Capital Markets Client Briefing

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Rights Issues - an option in the aftermath of the crack-down on third party allotments by the Tokyo Stock Exchange?

The Tokyo Stock Exchange (TSE) has recently announced plans to protect shareholders from dilution as a result of large third-party allotments (*daisansha wariate*) that do not meet rigorous criteria. Though largely welcomed by investors as a significant milestone in improving Japan's corporate governance regime, the timing of the measures may be problematic for Japanese companies who need to raise a significant amount of capital in the wake of the global financial crisis but for whom a public offering is not an option.

We take this opportunity to highlight both the details of the TSE's proposed measures for third party allotments and considerations under Japanese, U.S. and English law relevant to any Japanese company considering a rights issue.

TSE third party allotment proposals[1]

- The TSE takes the position that a third party allotment with a dilution ratio in excess of 300 per cent. is detrimental to existing shareholders and to market credibility generally and should, in principle, not be permitted. The TSE will establish procedures to examine the appropriateness of any third party allotment over that threshold.
- For third-party allotments that would dilute existing shareholders by 25 per cent or more or involve a change of control, the TSE is looking at measures including introducing a requirement for shareholder approval or the advice of an independent expert.
- To reduce opportunities for "anti-social forces" such as criminals or gangsters to become significant shareholders through third party allotments, the TSE will require written confirmation from issuers as to the identity and good standing of the party receiving the allotment (an allottee).
- For a certain period (likely to be three years) following an allotment that results in the allottee becoming the controlling shareholder, the TSE will reserve the right to review transactions between the issuer and the allottee to ensure no inappropriate transactions are entered between the two. It remains to be seen what types of transaction the TSE may consider to be "inappropriate", however it is likely that predatory or uncompetitive commercial arrangements may be targeted.

[1] The TSE has also announced that it will establish measures to examine the appropriateness of reverse stock splits which result in a significant number of shareholders being effectively disenfranchised by holding fractional shares.

- To satisfy rules against the issuance of shares on "especially favorable terms" (yuuri hakko), issuers will be required to disclose the basis of calculation of the issue price and procure a corporate auditor's opinion that the calculation is fair.
- To avoid opportunities for market manipulation by announcing third party allotments which do not have sound financial backing, issuers will be required to verify and disclose the financing by which the allottee will pay for the shares.
- Companies failing to comply will face a fine of ¥10m ($103,864) and may be delisted in certain circumstances.
- The new rules regarding a third party allotment are expected to be introduced in August 2009.

Rights Issues

Many companies now need to raise significant amounts of new equity and of those, only the largest and most successful are currently able do public offerings. The new TSE restrictions on third party allotments will be a hindrance to raising finance. For companies that are unable to access the traditional capital markets, rights issues may be an alternative, although perhaps not for all given the high risk and fees involved with such transactions.

Rights issues are the traditional way of raising additional capital in the UK. This is mainly a reflection of the strong pre-emption rights enjoyed by existing shareholders[2.] There is no similar principle under US law where rights issues are a relatively recent development. In Japan, shareholders enjoy no pre-emption rights and so companies have been free to raise new capital by way of public offer (koubo) or third party allotment.

Structure of a Japanese rights issue

The issuer (without shareholders approval) mandatorily allots share acquisition rights (SARs) for no consideration on a pro rata basis to all shareholders, thus avoiding any yuuri hakko issues. The issuer can then offer a substantial discount to market which may be necessary in order to incentivise shareholders. These SARs are securities for purposes of the Companies Act and the Financial Instruments and Exchange Law (the "FIEL") and are transferable. The SARs will be listed on the TSE and clearing will be dealt with through JASDEC. Under the TSE's listing rules, the exercise period must end within two months of the record date. Under the FIEL, this constitutes a public offering because the Japanese FSA interprets the free issuance of SARs as also being an offer of the underlying shares.

In order to avoid registration requirements overseas, for overseas investors, exercise of the SARs will need to be restricted to professional or institutional investors. Other investors will have the right to sell the SARs for cash through the TSE. Differing views have been expressed on whether the rights issues will be underwritten but the majority view is that some form of stand-by purchase commitment from a financial institution will probably be in place for rights not taken up by shareholders. A problem for an underwritten transaction is that the risk period will be approximately two months because it takes that long for the issuer to make various regulatory notifications required under Japanese law[3].

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[2] The basic principle is in Section 89(1) of the Companies Act 1985 (to be replaced by Section 561(1) of the Companies Act 2006 to come into force 1st October 2009) is that new shares issued for cash must first be offered to existing shareholders and disapplication of this principle requires approval at the shareholders meeting. The normal practice is to ask for that approval each year but institutional investor guidelines (the ABI) in practice limits such approval to 5 per cent. of outstanding shares (and 7.5 per cent of outstanding shares over a rolling three year period).

[3] In the UK, where companies raised £23 billion by way of rights issues in 2008, following a review of the rights issue process by industry experts, the Financial Services Authority of the UK amended its

A Japanese prospectus would need to be prepared but sales overseas may be by way of an undocumented offer or by an English translation of the Japanese prospectus or the issuer's most recent published financial report (kessan tanshin). If an offering circular were prepared to a sufficient standard, then it might also be possible to register that as a prospectus in the EU.

Specific legal considerations

Japanese law

- Exclusion of certain shareholders

Under the Companies Act, the issuance of SARs at especially favorable conditions must be approved by the shareholders meeting. In order to avoid such requirement, pursuant to the exemption from such shareholders approval requirement under the Companies Act, SARs must be granted to all shareholders, including overseas non-institutional shareholders, on pro rata basis ("free allotment of SARs").

- Differential treatment in relation to exercise conditions or call options of SARs

According to the Bulldog Sauce precedent, the principle of equality of treatment of shareholders applies to SARs which are granted to all shareholders by free allotment of SARs. Thus, in general, discriminative conditions regarding exercise of SARs or discriminative call options are not permitted unless there are justifiable reasons.

Although the position has not been conclusively tested, based on academic discussion and principles derived from a number of Japanese cases, it may be possible to take the position that excluding overseas non-institutional shareholders from exercising SARs granted by free allotment is acceptable if it can be substantiated that the primary reason for excluding such shareholders was not to avoid the requirement for shareholders' approval but to facilitate the raising of capital. In this respect, it may be persuasive that it is more expeditious and cost-effective to limit capital raising to foreign institutional investors, particularly where the economic interests of excluded overseas shareholders are protected.

- Manner of delivery

Whilst it would be easiest if the offer documents could be posted on the homepage of the issuer , Japanese rules relating to communication of securities offerings require physical delivery[4].

- How to determine who are the shareholders?

The starting point is that the person named in the register is the shareholder. The information shown in the register varies so that sometimes the address of the custodian is the headquarters' address or only the Tokyo sub-custodian. We understand that the disclosure by global custodians of their HQ addresses is voluntary. Under the new clearing law applicable to listed shares, the issuer is entitled to ask for the list of shareholders as shown in the JASDEC system in order to satisfy law/regulations including foreign laws (sou kabunushi tsuchi under Section 151).

US law

US federal securities law distinguishes between the issuance of rights and the exercise of those rights. The issuance of rights without payment does not trigger registration

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Listing Rules by reducing the minimum subscription period for a rights issue from 21 days to ten business days and the London Stock Exchange amended the Admission and Disclosure Standards to reduce the minimum duration of open offers to ten business days.

[4] EU and US rules are not relevant here since only Japanese law governs the appropriate manner of communicating with shareholders.

requirements under the Securities Act because the allocation is not "for value". Exercise of such rights, however, would be treated as a "sale", and any sale of securities in the US must be registered under the Securities Act, unless an exemption from the registration requirements is available. One exemption that has been used by various issuers is Section 4(2)[5] under which the rights are allowed to be exercised only by institutional investors. In some such cases, the institutional investors receive the cash value of their rights in lieu of the right to exercise rights for additional shares.

Rule 801 of the Securities Act may be another available exemption, provided that "US holders" hold no more than 10 per cent of the outstanding class of securities that is the subject of the rights offering. The US rules contain detailed provisions for the determination of "the holding of" or "the percentage of shares held by" US holders6. A "reasonable inquiry" must be made to record holders that are brokers, trust banks and other nominees located in Japan and the United States regarding the number of shares held on behalf of U.S. residents. It is important to note that one of the conditions of Rule 801 is equal treatment of US holders, who must be allowed to participate in the rights offering on "terms at least as favorable as those offered the other holders of the securities." This means that it would not be possible to limit the rights offering in the US to institutional investors only, if the rights are distributed widely in Japan.

For recourse to the Rule 801 exemption, information documents in English must be furnished electronically to the Securities and Exchange Commission through the EDGAR filing system on Form CB. The submission must include English translations of any reports or information published, or required to be published, by the company in connection with the rights issue in accordance with Japanese regulatory requirements.

EU law

A rights issue would generally be treated as a public offer requiring an EU prospectus. If, in contrast to a traditional rights issue, shareholders were instead allotted SARs then, subject to confirmation from the applicable EU regulatory authority, it may be possible to categorise the same as a two part transaction in order to fall outside the requirements of the prospectus directive. Firstly, the initial allotment of the SARs arguably falls outside the definition of an "offer to the public" as, in accordance with guidance from the Committee of European Securities Regulators ("CESR"), no consideration is payable, or investment decision required to be made, in order for shareholders to receive such SARs. EU case law has, however, held that "free" allotments of warrants can still trigger a prospectus requirement as an "offer to the public" may arise by virtue of the granting of the subscription right contained in the terms of such warrants. Consequently, it is necessary for the right to subscribe shares under the terms of the SARs to be limited within the EU to institutional investors only. On this basis any "offer" arising through the terms of the SARs arguably falls within an exemption to the prospectus directive. A "rights issue" structured using SARs in this manner would be unusual in the EU and regulatory clearance should be sought in advance.

An additional concern is the UK financial promotion rules and the applicability to material the Japanese company sends to its shareholders, particularly explaining that for non-professionals the only option is to sell the SARs (this looks like inducement to sell). In the UK, Articles 43 and 67 of the Financial Services Market Acts 2000 (financial promotion) Order

[5] See College Retirement Equities Fund, SEC No-Action Letter, Fed. Sec. L. Rep. (CCH) ¶78,503 (June 4, 1987).

2005 are of help because it exempts communications between the issuer and its shareholders from the financial promotion rules. Article 67 extends to communications to persons other than shareholders where the rules of the stock exchange or regulator require the offer or direction to sell to be so extended. It will be necessary to check whether similar restrictions on financial promotions and exemptions apply in other relevant EU countries. As to whether an issuer must determine whether the beneficial shareholders are resident in the EU, CESR guidance suggests that issuers may not be able to simply rely on the name on the register and should make some level of appropriate inquiry.

Other laws

UK practice is to exclude from the rights issue minority shareholders resident in foreign jurisdictions where compliance with applicable foreign securities laws would be impracticable. This may not be possible for Japanese rights offerings because of the Japanese legal requirements which make it difficult to get complete information about the whereabouts of beneficial shareholders.

Conclusion

For companies in need of significant capital for whom a public offering is out of the question and potential dilution makes a third party allotment impracticable under the new TSE rules, a rights issue is a feasible alternative. However, the equity risk associated with the length of the process under current regulation and market practice will complicate underwriting arrangements.

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