



**COUNTRY  
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# **The Legal 500 Country Comparative Guides**

## **Japan**

### **VENTURE CAPITAL**

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This country-specific Q&A provides an overview of venture capital laws and regulations applicable in Japan.

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# JAPAN

## VENTURE CAPITAL



### 1. Are there specific legal requirements or preferences regarding the choice of entity and/or equity structure for early-stage businesses that are seeking venture capital funding in the jurisdiction?

Early-stage businesses that are seeking venture capital funding in Japan choose a company form called Kabushiki Kaisha ("KK") or joint-stock company.

While there are other forms of company available in Japan, such as Godo Kaisha ("GK") or limited liability company, they are intended for closely held ownership and are not appropriate for a company that is aiming to scale through external equity financing.

### 2. What are the principal legal documents for a venture capital equity investment in the jurisdiction and are any of them publicly filed or otherwise available to the public?

The principal legal documents for a venture capital equity investment in Japan typically include the following:

- **Term Sheet:** This essentially non-binding document outlines the proposed key terms and conditions of the investment.
- **Subscription Agreement:** This legally binding agreement formalises the terms of the investment, including the terms of shares issued, warranties relating to the shares and the company (typically given by the company and the founders), and conditions precedent. This document can alternatively be called an Investment Agreement.
- **Shareholders' Agreement:** This legally binding agreement is typically entered into among the company, founders and investors, including existing investors, and sets forth the rights and obligations of the parties in relation

to the governance of the company including, among others, voting and information rights.

- **Distribution Agreement:** This legally binding agreement is entered into among the company, founders and all shareholders, and provides for provisions related to exits, such as drag-along rights as well as deemed liquidation preference.

None of these documents are publicly filed or publicly available, except for the terms of preferred stock or convertible equity, which form part of a subscription agreement and are filed as part of company registration of the company.

### 3. Is there a venture capital industry body in the jurisdiction and, if so, does it provide template investment documents? If so, how common is it to deviate from such templates and does this evolve as companies move from seed to larger rounds?

Japan Venture Capital Association (JVCA) is a well-known venture capital industry body in Japan with over 350 members, many of which are venture capital funds and corporate venture capitals.

In Japan, there are no template investment documents published by an industry body which are widely used; however, there are several Japanese-language template documents that are sometimes referenced by practitioners. For instance, the Ministry of Economy, Trade and Industry of Japan (METI) and JVCA, among others, published a primer regarding key considerations for investment documents for healthy venture capital investments as well as a sample term sheet. In addition, the Small and medium Enterprise Agency of Japan, METI's extra-ministerial bureau, has a template share purchase agreement and a primer for small to mid-sized enterprise to use when procuring equity financing.

#### 4. Are there any regulatory frameworks in respect of companies offering shares for sale that need to be considered, for example any restrictions on selling and/or promoting the sale of shares to the general public?

Companies offering shares for sale in Japan must comply with the disclosure requirements under the Financial Instruments and Exchange Act of Japan ("FIEA").

Under the FIEA, a company that seeks to raise funds by offering shares would need to file a registration statement unless one of several exemptions applies. Early-stage businesses generally rely on the following exemptions:

- **Small number of offerees:** an offer is made to less than 50 persons (inclusive of the number of investors who are offered the same type of shares in the last three months); and
- **Qualified institutional investors or professional investors:** an offer is made only to qualified institutional investors (as defined in the FIEA) or only to professional investors (as defined in the FIEA), subject to compliance with certain other rules under the FIEA.

In each of the foregoing exemptions, certain resale restrictions apply in order to avoid circumvention of the disclosure requirements.

#### 5. Are there any general merger control, anti-trust/competition and/or foreign direct investment regimes applicable to venture capital investments in the jurisdiction?

First, in terms of anti-trust/competition, the Japanese Fair Trade Commission (JFTC) and METI published guidelines in 2022 that are applicable to collaboration with or investments in Japanese start-ups. The guidelines provide for terms of investment which may constitute an abuse of an investor's superior position or unfair trade practices under Japanese anti-trust regulations (refer to Question 10).

Second, in the event the investment is made by foreign investors into a Japanese company, that investment would be subject to Japanese foreign direct investment regulations. Importantly, if the target company engages in a regulated business under the Foreign Exchange and Foreign Trade Act of Japan, foreign investors must typically file a prior notification with the relevant

governmental ministries and obtain clearance. Notably, the scope of regulated businesses broadly includes telecommunications, information processing services, and software businesses.

Third, while less likely, the acquisition by a venture capital investor of shares in a Japanese start-up may be subject to Japanese merger control rules. That is, the investor must make a prior filing of the proposed share acquisition with the JFTC and obtain clearance. Pre-notification is required for a share acquisition if all the following thresholds are met:

- i. as a result of the share acquisition, the voting rights ratio held by the investor group in the target company exceeds either 20% or 50%;
- ii. the total Japanese turnover generated by the acquiring company group for the last fiscal year exceeds JPY 20 billion; and
- iii. the total Japanese turnover generated by the target company and its subsidiaries for the last fiscal year exceeds JPY 5 billion.

#### 6. What are the prevailing tax incentives or structures offered to venture capital investors in the jurisdiction, if any?

The Japanese government offers several tax incentives to angel investors and other venture capital investors.

Most importantly, under the so-called "Angel Tax System," if applicable eligibility requirements are met, unconnected individual investors may be eligible for certain tax incentives for investment in qualified start-ups which are less than 5 years old or 10 years old. Eligible investors can benefit from (i) deferral of capital gains tax such that the investment amount can be deducted from taxable income at the time of investment and such amount is subject to capital gains tax at the time of the sale of shares, or (ii) exemption from certain capital gains tax such that the investment amount can be deducted from taxable income at the time of investment without capital gains taxation at the time of the sale of the shares. In addition, at the time of the sale of shares, eligible investors may also benefit from the offset of capital losses against other capital gains from share transfers and, if they cannot offset all the capital losses, the carry-forward of capital losses over a certain time period.

#### 7. What is the process, and internal approvals needed, for a company issuing shares to investors in the jurisdiction and

## are there any related taxes or notary (or other fees) payable?

Under the Companies Act of Japan, a company issuing shares to investors must generally obtain approval of its board of directors and shareholders to issue shares. It should also comply with any restrictions or actions required under contracts by which it is bound, including those under investment documents of prior series of funding.

Upon the issuance of new shares, the issuing company must bear registration tax at the rate of 0.7% over the amount of paid-in capital to be increased as a result of the new share issuance. There is no notary fee payable in connection with the issuance of new shares.

## 8. How prevalent is participation from investors that are not venture capital funds, including angel investors, family offices, high net worth individuals, and corporate venture capital?

In seed and early stages, founders and angel investors (including high net worth individuals) mainly participate in the company as holders of common shares and it is not very common that other categories of investors participate in the company.

In middle and later stages, venture capital funds, as well as business corporations and corporate venture capital funds tend to participate in the company as holders of preferred shares.

## 9. What is the typical investment period for a venture capital fund in the jurisdiction?

Typically, the lifetime of a venture capital fund is 10 years with the investment period being the first 3-5 years after its formation. In recent years, several venture capital funds have set longer investment periods and lifetimes so that they can observe the company in which they invested mature over a longer period.

## 10. What are the key investment terms which a venture investor looks for in the jurisdiction including representations and warranties, class of share, board representation (and observers), voting and other control rights, redemption rights, anti-dilution protection and information

## rights?

Venture capital investors commonly receive preferred shares that carry certain rights and preferences not afforded to common shares. Below are some key investment terms that venture capital investors typically look for when investing in Japan:

- **Representations and Warranties:** In a subscription agreement, venture investors usually request a broad range of representations and warranties regarding the company given by both the company and founders, including capitalization, intellectual property, employment, taxes and litigation. In case of a material breach of such representations and warranties (as well as covenants), it is common for investor to have a (i) redemption right against the company, and (ii) put option against founders. However, the guidelines jointly issued by METI and JFTC in 2022 provide that it is desirable not to provide put option against founders (item (ii) above), since it deviates from global practice and may discourage entrepreneurs from starting a business.
- **Liquidation Preference:** As preferred shareholders, venture investors are paid out before common shareholders in the event of a sale or liquidation of the company. Liquidation preference can be a multiple of the investment made and can be structured as either “participating” or “non-participating”. Liquidation preference is usually structured as “1x” and “participating,” under which holders of preferred shares (i) are first paid an amount equal to their investment before holders of common shares are paid, and (ii) are entitled to, and participate in, any residual proceeds alongside holders of common shares on a pro-rata basis.
- **Voting:** Venture investors would normally expect voting rights and the right to vote equally as common shareholders.
- **Anti-dilution:** Anti-dilution provisions protect investors from the dilution of their voting ratio if the company issues additional shares at a lower price per share in subsequent financing rounds. There are several types of anti-dilution provisions with the most common being broad-based weighted average (on a fully diluted basis).
- **Information Rights:** Venture investors typically negotiate for the right to receive regular financial and operational information from the company, such as quarterly and

annual financial statements.

- **Board representation and Observers:** Depending on the size of their investment, venture investors will usually negotiate for the right to nominate one board member and/or the right to appoint one or more observers.
- **Veto Rights:** It is common for majority holder(s) of preferred shares to negotiate for the right to veto certain important matters for the company (e.g., change of articles of incorporation, merger or sale of the company). In some cases, majority holder(s) are calculated based on the number of all preferred shares, and in other cases, majority holder(s) are calculated in each class based on the number of preferred shares of each class.
- **Rights relating to Transfer:** Venture investors would expect (i) rights of first refusal applicable to a sale of shares by the founders, (ii) tag-along rights applicable to sales of shares held by the founders and/or investors, and (iii) drag-along rights of majority shareholders in the case of a sale of the company.

### 11. How common are arrangement/monitoring fees for investors in the jurisdiction?

It is rare for arrangement fees or monitoring fees to be paid by the company or follow investors to the lead investor.

### 12. Are founders and senior management typically subject to restrictive covenants following ceasing to be an employee and/or shareholder and, if so, what is their general scope and duration?

It is common that venture capital investors require non-competition and non-solicitation as well as confidentiality obligations in the investment documents (typically in a shareholders' agreement).

As for non-competition, founders and other directors who hold the company's shares are restricted from conducting, or having any interests in, any businesses or actions that actually or potentially could compete with the businesses of the company for a certain period (e.g., two years) after they cease to be an officer, employee or shareholder of the company.

It would be uncommon for directors or senior

management who do not hold any shares in the company, to be subject to the above restrictions under the investment documents; however, in general terms, such persons may be subject to similar restrictions under their relevant service agreement or employment agreement.

### 13. How are employees typically incentivised in venture capital backed companies (e.g. share options or other equity-based incentives)?

Employees of the company are typically incentivised by stock options through which they can acquire shares in the company at a relatively low exercise price. The conditions for exercising the option vary depending from case to case. In some cases, employees may only exercise their rights after an IPO of the company or if there is a sale of the company.

### 14. What are the most commonly used vesting/good and bad leaver provisions that apply to founders/ senior management in venture capital backed companies?

In venture capital-backed companies in Japan, vesting and leaver provisions are not commonly used.

On the other hand, we understand that an agreement is sometimes executed among founders upon incorporation of the company. Although the obligations of the founders under such an agreement differ depending on the case, it is relatively common for the founders to undertake obligations to sell a certain amount of their shares in the company to the other founders for a pre-agreed price (e.g., the price for which the founder acquired the shares) according to the amount of time that the founder worked as a director or an employee, if he/she ceases to be a director or an employee of the company (in many cases, regardless of the reasons for no longer continuing as a director or employee).

### 15. What have been the main areas of negotiation between investors, founders, and the company in the investment documentation, over the last 24 months?

In relation to the investment terms described in Q10, the following are the main areas of negotiation among the investors, founders and the company: (i) the scope of the representations and warranties given by the company and founders; (ii) the scope of any veto rights; and (iii) board representation and observer rights.

## 16. How prevalent is the use of convertible debt (e.g. convertible loan notes) and advance subscription agreement/ SAFEs in the jurisdiction?

In Japan, equity financing and loans are common forms of financing a start-up. The use of convertible debt is not as prevalent as in other jurisdictions, particularly the U.S. In an effort to promote the benefits of convertible securities, METI published guidelines in 2020 regarding convertible securities which has helped to increase their use in Japan. Among convertible securities, J-KISS, a convertible equity similar to the Keep It Simple Security (KISS) in the U.S., is the most commonly used instrument. Convertible bonds are also used on occasion as a source of financing.

## 17. What are the customary terms of convertible debt (e.g. convertible loan notes) and advance subscription agreement/ SAFEs in the jurisdiction and are there standard form documents?

Customary terms of convertible bonds and J-KISS are:

**Conversion Price:** The holders of these convertible securities are normally entitled to convert these securities into shares at a discounted rate in the next financing round.

**Valuation Cap:** The valuation cap entitles the holders to convert these securities at the pre-agreed valuation cap regardless of the valuation in the next financing round.

In case of J-KISS, the holders are entitled to convert J-KISS into common shares (or preferred shares that had already been issued at the time of issuance of the J-KISS) at the valuation cap if the next financing round does not occur prior to the pre-agreed deadline for conversion. On the other hand, in case of convertible bonds, if the bonds are not converted into equity prior to the maturity date, the principal and accrued interest of the bonds must be fully repaid.

Coral Capital, a well-known venture capital fund in Japan,

has published a template form for the J-KISS instrument which has been widely used in practice.

## 18. How prevalent is the use of venture or growth debt as an alternative or supplement to equity fundraisings or other debt financing in the last 24 months?

Due to a slowdown in the equity financing market over the last 24 months, the need for venture or growth debt has increased. In the last two years, some new venture debt funds have been formed by Japanese banks and other financial institutions, and it is expected that the venture/growth debt market will continue to expand.

## 19. What are the customary terms of venture or growth debt in the jurisdiction and are there standard form documents?

Venture or growth debt is customarily structured as a bond or loan accompanied by an equity kicker (an option to acquire shares). The customary terms of bonds or loans include the maturity date, interest rates, affirmative and negative covenants and events of default. Covenants of venture or growth debt tend to be broader and more strict than normal corporate loans.

There are no template documents published by an industry body that are widely used; rather each financial provider tends to use their own template forms.

## 20. What are the current market trends for venture capital in the jurisdiction (including the exits of venture backed companies) and do you see this changing in the next year?

The number of companies which were newly listed on the Tokyo Stock Exchange in the last few years has been stable and an IPO remains the main exit pathway for venture-backed companies. However, in the longer term, M&A transactions, including acquisitions by a strategic buyer, may increase in prevalence as an alternative exit pathway.



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