Newsletter

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Overview of the Report of the Working Group on Tender Offer Rules and Large Shareholding Reporting Rules of the Financial System Council (December 25, 2023)

I. Introduction

The Financial System Council made a decision to review the rules of tender offers and large shareholding reporting on March 2, 2023. Subsequently, the Working Group on Tender Offer Rules and Large Shareholding Reporting Rules began deliberations on June 5, and released its report (the Report of the Working Group on Tender Offer Rules and Large Shareholding Reporting Rules of the Financial System Council) on December 25[1]. With 17 years having passed since the previous round of amendments, the review of the tender offer and large shareholding reporting rules is expected impact various players, including listed companies, investors and financial institutions, on a practical level. This newsletter provides a brief overview of the report.

II. Overview of Report

1. Tender Offer Rules

(1) Main Proposals

Based on changes in the market environment including the increase in the number of hostile take overs through market transactions, etc. and the diversification of M&A practices, the report makes the following proposals regarding tender offer rules[2].

① **A tender offer should be obligatory when a market transaction would have significant impact on company control in order to ensure transparency and fairness of capital markets**

Recently there have been cases where more than a third of voting rights have changed through a market (on-floor) transaction within a short period of time, and it has become apparent that general investors have not had sufficient information or time to make investment decisions regarding such transactions, which have a significant impact on company control. Consequently, the report proposes applying a one-third rule to market (on-floor) transactions in order to ensure transparency and fairness in securities transactions which result in significant changes in company control.

If the one-third rule is to be applied to the acquisition of shares through market transactions, then it will be necessary to track and control the state of market transactions so as to comply with the rule. In particular, the control structure may need to be reviewed in financial groups consisting of numerous group companies. The change is also likely to impact the purchase methods employed on the buyer side. As such, it will be necessary to keep an eye out for future amendments.

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[1]The full report (in Japanese) can be viewed at the FSA website:
https://www.fsa.go.jp/singi/singi_kinyu/tosin/20231225.html

[2]In addition to the proposals mentioned in this newsletter, the report also makes suggestions regarding clarifying the scope of application of the so-called 5% rule, notice of a tender offer and other topics.

② The threshold for "significant impact on company control" should be lowered from "one-third of voting rights" to "30% of voting rights" in light of voting rights ratios and international standards

The report proposes that it would be appropriate to lower the one-third rule threshold to 30% in light of the fact that many foreign tender offer systems set the threshold for mandatory tender offers at 30%, and considering the ratio of voting rights exercised in listed companies in Japan, a shareholder having 30% of voting rights can often prevent many listed companies from passing a special resolution at a general shareholders meeting and may have a significant impact on ordinary resolutions at a shareholders meeting.

However, even if the threshold is lowered slightly from one third (approx. 33.4%) to 30%, the practical impact is likely to be limited. Currently, the guidelines for responding to corporate takeovers (so-called takeover defense measures) often require investors to take various actions based on a 20% threshold, but there has been no discussion of lowering the one-third rule threshold to 20%, and it is expected that each listed company will continue to create guidelines for responding to corporate takeovers and take other actions to respond to acquisitions of 20% to 30%, as necessary.

③ Companies should be obligated to explain their handling of conflicts of interest with minority shareholders after a tender offer in the case of a tender offer with a maximum number of shares to be purchased

Under current tender offer rules, partial tender offers (tender offers with a maximum limit) are basically allowed, but such partial tender offers may cause several problems. Namely, if the corporate value of the target company is expected to decrease after the acquisition of control, general shareholders may have an incentive to tender their shares in the tender offer even if they are dissatisfied with the tender offer price, etc. in order to avoid disadvantages caused by the decrease in corporate value (the so-called "coercion" problem). Moreover, even though conflicts of interest may arise or change between the controlling shareholder and general shareholders due to a change of controlling shareholder, the system of pro rata settlement does not guarantee that all tendered shares will be sold, and as such, general shareholders may not be given sufficient opportunities to sell their shares. In light of these inherent problems of partial tender offers, the report states that the bidder in a tender (and the company consenting to such partial tender offer) should at least make efforts to gain the understanding of general shareholders when conducting a partial tender offer, and proposes strengthening regulations regarding disclosure in tender offer statements, as well as imposing an obligation to explain policies for handling conflicts of interest with minority shareholders arising after a partial tender offer and responding to opposition from general shareholders. The report further recommends that the bidder should be able to set an additional tender period after the tender offer is completed at its discretion, including in the case of a tender offer for all shares (a tender offer with no maximum limit).

The Working Group also discussed whether partial tender offers should be prohibited entirely, but ultimately decided that the issue requires further consideration given opinions that doing so might have the effect of discouraging desirable M&A transactions. As such, while partial tender offers will remain as a possible M&A method, it should be noted that providing sufficient explanations of various treatments after the partial tender offer will be required.

④ A system that allows exceptional treatment as necessary for individual cases should be established and the necessary systems of regulatory authorities reinforced to avoid uniformity that does not correspond to actual conditions

The current tender offer rules establish various regulations regarding the conditions of tender offers, but do not permit case-by-case exceptional treatment from a practical perspective. The report therefore proposed that, on the presumption that the regulatory authorities' system will continue to be reinforced, the following regulations should be amended so as to allow requirements to be waived on a case-by-case basis upon obtaining the regulatory authority's approval.

- Regulations on prohibition of separate purchases
- Regulations concerning specially related parties (including the exclusion from the scope of specially related parties in certain cases, regardless of the existence of certain capital relationships)

- Regulations concerning the tender offer period (including allowing a voluntary extension exceeding 60 business days or waiving or shortening the mandatory extension period following an amendment of the tender offer statement in certain cases)
- Regulations concerning the change of tender offer terms
- Regulations concerning the withdrawal of tender offers
- Regulations concerning obligations to make a tender offer/solicitation for all shares (including the exclusion of foreign depositary receipts from the scope of the obligation to solicit for all shares in certain cases)

If a system that allows for exceptional treatment in individual cases is established, it can be expected to promote a more practical approach. On the other hand, if the authorities' discretion is expanded, there is a concern that tender offerors may be required to take measures they are reluctant to take because of the authority's decision. Overall, the expectation is that the regulatory authorities' systems will be reinforced to allow them to act more appropriately in the future.

(2) Issues for further consideration

Major issues that were considered for discussion but not recommended include the following.

① European-style regulations

The Working Group discussed the possibility of moving towards European-style regulations, under which the tender offer system is positioned as a tool to ensure that minority shareholders have an opportunity to sell their shares at a fair price in the case where company control would change as a result of the transaction, the necessity of a tender offer is not determined by type of transaction, conducting a subsequent tender offer is obligatory in principle if a certain threshold is exceeded, partial tender offers are prohibited in principle, and minimum price regulations are adopted. As a result of the deliberations, the Working Group did not conclude that Japan should immediately shift towards European-style regulations, but the possibility of a future move towards such regulations should be kept in mind, while reviewing individual issues, including the scope of application of tender offer rules and whether or not partial tender offers should be allowed, and continue to be considered based on the progress of authorities in implementing systems for making decisions according to individual circumstances.

Japan's tender offer rules have developed into a unique system that falls somewhere between the U.S.-style and European-style systems. The transition to European-style regulations will remain an issue for the future, but for the time being, the expectation is that the current system will be amended to address issues arising from changes in social conditions, etc., without making fundamental changes in the system itself.

② Remedies before/after tender offer

The Working Group considered whether a system for remedies before/after a tender offer should be created. Specifically, the Working Group considered whether systems should be implemented should to grant a right to petition for an injunction against a tender offer in case of a breach of laws or regulations or use of clearly unfair methods by the company or its shareholders as a means of prior remedy, and to suspend voting rights of shares acquired in breach of tender offer rules, and considered a proposal to impose a sale order as a post tender offer remedy. While the Working Group did not conclude that such systems should be introduced immediately, the issue was left open for further consideration in the future should the need arise.

2. Large Shareholding Reporting System and Transparency of Beneficial Shareholders

(1) Main Proposals

The following main recommendations were made with respect to the large shareholding reporting system and transparency of beneficial shareholders, due to changes in the market environment, including the

increase in passive investment, the growing importance of constructive dialogue between companies and investors, and the expansion of collaborative engagement[3].

① **The possibility of receiving a special exception relaxing the frequency of report submission requirements for making a proposal "for the purpose of an action that is not directly related to corporate control" in a manner that "leaves the decision to the management of the company" should be clarified in order to enable in-depth dialogue between passive investors and companies**

If financial instruments business operators, etc. wish to use the special reporting system (including a relaxed reporting frequency), one of the requirements is that their purpose of holding shares is not to engage in making material proposals. However, although a certain degree of clarity with respect to the scope of "making material proposals" was achieved with the formulation of the Stewardship Code in 2014, the scope of the rule remains vague or broad. As such, it has been pointed out that further clarification or limitation of the rule is necessary to promote effective engagement between companies and investors. The concept of "making a material proposal" focuses on the influence of the act on company management and if shares are held for the purpose of making such proposals, then the shareholder is required to make prompt disclosures using the general reporting system instead of the special reporting system. However, in cases where the purpose of the proposal is not directly related to company control, such as proposals for a change in dividend policy or capital policy, it is difficult to say that the mere act of making a proposal will immediately have significant impact on management. The report therefore suggests that making proposals the purpose of which is directly related to company control should be broadly regulated as the making of material proposals, whereas the focus for proposals that are not directly related to company control should be the manner of proposal, and the act of making a proposal should only be regulated if the manner of the proposal is such that the issuing company's management cannot make a decision on whether or not to adopt the proposal.

It is expected that a revision of the scope of "making material proposals" will clarify the availability of the special reporting system and promote engagement activities by institutional investors.

② **From the perspective of promoting collaborative engagement, there should be no need to aggregate the percentage of ownership of multiple institutional investors as "joint holders" unless they have made certain agreements**

It has been pointed out that while the application of the concept of joint holders in the context of the large shareholding reporting system is limited to situations where parties have made agreements as shareholders regarding voting rights and other rights, and therefore could be thought to have no direct relationship with collaborative engagement, institutional investors are nonetheless discouraged from collaborative engagement due to the inclusion of implied agreements in such agreements. Given that the concept of joint holding is a rule where the focus is on the impact on management, the report therefore proposes that in order to reduce such discouraging effect related to collaborative engagement by institutional investors, it would be appropriate not to apply the concept of joint holding in cases where institutional investors have not made a joint agreement related to the making of material proposals, and where they have made non-continuous agreements related to the exercise of voting rights.

Excluding certain cases from the application of the joint holding concept is expected to promote institutional investors' collaborative engagement activities. On the other hand, there have also been cases where parties which should submit large shareholding reports as joint holders have not made the appropriate disclosures, and as mentioned in footnote 3, the report also makes proposals related to ensuring the effectiveness of the large shareholding reporting system. With respect to the difficulty of proving the existence of a joint holder relationship, these include expanding regulations to the effect that a person is deemed to be a joint holder if certain external facts exist.

[3]The report also made recommendations regarding other issues, such as ensuring the efficiency of the large shareholding reporting system. The report concludes that an appropriate response is necessary for a number of issues, but among those, particularly noteworthy is the conclusion that "with respect to the issue that parties may be deemed to be joint holders despite having a policy of exercising voting rights, etc., independently if certain capital relationships exists, a system should be introduced to allow authorities to exempt the application of classification as joint holders under certain circumstances," which may have a practical impact on large shareholding reporting by financial groups.

③ Cash-settled equity derivative transactions that potentially have influence over management or circumvent rules

Under current rules, simply holding a long position in cash-settled equity derivative transactions is basically not subject to the large shareholding reporting system. However, there have been cases of cash-settled equity derivative transactions which are intended to be converted into physical stock-settled equity derivative transactions, and cases where engagement targeting the issuing company is conducted upon having such a position. It has been pointed out that in such cases information disclosure under the large shareholding reporting system should be required. The report suggests that in such cases it is possible to determine that there is potential for influence over management already at the time of commencement of the cash-settled equity derivative transaction, and that the transaction effectively circumvents the large shareholding reporting system, and therefore it is appropriate to apply the large shareholding reporting system. The report envisions regulations to apply in situations where (i) the purpose is to acquire shares from the counterparty to the transaction, (ii) the purpose is to have a certain influence over the exercise of voting rights in shares held by the counterparty to the transaction, and (iii) the purpose is to make material proposals to the issuing company based on having a position such as those described in (i) and (ii).

Regulating such transactions which may potentially have an impact is considered to be an exceptional case, and as per the following statement made in the report, in principle holding a long position in a cash-settled equity derivative transaction is not intended to be subject to regulations.

"If we emphasize the fact that the large shareholding reporting system is a system that requires information disclosure focusing on the impact on management, the need to require information disclosure is not high for cash-settled equity derivative transactions conducted for the purpose of gaining financial profit and which do not involve a transfer of voting rights or other shareholder rights." (Underline added by the author.)

As such, although the envisioned application of regulations under (iii) above is abstractly worded and its scope of application is unclear, based on the above explanation of the main principle and exceptions to it, it can be understood that (iii) above refers to cases where an investor holds a long position in a cash-settled equity derivative transaction that is unknown to the issuing company and indicates to the issuing company that it is able to exercise more voting rights. In any case, it is hoped that the issue will be clarified in the future legislative process.

④ In the interest of transparency and effective identification of beneficial shareholders, (1) it should be clarified that as a principle of conduct institutional investors should respond to questions from issuing companies regarding their shareholdings, and (2) imposing an obligation to do so under the legal system should be considered

Under the current system, issuing companies and shareholders are able to identify nominee shareholders from the shareholder register and disclosure of the status of large shareholders in annual securities reports. On the other hand, there is no system for them to identify parties holding investment rights or rights to give instructions on the exercise of voting rights (so-called beneficial owners) unless the threshold of the large shareholding reporting system (holding over 5% of shares) is exceeded. Therefore, it has been pointed out that practical consideration should be made with reference to systems in other jurisdictions so that the issuing company and other shareholders can efficiently identify beneficial shareholders and the number of shares they hold, in order to promote dialogue between companies and shareholders/investors. Specifically, the report proposes that, as the first, and urgent step, it should be clarified that the principle of conduct for institutional investors should be to respond to questions regarding their shareholdings from issuing companies, and subsequently responding to such questions should be made legally obligatory.

Issuing companies have long pointed out the issues presented by the absence of a system to identify beneficial shareholders, and it is hoped that, as a result of this proposal, a means of identifying beneficial shareholders will be put in place through questions from issuing companies.

(2) Issues for further consideration

There were opinions within the Working Group that the most potent way to ensure the effectiveness of the large shareholding reporting system would be to follow Europe's example and create a system where the

voting rights of shares held by a person who has breached the large shareholding reporting system can be suspended. However, such a system entails issues similar to those discussed in relation with the tender offer rules, and were left open for further consideration if necessary.

III. Future Developments and Impact on Practice

In terms of future developments, it is possible that the FSA and related ministries will prepare an amendment draft and submit it for discussion by this year's ordinary session of the Diet as a bill to amend the Financial Instruments and Exchange Act as a response to the report on the tender offer rules and large shareholding reporting system. Although there is no certainty at this time, if the amendment bill is deliberated in this year's ordinary Diet session and enacted in May or June, it could be expected to go into effect approximately one year later, after amendments to cabinet orders and cabinet office orders. Developments in the so-called soft law front would be expected to proceed in parallel, including with respect to the proposal concerning the code of conduct of institutional investors regarding transparency of beneficial shareholders (Japanese Stewardship Code).

Changes to tender offer rules and the large shareholding reporting system will have a practical impact on various players, including listed companies, investors, and various financial institutions, in terms of M&A practices, the investment behavior of investors, and the responses of various financial institutions involved in these activities.

Author/Contact

Yukihito Machida
Partner
E: yukihito.machida@aplaw.jp

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Atsumi & Sakai
www.aplawjapan.com/en/
Tokyo Office: Fukoku Seimei Bldg., 2-2-2 Uchisaiwaicho, Chiyoda-ku, Tokyo 100-0011, Japan
Fukuoka Affiliate Office: Tenjin Bldg. 10F, 2-12-1 Tenjin, Chuo-ku, Fukuoka-shi, Fukuoka 810-0001 Japan
New York Affiliate Office: 1120 Avenue of the Americas, 4th Floor, New York, New York 10036
London Office: 85 Gresham Street, London EC2V 7NQ, United Kingdom
Frankfurt Affiliate Office: OpernTurm (13F) Bockenheimer Landstraße 2-4, 60306 Frankfurt am Main, Germany

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