



RECENT REVISIONS TO JAPANESE TENDER OFFER RULES: TOWARD TRANSPARENCY AND FAIRNESS

DEVELOPMENTS IN THE JAPANESE M&A MARKET

Japanese tender offer regulations were substantially amended in December 2006 in the wake of recent hostile-takeover activities in Japan. The tender offer regulations, which were first introduced in Japan in 1971, were substantially revised in 1990. These revised regulations form the basis of the current legal framework. The additional revisions made in 2006 (the “Revisions”) are intended to increase the transparency and fairness of tender offers by, for example, enhancing the disclosure requirements and expanding the scope of application of the tender offer rules.

Historically, the pace of M&A activity, particularly takeovers, in Japan has been relatively slow. For example, only four tender offers were actually conducted in Japan during the 20-year period from 1971 to 1990. After the collapse of the so-called Japanese bubble

economy in 1991, Japanese businesses underwent significant corporate restructuring for more than a decade, and the number of tender offers gradually increased as part of the effort to recover from the deflationary economy in the late 1990s. Tender offers in Japan in 2005 and 2006 numbered 50 and 68, respectively. However, after the collapse of the economic bubble, hostile offers were almost nonexistent in Japan until 2000, when a Japanese activist fund managed by Mr. Yoshiaki Murakami engaged in a hostile offer for Shoei Co., Ltd., a real estate company. This was followed by hostile tender offers made simultaneously for two mid-sized companies, Sotoh Corporation and Yushiro Chemical Industry Co., Ltd., by Steel Partners Japan, a U.S.-based activist fund, in December 2003. While the level of hostile offers is still a relatively small portion of overall M&A activity, there are signs of an increase in hostile takeovers in Japan. In order to stimulate the stagnant Japanese economy, a new law entitled the “Corporation Law” was

promulgated in 2005. This law entirely replaces the provisions governing companies included in the Commercial Code and provides for more flexibility in corporate governance and corporate reorganizations, including cash squeeze-outs of minority shareholders.

In the face of this changing landscape, the Ministry of Economy, Trade and Industry and the Ministry of Justice jointly promulgated guidelines for takeover defenses in May 2005, for the purpose of clarifying the rule that offers which are expected to increase enterprise value and shareholders' common interests are not to be frustrated. While a small number of Japanese companies have adopted takeover defense measures similar to poison pills in the U.S., many others have not yet gone that far and have instead taken the modest step of adopting a takeover defense policy, which usually formulates the procedures that unsolicited suitors are required to follow and clarifies the types of information they must provide to the target company in order to avoid antitakeover actions. Recent takeover activities revealed gaps and shortcomings in Japanese tender offer regulations, which prompted the Financial Services Agency of Japan (the "FSA") to overhaul them.

OVERVIEW OF REVISIONS

Japanese tender offer regulations are governed by the Securities and Exchange Law of Japan (the "SEL") and regulations promulgated thereunder. The Revisions were part of sweeping changes to the SEL that were approved by the Japanese Diet on June 7, 2006. Changes in the SEL are implemented in four stages: (i) increase in criminal penalties for SEL violations (effective as of July 4, 2006); (ii) the Revisions (effective as of December 13, 2006); (iii) substantial changes in and renaming of the SEL as the Financial Instruments and Exchange Law (the "FIEL") (expected to take effect in the fall of 2007); and (iv) implementation of management reports on internal control over financial reporting and quarterly reporting (to take effect with respect to the fiscal year of each listed company that will start on or after April 1, 2008).

As mentioned above, the primary purposes of the Revisions are to (i) expand the scope of application of the tender offer rules and (ii) enhance the disclosure requirements to allow

proper investment decisions by investors and to indirectly promote the fairness of tender offers. The changes and their impact, however, are far-reaching. Set out below are major points of the Revisions:

- *Clarification of scope of mandatory tender offers.* To prevent the circumvention of the tender offer regulations (as more fully discussed below), a purchase by tender offer will be mandated, and thus a series of purchases otherwise than through a tender offer will be prohibited, if (i) a purchaser acquires no less than 10 percent of the voting rights of the target company within a three-month period in a transaction or series of transactions, (ii) out of such acquisition of no less than 10 percent of the voting rights, 5 percent or more of the voting rights are acquired by the purchaser in off-exchange transactions or certain on-exchange transactions, and (iii) the purchaser owns more than one-third of the total voting rights of the target company after such acquisition or acquisitions;
- *Equality of offerors by mandating purchase by tender offer.* If there is a pending tender offer, a purchase of more than 5 percent of the voting rights by a shareholder that already owns more than one-third of the total voting rights of the target company during the tender offer period (but excluding any extension of the original tender offer period) must be made by way of a tender offer (as more fully discussed below);
- *Tender offer period and target company's right to extend tender offer period.* The tender offer period is now required to be no shorter than 20 and no longer than 60 business days, as opposed to the previous period of no shorter than 20 and no longer than 60 calendar days. Further, if the original tender offer period is shorter than 30 business days, the target company may request that the period be extended to 30 business days by so stating in the report expressing its opinion in respect of the tender offer (the "Opinion Report");
- *Target company's opinion.* The target company is required to file the Opinion Report with the Kanto Local Finance Bureau within 10 business days of the commencement of the tender offer;

- *Target company's inquiry right and offeror's response.* The revised tender offer rules permit the target company to raise questions addressed to the offeror in the Opinion Report, in which case the offeror will be required to respond by filing a Report on Response to Questions within five business days of receiving a copy of the Opinion Report from the target company. This inquiry-and-response procedure is limited to one round of questions and answers. However, the regulations do not prohibit additional rounds of questions and/or answers outside of this legal requirement;
- *Mandatory purchase of all tendered shares and mandatory offer for all equities.* The offeror is permitted to set both the minimum tender condition (i.e., the minimum number of tendered shares as a condition precedent to a purchase of tendered shares) and the maximum number of shares to be purchased in the tender offer, provided, however, that the offeror is now required to purchase all of the tendered shares if the offeror is to own two-thirds or more of the total voting rights of the target company as a result of the tender offer by making an offer to purchase all of the outstanding shares and other equity of the target company;
- *Change in offer price.* The tender offer regulations allow an increase in the offer price but strictly prohibit the offeror from decreasing the offer price, with the exception that, where the target company effectuates a stock split or free distribution of shares or options to its shareholders, a reduction in the offer price will be permitted to an extent not greater than the rate of reduction in stock value due to such split or free distribution;
- *Withdrawal of tender offer.* The tender offer regulations strictly limit the offeror's ability to withdraw the offer once it is commenced, but the Revisions have expanded the scope of exceptions to this limitation; for example, withdrawal is permitted when the target company effectuates certain defensive actions or decides not to cancel a defense scheme already in place, provided, however, that a withdrawal of the offer will be permitted only where the tender offer commencement notice and tender offer registration statement (the "Registration Statement") both specifically provide for such event as a condition of the offer; and

- *Enhanced disclosure.* The level of disclosure required in the Registration Statement and Opinion Report is more detailed in many respects (as more fully discussed below).

Calculation of percentage of voting rights. For the purposes of the tender offer regulations, the percentage of voting rights owned by the offeror is aggregated with that of its "special related parties" (as defined in the SEL/FIEL) when considering whether the tender offer regulations may apply. The definition of "special related party," while very technical and detailed, essentially refers to a person who falls under any of the following: (i) director or officer of the offeror; (ii) a person no less than 20 percent of whose voting rights are owned directly or indirectly by the offeror; (iii) a person who directly or indirectly owns no less than 20 percent of the voting rights of the offeror; (iv) a person who has an agreement with the offeror to act jointly in connection with the purchase or sale of the shares, or the exercise of the voting rights or other shareholder rights, of the target company; or (v) a person who agrees to sell or purchase the shares of the target company to or from the offeror after the tender offer. Further, it must be noted that nonvoting stock owned by the offeror or its special related parties also will be counted if such stock is convertible into voting stock, and the number of voting rights of any equity securities will be counted on the higher of the current level and the level when and if exercised or converted.

SCOPE OF APPLICATION OF TENDER OFFER REGULATIONS AFTER THE REVISIONS

Japanese tender offer regulations apply, and a tender offer will be mandated, if an acquisition of listed shares (or shares issued by the reporting company under the SEL/FIEL) meets certain criteria stipulated under the SEL/FIEL. In general, types of acquisitions that will trigger tender offer regulations (subject to certain exempted transactions) are as follows:

- *Off-exchange transactions.* If (i) shares are to be purchased outside a stock exchange from more than 10 sellers (for the purpose of this rule, the number of sellers during a 60-day period preceding the current purchase, if any, to be added), as a result of which the total voting rights owned by the purchaser (together with its "special related parties,"

as referenced above) exceed 5 percent of the total voting rights of the target company, or (ii) shares are to be purchased outside a stock exchange with the result that the total voting rights owned by the purchaser (together with its special related parties) exceed one-third of the total voting rights of the target company, regardless of the number of sellers, then such purchase must be made by way of a tender offer.

- *Nonregular on-exchange trades outside session hours.* If a purchase is to be made through a trade outside the regular trading session hours on a stock exchange, such as the Tokyo Stock Exchange Trading Network System ("ToSTNet"), with the result that the total voting rights owned by the purchaser (together with its special related parties) exceed one-third of the total voting rights of the target company, then such purchase otherwise than by way of a tender offer will be prohibited. This prohibition was added to the tender offer regulations following the infamous acquisition by livedoor Co., Ltd., an internet portal operator, of approximately 30 percent of the voting shares of Nippon Broadcasting System, Inc. on a single day through a series of ToSTNet trades in February 2005, resulting in its acquisition of more than 35 percent of the company's voting rights. The prevailing interpretation at that time was that a purchase through ToSTNet was not subject to tender offer regulations because it was a trade on a market operated by the Tokyo Stock Exchange and should be deemed an on-exchange transaction. In the face of public criticism, which held that such a loophole should not be permitted because a ToSTNet trade is not the same as the regular on-exchange trade in that there is no auction involved, the Diet acted swiftly and amended the SEL to subject this type of trade to the tender offer regulations, with effect on July 9, 2005.
- *Certain transactions resulting in acquisitions of more than one-third of voting rights.* If (i) the total percentage of the voting rights owned by the purchaser (together with its special related party) as a result of the acquisition exceeds one-third of the total number of voting rights of the target company, (ii) the total voting rights acquired by the purchaser and its special related parties within a three-month period are no less than 10 percent of the total voting rights of the target company, regardless of whether it is an acqui-

sition of outstanding shares through an on-exchange or off-exchange transaction or an acquisition of new shares or treasury stock being issued or disposed of by the target company, and (iii) out of such acquisition of no less than 10 percent of the voting rights, the acquisition of no less than 5 percent of the total voting rights of the target company is made through either (x) an off-exchange transaction or transactions (but excluding those acquired in a tender offer) or (y) a ToSTNet-type nonregular trading on a stock exchange referenced above, then a tender offer will be mandated. Prior to the Revisions, it was not clear whether and to what extent a series of acquisitions was subject to the tender offer regulations, and the FSA stated that the purpose of this portion of the Revisions is to clarify the application in such a setting. For example, a Japanese activist fund managed by Mr. Yoshiaki Murakami acquired almost 40 percent of the voting stock of Hanshin Electric Railway Co., Ltd. ("Hanshin") through a combination of transactions comprising on-exchange and off-exchange purchases of shares and convertible bonds, coupled with an acquisition of Hanshin shares in a share swap, without conducting a tender offer. This scheme was criticized by the media. The Revisions subject manipulative tactics (such as the above-mentioned scheme) to the tender offer regulations. In this regard, the FSA takes the position with respect to a series of transactions of the type described above that all transactions conducted within a three-month period are deemed a single unified transaction, with the result that both the portion of transactions exceeding a threshold (one-third, 5 percent, or 10 percent) and each other portion of the whole series of transactions conducted within such three-month period are in violation of the tender offer requirements.

- *Purchase in competition with pending tender offer.* If a shareholder (together with its special related party) who already owns more than one-third of the total voting rights of the target company seeks to acquire more than 5 percent of the voting rights of the target company during the original tender offer period of an offer launched by another acquiror, such acquisition must be made by way of a tender offer. This portion of the rule has been introduced by the Revisions in order to ensure the equal footing of competing offerors/acquirors. An incident that prompted the codification of this rule was the purchase in February 2006

by Don Quijote Co. Ltd., operator of a Japanese chain of discount shops. Don Quijote already held 31.06 percent of the voting stock of Origin Toshu Co., Ltd, operator of a Japanese takeout lunch-stand chain, before commencing an unsolicited tender offer to purchase additional voting stock of Origin Toshu (for the period from January 16 to February 9, 2006). This offer was countered by a tender offer (for the period of January 31 to March 1, 2006) by AEON Co., Ltd., operator of a supermarket chain, appearing as a white knight. Following the unsuccessful tender offer attempt, Don Quijote purchased an additional 16.75 percent of the voting stock of Origin Toshu through on-exchange transactions between February 10 and 17, 2006, raising its ownership of voting rights to 47.81 percent, while the tender offer by AEON was still pending. This resulted in criticism to the effect that Don Quijote should have extended the tender offer period or refrained from the purchase of additional shares while AEON's tender offer was pending. Don Quijote eventually tendered its entire holding of Origin Toshu shares in AEON's tender offer, disposing of the entire 47.81 percent interest. While the Revisions are aimed at preventing an attempt by a competing offeror to purchase shares through either on-exchange or off-exchange transactions while a tender offer by another bidder is pending, the FSA was concerned about excessive regulations and, accordingly, the Revisions are designed to strike a balance between the need to ensure an equal footing between competing offerors/acquirors and the need to avoid excessive regulation.

TENDER OFFER RULES AFTER THE REVISIONS

Certain fundamentals of the Japanese tender offer rules that are not addressed above are noted below:

Commencement of a tender offer. A tender offer is commenced by issuing a public notice of the commencement of the tender offer (the "Commencement Notice") containing the terms of the offer and other pertinent information about the tender offer and offeror. A Commencement Notice needs to be carried either on two or more daily newspapers of general circulation or electronically on the Electronic Disclosure for Investors' NETwork ("EDINET"), but in practice almost all such notices are now made electronically. A Registration

Statement must be filed with the Kanto Local Finance Bureau on the day the Commencement Notice is given. Any solicitation of tender or other similar activity will be prohibited until a Registration Statement is filed.

Disclosure required in Commencement Notice and Registration Statement. The required disclosure in a Commencement Notice and a Registration Statement has become more detailed as a result of the Revisions. For example, as regards the purposes of the offer, if the offeror intends to acquire control or participate in the management of the target company, the offeror must describe in the Registration Statement (i) such intention of acquisition of control or participation in management, (ii) details of the contemplated process of acquiring control or participating in management, and (iii) if the offeror contemplates after the tender offer any corporate reorganization (such as a merger or share swap), purchase or disposition of important assets, change in management, borrowing of large amounts, material changes in dividend or capital policy, or any other action that is expected to materially change, or have a material effect on, the management of the target company, the details of such plan and reasons therefor. If the tender offer is being made for investment purposes, the offeror must state in the Registration Statement (i) its policy following the tender offer regarding shareholding, purchase and sale of shares, and exercise of voting rights in respect of shares of the target company and (ii) the reasons for such policy and, particularly if the tender offer is being made for the purposes of long-term investment, the reasons why the tender offer is necessary for such purpose.

In addition, the offeror must describe in the Registration Statement, regardless of the purpose of the tender offer, (i) whether the offeror has a plan to acquire additional shares of the target company following the completion of the tender offer and, if so, details of such plan and the reasons therefor, and (ii) if delisting of the shares of the target company is likely, a statement to such effect and details of the reasons therefor. While the above requirements are directly addressed in the Registration Statement, the descriptions of the purposes of the offer in the Commencement Notice are usually the same as those set forth in the Registration Statement.

Additional disclosure requirements in the case of MBOs, etc. The number of management buyouts (“MBOs”) in Japan is increasing. Such transactions are inherently subject to conflicts of interest between management and shareholders. A recent example of an alleged conflict of interest reported in the media is the MBO of Rex Holdings Co., Ltd., an operator and franchiser of restaurants and convenience stores in Japan. Before commencing a tender offer on November 11, 2006, Rex Holdings announced a change in accounting principles and a downward adjustment of its earnings forecast on August 21, 2006, following which its share price dropped substantially. Because (i) the offer price was only 13.9 percent above the average of the closing prices over the 30 trading days preceding the commencement of the tender offer and (ii) the company announced on the eve of the commencement of the tender offer that it would not make any year-end dividend payment in respect of the current fiscal year, some disgruntled shareholders claimed that management’s announcement of the downward adjustment of earnings forecast and elimination of dividends was motivated by the desire to induce the tender of shares notwithstanding an inadequate offer price.

To address conflict-of-interest issues and to promote the fairness of the offer price, the tender offer rules after the Revisions now require that if the offeror is either (a) the management or is acting at the request of, and has common interests with, the management or (b) the parent of the target company, then the disclosure of the following matters must be made in the Registration Statement: (i) measures designed to ensure the fairness of the offer price (if any); (ii) the process leading to the commencement of the tender offer; and (iii) measures intended to avoid a conflict of interest (if any). The tender offer regulations do not mandate that the offeror take such measures to ensure fairness of the offer price or avoid a conflict of interest, but if such measures are taken, the offeror must describe such measures in the Registration Statement. In addition, if there is an evaluation report or opinion that the offeror has referred to in deciding on the offer price, the offeror will be required to file such report or opinion as an attachment to the Registration Statement.

Change in offer terms. In order to protect investors, the tender offer regulations prohibit certain changes in the terms of an offer that are disadvantageous to investors, including a reduction in the offer price (with the exceptions referenced above), acceleration of the tender offer period, an increase in the number of shares in the minimum tender condition, and a reduction in the number of maximum shares to be purchased by the offeror. Further, if the tender offer is commenced without such a minimum tender condition or the maximum number of shares to be purchased, the offeror may not add such condition.

Rules on offer price. There is no substantive regulation of the offer price and, accordingly, an offer price need not be higher than a trade price at the time of tender offer or any time up to the commencement of the tender offer. (Strangely, there were some tender offers made in Japan where the offer price was lower than the then-current market price.) The same price, however, must be offered to all holders of shares of the same class in the tender offer to ensure the equal treatment of tendering shareholders. Therefore, if there is an increase in the offer price, the same price will apply to those shareholders who had already tendered shares before the increase.

Cancellation rights of tendering shareholders. Shareholders who have tendered their shares are free to cancel their tender during the tender offer period. The tender offer rule further provides that the offeror is prohibited from charging any fee to, or seeking damages or reimbursement of costs from, cancelling shareholders in connection with the cancellation or return of deposited share certificates.

Prohibition of purchase outside the tender offer. The offeror and its special related parties are prohibited from purchasing target shares outside the tender offer while the tender offer is pending (subject to certain exceptions).

CONCLUSION

The Revisions reflect an increase in the frequency and complexity of takeover activities in Japan. It is notable that this activity is engaged in not only by non-Japanese entities or funds, but also by Japanese corporations (something that was unheard of just five years ago). In our view, this means that this sort of activity is likely to increase in the future. Increased hostile-takeover attempts are expected to drive the entire M&A market, as they may well trigger mergers with or acquisitions by friendly parties, fueling the consolidation of businesses. We expect to see strong growth in the Japanese M&A market, in both friendly and hostile transactions, over the next few years, which should present an opportunity to both strategic and financial buyers from overseas looking for a chance to invest in Japanese companies.

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