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Equity finance by Japanese listed companies through third-party allotment pursuant to an equity program (PIPEs)

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I. Introduction

In Japan, the means of equity financing utilized by Japanese listed companies are (1) public offerings, (2) third-party allotment (PIPEs) and (3) rights offerings to existing shareholders. When third-party allotment is selected, common stock, preferred stock, stock acquisition rights (warrants), and/or convertible bonds are usually issued to specific investor(s). Typically, such securities are issued once on a specific date, and the issuer does not repeatedly issue multiple securities within a short period of time¹.

Recently, however, there have been some cases of listed companies issuing common stock, warrants and/or convertible bonds over several months in several installments through the establishment of a so-called equity program. In light of this trend, this newsletter provides a general overview of third-party allotment by listed companies pursuant to such equity programs.

II. Overview of Equity Program

The typical schedule for ordinary third-party allotment and third-party allotment pursuant to an equity program is as follows².

	Ordinary third-party allotment	Equity Program
Initial announcement (X)	Board resolution for placement Execution of subscription agreement ³	Board resolution for the 1st placement Execution of Equity Program Agreement
X+15 days or more	Payment date	Payment date for the 1st placement
Determination of terms and conditions for the 2nd Placement (Y)	-	Resolution for the 2nd placement
Y+15 days or more	-	Payment date for the 2nd placement
Determination of terms and conditions of nth Placement (Z)	-	Resolution for the nth placement
Z+15 days or more	-	Payment date for the nth placement

In the case of a third-party allotment pursuant to an equity program, at the time of the initial announcement (X), the issuer publicly discloses its plan for the second and subsequent placements, including the scheduled

¹ However, for securities that are expected to be converted into common stock, such as warrants, shares may be issued more than once within a short period of time if the conversion rights are exercised multiple times.

² This is only a typical schedule; actual schedules should be considered on an individual case basis.

³ This schedule assumes that the purchaser's obligation is conditioned upon the securities registration or shelf registration becoming effective.

announcement date of the terms and conditions, scheduled closing date, and the scheduled number of securities to be issued or total value of the placements, together with the terms and conditions for the first placement. In addition, certain conditions (equity condition) may be attached to the implementation of the second and subsequent placements, such as the share price exceeding a certain amount during the period prior to the determination of the terms and conditions, and if such conditions are not fulfilled, the second and subsequent placements may not take place.

III. Key Applicable Japanese Regulations

The key Japanese regulations applicable to third-party allotment pursuant to an equity program are as follows.

1. Companies Act

(1) Board Resolution and Public Notice Period

Under the Companies Act of Japan (the “Companies Act”), the issuance of new shares, warrants or convertible bonds by a listed company must be approved, in principle, by resolution of the board of directors of such company⁴. In addition, certain items among the matters subject to such approval must be publicly disclosed at least two weeks prior to the payment date for such issuance.

Accordingly, in Japan, following the relevant board resolution, it would take at least two weeks to complete the third-party allotment. In the case of third-party allotment pursuant to an equity program, it is generally expected that such procedure would be followed for each placement, which would make the entire process somewhat long.

(2) Issuance at a “Specially Favorable Price” or “Specially Favorable Conditions”

Under the Companies Act, as an exception to the rule mentioned in (1) above, any offering of new shares, warrants or convertible bonds by a listed company at a “specially favorable price” or with “specially favorable conditions” must be approved at a general meeting of shareholders of such company. In the case of common stock, it is generally considered that an issue price that is no less than 90% of the market price on the trading day immediately preceding the board resolution would not constitute a “specially favorable price”. In the case of warrants and convertible bonds, it is a standard practice to appoint a third-party valuation firm, and such valuation firm conducts a valuation of the warrants and convertible bonds in order to ensure the issuance is not conducted under “specially favorable” conditions.

In the case of third-party allotment pursuant to an equity program, it would significantly impact the transaction schedule if a general meeting of shareholders of the issuer is required to be held. Therefore, it is essential for both the issuer and the investor to confirm that the issuance of securities is not at conducted at a “specially favorable price” or under “specially favorable conditions”. In the case of third-party allotment pursuant to an equity program, it is generally expected that such confirmation would be conducted for each placement.

2. Financial Instruments and Exchange Act

(1) Public Disclosure Requirements

When a Japanese listed company issues common stock, warrants or convertible bonds through third-party allotment, in principle, such issuance would constitute a “public offering of securities” under the Financial Instruments and Exchange Act of Japan (“FIEA”), and the issuer may not solicit the acquisition of such securities without filing a securities registration statement or shelf registration statement, and may not enter into a binding agreement with an investor to sell such offered securities until the securities registration statement becomes effective, or until the shelf registration statement becomes effective and a supplemental document to the shelf registration is filed. In order for the issuer to file a shelf registration statement, an issuer is required to meet certain eligibility requirements specified by the FIEA.

In the case of third-party allotment pursuant to an equity program, it is generally expected that a securities registration statement or a shelf registration statement must be filed on the initial announcement date (X), and an

⁴ If the company is a “Company with an Audit and Supervisory Committee” or a “Company with Three Committees”, the decision-making on such issuance can be delegated to a director or an executive officer. In addition, in certain circumstances, the issuance must be approved at a general meeting of shareholders.

amendment to the securities registration statement or supplemental document to the shelf registration must be filed once the terms and conditions of the second and subsequent placements are determined (Y, Z). In order to file a securities registration statement or a shelf registration statement, prior consultation with the local finance bureau is required. In addition, the closing of the transaction can occur only after the securities registration statement or the shelf registration statement becomes effective.

(2) Insider Trading Regulations

Under the FIEA, the related parties of a listed company are prohibited from selling and purchasing certain securities of the listed company with knowledge of matters (material facts) that could have a material effect on investment decisions regarding the company's securities ("MNPI") before those matters have been made public. Therefore, In the case of third-party allotment pursuant to an equity program, from an investor's perspective, in order to freely trade the issuer's shares even during the equity program period, it is essential to ensure that the investor is not in possession of MNPI of the issuer. However, it may not be practicable for the issuer not to possess or disclose any MNPI during the equity program period, and treatment of MNPI would often be an issue to be negotiated between the issuer and the investor.

3. Stock Exchange Rules

Under the rules of stock exchanges, in principle, public announcements shall be made if a listed company decides to issue new shares or other securities. In addition, in respect of third-party allotments, in principle, an issuer is required to confirm certain matters regarding the allottee (investor), including whether the allottee does not have any relationships with anti-social forces and has sufficient funds to pay for the securities. Such confirmation, especially on whether the allottee does not have any relationships with anti-social forces, may need to be checked by a third-party investigator depending on the attributes of the allottee (investor), and this process may take a certain amount of time.

4. Foreign Exchange and Foreign Trade Act

Under the Foreign Exchange and Foreign Trade Act of Japan (the FEFTA), if a foreign investor acquires shares of or voting rights in a Japanese corporation that is listed on a Japanese stock exchange and as a result of the acquisition, the foreign investor, in combination with any existing holdings, directly or indirectly holds 1% or more of the total number of issued shares of or the total number of voting rights in the relevant corporation, such acquisition will constitute an "inward direct investment". If a foreign investor intends to consummate an acquisition of shares of or voting rights in a Japanese listed corporation that constitutes an "inward direct investment", a prior notification in respect of the relevant inward direct investment will need to be filed with the Minister of Finance and any other competent Ministers unless certain exemptions apply (such as where that Japanese corporation is not engaged in certain businesses designated by the FEFTA and related regulations). If such prior notification is filed, the proposed inward direct investment may not be consummated until 30 days after the date of filing, during which time the Ministers will review the proposed inward direct investment, although this screening period may be shortened.

Given such regulations, if the investor is a "foreign investor", it is essential for the issuer and the investor to check whether such prior notification requirement would be triggered.

IV. Characteristics of Equity Program

Third-party allotments pursuant to an equity program, when compared to ordinary third-party allotments, include the following characteristics.

1. Longer period to complete the transaction

In respect an ordinary third-party allotment, the payment date is expected to be approximately 15 days from the time of the initial public announcement in accordance with the regulations mentioned above, and fundraising is in principle completed once the payment date arrives⁵. On the other hand, in respect of a third-party allotment pursuant to an equity program, a longer period of time is required to complete the fundraising because the issuance procedures need to be conducted multiple times. As a result, both the issuer and investors are exposed to risks in relation to changes in the environment and stock price fluctuations during the program period, which

⁵ However, if it is a warrant, the financing is not complete until it is subsequently exercised.

must be taken into consideration in the design of the program.

2. Amount to be raised

In respect of an ordinary third-party allotment, typically, the issue price per share, the exercise price of the warrants and the conversion price of the convertible bonds (the “issue price, etc.”) are determined by reference to the most recent share price on the initial announcement date (X in the table above). On the other hand, in respect of a third-party allotment through an equity program, the issue price, etc. for the second and subsequent placements are usually determined by reference to the share price on the most recent date for determining the terms and conditions of the second and subsequent placements (Y and Z in the above table). Therefore, if the issuer expects to grow in a short period of time or achieve a certain milestone in the future, the issuer may be able to enjoy an upside that incorporates the expectation of a future increase in stock price by staggering or postponing the timing for the determination of the issuance conditions while meeting its funding needs in the present. On the other hand, the investor will need to invest more funds if the stock price rises, but it will need to invest less funds if the stock price falls.

3. Second and subsequent placements

As mentioned above, in respect of a third-party allotment pursuant to an equity program, certain equity conditions, such as the closing price being above a certain amount on the business day before the determination date of the terms and conditions, may apply to the second and subsequent placements, and if these conditions are not met, the second and subsequent placements may not be implemented. If these conditions are not met, the issuing company must reduce the amount of funds raised, but this will reduce the degree of dilution. For the investor, the imposition of such conditions allows for a certain degree of risk hedging by allowing the investor to cancel the second and subsequent placements if an unexpected event occurs after the initial investment decision.

V. Other Considerations

Given the points mentioned above, it would be important for the issuer and the investor to carefully consider and design the equity program. Such consideration may involve (i) the number and issuance period of the securities, (ii) the contents of equity conditions, (iii) the representations and warranties and covenants in the investment agreement (e.g., material adverse changes, restriction of the issuer’s public disclosures, ROFR and lock-ups).

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