

NO&T Capital Market Legal Update

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Japan's first Accelerated Share Repurchase (ASR) transaction

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Introduction

Smooth and reliable implementation of share repurchases is an important capital policy issue of listed companies in order to return profits to shareholders. Currently, for listed companies in Japan, market purchases of treasury stock are typically made through either (i) auction-market purchases¹ or (ii) off-auction purchases of treasury stock using the Tokyo Stock Exchange's "ToSTNeT-3" system. Purchases in the auction market, however, are subject to market fluctuations and other factors, and it can be difficult to make through ToSTNeT-3 unless there are shareholders who already intend to sell shares. Therefore, even when a company announces a Board of Directors' resolution regarding the repurchase of its own shares, in many cases it is difficult for the listed company to accurately convince its shareholders or prospective investors that the share repurchase will be certainly conducted with the actual volume and amount set forth in the announcement.

Table of Repurchase Method

Type Characteristics	Purchases in the auction market	Off-Auction Purchase of Treasury Stocks Using the ToSTNeT-3	Accelerated Share Repurchase transactions (Japan ASR)
Certainty of acquisition	△ (Subject to market fluctuation)	△ (Subject to the willingness of selling shareholders)	○
Acquisition period	△ Over a long period	○ (1 day)	○(1 day) (*Long only for adjustment transactions)

A "bulk share repurchase transaction" is the Japanese equivalent of the accelerated share repurchase transactions commonly used in the U.S. (such bulk share repurchase transactions hereinafter "ASR transactions"). In such an ASR transaction, a listed company (hereinafter referred to as the "Issuer") executes a two-step method, consisting of (i) the initial transaction and (ii) the subsequent adjustment transaction.

(i) Initial transaction

Market purchase by using ToSTNeT-3

Implement shareholder returns reliably and promptly by immediately effecting the initial planned amount of share repurchases.

(ii) Subsequent adjustment transaction

Subsequent Adjustment Transactions with a Financial Instruments Business Operator or a similar institution

Adjustment transactions are executed so as to have the same consequences as the Issuer's repurchase of its own shares at the average stock price for a certain period of time.

¹ In order to avoid the risk of insider trading regulation violations, when using the auction market, it is common to use a trust involving appointment of a trust bank, or a discretionary account by appointing a financial instruments business operator or similar institution.

This two-step procedure is intended to enable the Issuer to quickly recognize the effects of share repurchases in the capital markets.

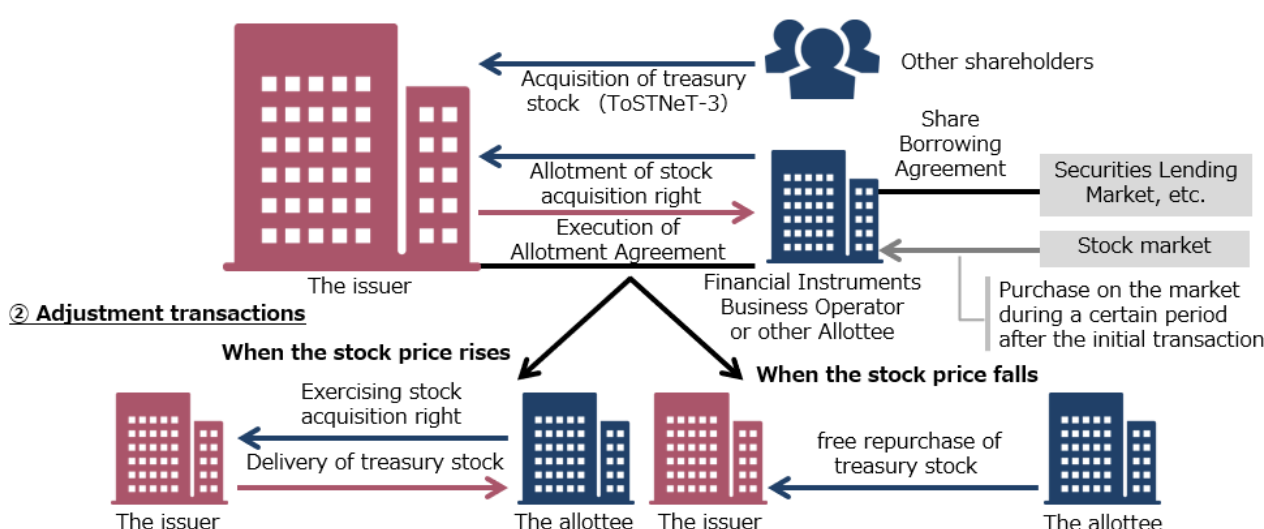
We advised on the first ever ASR transaction in Japan, the Fully Committed Share Repurchase (or "FCSR") of Joyful Honda Co., Ltd., proposed by Nomura Securities Co., Ltd. (the "Transaction"). Thus, as attorneys who have assisted with the development of the ASR transaction in Japan, we will outline its characteristics below.

Characteristics of FCSR transactions

The following is an outline of a standard ASR transaction (which is announced as an "FCSR" transaction in the Transaction).

① Initial transaction

Acquisition of treasury stock and Allotment of Stock acquisition right



(i) Initial transaction:

Acquisition of treasury stock	<p>Execution of off-auction repurchase of treasury shares using the ToSTNeT-3 system after announcement of Board of Directors'² resolution.</p> <p>Characteristics: In the ToSTNeT-3 system, selling orders from general shareholders are accepted and executed in preference to the selling order for sale from a Financial Instruments Business Operator's own account.</p> <p>With respect to borrowed shares: Assuming that the volume of order for sales from general shareholders falls short of the number of shares to be purchased, a Financial Instruments Business Operator places an order to sell based on their own account, by borrowing the corresponding number of shares in the stock lending market, etc.</p>
Allotment of stock acquisition right	<p>Issuance of a stock acquisition right via third party allotment to the Financial Instruments Business Operator or other allottee.</p> <p>Characteristics: Adjustment transactions are executed with respect to the number of shares entered into with the Financial Instruments Business Operator through ToSTNeT-3 as described above.</p> <p>Purpose: To have the same consequences as if the Issuer had repurchased its own shares at its subsequent average stock price.</p> <p>What is average stock price? An average of the stock prices of trading days for a certain period from the trade date of ToSTNeT-3, etc.</p>

² Subject to the provisions of the Articles of Incorporation regarding authorization to the Board of Directors pursuant to Article 165, Paragraph 2 of the Companies Act or the provisions of the articles of incorporation that delegate the authority to decide on dividends of surplus, etc. pursuant to Article 459, Paragraph 1 of the Companies Act, a special resolution of a general meeting of shareholders shall not be required.

(ii) Adjustment transactions:

If the Stock Price rises: When the average stock price is higher than the purchase price of treasury stock on ToSTNeT-3

- ▶ The Financial Instruments Business Operator or other allottee exercises its one stock acquisition right (by paying one yen) to receive the shares as calculated below.

$$\left(\begin{array}{c} \text{The number of shares to} \\ \text{be transferred by the} \\ \text{Issuer upon the exercise} \\ \text{of the stock acquisition} \\ \text{rights} \end{array} \right) = \begin{array}{c} \text{The number of} \\ \text{treasury shares} \\ \text{acquired from Financial} \\ \text{Instruments Business} \\ \text{Operator} \end{array} - \frac{\begin{array}{c} \text{The total acquisition price of treasury} \\ \text{stock acquired from a Financial} \\ \text{Instruments Business Operator} \end{array}}{\text{Average stock price}}$$

If the Stock Price falls: When the average stock price is lower than the purchase price of treasury stock on ToSTNeT-3

- ▶ The Issuer shall acquire treasury shares from Financial Instruments Business Operators or similar institution without charge.

$$\left(\begin{array}{c} \text{The number of shares to be} \\ \text{acquired by the Issuer} \\ \text{without consideration} \end{array} \right) = \frac{\begin{array}{c} \text{The total acquisition price of treasury} \\ \text{stock acquired from a Financial} \\ \text{Instruments Business Operator} \end{array}}{\text{Average stock price}} - \begin{array}{c} \text{The number of treasury} \\ \text{shares acquired from} \\ \text{Financial Instruments} \\ \text{Business Operator} \end{array}$$

Regardless of whether the stock price rises or falls, the calculation method of the number of shares to be received by the allottee or the issuer remains basically the same.

(iii) Purpose of the transaction:

The purpose of the transaction is to adjust the total number of shares repurchased from the Financial Instruments Business Operator by using the amount paid by the Issuer on ToSTNeT-3 of the initial transaction so that this total amount will thus be the same as the result of repurchasing the number of shares when the Issuer repurchases its own shares at the average stock price.

$$\left(\begin{array}{c} \text{Total number of shares} \\ \text{repurchased in transactions} \end{array} \right) = \frac{\begin{array}{c} \text{Total amount of treasury stock purchased on ToSTNeT-3 from} \\ \text{Financial Instruments Business Operator} \end{array}}{\text{Average stock price}}$$

| Stock borrowed by Financial Instruments Business Operator

As described above, it is assumed that the Financial Instruments Business Operator will borrow the number of the Issuer's shares for which it has placed an order to sell on ToSTNeT-3, and in order to return the borrowed shares, the Financial Instruments Business Operator will purchase the Issuer's shares in the market after the initial sale on ToSTNeT-3. Then, when the share price rises, the borrowed shares will be returned in a combination of the shares purchased on the market and the shares delivered by the exercise of the stock acquisition rights. Conversely, when the stock price declines, shares in excess of the borrowed shares will be delivered to the Issuer free of charge.

(iv) Benefits of the transaction

- Sizable and instantaneous share repurchase via ToSTNeT-3 in the initial transaction.
- The total number of shares to be acquired over the course of the entire transaction will equal to the number of shares to be acquired in the market based on the average stock price over a certain period of time rather than at a given point.
- As it is a capital transaction similar to ordinary share repurchases, the impact of the adjustment transaction on the income statement (PL) should be minimal under the Japanese GAAP.

Major legal issues

Issue 1 the Japan's Share Repurchase Restrictions

Companies Act Procedure Regulations on Share Repurchase

Two share repurchase transactions exist in FCSR transactions. No shareholder resolution is required in either case.³

(i) Share repurchase through ToSTNeT-3 in the initial transaction

- ▶ Share repurchases through ToSTNeT-3, which are announced prior to execution of the repurchase, are conducted pursuant to **special provisions for share repurchases through market transactions, etc. (Article 165, Paragraph 1 of the Companies Act)** and treated as market transactions.
- ▶ An order for sale by a shareholder (general shareholder) other than a Financial Instruments Business Operator takes precedence and in the event that the number of shares offered for sale by a general shareholder falls short of the number of shares to be purchased, the offer for sale by the Financial Instruments Business Operator's own account functions as a back-up.

(ii) Free acquisition of treasury stock at the time of a decline in stock prices

- ▶ "Acquisition of own shares **without consideration**" is **not subject to the regulation on repurchase of shares** (Article 155, Item 13 of the Companies Act and Article 27, Item 1 of the Enforcement Regulations of the Companies Act).

Purpose of Share Repurchase Regulations

Why isn't a special resolution of shareholders meeting required when market transactions are used for stock repurchases (Article 165 of the Companies Act)?

(i) All shareholders have an opportunity to sell

- ▶ As mentioned above, in repurchasing shares through ToSTNeT-3, selling orders of general shareholders take priority over orders from the Financial Instruments Business Operator, so all shareholders have the opportunity to sell their shares.

(ii) Repurchase is conducted at fair market value

- ▶ The purchase price on ToSTNeT-3 is the closing price on the previous trading day, which is the fair market price. In addition, if we look at the entire FCSR transaction from the Issuer's perspective, including the stock acquisition right and right for free acquisition, the FCSR transaction has the same consequences as acquiring treasury shares at the market average stock price over a given period.
- ▶ In the entire FCSR transaction, the Issuer is expected to repurchase its own shares at the market average price fairly determined by the market.

Regulations on stock repurchases from specific shareholders (Article 160 of the Companies Act) and the principle of shareholder equality

The Companies Act stipulates strict procedures for the acquisition of treasury stock from specific shareholders, such as a special resolution of the general meeting of shareholders:

(i) Equalize opportunities to sell stocks that are difficult to cash in

- ▶ Since the subject of FCSR transaction is listed stocks, it is generally not difficult to liquidate them, and there are also sales opportunities for general shareholders in ToSTNeT-3. It is also possible for general shareholders to sell shares at the market average price during the same period in the auction market.

(ii) Preventing the acquisition of high prices from greenmailing ⇒ Why this case is different

- ▶ When looking at FCSR transactions as a whole, the Issuer acquires their own shares at the market-average stock price over a given period, without acquiring a high relative to the market price.
- ▶ A stock acquisition right is granted to the allottee, and if the stock price rises, the allottee will be able to acquire the Issuer's shares (corresponding to the increase in the stock price). When the stock price falls, treasury shares (corresponding to the decrease in the stock price) will be delivered free of charge to the Issuer so that economically speaking it is as if the Issuer acquired treasury shares at the average stock price based on the total repurchase price of the treasury shares sold in ToSTNeT-3 in the initial transaction.
- ▶ FCSR transactions are designed so that the economic value of combination of both the stock acquisition right and the free acquisition of treasury shares is zero for the allottee.

³ See footnote No. 2.

| Acquisition of Shares without consideration

Article 27, Item 1 of the Enforcement Regulations of the Companies Act does not impose any restrictions on procedure or distributable amount with respect to the free acquisition of treasury stock:

⇒ As long as any consideration is not paid by the Issuer, the acquisition of treasury stock does not have a harmful effect on the Issuer.

In cases where treasury stock is acquired without consideration, the stock acquisition right granted to allottee does not satisfy its exercise conditions and expires.

- ▶ The issuance of stock acquisition rights does not impose any expenses on the Issuer, and the potential dilution of the value of shares held by existing shareholders should be considered under the Companies Act. When acquiring shares without consideration, stock acquisition right will expire without being exercised, so there will be no financial expenses to be borne by the Issuer or dilution to share value.
- ▶ When considered in light of the entire transaction, the Issuer's acquisition of its own shares is considered essentially "free".

Issue 2 Regulation of distributable amount with respect to own stock repurchases
| Regulation of distributable amounts under the Companies Act

No additional cash is paid by the Issuer in subsequent adjustments of FCSR transactions.

- ▶ The "Total book value of money, etc. to be delivered to shareholders," under Article 461, Paragraph 1 of the Companies Act, can be calculated as of the date when the repurchase of treasury stock is conducted through ToSTNeT-3.

| Calculation of Distributable Amount after Initial Acquisition and Adjustment Transaction

The total repurchase price of the relevant treasury stock is fixed in the initial transaction at the repurchase of treasury stock through ToSTNeT-3.

- ▶ The amount available for distribution will not decrease in subsequent adjustment transactions (there will be an increase of only 1 yen if any stock acquisition right is exercised).

Issue 3 Characteristics of stock acquisition right
| Integration of Stock Acquisition Right and Right Pertaining to Acquisition without Contribution

In FCSR transactions, the Issuer's right to acquire shares without consideration is extinguished when the stock acquisition right is exercised (when the stock price rises), and the stock acquisition right is extinguished when the Issuer acquires its own shares without consideration (when the stock price falls).

- ▶ This reciprocal structure ensures that the stock acquisition right and the right to acquire shares without consideration are considered as indivisible.

| Valuation of stock acquisition rights

The allottee's position in the FCSR transaction is just to make a settlement based on stock price increases or decreases up to a certain point in the future. Because the stock price can fluctuate either upward or downward as mentioned above, the allottee's position is neutral and does not have any positive value. If both the stock acquisition right and the Issuer's right to acquire shares without consideration are valued together, the value is zero.

- ▶ The stock acquisition right is issued based on the valuation by a third-party valuator.
- ▶ Therefore, it does not fall under the category of "specially favorable conditions" (Article 238, Paragraph 3, Item 1 and Article 240, Paragraph 1 of the Companies Act), which requires a special resolution of a general meeting of shareholders.

| Issue of stock acquisition rights without consideration in other situations
Example 1: Convertible bond-type bonds with stock acquisition rights ("CB")

A CB is a financial instrument which is essentially a combination of a bond with a stock acquisition right. The bond is inseparable from the stock acquisition right (Article 254, Paragraphs 2 and 3 of the Companies Act). When the stock acquisition right is exercised, the bonds are contributed in kind (Article 236, Paragraph 1, Item 3 and Article 284 of the Companies Act) and when the bonds are redeemed in advance, the stock acquisition

rights cannot be exercised.
Example 2: Loan with stock acquisition rights
As with a CB, these are similar financing structures in which stock acquisition rights are inseparable from loan obligations.
Example 3: Stock Options
Stock options are normally issued without any cash payment in recognition of services provided by officers and employees.
▶ Article 238, Paragraph 3, Item 1 of the Companies Act assumes that a company issues stock acquisition rights without consideration, whereas there are no specially favorable conditions which require a special resolution of shareholders' meeting.

| Allotment of stock acquisition rights

In an FCSR transaction, an allotment agreement of the stock acquisition right is executed. In principle, under the Companies Act, the board of directors of the Issuer has the discretion to determine the party to whom stock acquisition rights are allotted and with whom the agreement to acquire shares free of charge is entered into, provided that such allotment is not made under specially favorable conditions. Existing shareholders do not have preemptive rights with respect to such allotment, but FCSR transactions are designed to have zero value for the allottee, as noted above.

Issue 4 Organizational decision of the Issuer and announcement of important facts (MNPI)

In order to comply with insider trading regulations, the Issuer must disclose all material facts prior to the ToSTNeT-3 repurchase of its own shares.

- ▶ Announcement of details of each step of the transaction must be made:
- First, a formula for the number of shares to be delivered upon exercise of the stock acquisition right and the number of shares to be delivered upon execution of free acquisition is disclosed.
 - Second, the number of shares acquired from the Financial Instruments Business Operator (i.e., the number of shares subject to adjustment) is disclosed at the time of announcement of the outcome of share repurchases through ToSTNeT-3.

Conclusion

In ASR transactions, the effects of share repurchases in the capital market, and therefore also the shareholder returns, can be quickly realized. In the U.S., Apple Inc. and other major companies commonly implement accelerated share repurchases. For many Japanese companies seeking to enhance shareholder returns and improve capital efficiency, smooth and reliable implementation of share repurchases is an important capital policy issue, and ASR transactions remain an effective option for such purposes.

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Chambers Global 2022 Leading Individual - ranked as Band 1 in the Capital Market
"He rises in the rankings after receiving extensive praise from market sources and clients alike, with one noting: "He can solve complex problems, challenge the status quo and drive innovation forward. Whenever we need a new approach, we call him first." (Chambers Global 2021)

ALB Dealmakers of Asia 2020 (Asia Legal Business)
<https://www.legalbusinessonline.com/features/dealmakers-asia-2020>



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