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Rule 802 and application of U.S. securities laws to Japanese business combinations involving stock consideration

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Rule 802 under the U.S. Securities Act of 1933, as amended (the "Securities Act"), provides an exemption from the registration requirements of the Securities Act for certain exchange offers and business combinations by foreign private issuers ("FPI")[1] involving the issuance of securities. This client update discusses how Rule 802 and the Securities Act apply to Japanese mergers, share exchanges and similar stock-for-stock business combination transactions.[2]

I. Regulation of business combinations

A. Registration requirement

Section 5 of the Securities Act requires registration with the U.S. Securities and Exchange Commission (SEC) of any offer or sale of a security unless an exemption is available. Rule 145(a) under the Securities Act extends the terms "offer" and "sale" to include mergers and other transactions involving the exchange of securities if shareholders vote to approve the exchange or the transaction otherwise involves an investment decision.[3]

Section 5 does not specifically exclude offers or sales of securities conducted outside of the United States by non-U.S. companies. However, the SEC lacks the authority under Section 5 to regulate such offers or sales unless such offers or sales have a requisite connection to the United States. This requisite connection to the United States is present if the transaction involves the use of "U.S. jurisdictional means." The use of such U.S. jurisdictional means is unavoidable for most Japanese merger and similar share-for-share exchange transactions among listed companies in Japan, and these transactions are thus generally subject to Section 5.

On the other hand, business combinations that are structured as a cash-for-stock transaction (such as a cash tender offer) are not subject to SEC registration under Section 5. This is because Section 5 regulates "offers" and "sales" of securities, not offers of cash for securities.

Insights

[1] A "foreign private issuer" is any foreign issuer (other than a foreign government), except an issuer meeting the following conditions as of the last business day of its most recently completed second fiscal quarter: (i) more than 50% of the outstanding voting securities of such issuer are directly or indirectly owned of record by U.S. residents; and (ii) (x) the majority of the executive officers or directors are U.S. citizens or residents, (y) more than 50% of the assets of the issuer are located in the United States or (z) the business of the issuer is administered principally in the United States. *See* Rule 405 under the Securities Act and Rule 3b-4 under the U.S. Securities Exchange Act of 1934, as amended (the "Exchange Act"). Most Japanese companies listed in Japan will qualify as an FPI.

[2] This client update does not discuss considerations relevant to a rights offering, exchange offer or tender offer. *See* Davis Polk client updates on these and other topics at davispolk.com/capabilities/region/japan/insights.

[3] For example, the decision to tender shares in a tender offer (if the consideration is for shares), vote shares in favor of a merger or exercise appraisal rights (*hantai kabunushi kaitori seikyū ken*).

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1. Transactions potentially subject to registration

The following Japanese business combinations involve an exchange of securities and are potentially subject to SEC registration. In this client update, we refer to these transactions as "share exchange transactions."

- *Merger (kyūshū gappei)*: one company is merged into another company; the surviving company's shares are offered to the non-surviving company's shareholders;
- *Consolidation-type merger (shinsetsu gappei):* two or more companies merge into a newly formed company; the shares of the newly formed company are offered to shareholders of the non-surviving companies;
- *Joint share transfer (kyōdō kabushiki iten):* two or more companies (the "incorporators") jointly form a new holding company to acquire all their shares; the holding company's shares are offered to the incorporators' shareholders;
- *Independent share transfer (tandoku kabushiki iten):* one company (an "incorporator") forms a new holding company to acquire all of its shares; the holding company's shares are offered to the incorporator's shareholders;
- *Share exchange (kabushiki kōkan):* a company acquires all of the shares of another company in a share exchange; the acquirer's shares are offered to target shareholders;
- *Stock distribution spinoff (supinofu):*[4] a parent company distributes to its shareholders 100% of the outstanding shares of either an existing subsidiary (*kabushiki bunpai ni yoru supinofu*) or a newly carved-out business (*bunkatsu gata bunkatsu ni yoru supinofu*);[5] and
- *Share delivery (kabushiki kōfu):*[6] one company acquires shares of another company in order to turn such company into a statutory subsidiary (with the acquiring company owning at least 50% of the outstanding voting rights of the target company after the transaction), with the acquiring company's shares delivered as consideration to the target company's shareholders.

In this client update:

- each of the following is an "acquirer":
  - the surviving company in a merger;
  - the non-surviving companies in a consolidation-type merger;
  - the newly formed holding company and the incorporators or incorporator in a joint or independent share transfer; and
  - the acquirer in a share exchange.
- each of the following is a "target":
  - the non-surviving company or companies in a merger;
  - the incorporators in a joint or independent share transfer; and
  - the target in a share exchange or share delivery.
- in the case of a consolidation-type merger and a joint or independent share transfer, each of the non-surviving company or companies and the incorporator or incorporators is considered to be both an acquirer and a target.

[4] Our understanding is that adverse tax consequences under Japanese law had historically made spinoff transactions structured as a combination of a demerger (*kaisha bunkatsu*) and distribution of shares as a dividend in kind (*genbutsu haitō*) impracticable. However, following tax reform enacted in Japan in March 2017 that allowed a parent company and its shareholders to avoid such negative tax consequences if the spinoff transaction satisfies certain requirements, we are aware of Japanese companies that have taken advantage of this transaction structure.

[5] In general, if the spinoff transaction is considered a "sale" of securities by a parent company, the distribution of the spun-off subsidiary's securities must be registered with the SEC or otherwise be eligible for an exemption from registration requirements under the Securities Act. The SEC staff has, however, issued guidance that such a transaction would not be considered to be a sale of securities if it satisfies certain conditions, including a condition that the parent company provides "adequate information" about the spinoff and the new spun-off entity to its shareholders and to the trading markets. Davis Polk has advised Japanese companies conducting spinoff transactions on compliance with this SEC guidance and can provide more information on this topic upon request.

[6] Introduced pursuant to amendments of the Companies Act of Japan effective March 2021.

2. Transactions not subject to registration

The following Japanese business combinations are structured as cash-for-stock transactions and are generally not subject to SEC registration under Section 5.[7] In this client update, we refer to these transactions as "cash transactions." The following list introduces the typical cash transaction structures and the general basis for concluding that the transactions are not subject to SEC registration:

- *Cash tender offer (kinsen taika no kōkai kaitsuke)*: a tender offer of cash[8] for shares of another company; does not involve an "offer" or "sale" of a security under Section 5;
- *Share exchange or merger for cash (kinsen taika no soshiki saihen torihiki)*: a share exchange or a merger in which shares of another company are converted into cash; does not involve an "offer" or "sale" of a security under Section 5;
- *Going-private transaction using redeemable shares (zenbu shutoku jōkōtsuki shurui kabushiki wo mochiita kanzen kogaishaka torihiki)*: a multi-step recapitalization, sometimes referred to as the "redeemable shares method." We understand that this method is used less frequently since the introduction of the mandatory squeeze-out described below;
- *Mandatory squeeze-out:*[9] as the second step of a two-step cash tender offer, a shareholder holding at least 90%[10] of the total voting rights of a target (either directly or through one or more wholly owned subsidiaries) is granted a conditional call option by operation of law as a "Special Controlling Shareholder" and, upon notification to and approval from the board of directors of the target company, forces a cash acquisition of the remaining shares held by minority shareholders; does not involve an "offer" or "sale" of a security under Section 5; and
- *Reverse stock split:* under Rule 145(a)(1) under the Securities Act, a reverse stock split where public shareholders receive only cash for fractional shares generally will not constitute an "offer" or "sale" of securities.

B. Consequences of SEC registration

Registration of a share exchange transaction with the SEC under the Securities Act may be an acceptable alternative for a Japanese public company that already maintains a U.S. stock exchange listing. For companies that are not already SEC reporting companies, there are several important consequences of SEC registration of a share exchange transaction, including the need to file a registration statement on Form F-4 with the SEC and fulfill ongoing disclosure obligations as an SEC-reporting company. For further details, please refer to our client update Form F-4 Registration of Japanese Business Combinations with the U.S. SEC under the U.S. Securities Act.

II. The Rule 802 exemption

Rule 802 exempts from the registration requirements of Section 5 of the Securities Act a business combination that satisfies conditions relating to:

- limitations on U.S. ownership;
- equal treatment of U.S. shareholders;

[7] Although cash transactions generally do not need to be registered with the SEC, if the target company has U.S. resident shareholders, they are still generally subject to U.S. securities laws, including U.S. federal and state antifraud laws that prohibit manipulation, fraud and misleading statements or omissions in connection with the purchase or sale of any security, or U.S. tender offer and other rules.
[8] Our understanding is that adverse tax consequences under Japanese law have historically made Japanese business combinations structured as a stock tender offer *(jisha kabu taika no kōkai kaitsuke)* impracticable. However, following a 2015 amendment to the Japanese Companies Act *(kaisha hō)* that introduced mandatory squeeze-outs by stockholders holding at least 90% of the total voting rights and amendments effective July 2018 to the Japanese Act on Strengthening Industrial Competitiveness *(sangyō kyōsōryoku kyōka hō)* that allow an acquirer to avoid such negative tax consequences upon receipt of prior approval for a reorganization plan from the Ministry of Economy, Trade and Industry, we understand there has been discussion within the Japanese legal community on the possible benefits of structuring Japanese business combinations as a stock tender offer. Moreover, some commentators have suggested that a stock tender offer with such approval may not be subject to SEC registration on Form F-4 if U.S. shareholders are excluded from such offer. However, we understand such discussions to be hypothetical at this time, as there has not yet actually been an example of such a transaction under the amended rules.
[9] Introduced pursuant to amendments of the Companies Act of Japan effective May 2015.
[10] Further amendments to the Companies Act of Japan effective July 2019 have provided another approach under which a shareholder (or group of shareholders forming a consortium) owning as little as 66 2/3% of the outstanding voting rights in a target company may be able to implement a squeeze-out of minority shareholders, subject to additional conditions requiring that (i) a single acquirer own at least 50% of the outstanding voting rights, (ii) the acquirer obtain approval from the applicable ministry of a business restructuring plan demonstrating the transaction will result in improvements to the acquirer's business over the ensuring three to five years and (iii) the acquirer provide the applicable ministry with a report indicating the consideration offered to minority shareholders is fair from a financial point of view.

- informational documents; and
- legends.[11]

A. Limitations on U.S. ownership

The Rule 802 exemption will be available for a share exchange transaction only if U.S. holders own no more than 10% of the total number of shares[12] outstanding. We generally advise companies to hire a professional service provider to assist with identifying U.S. holders. The SEC rules do not require companies to retain such a service provider, but the SEC might consider the failure to do so as a factor weighing against any company that attempts to rely on Rule 802 and later determines that U.S. ownership exceeds the 10% threshold.

The U.S. holder percentage ownership is determined as follows:[13]

- *Calculation reference dates*. The percentage should generally be calculated on a date within a 90-day period that is no more than 60 days (in some cases 120 days) before and no more than 30 days after the public announcement of the share exchange transaction;[14] and
- *Determination of U.S. holders.* The percentage is calculated as a ratio of (i) the number of shares of the subject securities held by U.S. holders (the *numerator*) divided by (ii) the number of outstanding shares of the subject securities (the *denominator*). Shares owned by the acquirer or the target are excluded from the numerator and the denominator.

In limited situations, where the parties to a share exchange transaction are unable to conduct the required look-through analysis for exceptional reasons, Rule 802 will allow the determination to be conducted based on an alternative "average daily trading volume" test.

For purposes of Rule 802, a "U.S. holder" is any security holder resident in the United States and will generally include entities organized or incorporated in the United States. The rule requires entities relying on the exemption to query some record holders and to review public beneficial holder filings to determine beneficial ownership by U.S. holders.

This limitation on U.S. ownership generally applies in the following manner to share exchange transactions:[15]

- *Mergers.* U.S. holders must hold no more than 10% of the shares of the non-surviving company;
- *Consolidation-type mergers.* U.S. holders must hold no more than 10% of the shares of the newly formed company, calculated on a pro forma combined basis and assuming completion of the transaction;
- *Joint share transfers.* U.S. holders of the incorporators must hold no more than 10% of the shares of the holding company, calculated on a pro forma combined basis and assuming completion of the transaction;[16]
- *Independent share transfers*. U.S. holders must hold no more than 10% of the shares of the incorporator; and
- *Share exchanges.* U.S. holders must hold no more than 10% of the shares of the target.

[11] Note: (i) Rule 802 is not available for an investment company required to be registered under the U.S. Investment Company Act of 1940, as amended; (ii) a transaction or series of transactions in technical compliance with the Rule 802 exemption will be subject to registration if the transaction or series of transactions is a scheme to evade registration; and (iii) Rule 802 provides an exemption for the issuer of the securities and not for any affiliate of the issuer or for any other person engaged in resales of the issuer's securities.
[12] In each case, the share percentage figures refer to the shares of the class of securities that are the subject of the share exchange transaction.
[13] As mentioned above, the methodology for determining the U.S. holder percentage is complex and we generally advise companies to hire a professional service provider to assist with identifying U.S. holders. Davis Polk can provide more information on this topic as requested.
[14] The adopting release for the 2008 amendment of Rule 802 stated that "public announcement" is any oral or written communication by an acquirer or any party acting on its behalf, which is reasonably designed to inform or has the effect of informing the public or security holders in general about the transaction. *See* https://www.sec.gov/rules/final/2008/33-8957.pdf. The initial "public announcement" does not need to include an exchange ratio or final structure.
[15] We note that the calculation of U.S. holders in the case of "share delivery" transactions, which have not yet been used in connection with the acquisition of a publicly traded target, will need to be carefully analyzed based on the structure and facts of the transaction.
[16] Rule 802 provides that in the case of a business combination in which the securities are to be issued by a "successor registrant," U.S. holders may hold no more than 10% of the class of securities of the successor registrant, as if measured immediately after completion of the business combination. The SEC interprets the phrase "successor registrant" to refer to a new company formed for purposes of the transaction, such as the holding company formed in a joint share transfer.

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B. Equal treatment of U.S. shareholders

Rule 802 will only be available if U.S. holders of the subject securities are permitted to participate in the share exchange transaction on terms at least as favorable as those offered to other holders. In theory, equal treatment under Rule 802 should permit an acquirer to offer cash to U.S. holders while offering securities to non-U.S. holders so long as the acquirer has a reasonable basis to believe that the cash being offered to U.S. holders is substantially equivalent to the value of the consideration being offered to non-U.S. holders. As noted above, however, we are not aware of a share exchange transaction where this has been attempted and we are advised by Japanese counsel that an acquirer in a share exchange transaction may not offer cash to some holders of a Japanese public company while offering securities to other holders.

C. Informational documents

Rule 802 contains requirements with respect to informational documents. The phrase "informational document" is not defined in Rule 802, but will generally be read to include any document (or amendment) published or otherwise disseminated by an acquirer or target to the holders of the subject securities in connection with a share exchange transaction.[17] It may also include documents, such as earnings announcements, that do not mention the share exchange transaction but that are relevant to the voting decisions to be made by holders of the subject securities.

Rule 802 contains the requirements described below with respect to informational document filing and delivery.

- *Electronic EDGAR submissions.* Informational documents must be furnished electronically to the SEC under cover of Form CB via the SEC's Electronic Data Gathering, Analysis and Retrieval (EDGAR) system. Submissions must be made by the first business day after publication or dissemination.[18] The Form CB needs to include an English translation (or, if permitted, an English summary) of any report or information that, in accordance with Japanese requirements, must be made publicly available, or that is made publicly available, by the acquirer or the target in connection with the transaction.
- *Form CB submissions.* With respect to Form CB submissions:
  - Form CB is a cover sheet which attaches an English translation (or if permitted, an English summary) of the informational document. There is no fee for submitting Form CB;
  - an informational document must be submitted by the acquirer regardless of which entity actually disseminates or publishes the document;
  - in order to submit Form CB, appropriate EDGAR codes (for both the acquirer and the target) need to be obtained in advance;[19]
  - English summaries, rather than full translations, may be permitted for certain documents which are made available, but not published or otherwise disseminated, to holders of the subject securities; and
  - informational documents submitted under cover of Form CB are furnished to the SEC, not filed, and therefore are not subject to potential liability under Section 18[20] of the Exchange Act. Submissions on Form CB will not constitute registration under the Securities Act or otherwise result in the acquirer incurring reporting obligations under the Exchange Act.
- *Dissemination to U.S. holders on a comparable basis.* Informational documents must be disseminated in English to U.S. holders on a basis comparable to that provided to security holders in Japan.[21]

[17] Examples of such informational documents could include the Tender Offer Explanatory Statement (*kōkai kaitsuke setsumeisho*), the Securities Registration Statement (*yūka shōken todokesho*) (if securities are offered as consideration) or the convocation notices (*kabunushi sōkai shōshū tsūchi*) for each company holding a shareholder vote (if structured as a share transfer or share exchange).
[18] Because any communication that is made after 5:30 p.m. Eastern Time is considered made on the next business day, in certain circumstances it may be desirable to issue press releases, employee communications, etc., relating to the transaction after 5:30 p.m. Eastern Time to ease the logistical burden of complying with the SEC rules.
[19] U.S. counsel can obtain these codes pursuant to a power of attorney from the respective companies.
[20] A defendant can be liable under Section 18 for certain damages arising based on false or misleading statements in documents filed with the SEC under the Exchange Act, unless the defendant can show that he or she acted in good faith and had no knowledge that the statement was false or misleading. As described below, informational documents submitted under cover of Form CB will still be subject to U.S. federal and state antifraud laws.
[21] Any information published in Japan must also be published in a similar manner in the United States.

- *Publication reasonably calculated to inform U.S. holders.* If an informational document is disseminated by publication in Japan, it must also be published in the United States in a manner reasonably calculated to inform U.S. holders of the offer.
- *Informational document legends.* A legend must be included on the cover page or other prominent location of any informational document published or disseminated to U.S. holders—including documents furnished under cover of Form CB. *See* Annex A for a sample legend.

D. Agent for service of process

A Form F-X will need to be submitted to the SEC via EDGAR along with the initial Form CB submission (but not generally with subsequent Form CB submissions). There is no filing fee for Form F-X.

In Form F-X, the acquirer submits to the jurisdiction of U.S. courts and appoints an agent for service of process in the United States. The appointment generally needs to be maintained for a minimum of six years from the date of the final amendment to the corresponding Form CB. A U.S. subsidiary of the furnishing company or a professional service provider is generally appointed to serve as Form F-X agent for service of process.

III. Practical considerations

The following is a list of practical considerations from U.S. securities law perspective in connection with planning for a Japanese merger, share exchange or similar stock-for-stock business combination transaction.

- *Consider issues surrounding the confirmation of Rule 802 availability well in advance of announcement.* The availability of a regular shareholder registry 60 days prior (or, if not available during such 60-day period, 120 days prior) to announcement of a share exchange transaction will often permit confirmation prior to the announcement of the transaction of satisfaction of the U.S. ownership element of the Rule 802 exemption. In other situations, transaction parties may need to obtain a special registry by making a special request to the JASDEC (Japan Securities Depository Center, Inc.) (*Hofuri*) (i) prior to announcement, which could signal to the market that a transaction is in contemplation, or (ii) after announcement, which may raise issues since it will not be known until well thereafter whether SEC registration will be required or Rule 802 will be available. Whether the transaction will be registered or exempt, because the duty to provide transaction-related information to the SEC often begins at announcement, U.S. counsel should be contacted well in advance of the announcement date for assistance with planning.
- *Arrange assistance for identification of U.S. holders.* Consider hiring a professional service provider to assist with identifying U.S. holders. The SEC rules do not require companies to retain these professionals but the SEC might well consider the failure to do so as a factor weighing against any company that attempts to rely on Rule 802 and later determines that U.S. ownership exceeds the 10% threshold.
- *Prepare a contingency plan.* If it is determined that Rule 802 will not be available, a decision needs to be made whether to modify the transaction or register the transaction under the Securities Act. If SEC registration is a realistic option it will likely significantly affect the timetable and require substantial additional planning, expense and labor.
- *Determine date and content of communications.* It will be important to plan ahead with respect to transaction communications. If Rule 802 will be relied upon and documents are disseminated by publication, arrangements will need to be made to reserve space in a U.S. publication, such as the *Wall Street Journal*, and to hire an advertising firm to coordinate typesetting, media and production work.
- *Arrange printer assistance for filings.* If Rule 802 will be relied upon, a financial printer may be needed to convert informational documents into EDGAR format and to submit them electronically on Form CB. EDGAR codes will need to be obtained and, depending on the circumstances, translators may be needed. U.S. counsel can assist in introducing financial printers and translators and obtaining the EDGAR codes, and is also capable of EDGARizing documents as necessary.

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- *Arrange an agent for service of process.* If Rule 802 will be relied upon, an agent for service of process will need to be arranged prior to the filing of the Form F-X. The agent can be a U.S. affiliate of a transaction party or a professional service provider. U.S. counsel can introduce a professional service provider.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your usual Davis Polk contact.

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Sample informational document legend

The following sample legend is for illustrative purposes only (and will require modification depending upon the particular transaction):

The acquirer and target are Japanese companies. Information distributed in connection with the proposed share exchange transaction and the related shareholder vote is subject to Japanese disclosure requirements that are different from those of the United States. Financial statements and financial information included herein are prepared in accordance with Japanese accounting standards that may not be comparable to the financial statements or financial information of United States companies.

It may be difficult for you to enforce your rights and any claim you may have arising under the U.S. federal securities laws in respect of the share exchange transaction, since the companies are located in Japan and all of their officers and directors are residents of Japan. You may not be able to sue the companies or their officers or directors in a Japanese court for violations of the U.S. securities laws. Finally, it may be difficult to compel the companies and their affiliates to subject themselves to a U.S. court's judgment.

You should be aware that the companies may purchase shares of the target otherwise than under the share exchange transaction, such as in open market or privately negotiated purchases, at any time during the pendency of the proposed offer.
