# The Corporate Counselor

*- Insights into Japanese Corporate Law -*

**July 2019/No.27**

## COMMUNICATION PROTOCOLS FOR ACQUISITIVE STRATEGIC INVESTORS WITH BOARD NOMINEES

Strategic investors owning more than 10% of the shares of a Japanese company often seek board appointment rights as a measure to protect their investment. Board appointment rights offer a strategic investor a number of significant benefits, such as permitting the strategic investor to obtain useful information about the business plans and key technologies of the company. Although the director nominated by a strategic investor could breach contractual commitments and fiduciary duties if such director relays certain confidential information to the strategic investor, it is inevitable in these arrangements that a strategic investor will obtain some key information that it ordinarily would not have obtained had its nominee not served as a director. The receipt of confidential information is a double-edged sword for a strategic investor as such information can be very useful for investment monitoring and competitive purposes, but at the same time can result in a violation of Japanese securities laws if a strategic investor makes a purchase or sale while in possession of material non-public information ("MNPI"). Consequently, a strategic investor contemplating a securities transaction with a publicly traded portfolio company (a "Public Investee Company") in which it has a nominee serving on the board should implement communication protocols to channel information flows to and from its director nominee and the Public Investee Company so the strategic investor does not breach Japanese securities laws (curiously, the prohibition under Japanese insider trading rules does not apply to a privately held company).

This issue of the *Corporate Counselor* provides guidelines that a strategic investor could implement to minimize the risk that it will receive MNPI during the pendency of a securities transaction with a Public Investee Company in which it has a nominee serving on the board. The newsletter commences with an overview of Japan's insider trading rules, followed by specific communication protocols that a deal team should consider implementing.

Article 166 of Japan's Financial Instruments and Exchange Act states that "insiders" who have received "material information" are prohibited from trading or otherwise transferring securities of a publicly traded company until the "material information" has been made public. The term "insiders" includes directors, officers and employees (to the extent that such director, officer or employee receives material information in connection with his/her respective duties at the publicly traded company). Under Japanese securities laws, "material information" generally includes information that would significantly affect the investment judgment of an investor relating to the management, operation, business or assets of the public company or its subsidiaries. Unlike U.S. securities laws, Japanese securities laws specifically enumerate events that are generally deemed to be material information (e.g., change of a major shareholder, issuance or repurchase of shares, cancellation of a business collaboration, suspension of business, material changes in published financial forecasts, etc.), along with general catch-all clauses. An analysis of whether an event or matter constitutes material information may not be immediately obvious given the vagaries of Japanese legislation, so legal counsel should be consulted early in the process.

A strategic investor insider who violates Japan's insider trading rules could be subject to (i) imprisonment of up to five years or the imposition of a fine of up to JPY 5 million or both, and/or (ii) an administrative monetary penalty. Recently, only administrative monetary penalties have been imposed in most cases of insider trading violations in Japan. Generally speaking, the amount of the penalty is equal to the difference of (i) the price at which the strategic investor insider actually sells or purchases shares of the publicly traded company with the knowledge of MNPI and (ii) the highest (in the case where shares of the publicly traded company were purchased) or the lowest price (in the case where shares of the publicly traded company were sold) during the two-week period after the publication of the MNPI, multiplied by the number of shares actually purchased or sold by the strategic investor insider.

Stephen D. Bohrer
Nishimura & Asahi NY LLP
Partner
+1-212-830-1603
s_bohrer@jurists.co.jp

Yusuke Urano
Nishimura & Asahi NY LLP
Counsel
+1-212-830-1612
y_urano@jurists.co.jp

A strategic investor should vigilantly control the flow of information pending the launch of a securities transaction with the Public Investee Company. To reduce the chance of a strategic investor inadvertently receiving MNPI or being deemed to have improperly used MNPI in connection with a securities transaction, the deal team should consider implementing the following "MNPI Communication Protocols" promptly after a strategic investor has determined that a securities transaction with the Public Investee Company is reasonably possible:

***General Rules***

- Persons should be designated from each of the strategic investor and the Public Investee Company to receive all communications and data flowing between them relating to the proposed transaction so communication flows can be effectively monitored. Often such persons will be members of the respective parties' in-house legal teams. The designee of the strategic investor should funnel information received from the Public Investee Company to the appropriate internal team members taking into account overall compliance with the communication protocols (e.g., financial information and projections can be shared only with persons *X, Y and Z*).

- Persons should be designated from each of the strategic investor and the Public Investee Company to review all public statements concerning the proposed transaction.

- The strategic investor and the Public Investee Company should appoint respective legal contacts to serve as the source for guidance concerning the implementation of the MNPI Communication Protocols.

- The MNPI Communications Protocols should be formalized in writing and distributed to the relevant persons at the strategic investor and the Public Investee Company, with periodic reminders distributed to these persons depending on the length of the proposed transaction.

***Enhanced Confidentiality Procedures***

- Information concerning the proposed transaction should be disclosed to persons only on a strictly "need to know" basis.

- Code names should be used whenever possible on all documents, correspondence (including emails) and discussions relating to the proposed transaction, and passwords should be affixed to all electronic documents used in connection with the proposed transaction.

- All meetings, conversations or discussions regarding the proposed transaction should be held behind closed doors, not in hallways or open meeting areas.

***Control of Information Flow***

- The Public Investee Company should review all responses to due diligence questions and document requests to ensure that the responses and documents delivered to the strategic investor do not contain MNPI. Typically, the Public Investee Company will form a small steering committee consisting of a member of its in-house legal team and a business leader to review responses.

- All meetings between the strategic investor and the Public Investee Company should be arranged in advance with agreed agendas (rather than on an *ad hoc* basis) to ensure that MNPI will not be inadvertently relayed.

- The Public Investee Company should provide directors with agendas for upcoming board meetings sufficiently in advance in order for the nominated directors of the strategic investor to have an opportunity to recuse him/herself from those portions of the board meeting where the proposed securities transaction or MNPI will be discussed (and the directors of the Public Investee Company should be admonished not to raise matters not previously set forth in a distributed agenda). Director nominees of the strategic investor should note that directors should act in the best interest of the Public Investee Company and its shareholders as a whole (and not solely for the benefit of the strategic investor). As such, the director nominee of the strategic investor should refrain from participating in Public Investee Company board deliberations when impartiality is difficult.

***Breaches***

- If a nominated director of the strategic investor nonetheless receives MNPI, then the director should take extra care to ensure that such information is not shared with those persons at the strategic investor who (i) will play a role in evaluating, negotiating, implementing or deciding whether to proceed with the potential securities transaction with the Public Investee Company (unless such information is made public before the strategic investor undertakes the transaction), or (ii) have influence or authority over the persons at the strategic investor who will decide whether the strategic investor should proceed with the potential securities transaction.

- A breach of the MNPI Communication Protocols should be promptly reported to the respective legal contacts at the strategic investor and the Public Investee Company. The strategic investor and the Public Investee Company should discuss whether it is necessary for the divulged MNPI to be publicly released by the Public Investee Company prior to the launch of the proposed securities transaction.

MNPI Communication Protocols can cease upon the completion of the proposed securities transaction, unless an earlier decision is made to abandon the transaction.

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Broad-brush impregnable MNPI Communication Protocols do not need to be established between the strategic investor and the Public Investee Company during the pendency of a securities transaction with a Public Investee Company. A strategic investor will have a legitimate need for daily information in order to monitor and coordinate its investment in the Public Investee Company, and the director nominees of a strategic investor may breach their fiduciary duties if they do not participate in Public Investee Company board meetings for a prolonged period. Accordingly, it is preferable to implement clear MNPI Communication Protocols restricting the flow of specified information coupled with a strong policing mechanism, rather than a total information blockade.

Communication protocols in general should not be viewed in isolation and can apply even if a strategic investor does not have a nominee serving on the board of the Public Investee Company. For example, anti-trust regulations may require the strategic investor and the Public Investee Company to limit the flow of competitively sensitive information to "clean team" members, the Public Investee Company may have entered into contractual arrangements that restrict the disclosure of confidential information to third parties, certain data may not be disclosed due to privacy law matters, and a strategic investor cannot buy or sell securities of a Public Investee Company while in possession of MNPI regardless of most sources of the information. Therefore, the deal team should take a holistic approach when formulating information sharing guidelines and may wish to consult with experienced legal counsel.