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■ MERGERS AND ACQUISITIONS (M&A)

More Flexible Spinning Off and Squeezing Out? 2017 Tax Reforms Impacting Japanese M&A

I. Introduction

On March 27, 2017, the Japanese National Diet enacted the 2017 tax reform bills. The 2017 tax package introduces important reforms of several aspects of corporate taxation in Japan including the rules relating to corporate officer remuneration and offshore tax havens. Two major components of the changes that will impact Japanese M&A activity are the introduction of a tax-free spin-off regime and changes to the taxation of squeeze-outs of minority shareholders. These two changes are canvassed hereafter in turn.

II. New Tax-free Treatment of Spin-offs

A spin-off is a type of business divesture in which a company divests a certain business unit into a newly incorporated company which becomes an independent entity not controlled by the divesting company. Spin-offs have been widely used by listed companies in the US for many years. eBay's spin-off of PayPal in 2015 is a relatively recent high profile example of a spin-off in the US market.

By contrast, spin-offs have rarely been undertaken in the Japanese M&A market. This is despite the fact that it is possible for Japanese companies, including listed companies, to undertake spin-offs by way of a combination of a demerger (in Japanese, *'kaisha-bunkatsu'*) and distribution of shares as dividend.

A major reason for the paucity of spin-offs has been the tax implications of these types of transactions. Prior to the 2017 tax reforms, when a company by way of a demerger transferred one of its business units to another newly incorporated entity not controlled by the divesting company, the divesting company was exposed to capital gains tax on the transfer.

In addition, when the shares of the new company (into which the business had been transferred) were distributed to the shareholders of the divesting company, shareholders of the divesting company were exposed to tax on the distribution as it may have been deemed as a dividend.

However, the 2017 tax reform has opened the door to tax-free spin-offs if certain requirements are satisfied in the context of the following types of spin-off transactions:

(i) A divesting company that has no controlling shareholder (typically a listed company) carves out one of its business units into a newly incorporated

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company by way of an incorporation-type demerger (in Japanese, *'shinsetsu-bunkatsu'*) and on the same day distributes all of the shares of the newly incorporated company to its shareholders as a dividend in kind; or

(ii) A divesting company that has no controlling shareholder distributes all of the shares of its wholly-owned subsidiaries to its shareholders as a dividend in kind.

The rationale behind the introduction of the tax-free treatment of the aforementioned types of spin-off is to enable and encourage Japanese companies to focus on their profitable core businesses and strategy and more easily dispose of less profitable or less strategically aligned business lines. It is also hoped that the spun off non-core businesses will be able to develop and realize their full stockholder value.

III. Squeeze-out Taxation

Japanese corporate law provides for a number of mechanisms by which a majority shareholder may squeeze out minority shareholders.

If a majority shareholder owns 90% or more of the total outstanding shares of the target company (typically as a result of a tender offer), the majority shareholder has the statutory right under the Japanese Companies Act to require that all other shareholders sell their shares in the target company.

By contrast, if the majority shareholder owns less than 90% of the total outstanding shares of the target company, it is common to use a reverse share split (in Japanese, '*Kabushiki-heigo*') to squeeze out the minority shareholders. A reverse share split reduces the number of shares of the target company by a ratio that results in all of the minority shareholders owning less than one share, at which point they cease to be shareholders in the target company.

The same result as the reverse share split can be achieved by a simple share exchange (in Japanese, '*kabushiki-koukan*') or merger between the majority shareholder and the target company where the majority shareholder distributes cash in consideration for the shares of the target company owned by the minority shareholders. However, under current tax regulations and prior to the implementation of the 2017 reforms, if cash is used in a share exchange or merger, it will not be classified as either a qualified share exchange or a qualified merger and capital gains or evaluation gains may be realized. By contrast, capital gains or evaluation gains are not realized under a reverse share split.

However, under the new rules in the 2017 tax reform package which apply to squeeze-out transactions that take effect on or after October 1, 2017, the different tax treatment under each method of squeeze-out will effectively be eliminated. If the majority shareholder owns two-thirds or more of the total shares of the target company, a share exchange or merger in which cash is to be delivered as consideration for shares will be classified as a qualified share exchange or qualified merger provided that certain other requirements are satisfied. It should be noted, however, that in a qualified merger, certain restrictions may be applied to the deduction of net operating loss carryforwards or losses incurred from the disposal of assets after the merger. As a result of the tax reform, it is anticipated that a share exchange where cash is delivered as consideration will become the prevailing method of squeeze-out moving forward.

IV. Comment

The thrust of these tax changes appears to be to inject further flexibility into Japanese corporate reorganizations by removing tax barriers to spin-offs and the squeeze-out of minority shareholders in the aforementioned circumstances. It will be interesting to see the extent to which these changes are taken advantage of moving forward, in particular by public companies.

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- ***Customer-oriented business operations***
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  by Kazuyuki Ohno

■ GENERAL CORPORATE/CAPITAL MARKETS

Leveling the Playing Field? Japan's New Fair Disclosure Rule

I. Introduction

On May 17, 2017, the Act for Partial Revision of the Financial Instruments and Exchange Act of Japan (the 'FIEA') was enacted and a fair disclosure rule was introduced in Japan for the first time (the 'FD Rule').[1]

Once the FD Rule comes into effect, it will prohibit Japanese listed companies from making selective disclosures to certain types of recipients. The objectives of the FD Rule are to ensure the fair and timely disclosure into the public domain of material information about the disclosing company and to prevent market participants with access to selective disclosures from making a profit or avoiding a loss at the expense of other participants who may not have received such disclosures.

The FD Rule is similar to Regulation FD in the US. It is due to come into effect by no later than May 24, 2018.

II. Background to Japan's Fair Disclosure Rule

The main driver behind the introduction of the FD Rule is the apparent practice by some securities analysts of attempting to obtain non-public financial information from listed companies through interviews with company representatives.

Such analysts conduct these interviews immediately prior to the announcement of public companies' quarterly reports so that they can convey the information to their customers before the companies' reports are made public. The concern is that such customers may then be able to generate profits or avoid losses using such information before it has reached other market participants.

Of course, such practices are presently subject to the existing prohibition against insider trading. This type of conduct is also subject to other rules such as the FIEA regulation concerning securities firms' handling of public companies' information and also the timely disclosure rule of the Tokyo Stock Exchange (the 'TSE') which governs the public disclosure of the material information of listed companies.

However, these regulatory tools are now widely considered to be ineffective at preventing the aforementioned practices of some securities analysts. This is because the Japanese insider trading regulation insofar as it applies to financials mainly deals only with financial information such as earnings forecasts which are calculated on an annual basis. It generally does not apply to such information when it is prepared on a half-yearly or quarterly basis which means that securities dealings based on selective disclosures of half-yearly or quarterly financial information may escape the scope of the insider trading prohibition.

Further, the FIEA regulation regarding the handling of public companies' information only applies to securities firms and the timely disclosure requirements of the TSE have quite a limited scope of application.

III. Overview of the Fair Disclosure Rule

In principle, the FD Rule obliges a public company which discloses non-public material information to certain third parties such as securities analysts and investors to make such information publicly available at the same time. As explained further below, such third parties are defined as 'Trade Related Parties'.

(i) Regulated Communications

The FD Rule regulates public companies' disclosure of material information and such companies' directors, officers, employees and agents are subject to the rule. Only employees and agents whose roles actually require them to communicate company information to Trade Related Parties are subject to the FD Rule. In the case of employees, this typically includes staff responsible for investor relations ('IR'). Not surprisingly, directors and officers are generally subject to the FD Rule regardless of whether their roles require them to communicate such information to Trade Related Parties.

(ii) Trade Related Parties

The recipients of information subject to the FD Rule are defined as Trade Related Parties under the FIEA. Trade Related Parties include Financial Instruments Business Operators, Registered Financial Institutions, Credit

1 New Articles 27-36 to 27-38 of the FIEA.

Rating Agencies, Investment Corporations and other types of entities which shall be specified pursuant to a Cabinet Order which has yet to be published. Trade Related Parties include the directors, officers and employees of these entities. In practice, this will include securities analysts in securities firms.

Trade Related Parties also include persons specified by the aforementioned Cabinet Order such as investors who receive material information via a listed company's IR activities and who are likely to sell or buy shares of that company based on such material information. In practice, this will include shareholders and investors who participate in a public company's IR meetings. Japan's Financial Services Agency has clarified that in general, the media and customers or suppliers of public companies are not Trade Related Parties.

Importantly, the FD Rule does not apply to a Trade Related Party subject to contractual obligations to keep the relevant material information confidential and also not deal in the shares of the relevant listed company. Whilst a typical confidentiality or non-disclosure agreement should satisfy the confidentiality requirement, there is a question mark over whether such an agreement would also meet the no-dealing requirement. A party which wishes to be excluded from the FD Rule may need to enter into a new arrangement with the listed company in question in order to satisfy both of these requirements.

(iii) Information subject to the FD Rule

Information subject to the FD Rule is non-public material information concerning the management, business or assets of a listed company which, if publicly disclosed, would have a material influence on investors' investment decisions. It is considered that this scope of information is somewhat broader than the information subject to the Japanese insider trading regulation.[2]

(iv) Timing and Method of Disclosure

If a listed company conveys material information to Trade Related Parties, the company must disclose such material information to the public simultaneously with the disclosure to the Trade Related Parties. However, if the company (or the relevant director, officer, employee or agent) did not know that the disclosed information falls under the definition of material information at the time of the disclosure to the Trade Related Parties, the company must publicly disclose such information as soon as it has become aware that such information disclosed to the Trade Related Parties is material information for the purpose of the FD Rule.[3]

The method of disclosure under the FD Rule will be determined by Cabinet Order. However, it seems likely that disclosure through EDINET (which is a statutory disclosure system in Japan), TDnet (a stock exchange based timely disclosure system) and the webpage of the listed company will be permissible methods of disclosure.

(v) Sanctions for Violation of the FD Rule

A failure to make a public disclosure required under the FD Rule is not subject to criminal sanction, however, it may be subject to an administrative order. Consequently and subject to the comments below, even if directors, officers or employees of a public company fail to comply with the FD Rule, those individuals will not be exposed to any liability under the FD Rule. This differs from the sanctions under the prohibition against insider trading.

If a listed company violates the FD Rule, the regulator may conduct an inspection of the listed company, demand the company submit documentation or provide a report to the regulator and/or require the company to make the relevant material information public. If the company and/or its directors, officers or employees fail to comply with or otherwise obstruct such administrative order, such failure or obstruction can result in criminal sanctions such as imprisonment and a fine.

IV. Outlook and Comments

The FD Rule brings this aspect of Japanese market regulation into line with the US and the EU. It is expected to have an impact on IR practice in the Japanese market and contribute to creating a more level playing field for market participants.

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2 Under the so-called basket clause at Article 166, Paragraph 2, Section 4 of the FIEA, the Japanese insider trading regulation extends to material facts concerning the operation, business or assets of the listed company in question which may have a significant influence on investors' investment decisions. As a matter of Japanese statutory interpretation, the scope of information subject to this regulation is considered to be narrower than the information subject to the FD Rule.

3 Some other exceptions will be separately specified by Cabinet Order such as circumstances where there is a compelling reason that the listed company should not be required to publicly disclose the information in question.

Public companies should give consideration to existing IR protocols to prepare for the coming-into-effect of the FD Rule. There may be a need to revise or set up an internal IR compliance regime and manage company information and communications more carefully in order to fully comply with the FD Rule. Securities analysts, shareholders and investors will need to understand the FD Rule and communicate with listed companies accordingly.

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