

Client Alert

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J-REIT Reform – Finance and Insider Trading Regulations

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On December 7, 2012, the working group of the finance committee of the Financial Services Agency of Japan (the “Working Group”) issued its final report (the “Final Report”) with respect to the reform of the legal regime of Japanese real estate investment trusts^[1] (“J-REITs”). The Japanese government plans to submit a bill to effect the reform of J-REITs in the current Diet session.

A. PURPOSE OF J-REIT REFORM

The main purpose of the Working Group was to review the current J-REIT system, which started in 2001, and to propose reforms for improvements. In order to increase the attractiveness of J-REITs to investors around the globe and lead to greater assets and better management efficiency, an urgent priority was to make the J-REIT system comparable to the global standard. The Working Group was particularly focused on (i) **improvements to financial stability** and (ii) **the implementation of mechanisms to attain more trust from investors**.

In this client alert, among the various reforms proposed, we would like to introduce the following aspects: (i) increased means for fund raising and capital management and (ii) application of the insider trading regulations.

B. INCREASED MEANS FOR FUND RAISING AND CAPITAL MANAGEMENT FOR J-REITS

1. New Measures to be Implemented

While the J-REIT market has shown trends of recovery in recent months, the global financial crisis following the turmoil in the subprime market has revealed vulnerability and the lack of adequate means of financing J-REITs during financially challenging times.^[2] The Working Group intends to respond to this issue by implementing the following three measures:

(a) Rights Issues

In the Final Report, the Working Group concluded that it recommends the introduction of **a system that would allow J-REITs to conduct rights issues** (the “Rights Issues”), as this would contribute to the operational stability of J-REITs. In essence, the Rights Issues enable J-REITs to raise funds in financially challenging environments, while protecting the existing investors from dilution. Expansion of financing alternatives by J-REITs would contribute to raising the credibility of the J-REIT system by providing a contingency plan to respond to other possible financial crises.

^[1] In Japan, in practice, REITs take the legal form of an investment corporation (*toshi hojin*), as opposed to the form of investment trusts. In this newsletter, a J-REIT refers to an investment corporation that is listed on a Japanese stock exchange and invests primarily in real estate assets.

^[2] The serious impact even led to one J-REIT, New City Residence Investment Corp., filing for bankruptcy in October 2008.

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Specifically, it is likely that the Investment Trust and Investment Corporation Law (the “ITICL”) will be amended to permit J-REITs to issue warrant-type securities^[3] to unitholders for the purposes of conducting Rights Issues. These warrant-type securities would allow the unitholders to acquire investment units^[4] in J-REITs (the “Rights”).

Before the Japanese government submits a proposed amendment to the ITICL, certain issues must be considered, for example, when the Rights can be issued and how the listing of the Rights may be established on a stock exchange. Additionally, despite a series of reforms to Japanese law and rules of stock exchanges and clearing institutions removing many obstacles for Japanese issuers to conduct Rights Issues, there have been only a few cases where ordinary business corporations (i.e. *Kabushiki Kaisha*) have conducted Rights Issues in Japan.^[5] Further legal reforms and efforts by Japanese market participants may be necessary in order to make Rights Issues a more popular and established financing method in Japan.

(b) Acquisition of Treasury Investment Units

In the current J-REIT system, except in certain limited circumstances,^[6] a J-REIT is prohibited from acquiring its own investment units. The Final Report states that **the acquisition of its own investment units** (the “Treasury Investment Units”) should be allowed, as it contributes to the operational stability of the J-REITs. Through the permitted acquisition of Treasury Investment Units, J-REITs will have broader tools to structure and effect their capital strategies.

However, it is still unclear to what extent the acquisition of Treasury Investment Units will be permitted. For a *Kabushiki Kaisha*, the acquisition of its own shares is only allowed, as with the declaration of dividends, to the extent there are retained earnings and other distributable amounts within the company as defined in the Company Law. On the other hand, under the current provisions of the ITICL, J-REITs can make distributions without being subject to the requirement of having a ‘distributable amount’,^[7] and therefore by analogy, acquisition of Treasury Investment Units may also be permissible without any such restriction, unless the ITICL provides otherwise. The maximum amounts available for acquisition, acquisition procedures and the governing body that would authorize the acquisition, tax treatment and the after-treatment of acquired Treasury Investment Units are all outstanding issues that need to be considered.

^[3] The ordinary business companies (i.e. *Kabushiki Kaisha*) under the Companies Law of Japan (the “Company Law”) can issue stock acquisition rights (*shinkabu yoyaku ken*) that represent rights to acquire shares at pre-determined purchase price and are transferrable to other investors. In Japanese Rights Issues, the issuer allots stock acquisition rights to all existing shareholders on a *pro rata* basis, free of consideration, and such stock acquisition rights are listed on a stock exchange.

^[4] These are the equity shares of J-REITs (i.e. equivalent to shares in *Kabushiki Kaisha*).

^[5] Issuers of these Rights Issues were Japanese small or mid-sized listed companies, all of which were “non-commitment type” Rights Issues where no securities company was involved as underwriter in the offering (i.e. these rights have adopted a mechanism where all unexercised rights lapse).

^[6] For instance, in the context of mergers of J-REITs, the assumption of the Treasury Investment Units (as defined herein) from the dissolving J-REIT and the purchase of the Treasury Investment Units from objecting investors are permitted (e.g. Articles 80, 149-8 and 149-13 of the ITICL).

^[7] However, in addition to the minimum net asset requirement under the ITICL, the rules of the Investment Trust Association of Japan provide for certain restrictions on distributions by a J-REIT in excess of its retained earnings (i.e. return of capital). Specifically, such distributions must be made with (i) 60% of the depreciation expenses for the relevant fiscal period or (ii) if the amount of the income prescribed under the same rules is less than the taxable income, the amount of such taxable income.

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(c) Capital Reduction

The Final Report also proposed to allow J-REITs to conduct **capital reduction without returning capital to unitholders** (“Capital Reduction without Consideration”).

Capital Reduction without Consideration has been advocated by the J-REIT industry for some time. The issue arises, for example, when the market value of managed real estate substantially drops and requires the J-REIT to book an impairment loss. Due to the difference in the loss recognition rules under Japanese GAAP and tax laws, impairment losses may cause high corporate taxes to be imposed on J-REITs. Capital Reduction without Consideration is said to provide a straightforward method for a J-REIT to avoid this corporate tax consequence.

2. Other Measures Discussed

The Working Group also explored the feasibility of **convertible investment corporation bonds^[8]** and **different classes of investment units (e.g. non-voting preferred units)**. However, with the simple governance structure used in J-REITs, it is difficult to balance the interests of different investors. The implementation of these measures was concluded to be premature and will not be permitted for J-REITs at this time.

C. APPLICATION OF INSIDER TRADING REGULATIONS TO INVESTMENT UNITS OF J-REITS

The investment units of J-REITs are currently not subject to the insider trading regulations (the “Insider Trading Regulations”)^[9] under the Financial Instruments and Exchange Law of Japan (the “FIEL”). This is mainly due to the fact that investment units of J-REITs were believed to have little risk of insider trading because the prices were thought to be determined based on the net asset value of managed real estate.

However, it has become clear that the prices of the investment units are volatile and greatly affected by the market forces. Therefore, in order to preserve the trust of the investors and the integrity of the market, the application of the Insider Trading Regulations is now seen as necessary with respect to the J-REIT investment units.

1. Final Report

In the Final Report, it has been concluded that **the investment units of J-REITs should be subject to the Insider Trading Regulations**. In addition, the Final Report especially pointed out that (i) in light of the fact that the asset managers (the “Asset Managers”) of J-REITs acquire, hold and manage the material information of the acquiring assets, the officers, employees and other related persons of the Asset Managers shall be treated in the same way as those of the J-REITs themselves and (ii) given that the parent company of the Asset Manager (the “Sponsor”) plays an important role in the provision of

^[8] Convertible investment corporation bonds are bonds that could be converted into investment units with a predetermined conversion price.

^[9] To be precise, investment units of J-REITs are not subject to the general prohibition of insider trading provided for in Article 166 of the FIEL, but are subject to Article 167 of the FIEL (the prohibition of trading of target company’s securities, when one is aware of a decision to conduct a tender offer or certain accumulation of shares of a listed (or traded in the over-the-counter market) target company).

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personnel, know-how and potential investment assets, the Sponsor should be subject to the Insider Trading Regulations as well.^[10]

The Final Report also indicated that due to the distinct nature of J-REITs, the events that influence market prices of investment units differ from those of shares of *Kabushiki Kaisha* and also tend to not be clearly evident. Based on historical data of the events that have led to investment unit price changes, **the Final Report provided examples of those changes as follows:**

- Changes in the content and conditions of the investment units (e.g. announcements of public offerings);
- Changes in the J-REIT assets (e.g. announcements of major tenant departures; announcements of changes in financial forecasts);
- Changes in the operations or business of the J-REITs (e.g. announcements of bankruptcy); and
- Changes in the operations or business of the Asset Manager or Sponsor changes (e.g. announcements of changes of Sponsors).

In the proposed amendment to the ITICL, the details of material information subject to insider trading restrictions will likely be structured around these events.^[11]

2. Other Developments in Insider Trading Regulations

In response to recent violations of the Insider Trading Regulations in equity offerings by Japanese issuers, the Financial Services Agency has announced a separate plan of further general amendments to the Insider Trading Regulations. Under the proposed amendments, transmitting non-public material information for the purpose of insider trading or encouraging trading while withholding such information will be included in the categories of illegal actions. Also, the penalties to be imposed on investment managers or financial intermediaries (such as securities companies) for violation of the Insider Trading Regulations will be revamped to achieve effective enforcement. These amendments, once introduced, would equally apply to J-REIT issuers, Asset Managers, Sponsors and investors.

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^[10] Under the Insider Trading Regulations, certain corporate insiders (e.g. directors, employees, parties who conduct transactions with the listed company) as specifically enumerated in the FIEL, and any person who directly receives non-public material information from such corporate insiders, are prohibited from trading securities of a listed company before such material information is made public.

^[11] It is also likely that there will be a basket provision that picks up unremunerated items of information to be included in the categories of material information in the same way the current Insider Trading Regulations do with respect to shares of *Kabushiki Kaisha*.

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