to consider the applicability of the FDI regulations from an early stage and make preparations well in advance so that the requirements under the FEFTA do not unexpectedly adversely affect the investor's or the relevant business' intended activities.

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