THE WALL STREET JOURNAL.

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Japan’s Foreign-Investor Screening Risks Undoing Years of Reform

National-security proposals to screen foreign shareholders far more tightly would frustrate a surprising proportion of overseas investors.

By Mike Bird

The Japanese government’s proposals to tighten screening of foreign investors may keep the country a little safer—at the cost of undoing several years of hard work in improving the investment climate.

If proposals published by the Ministry of Finance this week take effect, foreign shareholders would have to inform regulators when their stake in certain listed companies reaches 1%, down from the current 10%. The sectors affected would range from defense to telecommunications to marine transport, though there is no strict determination of which of Japan’s 3,680 listed companies fall within a covered category. The onus would be on the investor to decide.

The unspoken intent seems to be increase government scrutiny of sensitive Chinese investments, but a much wider swath of foreign activity would be caught.

The current notification process, conducted only in Japanese, is paper-based and generally onerous. Investors inform the government once they cross the threshold, triggering a review that can lead to the trade's being canceled. A decision takes 30 days, although the Ministry of Finance says it will reduce this.

Western brokers working for Japanese investors—including Wall Street's top banks—would be at a disadvantage to their Japanese competitors, since the proposed rules don't differentiate between end-investors and intermediaries. Activists attempting to assemble a stake, perhaps pursuing the 3% level at which they can call a general meeting of shareholders, also would be frustrated.

Since stock trading by foreign brokerages represents more than half the total volume in Japan, and even more for the largest companies, the disadvantage wouldn't be solely for overseas investors. Equity trading could become considerably less liquid if brokers are perpetually bogged down or, worse, decide the business no longer makes sense for them to conduct at all. This is a cost that Japanese investors would have to bear.

Japan already ranks lower for foreign investors' rights than almost all other developed markets, according to index giant MSCI. The new rules would only aggravate that weakness.

Of course, other countries have their own investment laws related to national security. Most notably, the Committee on Foreign Investment in the United States has blocked several acquisitions in recent years, particularly by Chinese companies.

But even if it is becoming stricter, the Cfius system entails far less aching bureaucracy for the vast majority of investors. The committee recorded 143 voluntary notifications and 66 investigations in 2015, according to its 2017 report to Congress, the most recent. Japan's system already produces an average of 607 notifications a year, and the Ministry of Finance expects that to rise 700% as the shareholding threshold falls.

The Japanese government has made huge strides in reforming corporate governance and making the country's investment geography less labyrinthine for foreigners. With the current proposals, it runs the risk of spoiling those improvements.

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