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SEC Registration Procedures for Business Combinations involving Japanese Companies

With increasing foreign ownership among many Japanese companies, what are the US SEC regulatory considerations domestic entities need to take into account when conducting a business combination?

Takuo Hirose

Introduction

It goes without saying that the Japanese M&A market has been booming in recent years. Although certain theatrical hostile takeover transactions have tended to draw the principal attention of Japan's mass media, the bulk of the recent transactions in the Japanese M&A market have consisted of friendly acquisitions and business combinations. Particularly notable have been large business combinations of a previously unimaginable scale, prompted by significant corporate restructurings. While the most important reason for this recent trend has been the need for Japanese companies to consolidate in order to survive in the international market, it has been supported and enhanced by a series of major reforms and amendments of the Japanese Commercial Code. This began with the introduction of share exchange (*kabushiki kokan*) and share transfer (*kabushiki iten*) procedures in 1999, which are designed to facilitate business combinations between Japanese companies.

Meanwhile, as has been pointed out in the mass media, there has been a recent trend toward ever-increasing foreign ownership ratios for Japanese listed companies. Foreign ownership has risen continuously since the 1990s and has accelerated in the past couple of years. Foreign investors have also diversified, no longer limiting their investments to traditional favourites, such as Japanese high-tech companies. It is no longer uncommon to see leading Japanese listed companies with more than 30% of their shares held by foreigners.

These ever-increasing levels of foreign ownership have, however, raised a US securities regulatory issue that may be critical to Japanese companies planning business combinations. Specifically, US securities regulations may require the registration of the Japanese companies' securities with the US Securities and Exchange Commission (SEC) in conjunction with certain business combinations. This article outlines the basis and criteria underlying this registration requirement and summarizes the required procedures.

Registration with the SEC

The *Securities and Exchange Law* (SEL) of Japan was modeled after the US Securities Act of 1933 ('the 1933 Act', which principally governs the US' primary securities market) and the Securities Exchange Act of 1934 ('the 1934 Act', which principally governs the US secondary securities market). Consequently, the securities regulations of both Japan and the US are analogous in many aspects. Generally, in the event that a non-US company

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undertakes a public offering of securities in the US, such company is required to register such securities with the SEC pursuant to the 1933 Act, through the filing of a registration statement (Form F-1, F-2 or F-3) which is roughly equivalent to a Securities Registration Statement (*yukashoken todokedesho*) under the SEL.

In the event of a business combination in Japan effected through a merger, share exchange or share transfer, the shareholders of the subject company (the non-surviving company in the case of a merger, and the wholly-owned subsidiary in the case of a share exchange or share transfer) are to receive, in consideration for their shares in the non-surviving company or wholly-owned subsidiary (as the case may be), shares in the surviving company or parent company (as the case may be). The number of shares so received is calculated in accordance with an integration ratio agreed between the parties to the relevant business combination.

With respect to the aforementioned delivery of shares in a business combination, the SEL does not treat such share delivery as an 'offering' of securities which necessitates the filing of a Securities Registration Statement. Rather, such delivery requires limited disclosure through the filing of an Extraordinary Report (*rinji hokokusho*) or Securities Notice (*yukashoken tsuchisho*) in certain circumstances. The SEL in this respect reflects the regulatory view that such share delivery is made automatically under Japanese Commercial Code in conjunction with mergers, share exchanges and share transfers, and thus does not constitute an offering which requires shareholder approval. Accordingly, the delivery of shares in connection with a business combination does not require the level of disclosure that is necessary in an offering in which the shareholders exercise their investment judgment.

The 1933 Act, however, takes a different approach to this issue. Unlike the SEL, the 1933 Act reflects the basic premise that even a share delivery in conjunction with a business combination requires shareholders to exercise investment judgment. Such judgement is applicable in respect of both whether to accept a business combination as voiced through the exercise of shareholders' voting rights and whether to exercise statutory 'dissenter's rights' to demonstrate preference to receive cash instead of securities in a successor company. The 1933 Act therefore regards any such share delivery as an offering and requires the filing of a registration statement (Rule 145 under the 1933 Act).

For the purpose of this analysis, what is key is that SEC registration requirements apply not only to business combinations carried out in the US between domestic companies, but also to any business combinations carried out outside the US between foreign entities, provided that they have US resident shareholders. In any such case, the relevant non-US entities are required to file the so-called 'Form F-4' with the SEC unless an exemption (such as the Rule 802 exemption described below) is available.

Whether to file / Who must file?

The entity required to file a Form F-4 is, generally, the offeror of the relevant securities. For example, in the case of a merger where shareholders of the non-surviving company receive the surviving company's shares at the agreed on merger ratio, it is the surviving company that will be required to file a Form F-4, as it is the entity offering its shares to the shareholders of the non-surviving company. Similarly, in the case of a share exchange, the parent company will be subject to the filing obligation. In the case of a joint share transfer, in which multiple companies create a new holding company, such multiple companies will become joint filing obligors as the new holding company will not yet exist at the time of the filing.

Whether filing a Form F-4 is required for a particular business combination or not generally depends upon whether any 'US holders' receive shares, which is determined by examining the offeree(s) of the relevant securities, e.g., in the case of a merger, the shareholders of the non-surviving company to whom the offer of the surviving company is made. Similarly, in the case of a share exchange or share transfer, the shareholders of the wholly-owned subsidiary will be examined. According to the regulations under the 1933 Act, a 'US holder' is defined as "any security holder resident in the United States" (Rule 800 under the 1933 Act).

Needless to say, the regulations do not mean that the 1933 Act requires filings in all situations where US holders exist. Simply stated, the filing of a Form F-4 is required in the event that the ownership ratio of US shareholders in the subject company exceeds 10% of all shareholders (the calculation of this ratio, however, is subject to special rules described below). Although technically the filing obligation is triggered if the subject company has any US holders, the 1933 Act provides for an exemption from the Form F-4 filing requirement if all of the following three requirements are met (Rule 802 under the 1933 Act):

i. Limitation of US ownership - US holders of the subject company hold no more than 10% of the shares that are the subject of the business combination;
ii. Equal treatment - US holders may participate in the business combination on terms at least as favorable as those offered to any other shareholders of the subject company; and
iii. Information requirement - the parties fulfill certain filing and other requirements provided under the 1933 Act, including the filing of a Form CB.

Item (i) above is commonly referred to as the '10% test', and is critical in determining whether a transaction is subject to the Form F-4 filing requirement. The method of calculation of the relevant ownership ratio is provided for in detail in the rules under the 1933 Act, as briefly outlined below.

The applicable rules under the 1933 Act require that the 10% test be made as of the date falling 30 days prior to commencement of a business combination solicitation (the 'calculation date'). The date of "commencement of the solicitation of the business combination" is generally understood to mean the date of dispatch of a convocation notice of a shareholders' meeting to approve the business combination. As a practical matter, however, in light of the time required to prepare Form F-4, the parties will actually be required to make a preliminary 10% test far in advance of the calculation date in order to tentatively determine the necessity of filing. If the results of such preliminary test indicate that the filing is likely to be necessary, the parties will generally commence preparation for the filing on the assumption that it is necessary, and then make an official 10% test later, to ultimately determine whether the filing is required.

When calculating US ownership, the following points in particular should be noted: (i) for the purpose of the calculation, treasury stock and shares held by principal shareholders (shareholders owning more than 10% of the subject company) and certain company-related persons as specified under the 1933 Act must be excluded; and (ii) the parties must, in addition to relying upon the information in the shareholders register, undertake investigation as to beneficial ownership of shares.

Companies with relatively high levels of ownership by principal shareholders should be particularly aware of rule (i) above. Even though the ownership ratio of US holders among all shareholders may be far below 10%, the 10% threshold may nonetheless be easily reached if significant shareholders are excluded from the calculation. In such cases, subject companies may consider having principal shareholders dispose of their shares in advance of the business combination, thereby avoiding the 10% threshold. It should be noted, however, that such disposal may be deemed invalid for the purpose of the 10% test if it is considered a sham arrangement. For example, a buy-back option exercisable after the calculation date may be considered as such, in which case the SEC may deem such arrangement to constitute technical avoidance of the Form F-4 filing requirement.

With respect to Japanese listed companies, the shareholders register and, for shares held through the Japan Securities Depository Center, the beneficial shareholders register are normally required to be updated semi-annually. An issuer is in principle allowed to rely on the information regarding shareholders' addresses included in such registers for purposes of the 10% test. Accordingly, the most recent shareholders register and beneficial shareholders register available may be used to identify US holders for the purpose of the 10% test.

The general rule that a company may rely on shareholders registers, however, has some important exceptions. In particular, with respect to shares for which any Japanese or US nominees (such as financial institutions) are registered as holders, the relevant companies are required to reasonably investigate the underlying beneficial ownership by inquiring the nominees as to whether shares of the subject company are held on behalf of any customers resident in the US. If it is determined that such nominees are holding shares on behalf of US residents, such shares must be deemed held by a US holder for the purpose of the 10% test. In addition, another exception requires that the companies must take into account beneficial ownership information known to them through public filings or otherwise. Accordingly, the companies must reflect US beneficial ownership information as indicated by any Substantial Shareholding Reports filed under the SEL (*tairyo hoyu hokokusho*) and any reports received from research companies.

Preparation of the Form F-4

Once it has been determined that a Form F-4 filing must be made, the filing company must prepare the form on a schedule that will enable the registration to become effective by the date of dispatch of the convocation notice for the shareholders' meeting at which the business combination will be presented for shareholder approval.

The filing company is required to disclose in the Form F-4 various details as required by rules promulgated under the 1933 Act. This mainly consists corporate information regarding the parties to the business combination and background information concerning the business combination itself. Two items of required disclosure that can become particularly problematic for Japanese companies are: (i) financial statements of the companies and (ii) detailed information as to the business combination.

Financial statements are problematic for several reasons. First, the SEC will not allow financial statements prepared by companies for disclosure in Japan in accordance with Japanese GAAP to be used in a Form F-4. Instead, the filing company is required to file either (i) audited financial statements prepared in accordance with US GAAP, or (ii) audited financial statements prepared in accordance with Japanese GAAP, together with a reconciliation to US GAAP. This issue is not unique to the Form F-4, but occurs in all cases of Japanese companies making registered offerings of securities in the United States that are filed with the SEC. In our experience, Japanese companies generally tend to choose option (i), principally for efficiency and marketing reasons.

In addition, pro-forma financial statements for the surviving or new company resulting from the business combination may be required by the applicable SEC rules. For example, in the case of a joint share transfer of the type frequently used in recent large scale business combinations, the parties are required to disclose the pro-forma financial statements of the new holding company resulting from the joint share transfer, as well as the financial statements of all existing companies that will become wholly-owned subsidiaries of such new holding company.

The preparation of the above-mentioned financial statements, which will inevitably require the involvement of accounting firms, usually takes a considerable amount of time to complete, and sometimes causes substantial delay of an entire transaction. This must be carefully taken into account when the schedule for the Form F-4 filing is planned.

The SEC rules also require that the Form F-4 include detailed information on the negotiation history between the parties, the reasons for the business combination, the calculation of the integration ratio, etc. The required disclosure level is generally higher than the disclosure level required under Japanese regulations. Fulfilling the US disclosure requirements - while taking into account the ramifications of any discrepancy in information disclosed in the two countries - does require that the content of the Form F-4 be carefully evaluated by the parties with assistance from legal professionals.

Filing procedures

The filing of the Form F-4 with the SEC usually occurs in two steps: first, a preliminary confidential filing is made on a non-public basis, and second, subsequent to review and comment by the SEC on the preliminary filing, an official public filing is made. The official public filing only becomes "effective" (at which point the F-4 may be mailed to US holders) after all SEC comments have been resolved.

It should be noted for scheduling purposes the SEC review subsequent to the preliminary confidential filing usually takes two to three months to complete, depending on the complexity of the transaction, the quality of the draft submitted and the volume of comments given by the SEC.

Although the confidential filing may consist of a draft version of the Form F-4, such a draft must, as a practical matter, be close to final, except for portions impossible to complete at the time of filing (e.g., description as to the definitive agreement). The SEC usually requires that the financial statements (prepared in accordance with, or reconciled to, US GAAP) must be finalized and audited at the time of the confidential filing.

Breach of filing requirements

If a business combination necessitating a Form F-4 filing has been implemented, but the company subject to the filing obligation fails to complete such filing, this will generally constitute an illegal, non-registered public offering under the 1933 Act. In such a case, the violating company and its directors may be subject to general sanctions under the 1933 Act and may also be required to rescind the offering (i.e., to repurchase all shares from US holders). Inclusion in a Form F-4 of any false statement or misrepresentation may trigger various civil and criminal liabilities provided generally under the 1933 and 1934 Acts.

Ongoing Disclosure after a Form F-4 filing

Once a company makes a Form F-4 filing, it becomes subject to general ongoing disclosure rules under the 1934 Act. Pursuant to the Act, the filing company will be required to file an annual report (Form 20-F) annually within 120 days after the end of its fiscal year and current reports (Form 6-K) from time to time when any reportable event occurs.

Conclusion

Japanese companies must be aware that the filing a Form F-4 with the SEC may be required even in the case of a merger or integration in Japan by Japanese domestic companies. Current awareness and understanding among Japanese companies with respect to this filing, however, is not high. Japanese companies (in particular, companies which have relatively high foreign ownership) that implement a merger or integration while disregarding the Form F-4 may unknowingly be subjecting themselves to legal risk under the US securities regulations. Consultations in advance with legal and accounting professionals are recommended in order to address and manage this risk.

About the author

Takuo Hirose is a partner with Anderson Mori & Tomotsune (http://www.andersonmoritomotsune.com/). His principal areas of practice are securities law and corporate law, including capital markets and M&A transactions. He is admitted to practice in Japan (The Dai-Ichi Tokyo Bar Association) and the State of New York. He earned a Bachelor of Laws degree (LL.B.) from the University of Tokyo in 1995 and a Master of Laws degree (LL.M.) from the Northwestern University School of

ANDERSON MŌRI & TOMOTSUNE

アンダーソン·毛利·友常 法律事務所

www.andersonmoritomotsune.com

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For further information please contact:

Tokyo Office

Mr. Takuo Hirose
Mr. Yusuke Nakano
Mr. Yoshimasa Dan

Izumi Garden Tower
6-1, Roppongi 1-chome
Minato-ku, Tokyo 106-6036
Japan

Telephone: +81-3-6888-1000
E-mail: info@amt-law.com
URL: http://www.andersonmoritomotsune.com

Beijing Branch Office

Mr. Akira Moriwaki

Beijing Fortune Bldg., Room 809
No. 5, Dong San Huan Beilu
Chao Yang Qu, Beijing 100004
China

Telephone: +86-10-6590-9060
FAX: +86-10-6590-6062

Law in 2003. He was also associated with the New York and Tokyo offices of Shearman & Sterling LLP from 2003 to 2004. He is a native speaker of Japanese and is fluent in English.

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About the firm

The Japanese law firms of Anderson Mori and Tomotsune & Kimura merged their law practices as of January 1 2005. The name of the merged firm is Anderson Mori & Tomotsune, with principal offices located in Izumi Garden Tower, 6-1, Roppongi 1-chome, Minato-ku, Tokyo 106-6036, Japan. The combination of practices enables Anderson Mori & Tomotsune to provide an even higher level of legal services in a broader number of practice areas, with enhanced capability to handle extremely large and complex transactions such as large M&A and finance projects, global securities offerings and other cross-border investment transactions.

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