

Regulation of Controlling Shareholders in Japan

EU Asia Corporate Governance Dialogue
2015 Conference
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24 February 2015
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Situations in Japan

- Scope of this presentation: Parent company and/or subsidiary is listed on a stock exchange, where public shareholders may be harmed by the activities of the controlling shareholder or group-based management decisions.
- Type 1 in this presentation: Parent companies are listed on the Tokyo Stock Exchange. Since the lifting of the ban on holding companies in 1997, a number of corporate groups moved to the holding company structure, where the holding company is listed and the group's business operations take place at the level of subsidiaries. Today, the estimated number of "large-scale," wholly-owned subsidiaries, to which multi-layer shareholder derivative actions (explained below) are applied, is between 150 and 200.

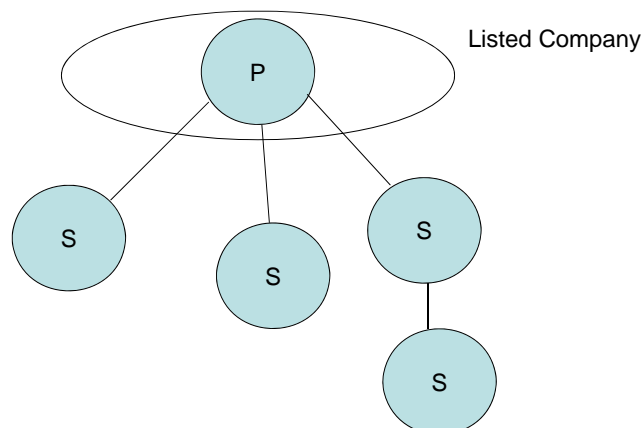
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Situations in Japan (cont'd)

- Type 2 in this presentation: Subsidiaries are listed on the Tokyo Stock Exchange ("TSE"). While most listed firms on the TSE do not have parent companies, some of them do. Out of 2,275 TSE-listed companies, 356 companies (15.6 percent) have controlling shareholders. Out of these, 67.7 percent (10.6 percent overall) have parent companies, and 32.3 percent (5.1 percent overall) have controlling shareholders other than parent companies. Of the companies with parent companies 89.6 percent (9.5 percent overall) have listed parent companies. [Tokyo Stock Exchange White Paper 2013]

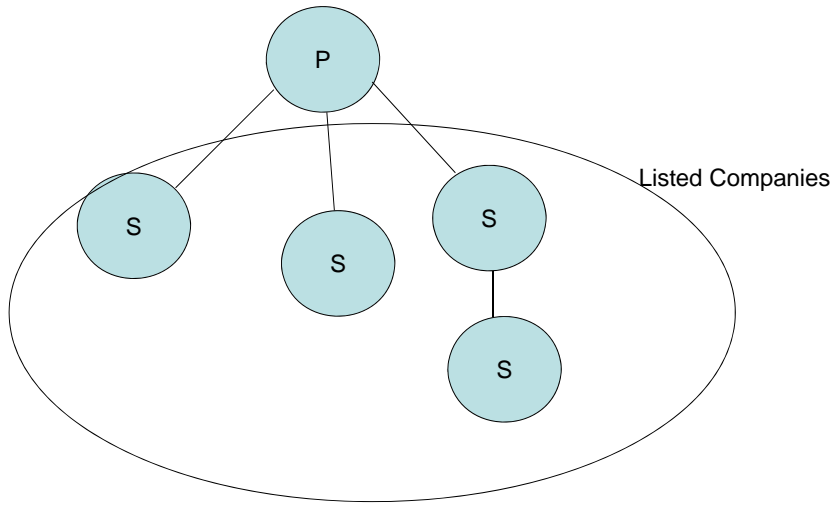
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Corporate Groups in Japan : Type 1 Parent Company is Listed



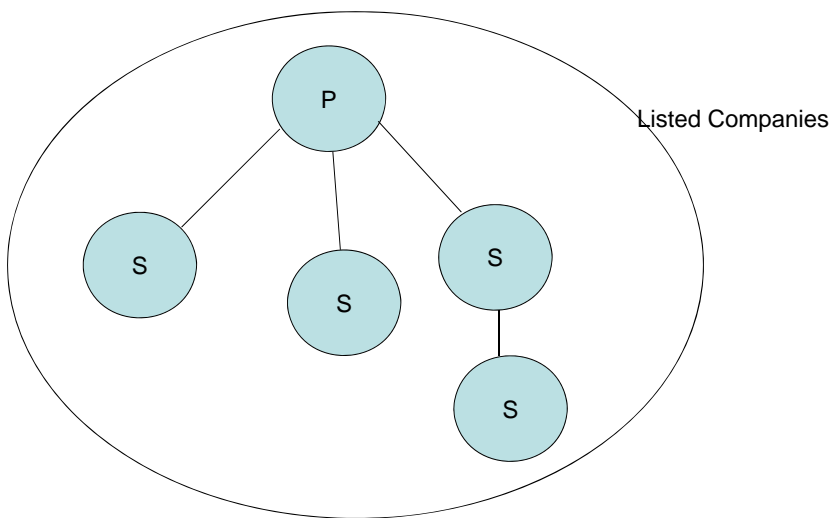
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Corporate Groups in Japan : Type 2 Subsidiaries are Listed



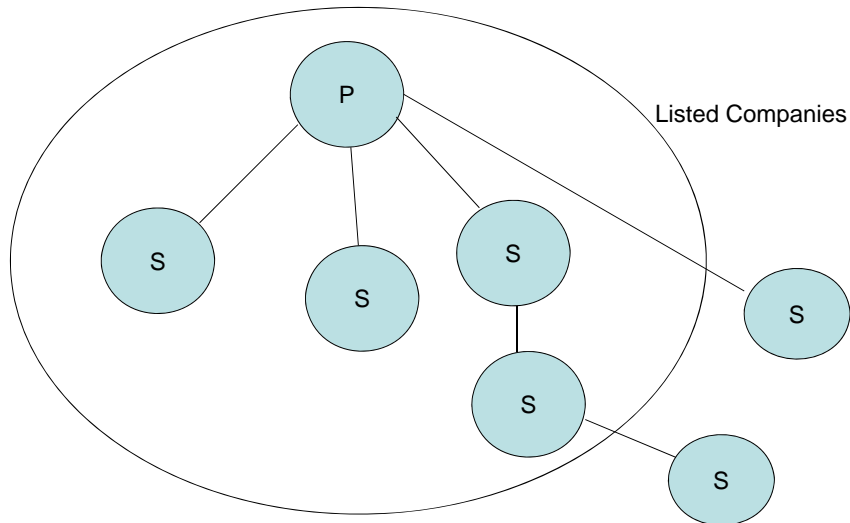
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Corporate Groups in Japan : Other



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Corporate Groups in Japan : Other



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Problems in Corporate Law and Securities Regulation

- A company produces agency problems, which are dealt with by corporate law and securities regulation, and a group structure may (and may not) aggravate agency problems.
- Agency Problems
 - Managers/Directors versus Shareholders
 - Majority Shareholders versus Minority (or Public) Shareholders
 - Managers/Shareholders versus Other Constituencies (such as Creditors)

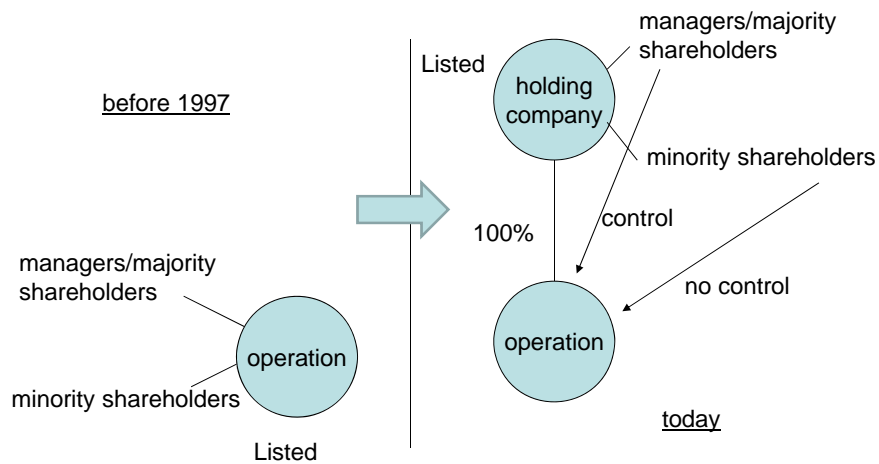
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Responses in Corporate Law and Securities Regulation

- Possible Responses
 - Disclosure
 - financial reporting on a consolidated basis
 - disclosure of intra-group transactions
 - disclosure of ownership structure
 - Ex Ante Rules
 - equal treatment of shareholders
 - approval by shareholders
 - Ex Post Standards
 - fiduciary duty (judicial review of conflict of interests transactions)
- Corporate Law in Japan
 - generally does not recognize a group as an entity, except for financial disclosure on a consolidated basis
 - provides special rules for parent companies of groups, e.g., inspection right by the parent's shareholders as to the subsidiary's books and records

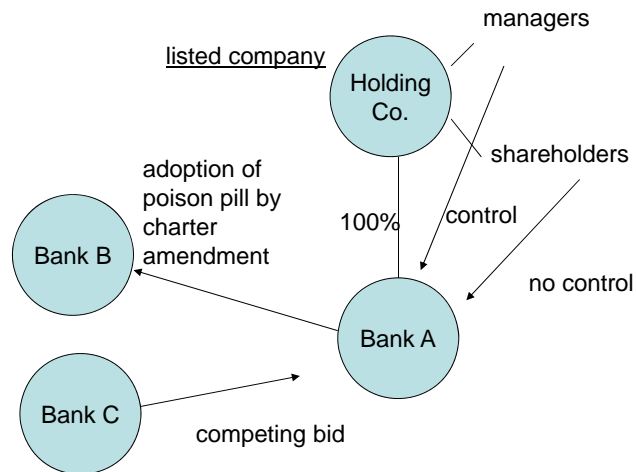
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Type1: A group structure may aggravate agency problems: a holding company example



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An Example of Type 1



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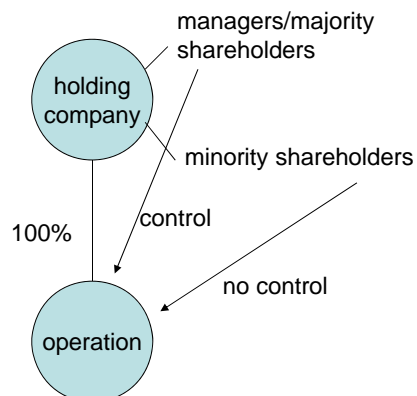
Type 1: Japanese law

Traditional legal approach seems to work with some modification.

Japanese law:

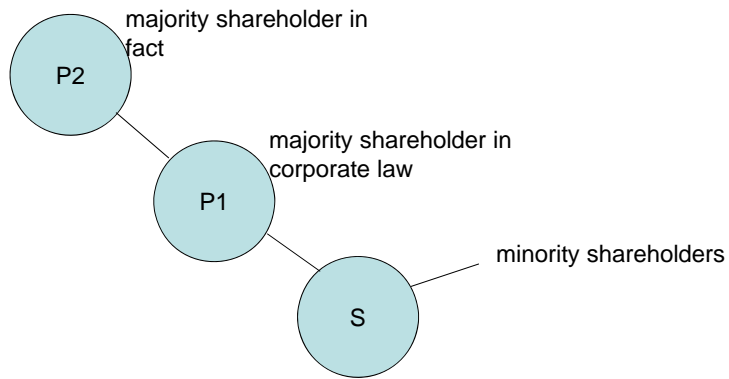
(1) disclosure, and (2) extension of traditional rules in corporate law

The 2014 amendments to the Companies Act introduced multi-layer shareholder derivative actions under limited circumstances.



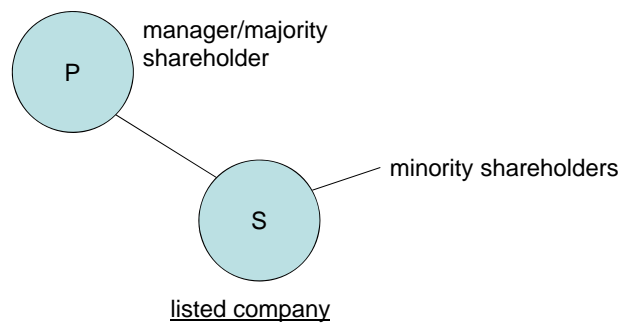
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Type 2: A group structure may aggravate agency problems: a simple example



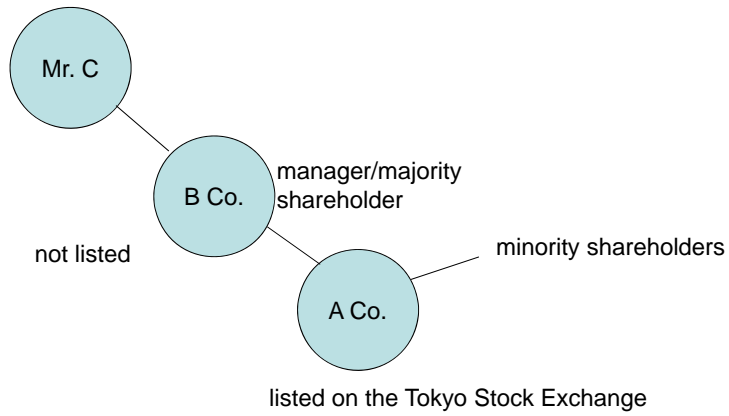
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Type 2: A group may pursue the interest of the group, not the interest of the individual company



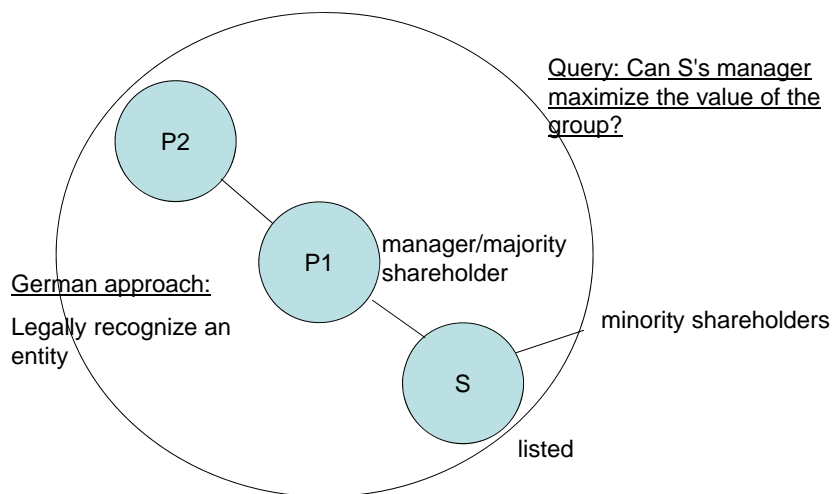
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An Example of Type 2



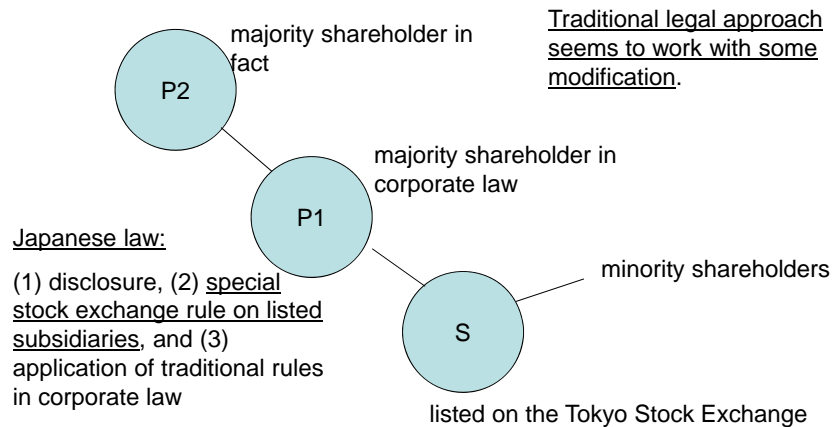
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Type 2: A possible law



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Type 2: Japanese law



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Rule of the Tokyo Stock Exchange (1)

- In general, Tokyo Stock Exchange requires listed companies to perform disclosure regarding their non-listed parent companies at a level similar to that for listed companies.
- Subsidiaries listed on the Tokyo Stock Exchange that have parent companies (whether they are listed or not) are subject to a set of rules that are not required by the Companies Act. [Tokyo Stock Exchange Rule 2010] Specifically, fairness opinions and additional disclosure are required for the transactions between a listed subsidiary company and its controlling shareholder.
- Note: Recent empirical studies tend to indicate that the economic performance of listed subsidiaries is not consistently worse than other listed firms. [E.g, Miyajima, Nitta and Shishido (2011)]

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Rule of the Tokyo Stock Exchange (2) New Listing Rule for IPO Listing of Companies having Dual Class Voting Shares

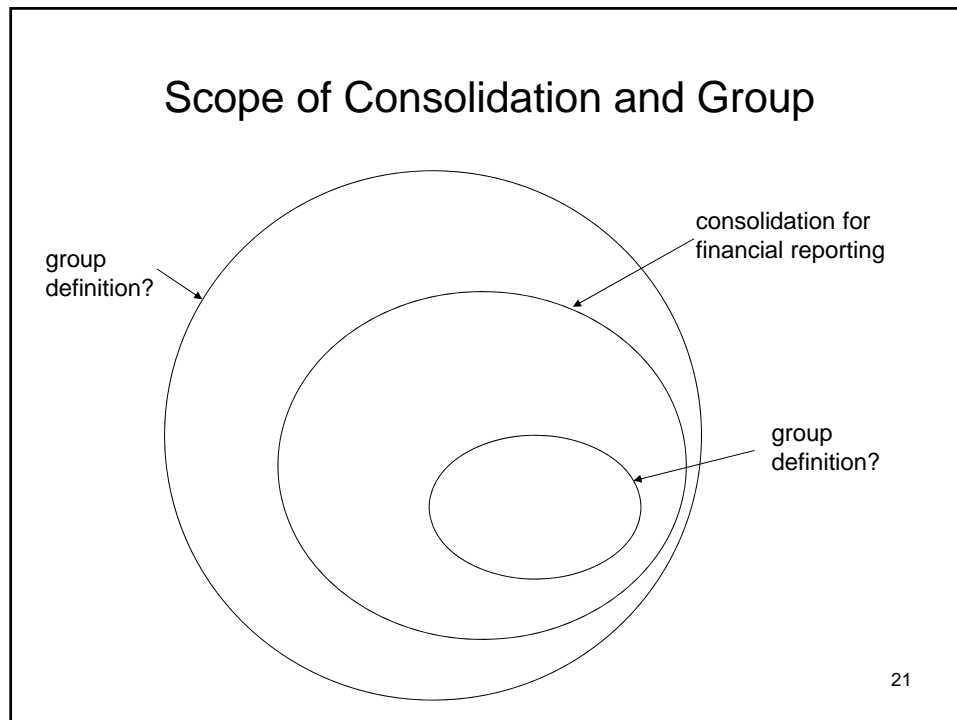
- General Rule: Listed companies are prohibited from issuing a new class of shares that would have more voting rights per share than the current class of shares. [Tokyo Stock Exchange Listing Rule 2008]
- Exception: Subject to certain conditions, companies may be newly listed with a structure where founders hold a class of shares that have more voting rights per share than the class of shares that would be listed. [Case in March 2015 and Tokyo Stock Exchange Listing Guidelines in July 2015]
- Cyberdyne (March 2015): Under the dual class structure, a founder owns 87.7% of voting shares and the remaining 12.3% of voting shares are listed on the Tokyo Stock Exchange and held by public investors.

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Fundamental Problem (1) Recognizing a Group as One Entity

- There are a variety of groups.
- It is difficult to define a group and apply "rules and standards" provided by traditional corporate law as if the group were one company.
- As a result, an attempt to define a group and regulate it may lead to being over-inclusive or under-inclusive.
- Defining a group for consolidated accounting purposes is often not appropriate for legal regulation.

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Fundamental Problem (2) Need for Functional Approach

- Is "Control" or "common strategy" relevant in determining the group?
- A functional approach seems better: It is not "control" or "common strategy" which produces a concern by company law, but it is conflict of interests issues with managers or majority shareholders of the company, and those issues may - and may not - be aggravated where the company is run under common control or strategy.
- A similar point can be made for the classification of (i) the group itself, (ii) intra-group relations and (iii) the group's external relations.

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Conclusion

- Disclosure
 - Disclosure is helpful, and it is required in Japan.
 - Disclosure delegates the solution to the market place.
 - For disclosure to work, proper infrastructure (associated with lawyers and accountants) is important.
- Rules and Standards
 - In Japan, type 1 structures (holding companies listing) are dealt with by corporate law (including the 2014 amendments).
 - In Japan, for type 2 structures (subsidiaries listing), Tokyo Stock Exchange imposes additional rules to corporate law.
- How can we regulate an entity which the law does not recognize?
This may be a wrong question – a functional approach is better.