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EXITING MINORITY INVESTMENTS IN JAPANESE PUBLICLY TRADED COMPANIES

Investors in Japanese public equities may soon receive a handsome payday! The April 2014 edition of the *Corporate Counselor* (available here) discussed the issues to consider when undertaking a minority investment in a Japanese publicly traded company (a "Public Company"). Investors who purchased Public Company shares in 2014 and who still hold these securities could be sitting on a gold mine. From January 1, 2014 through March 27, 2018, the Nikkei 225 increased from 16,291 to 21,317, representing an approximate 30% increase. With the appreciation in Japanese public equities and recent market volatility, investors may be tempted to sell all or part of their investments to solidify gains. Moreover, investors could be persuaded to sell Public Company shares for reasons independent of economic gain, such as the strategic cooperation between the parties underlying the investment no longer exists, management of the Public Company has changed, or a competitor has acquired a controlling stake in the investor resulting in a sale requirement pursuant to a shareholders' agreement or arising from antitrust concerns.

This edition of the *Corporate Counselor* discusses (i) the common sales scenarios for an investor to dispose of Public Company shares (along with the advantages and disadvantages to each approach), (ii) the principal Japanese legal issues that an investor should consider when selling Public Company shares, and (iii) Japanese governmental filings that the investor and the Public Company may need to make when an investor sells Public Company shares. This newsletter concludes with enumerating sequencing issues an investor may need to consider if the investor has a strategic business relationship with the Public Company or the exit will be effected through more than one sales scenario.

Common Sales Scenarios to Dispose of Public Company Shares

There are various ways an investor can dispose of Public Company shares, including by conducting a block trade, dribbling out sales over an extended period of time, participating in a stock repurchase by the Public Company, and effecting a directed share sale to a specific third party. Annex I provides a benefit/detriment analysis of these common sales scenarios to help gauge which of these sale structures could be the most ideal under the circumstances.

While it is not possible to suggest a preferred sales scenario in a vacuum, as a general matter, an investor may prefer to sell its shares back to the Public Company due to tax benefits or to avoid the need to find a purchaser for its shares (in addition to other possible motivations). However, if it is difficult for an investor to communicate in advance with the Public Company that it desires to sells its Public Company shares, or if the Public Company does not have sufficient available funds to repurchase the shares, then a block trade to sell the shares to a third party could be the most appropriate solution due to its speed and simplicity (although the execution of a block trade through a broker-dealer could be expensive).

Japanese Legal Issues Arising from a Minority Investment Sale

The following are the principal Japanese laws that investors should consider when selling an equity stake in a Public Company. The compliance requirements applicable to the prospective purchaser (which are discussed in the aforementioned 2014 edition of the *Corporate Counselor*) also should be considered because if onerous transfer requirements would apply, then such matters could motivate an investor to select a different plan of disposal of its Public Company shares or select a different prospective purchaser.

Insider Trading Rules. Article 166 of Japan's Financial Instruments and Exchange Act states that "insiders" who have received "material information" are prohibited from trading or otherwise transferring securities of a Public Company until the material information has been made public. The term "insiders" includes, among others, directors, officers and employees (to the extent that such director, officer or employee receives information in connection with his/her respective duties at the Public Company), and a third party who has an agreement with a Public

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Company (to the extent that such third party receives information in connection with such agreement), as well as anyone who receives material non-public information from the foregoing. Accordingly, as a first step, the investor should determine whether it would be characterized as an insider through its relationship with the Public Company and, if so, then it should assess whether it is in possession of material information that is non-public (as presumably it would be difficult for a non-insider to receive material non-public information).

Under Japanese securities laws, "material information" generally includes information that would significantly affect the investment judgment of an investor relating to the operation, business or assets of a Public Company or its subsidiaries. Unlike U.S. securities laws, Japanese securities laws enumerate specific events that ordinarily are deemed to constitute material information. The enumerated events fall within the following broad categories: (i) information relating to decisions made by the Public Company, (ii) information relating to the occurrence of material events with respect to the Public Company, (iii) information relating to accounting/financial matters, (iv) information relating to subsidiaries of the Public Company, or (v) information falling under a general catch all clause. Given its complexities and vagaries, parsing through the definition of "material information" is an exercise of patience, and legal counsel should be consulted at an early stage.

It is extremely important that the investor confirm that it is not in possession of material non-public information concerning the Public Company at the time of the share sale. An investor would be prudent to examine not only its current possession, but also that it is not likely to receive in the future material non-public information concerning the Public Company prior to the share sale.

- *Current Possession of Material Non-Public Information.* The investor should determine whether it is currently in possession of material non-public information concerning the Public Company through various means, including (i) a review of the Public Company's press releases (and the manner in which the information was publicly disclosed), and securities filings to confirm what information the Public Company has made available to the public, and (ii) the completion of questionnaires by officers and directors of the investor who are involved in the decision making process with respect to the proposed share sale to determine whether such persons possess material non-public information. If the investor has a nominee serving on the Public Company's board of directors, then legal counsel will need to evaluate how or whether material non-public information previously learned from such nominee could be imputed to the investor.

- *Reducing Future Possession of Material Non-Public Information.* An information barrier should be erected with the assistance of legal counsel between the investor and the Public Company promptly after the investor has determined that there is a reasonable possibility that it could sell its Public Company shares, especially if the investor has a nominee serving on the board of directors of the Public Company. If the investor has a nominee serving on the Public Company's board of directors or otherwise has access to sensitive Public Company business information (*e.g.*, through a strategic alliance agreement), procedures should be implemented to prevent such nominee or the key personnel of the investor who have decision making authority over the sale of the Public Company's shares from learning new material non-public information concerning the Public Company that could be imputed to the investor. Furthermore, directors of a Japanese company have a fiduciary duty to act in the best interests of the company and all of its shareholders (and not just for a particular shareholder). Therefore, the director nominee(s) of the investor should refrain from participating in board deliberations of the Public Company in situations where impartiality is impossible (especially in meetings where the share sale is discussed or how future dealings with the investor will be conducted after the share sale).

If the investor is in possession of material non-public information concerning the Public Company, then procedures to cleanse the investor of such material non-public information will need to be developed. Furthermore, regardless of whether the investor is in possession of material non-public information, so long as the investor is an insider under Japanese securities laws then it should (i) have its director nominee(s) follow the insider trading policies of the Public Company, and (ii) consider completing the sale for sake of good appearances shortly after the Public Company has publicly disclosed its most recent

financial results or earnings report.

An individual found to have violated Japanese insider trading rules is subject to imprisonment for not more than five years and a fine of not more than JPY5 million, while a company found to have violated Japanese insider trading rules is subject to a fine of not more than JPY500 million. A greater deterrent to insider trading is the significant reputational harm that an individual and a company would suffer upon being found guilty, which is normally much more damaging over the long-term given the future business opportunities that likely would be diverted from persons convicted of insider trading.

Short Swing Profit Rules. Similar to the securities laws of other jurisdictions, Japanese securities laws also have short swing profit rules that require directors (and equivalents thereto) or 10% or greater shareholders to disgorge profits earned from matching buy-sell transactions (i.e., purchases and sales occurring within a six month window of each other, subject to certain limited exceptions) regardless of whether they are in possession of material non-public information. To avoid a costly surprise, an investor should confirm that it has not acquired any Public Company shares during the six month period leading up to the proposed share sale in order to avoid the perfunctory short swing profit disgorgement rules under Japanese securities laws.

Filings in connection with a Minority Investor Exit from a Public Company

It is likely that both the Public Company and the investor will need to make various Japanese governmental filings depending on the number of Public Company shares being sold by the investor. The following is an outline from the perspective of each party.

Investor Filing Obligations. Generally speaking, the investor would not be required to make any Japanese governmental filings prior to the consummation of the share sale. However, after the share sale, the following filings could be required depending on the facts:

- if the investor owns 5% or more of Public Company shares and its ownership thereof would change by 1% or more, then the investor would need to make an electronic filing on EDINET (Japan's publicly available electronic disclosure system) amending its Large Shareholder Report (which is similar to a Schedule 13D under US securities laws) within five business days after each of (i) the date the investor agrees on the share sale and (ii) the completion date of the share sale;

- if the investor owns 10% or more of the outstanding voting rights of the Public Company, then the investor would need to file a short swing sales and purchase report (similar to a Form 4 under US securities laws) on EDINET by the 15th day of the month following the month in which the share sale is conducted; and

- if the investor is domiciled outside of Japan and it submitted a notification of inward direct investment when it initially acquired the Public Company shares, then the investor would need to file a foreign exchange notice with the applicable Japanese ministry, depending on the industry in which the Public Company operates, within 30 days after the share sale is completed (such filing resembles a notice, and would not trigger a Japanese government consent or approval requirement for the share sale).

Public Company Filing Obligations. Generally speaking, the Public Company also would not need to make any Japanese government filings prior to the consummation of the share sale, unless the share sale is effected through a company stock repurchase. However, the following filings could be required depending on the facts:

- if the sale is structured as a direct sale to a third party generating JPY100 million or more in proceeds, then the Public Company would need to file a securities notice with the applicable local finance bureau before an offer to sell is made;

- if the consummation of the sale would result in the purchaser becoming a major shareholder owning 10% or more of the voting rights in the Public Company (or it would result in an existing shareholder no longer being a major shareholder of the Public Company), then the Public Company would need to disclose such occurrence under the rules of the Tokyo Stock Exchange (assuming the shares trade over this exchange) and file a report with the applicable local finance bureau, as the case may be, as soon as the sale becomes definitive or has been consummated;

- if after the consummation of the sale an existing major shareholder would no longer be the largest shareholder of the Public Company (or it would result in an existing major shareholder becoming the largest shareholder of the Public Company), then the Public Company would need to disclose such occurrence under the rules of the Tokyo Stock Exchange (assuming the shares trade over this exchange) as soon as the sale becomes definitive or has been consummated; and

- if after the consummation of the sale an existing major shareholder would no longer be considered an affiliated company of the Public Company (or it would result in another existing major shareholder being considered an affiliated company of the Public Company), then the Public Company would need to disclose such occurrence under the rules of the Tokyo Stock Exchange (assuming the shares trade over this exchange) as soon as the sale becomes definitive or has been consummated.

An investor may be placed in an awkward situation if it is contractually required or it otherwise desires to inform the Public Company in advance that it is considering a sale described above (e.g., to provide the Public Company with sufficient time to prepare the requisite notices) because there is sufficient room to argue that upon learning such material non-public information the Public Company would need to publicly disclose the potential share sale or potential change in major shareholder. Depending on the facts, a change in a major shareholder (especially if a strategic investor will exit) could negatively impact the trading price of the Public Company's shares, so an early public announcement could result in the investor receiving lower sales proceeds for its Public Company's shares (depending on the sale scenario). Legal counsel should prove helpful in formulating a timeline and talking points for share sale discussions with the Public Company.

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A material divestment by a minority investor that has various business dealings with the Public Company often can lead to a complex web of thorny issues that will need to be addressed before the exit can be completed, including:

- the manner, method, and timing of disclosing the proposed sale by the investor to the Public Company to avoid having the sales plan constitute non-public "material information" necessitating the Public Company to publicly disclose the proposed exit (which could lead to fluctuations in the trading price of the Public Company shares to the disadvantage of the investor);

- whether the Public Company shares held by the investor are subject to a contractual right of first refusal or sale lockup;

- if the investor has representatives serving on the board of the Public Company, how such persons should continue to engage with the Public Company to meet their director fiduciary duties;

- whether the exit could lead to the termination of key Public Company agreements with the investor (such as a strategic alliance agreement or a commercial development agreement) and how to handle the wind down of these arrangements; and

- whether the exit should be effected through multiple sales scenarios to alleviate potential downward pressure on the trading price of the Public Company's shares (such as a share buyback by the Public Company accompanied by a block trade by the investor) and, if so (i) when should each sales scenario be publicly disclosed to avoid a party possessing non-public "material information," (ii) can multiple sales scenarios be consummated on the same trading day, and (iii) how can the investor assure at least an equivalent sales prices for its Public Company shares if all sales cannot be effected on the same trading day (and conversely how can the Public Company assure itself that it will not overpay for shares sold by the investor in a stock buyback).

As the Public Company and the investor may have different interests with respect to the above issues, an exiting investor will need to undertake careful planning to avoid a handsome return on investment leading to an unattractive dispute with local regulators and costly fines.

Annex I

	Block Trade	Dribble-Out	Company Repurchase	Direct Sale to Third Party
Description	・ Investor retains a broker-dealer to find one or more purchasers for the Public Company shares ・ Broker-dealer either holds the Public Company shares to be sold for its own account or immediately resells the shares to a third party purchaser (but the identity of the purchaser is not disclosed to the investor)	・ Investor sells the Public Company shares in the open market from time to time over multiple days/transactions	・ Public Company announces a stock repurchase plan through ToSTNet under which the investor sells its Public Company shares back to the Public Company ・ Using ToSTNet would enable the Public Company to avoid a shareholder approval requirement	・ Investor negotiates a sale of Public Company shares directly with one or more purchasers ・ None of the purchasers would be a licensed broker-dealer (to be more precise using local parlance, none of the purchasers would be a qualified financial instruments operator (*kinyu-shohin-torihiki-gyosha*)) ・ Sale would not be effected through ToSTNet
Advantages	・ Speed and simplicity	・ Investor is able to take advantage of upswings in the Public Company's share trading price to improve the financial outcome (although share dips cannot be ruled out) ・ Execution costs should be lower in comparison to a block trade through a broker-dealer	・ Speed ・ Allows the Public Company to possess additional treasury shares for tax planning or to reduce the number of its outstanding shares for financial purposes ・ Fewer documents to negotiate (in comparison to other sales scenarios)	・ The only structure of the options presented where it is possible to avoid public disclosure of Public Company material non-public information so long as the purchaser is willing to execute a confidentiality agreement
Disadvantages/ Considerations	・ Most expensive to execute in light of broker-dealer fee and offer discount price ・ Investor must be free of all Public Company material non-public information as the broker-dealer would	・ Takes a long time to execute in comparison to other options ・ Exposed to greater market fluctuations given the longer time to execute (so proceeds to the investor could be lower)	・ Public Company may not have adequate funds (i.e., distributable amount) to pay for the repurchased shares ・ Depending on the ToSTNet structure used, it is possible that the investor may	・ Investor would need to directly find the purchaser (not via broker) ・ Public Company would be required to file a securities notice (*yukasyoken-tsuchisho*) if the sales

	Block Trade	Dribble-Out	Company Repurchase	Direct Sale to Third Party
	not be willing to sign a purchase agreement ・ Japan's mandatory tender offer rules would be triggered if the purchaser and any related group collectively own more than one-third of the Public Company's shares after acquiring the investor's shares (so reduces ability to sell to a large existing shareholder)	・ Investor would need to be free of Public Company material non-public information for each trade (so potentially a long cleansing period in comparison to all the other options) ・ Investor most likely would need to file multiple Large Shareholder Reports since a filing is required if the investor's ownership changes by 1% or more ・ Investor would need to undertake a short-swing profit analysis over a long period since sales would occur over multiple days (so the investor would need to confirm that no matching purchase transactions occurred over a rolling six month period until the last dribble-out sale)	not be able to sell all of the shares in the repurchase plan, as the program must be open to all Public Company shareholders (although the risk should be low) ・ Public Company would need to disclose all material non-public information in advance	proceeds are JPY100 million or more, which is not a complicated form, but would require the investor to disclose the proposed share sale in advance to the Public Company ・ Japan's mandatory tender offer rules would be triggered if the purchaser and any related group collectively own more than one-third of the Public Company's shares after acquiring the investor's shares (so reduces the ability to sell to a large existing shareholder) ・ Sales price could be lower or higher if purchaser is required to receive Public Company material non-public information in order to satisfy Japanese insider trading rules ・ Investor would likely need to provide indemnification to the purchaser