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FUND STRUCTURES

Key Legal and Structural Considerations for Asian Equity Investments

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The favorable economic fundamentals of many growth-stage economies across the Asian region can provide tremendous investment opportunities for hedge funds and other investors. To generate good returns on a consistent basis, however, requires a deep understanding of the structural and legal issues that, in many cases, are unique to the countries in that region. For example, there is a greater tendency toward family control over listed and unlisted businesses in Asia in comparison to the U.S. or many European markets. In addition, the unique features of the legal and regulatory systems – which vary significantly across Asia – can, in some instances, either make or break investment returns.

This article examines several areas where knowing how best to navigate key legal and structural issues and opportunities in particular Asian jurisdictions can provide fund managers with a concrete investment edge and analyzes various topical examples.

Foreign Investment Restrictions

Foreign investment restrictions apply in certain designated "sensitive" or "restricted" sectors of all major Asian economies, but thoughtful structuring solutions are available when an investment opportunity calls for them.

Japan's Foreign Exchange and Foreign Trade Act

For example, political sensitivities in Japan resulted in the June 2020 Foreign Exchange and Foreign Trade Act (FEFTA) amendments, which apply to foreign investment in Japanese restricted-sector businesses such as media, telecommunications and defense technology. Foreign investors are now required to file a prior notification with the Bank of Japan before:

- acquiring a shareholding of 1 percent or more (previously 10 percent) in Japanese-listed companies operating any restricted-sector businesses;
- voting in favor of any resolution to appoint a foreign investor (or its closely related persons) as a director; or
- proposing and voting in favor of any transfer of all or part of the investee company's restricted-sector business.

Investors calling for larger share buybacks or higher cash dividends to boost equity returns is still unrestricted under FEFTA.

The impact of those amended FEFTA provisions on foreign investment into Japan is still being assessed. In any event, the changes also include useful exemptions, such as those for equity purchases by certain types of foreign financial investors, which will ease the practical effect of these new requirements.

Investors are advised to allow for additional time before making an investment in a Japanese company to properly consider the application of those rules to their intended actions, as well as to assess alternative investment structures that are designed to minimize any potential regulatory uncertainty or time lag.

See "AIMA (Japan) and Eurekahedge Survey of Investors in Japan Reveals Concerns With Hedge Fund Manager Registration Requirements, the Volcker Rule and Success of 'Abenomics'" (Jun. 23, 2016).

Variable Interest Entity Structures

Variable interest entities (VIEs) have long been used in Asian jurisdictions such as China, Vietnam and the Philippines, each allowing an offshore entity, via contractual arrangements, to control and receive the economic benefit of – but not own – an onshore operating business in a restricted sector. Investor acceptance of those structures remains high, with many businesses listed on the Hong Kong Stock Exchange (HKEx) and on U.S. exchanges.

In China, VIE structures are most commonly employed in the technology, media and telecom sector and with respect to other internet-based businesses, but the new foreign investment law remains silent on the treatment of VIE structures. Despite that legal uncertainty, the market expects the relatively widespread use and acceptance of these structures to continue.

The use of a VIE structure may create uncertainty as to whether the business should be classified as foreign-owned or domestic. That question is often relevant to the tax treatment of the business and its investors.

For example, in general, the Chinese tax authorities would, under their published rules, normally consider a U.S.-listed Cayman-incorporated company that controls onshore Chinese assets via VIE arrangements to be a foreign business for Chinese tax purposes. That is not necessarily the case, however, and it depends on a number of factors, such as where the business of the listed company is controlled and actually managed on a day-to-day basis.

See "How Hedge Funds Can Mitigate FIN 48 Exposure in China (Part Two of Three)" (Mar. 24, 2016); "Chinese Companies 'Going Dark': Finally Accountable to U.S. Hedge Funds and Other Shareholders" (Feb. 13, 2014); and "Questions Hedge Fund Managers Need to Consider Prior to Making Investments in Chinese Companies" (Jun. 23, 2011).

Public Equity Position Disclosures

Equity ownership disclosure is often one of the first questions considered by overseas investors prior to making a public market investment, particularly if investee engagement is contemplated. Time spent planning how to structure an equity position – such as between shares and total return equity swap exposure or other instruments – can pay strategic dividends as the investment plan unfolds.

In all Asian jurisdictions, the disclosure rules for equity interests are complex, but markets such as Hong Kong and Singapore represent the high-water mark, requiring most material equity exposure positions – whether shares, total return equity swaps or other equity exposure instruments – to be publicly disclosed. In other markets, such as Japan and Korea, certain total return equity swaps are not publicly discloseable, provided that careful analysis of the terms and factual situation reveals no ability on the part of the swap holder to control or direct title to, or voting of, any underlying or hedge position in the form of shares held by the swap counterparty.

For short positions and M&A event-driven trades, there are likely to be additional disclosure considerations. Again, suitable analysis and pre-planning can be a key part of mitigating the regulatory and other risks of those types of equity trades.

Timely disclosure of relevant market positions – whether long or short exposure – remains a key area of focus for regulators across Asia, so investors should plan for timely compliance with the applicable disclosure rules. When an investor has missed a disclosure deadline or made an incorrect filing due to an oversight, consideration should also be given as to whether its internal systems and controls need to be adjusted to avoid any repeated breach of the rules. That issue is often one of the regulator's primary concerns when assessing the gravity of any incidents of noncompliance.

See "Establishing, Maintaining and Exiting a Minority Equity Position: U.S. Securities Law Considerations for Hedge Funds" (Jan. 15, 2009)

Shareholder Rights to Protect and Enhance Investment Returns

Many Asian jurisdictions that have developed capital markets provide for shareholder rights that are of similar utility to those provided in other developed markets, such as the U.S. and the U.K., including rights to nominate directors, convene shareholder meetings and propose value-transformative shareholder resolutions.

Careful analysis is often required prior to the exercise of any shareholder rights to head off any unintended repercussions, such as public disclosure or mandatory offer requirements that can flow from several shareholders acting in a concerted manner to achieve a common, perhaps control-seeking, objective.

For example, in Japan, two or more otherwise independent shareholders that have agreed to jointly exercise shareholder rights can be classified as "joint holders." That can trigger aggregated public disclosure obligations for the investors' shareholdings or foreign investment approval requirements, blowing an investment strategy off course if those consequences were not properly anticipated.

That said, many of these rights have proven to be effective tools for shareholders, particularly when more proactive engagement with the investee is necessary. In those situations, investors will need to plan the nature of their equity holdings to ensure that the relevant shareholder rights can be exercised in accordance with the applicable statutory provisions.

It is worth noting in that context that, in many jurisdictions, only a shareholder holding shares in its own name is entitled to exercise shareholder rights, and the process of converting shares held in scripless form via a broker's account to shares held directly in the shareholder's name can take days – and even weeks – to complete. Accordingly, the benefits of holding a position in the form of a total return swap (such as trading flexibility, potential exemptions from disclosure, ease of obtaining leverage, etc.) should be weighed against the limitations of doing so (such as the inability to exercise certain shareholder rights) at an early stage in the life of any particular investment, taking into account the key investment objectives and likely investor actions that will be required to meet those objectives.

Independent Shareholder Rights in Privatization Transactions

For investors engaged in merger arbitrage or similar investment activities in the public M&A markets across Asia, it is important to understand the key shareholder or other approval thresholds that will be impactful in regard to the terms and deliverability of the transactions in hand.

The following chart illustrates certain minority shareholder protections by jurisdiction in the context of the privatization of listed companies by controlling shareholders.

JURISDICTION	MINORITY SHAREHOLDER PROTECTIONS
Hong Kong	It is common for promoter-led privatizations to be effected by way of a "scheme of arrangement," that is, a court-supervised takeover arrangement that binds all target shareholders once they vote it through by the required majority. Under the Hong Kong Takeovers Code, such a transaction is subject to minority protections – over and above the basic legal requirements of a scheme of arrangement – including a condition that not more than ten percent of the votes attaching to all disinterested shares are cast against the privatization scheme.
Singapore	The approach to minority shareholder protection in that context is to require approval of the privatization proposals by at least 75 percent of the votes cast by independent shareholders.
Japan	Privatizations can be achieved via a statutory merger, which is subject to approval by a majority of at least two-thirds of the votes cast by shareholders. Although there is no additional voting requirement prescribed by law, additional safeguards are often included in the terms of the transaction or its implementation. The bidding promoter and the target company board include those terms to ensure "fairness" in the transaction and head off challenges from disgruntled minority shareholders that may be unwillingly crammed down into the merger deal. One such safeguard is the inclusion of a majority-of-minority condition in the deal terms, requiring the privatization transaction to be approved by a majority of shareholders that are independent of the controlling shareholder bidder.

The authors have also seen differing approaches to the protection of minority shareholders being taken by the in-country securities regulators in that context. For example, the Securities and Exchange Board of India can be publicly interventionist at times, while the Japanese Financial Services Authority tends to take a less high-profile approach.

Capitalizing on Equity Shifts From the U.S. to Asia

As the world's securities exchanges look to attract the best and most valuable emerging tech unicorns, biotech firms and similarly innovative businesses, Chinese companies are at the forefront of global shifts in equity capital. International investors are able to access a large universe of Chinese businesses listed on regional equity markets, such as Hong Kong and Singapore, as well as markets farther afield in the U.S. and Europe.

Asia's equity exchanges have scrambled to amend their rules to accommodate and attract returning Chinese companies. Many of those businesses operate in the technology and new economy sectors and come with dual-class U.S.-style share structures that were previously not welcome on exchanges such as HKEx and Singapore Exchange (SGX). The adjusted rules for those exchanges now provide suitable exceptions to the previously inviolate one-share-one-vote principle, paving the way for those returnee companies.

In the last few years, certain key policy initiatives have been launched by Asian securities exchanges to attract Chinese businesses "coming home," which are depicted in the chart below.

TIMING	EXCHANGE	POLICY CHANGE
April 2018	HKEx	New listing regime created for emerging and innovative companies, such as pre-revenue biotech companies, large innovative companies with weighted voting rights structures, etc.
June 2018	SGX	Companies with dual class share structures are now permitted to list.
July 2019	Shanghai Stock Exchange	New NASDAQ-style Sci-Tech Innovation Board (the SSE STAR board) was launched.
Mid- 2020	Shenzhen Stock Exchange	A U.S.-style, registration-based initial public offering system was launched on the start-up board (Chinext) of the Shenzhen Stock Exchange.
July 2020	SGX	SGX and Nasdaq announced a framework allowing companies listed on Nasdaq to seek a secondary listing on SGX.

Investors in U.S.-listed Chinese take-private targets will be able to benefit from the value underpinning for minority shareholders provided by rules such as post-merger fair value appraisal rights. Additionally, as investors in companies such as Alibaba and NetEase have found, selecting the right business at the right time can represent a tremendous value opportunity as leading Chinese groups position for their next stage of growth.

See "Roadmap to China's New Shanghai-Hong Kong Stock Connect Program" (Nov. 20, 2014).

Conclusion

By being aware of the key legal issues that can impact investment returns and employing the optimal approach to structuring investments, well-prepared investors such as hedge funds can seek out and capitalize on a broad spectrum of attractive opportunities across Asia's diverse markets. Incisive, well-informed analysis of the important legal and structural factors – from inception to exit – is crucial to gaining that valuable edge for investment success in Asia.

See our two-part series "Structuring, Regulatory and Tax Guidance for Asia-Based Hedge Fund Managers Seeking to Raise Capital From U.S. Investors": Part One (Aug. 9, 2012); and Part Two (Aug. 16, 2012).

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