Different Law, Same Challenges: New Japanese FDI Rules Unlikely to Deter Activist Investors

In November 2019, Japanese legislators revised the Foreign Exchange and Foreign Trade Act, requiring foreign investors to obtain government approval before purchasing 1% or more of a listed Japanese company in industries considered sensitive to national security. The change will go into effect in May 2020, the month after the Ministry of Finance releases a list of companies to which the law will apply.

The revisions will increase the legal and administrative costs of investments in Japanese companies and effectively preclude aggressive activist strategies targeting many of the largest "Japan Inc." conglomerates. Yet the law's impact should not be overstated. Even though Japan's biggest companies are among the most difficult activist targets, they are still viable investments for most investors, including sovereign wealth funds, public pension funds, and other asset managers pursuing more passive strategies. Meanwhile, the rich set of activist opportunities in Japan's many small and medium sized companies remains, as do the many other challenges activists have long faced in the country.

New Rules and Uncertainties

On 22 November 2019, Japan's Diet (Parliament) amended the Foreign Exchange and Foreign Trade Act (FEFTA) to lower from 10% to 1% the threshold at which foreign investors must seek approval from the Japanese government before making an acquisition in certain sectors considered sensitive to national security. These include weapons, aircraft, space, nuclear power, gas and electricity, communications, water supply, railways, oil, cybersecurity, and industries that manufacture products which can be diverted to military use. The law was supported by Prime Minister Shinzo Abe and his Liberal Democratic Party, which has the majority in both houses of the Diet. Now the implementation falls to regulators, especially the Ministry of Finance (MOF). In April 2020 the MOF is expected to publish a list of 400 to 500 companies – potentially more than 10% of all listed Japanese equities – affected by the regulations.

The Japanese government has defended the law as in line with measures taken by the US and EU in the past year and a half, including the expansion of the Committee on Foreign Investment in the United States (CFIUS) via the Foreign Investment Risk Review Modernization Act (FIRRMA) in August 2018 and the establishment of an FDI screening framework in the EU in March 2019. However, the FEFTA revision prompted a

fierce backlash in Japan, especially from international banks and asset managers concerned that the 1% threshold would make it excessively expensive and difficult for foreign firms to take large bets on Japanese companies, and could be used to unfairly protect well-connected companies in the country.

In response, the MOF announced a range of implementation measures intended to streamline investments by foreign funds, including exemptions for pre-approved securities firms, hedge funds, sovereign wealth funds, banks, insurance companies, and other asset managers, provided they do not take an active role in the management of the company, propose directors, or suggest sales of key assets. For investors pursuing more passive strategies, the MOF exemptions will likely be sufficient to avoid major disruptions to investments, even if they require an initial legal and regulatory cost to register or otherwise engage with Japanese authorities.

Protecting Japan Inc.

However, it does seem likely that the law will go some way toward protecting Japan's most prominent, powerful, and best-connected companies from activist investors. Submissions are supposed to be filed to the Bank of Japan to then be passed on to the MOF and the relevant line ministry for a decision. For many of Japan's most prominent technology and industrial firms, that means the key player will often be the Ministry of Economy, Trade, and Industry (METI). It is hard to see how the METI – which has historically been very skeptical of activists – would support aggressive proposals or investments affecting major conglomerates like Hitachi and Toshiba, which will probably be included on the list of companies covered by the law. There is also enormous discretion in how the authorities enforce these rules, which will provide considerable scope for companies to lobby for favorable interpretations and regulators to block investments.

It is also unclear whether the MOF has the technical capacity and personnel to properly administer the law, especially in cases that require significant review. This situation would also advantage a company seeking to block permission for an investment or activist proposal, as such approvals require an affirmative decision from the authorities. These rules can also be changed with almost no notice, adding another layer of uncertainty. Even the definition of "foreign" is ambiguous, as shown in Japanese activist investor Yoshiaki Murakami's JPY 25.9 billion (USD 242 million) hostile bid for Toshiba Machine. The company rejected Murakami's offer on the grounds that Murakami should be subject to the FEFTA requirements because he is based in Singapore.

Plenty of Activism Opportunities Remain

However, the updated law is unlikely to dramatically shrink the universe of viable activist opportunities, even if it triggers a few high-profile disputes between large activist funds and with the MOF or METI over the appropriate scope of the law. Japan's largest technology and industrial conglomerates are among the most difficult, expensive targets for an activist investor. Instead, activist investors have historically succeeded in Japan with smaller, lower-profile target companies where management is either more willing to cooperate or forcing change is less threatening to the Japanese political and economic establishment. That dynamic still holds today and the new law is therefore unlikely to deter the growing number of activist funds investing in Japan.

This is especially true because these smaller public companies far outnumber the large ones that are more prone to receive regulatory attention and protection. Japan has more than 3,600 listed companies, including nearly 2,600 on the Tokyo Stock Exchange, 2,164 of which are in the more blue-chip "First Section" (TSE 1) that is the major focus for foreign investors. If in fact the updated law makes targeting 400 to 500 of these more difficult for activists and if all of them are in the first section, that still leaves approximately 1,700 other TSE 1 companies, for which the threshold remains at 10%. In comparison, the London Stock Exchange has 2,600 companies trading on its main market, and Hong Kong's main board has about 2,000 companies. The New York Stock Exchange, the world's largest by market capitalization, has about 2,800 companies. (See Figure 1)

Figure 1: Number of Listed Companies on Major Stock Exchanges

FDI regulations vary across jurisdictions, and listed companies on other stock exchanges may also be subject to FDI restrictions.

In short, even after the revisions go into effect, for most investors the regulatory and corporate governance challenges most foreign investors face in the Japanese equity markets will largely remain the same as they have been for more than a decade. Such issues include boards that lack independence, cross-shareholding interests that reduce accountability and market efficiency, and risk-averse management teams focused on maintaining the status quo rather than growing profits, among others. Despite the uncertainties inherent in the ongoing formulation of regulations stemming from the law, passive investors are not likely to be shut out, and the latest wave of activist funds investing in Japan will still have plenty to work on.

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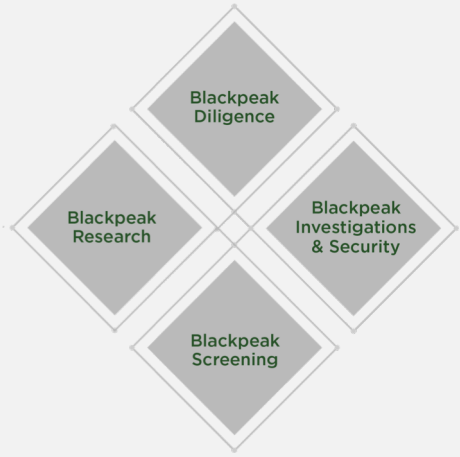

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