Financial Services Agency
Disclosure System Working Group
Legal Expert Study Group
Report
~ Issue between the Equal Treatment Rule among Shareholders in Japan and Foreign Securities Regulations regarding Rights Offering ~

1. Introduction

It has been pointed out that rights offering differs from public offering and third-party allotment, in that rights to acquire shares are granted to the existing shareholders in proportion to their shareholding percentage, with the result that this can be a capital increase technique which pays attention to fair treatment of existing shareholders. In addition, because a capital increase through third-party allotment which involves a large decrease in shareholding percentage of existing shareholders is becoming a problem from the viewpoint of investor protection, investors etc. are calling for active use of rights offering. Considering those opinions, it is desirable to develop a system where rights offering becomes another practical choice for Japanese companies to raise capital, alongside public offering and third-party allotment, especially for large capital raising which has large impacts on existing shareholders.

In the "Financial Services Agency Disclosure System Working Group Report ~ Development of Legal System for Rights Offering in Japan ~" (published on January 19, 2011)[1], the following was pointed out regarding correspondence to securities regulations of foreign countries for rights

[1] [Translator's note] The English translation thereof was published on March 25, 2011.

offering.

"In accordance with certain foreign country's securities regulations, due to the exercise of share options allotted in rights offering to shareholders who are residents of that country, it is possible that the issuer must register with that country's authorities and perform ongoing disclosure. It has been pointed out that there are cases in Europe where in order to avoid such burdens required to abide these regulations, rights are not allotted to certain foreign resident shareholders, or restrictions are placed on the exercise of rights by these shareholders. Following this idea, also in Japan, regarding the lack of conflict between the shareholder equality principle and restrictions on the exercise of rights by foreign resident shareholders in order to prevent excessive application of foreign securities regulations, it is appropriate to work on arrangement of concepts under current laws."

In order to facilitate the use of rights offering in Japan by avoiding excessive application of foreign securities regulations, this study group carried out discussion with the aim of sorting out the issue between the equal treatment rule among shareholders in Japan and the allotment of share options to all shareholders in rights offering by listed companies in Japan with the restriction on the exercise of share options (referred to hereinafter as "Exercise Restriction") to shareholders[2] who reside in certain foreign countries[3] (referred to hereinafter as "Certain Foreign Countries," and the shareholders who reside in the Certain Foreign Countries are hereinafter referred to as "Certain Foreign Shareholders").

This report delivers the result of discussion of this study group concerning issue between the equal treatment rule among shareholders in Japan and foreign securities regulations regarding rights offering. It should be noted that

[2] In a presentation by a securities company for discussion in this study group, it was explained that there were examples in practices of Europe etc. wherein instead of restricting the rights exercise by all shareholders who reside in certain foreign countries, exercise of the rights is allowed for persons who meet certain requirements among those shareholders in case where it does not conflict with the securities regulations of such countries.

[3] In some countries, legal jurisdictions may differ at the level of each state, etc. This "countries" also includes the legal jurisdictions in such cases.

this report only covers rights offering which is used for financing, not rights offering implemented in a situation where there is a dispute over rights to control a company. Also, as described below, this report only covers the situation when the share options in rights offering will be listed in the stock exchanges in Japan to ensure liquidity of those share options.

2. The Exercise Restriction and the Equal Treatment Rule

(1) Background

When implementing rights offering in Japan, it is assumed that share options are allotted to shareholders by an allotment of share options without contribution, in accordance with Article 277 of the Companies Act.

Article 109(1) of the Companies Act stipulates “the Equal Treatment Rule among Shareholders” which means that “A stock company shall treat its shareholders equally in accordance with the features and the number of the hold.” It is interpreted that since share options are not shares, there is not a strict “equal treatment rule” like that applied to shares. Therefore, it is interpreted that discriminatory treatment of share option holders regarding exercise conditions is not obviously illegal. On the other hand, Article 278(2) of the Companies Act stipulates that the features and the number or method for calculating the number of share options allotted to shareholders shall be determined in proportion to the number of shares held by shareholders. Considering above, under the judicial precedent, it is interpreted that the purpose of the equal treatment rule among shareholders extends to the case of an allotment of share options without contribution (refer to Supreme Court Decision, August 7, 2007, *Minshu*, Volume 61, No.5, page 2215).

Therefore, for imposing the Exercise Restriction in rights offering, there is an issue concerning what factors should be considered in order to interpret that the Exercise Restriction does not treat Certain Foreign Shareholders unequally and should not violate the equal treatment rule

among shareholders (and its purpose).

(2) Discussion

Under the judicial precedent where an allotment of share options without contribution with discriminatory exercise conditions in a dispute over rights to control a company was argued, it is interpreted that the discriminatory treatment among shareholders is not obviously against the purpose of the equal treatment rule among shareholders when the acquisition of management control by certain shareholders would damage the company's corporate value, the company's interests and consequently its shareholders' common interests so that the company needs to discriminate the shareholders when allotting share options to its shareholders in order to avoid such damages, as long as it does not conflict with the idea of equity and does not lack properness (Supreme Court Decision, August 7, 2007, cited above).

The judicial precedent cited above assumes a situation where there is a dispute over rights to control a company, and thus it is not clear whether or not this interpretation can be directly applied to a situation where there is not a dispute over management control. However, it is generally accepted that the framework of necessity (objective and rational necessity of discriminatory treatment to specific shareholders)[4] and properness (a situation where the disadvantage of the specific shareholders treated discriminatorily is compensated) behind the judicial precedent cited above could be used when considering the issue between the equal treatment rule among shareholders and the allotment of share options without contribution with the exercise restrictions based on the criteria of certain features of

[4] It is possible to evaluate that such supreme court judge assumes a situation in which one should give discriminatory treatment to specific shareholders in order to avoid a situation in which "the acquisition of management control by certain shareholders would damage the company's corporate value, the company's interests and consequently shareholders' common interests." In the discussion of this study group, it was pointed out that it could be allowed to interpret the required level of necessity as relatively lower in evaluating the Exercise Restriction in rights offering that are used in the situation where there is not a dispute over management control, compared to the level required in the supreme court judge which argued a situation of a dispute over management control.

shareholders. Considering the framework of this judicial precedent, the Exercise Restriction in rights offering could be interpreted as not typically conflicting with the equal treatment rule among shareholders (and its purpose) when there is a necessity to implement smooth rights offering as a tool of capital raising, and there is a properness in relation to the interests of Certain Foreign Shareholders who are restricted from exercising the share options. In order to make such an interpretation, it may be necessary to take the following factors into consideration.[5]

(1) Necessity to Use Rights Offering as a Tool of Capital Raising

It is considered that the issues regarding the implementation of capital raising and its method are basically entrusted to management judgment, and that there are situations where companies choose rights offering as a tool of capital raising when taking into account factors such as the fair treatment among existing shareholders, especially for the case of large capital raising. If rights offering by a company is implemented without the Exercise Restriction and procedures such as registrations with securities regulators of Certain Foreign Countries are not performed, there is a possibility that the company might violate the regulations of those Certain Foreign Countries.[6] On the other hand, complying with

[5] In the discussion of this study group, it was also pointed out that the framework of such judicial decision only covered the situation where there was a dispute over management control and specific shareholders were treated discriminatorily. Therefore, it was pointed out in this study group that it was not necessary to see the Exercise Restriction should be under as strict considerations as one such judicial precedent assumes when considering the Exercise Restriction in rights offering used in a situation where there is not a dispute over management control, and thus it is possible to interpret this treatment as not conflicting with the equal treatment rule among shareholders only if there is a rationale to treat Certain Foreign Shareholders discriminatorily.

[6] It is pointed out that in European countries etc., there are cases where companies avoid procedures such as registrations in a certain country by restricting the exercise of rights by shareholders who reside in such country. It is necessary to consider the differences in the corporate law system in each country, however, the fact that the similar treatment as the Exercise Restriction is used in the practices of European countries etc. can be evaluated that there is a rationale to some extent to use the Exercise Restriction to avoid the excessive application of securities regulations of Certain Foreign Countries.

In a presentation of a securities company for discussion in this study group, it was explained that in European countries etc., the exercise restriction to certain foreign shareholders was not determined as inherent conditions in rights but by writing these conditions in the prospectus (these are written by clarifying that the regions are subject to the rights offering and exercise of rights, and that the rights offering and exercise of rights are not applied to the other regions).

such procedures may require operational and cost burdens so that it could become obstacles for smooth capital raising.[7, 8] In such a situation, the Exercise Restriction becomes necessary for a company that plans to raise capital by rights offering.

(2) Properness in Relation to Interests of Certain Foreign Shareholders

When share options related to rights offering are listed on stock exchanges in Japan, liquidity of such listed share options is ensured, and consequently Certain Foreign Shareholders with Exercise Restriction can be compensated for their economic loss through trading at market prices, it is reasonable to say that Certain Foreign Shareholders with Exercise Restriction do not face economic disadvantages compared to other shareholders who can obtain shares at an exercise price below the market share price, because they can sell their allotted share options in the market. Also, in a situation where Certain Foreign Shareholders are able to purchase shares in the Japanese market, they can purchase shares and maintain their shareholding percentage.[9, 10]

[7] In the discussion of this study group, it was pointed out that although it depends on the administrative work required for the preparation of these procedures, considering the amount of time and costs regarding such procedures, there could be the cases where rights offering is not be a practical choice for capital raising due to such burden.

[8] In the discussion of this study group, it was pointed out that avoiding operational and cost burdens required by regulations of Certain Foreign Countries could benefit the common interests of the company's shareholders, including those of Certain Foreign Shareholders.

[9] In the discussion of this study group, it was pointed out that the Companies Act in Japan had adopted the authorized capital system (authorized shares system), and in order to allow flexible capital raising, public companies can, in principle, make a decision of financing either by a public offering or third-party allotment within the limit of the total number of authorized shares, by way of the resolution of board of directors without an approval in shareholders meeting (Article 201(1) of the Companies Act). Therefore, it was pointed out that maintaining the shareholding percentage were not ensured within the limit of the total number of authorized shares, and it was possible to focus on ensuring economic benefits in relation to the equal treatment rule among shareholders.

[10] In the discussion of this study group, it was pointed out that under the Companies Act in Japan, when a company implements third-party allotment, shareholders who are not allotted new shares face the disadvantage of dilution of their shareholdings. It was pointed out that compared with this situation, in the case of rights offering, even though Certain Foreign Shareholders face the disadvantage by dilution of their shareholdings, they can be compensated for their economic loss. Therefore, it was pointed out that in comparison to shareholder protection in other capital raising methods such as third-party allotment, it was possible to consider the Exercise Restriction was legal in rights offering.

In the discussion of this study group, whether or not an approval of the shareholders meeting is necessary was discussed to interpret that the Exercise Restriction is not against the equal treatment rule among shareholders (and its purpose). On this point, there was a discussion which said it is not necessary to entrust decisions to shareholders in the situations of rights offering which this report covers, and thus, it is possible to interpret that confirming the intention of shareholders through the approval of the shareholders meeting is not necessary regarding the Exercise Restriction in rights offering. There were no objections to this idea in this study group.

3. Conclusions

As described above, this study group discussed the issue between the Exercise Restriction and the equal treatment rule among shareholders, and delivered the factors to be considered for interpreting that the Exercise Restriction is not against the equal treatment rule among shareholders (and its purpose) in Japan. Based on the content of this report, it is expected that related parties will facilitate the practices of rights offering.

Also, in order to facilitate the practice of and to keep the fairness of rights offering, and to ensure the liquidity of share options in the market, it is expected that the rules such as listing rules of stock exchanges and self-regulations of the Japan Securities Dealers Association[11] will be developed and that the ideas of this report will be further clarified.

[11] For example, the “Guidelines for the Handling of Third-party allotment” of the Japan Securities Dealers Association stipulates self-regulations on capital increase by new shares at market price, based on the advantageous issuance regulations under the Companies Act.