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Revision of Large Shareholding Reporting System

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Summary

- On 13 March 2006, a bill for revision of the Securities and Exchange Law was submitted to the Diet for approval.
- The bill provided, among other things, for revision of the large shareholding reporting system.
- More specifically, the bill provided for an increase in the frequency (from 3 months, in principle, to 2 weeks) with which institutional and other professional investors eligible to take advantage of the special simplified reporting procedure would in future be required to report.

Contents

Introduction (submission of Securities and Exchange Law revision bill to the Diet)

On 13 March 2006, a bill for partial revision of the Securities and Exchange Law (hereafter, "Securities and Exchange Law revision bill") was submitted to the Diet for approval [1]. The main features of the bill are summarized in the following chart.

Structure and Key Features of the Securities and Exchange Law Revision Bill

Laws to be revised	Description	Enforcement
1. Securities and Exchange Law (name not changed)	(1) Authority of securities trading surveillance committee strengthened (2) "False order" regulations strengthened (3) Penalties for market manipulation, etc strengthened	20 days after promulgation date
2. Securities and Exchange Law (name not changed)	(4) TOB system revision - Clarification of scope of application of TOB system (on/off-market transactions, competition between buyers, etc) - Amplification of disclosure (obligation to submit opinion report, etc) - Extension of TOB period - Relaxation of rules governing changes in TOB conditions, etc - Introduction of requirement to buy all tendered shares	Date designated by government ordinance within six months of promulgation date
	(5) Revision of large shareholding reporting system - Use of special reports prohibited when major proposal planned	As above
	- Increase in frequency with which special reports submitted (from every 3 months, in principle, to every 2 weeks)	Date designated by government ordinance within one year of promulgation date
3. Securities and Exchange Law => Name changed to Financial Instruments and Exchange Law	(6) All changed to the Securities and Exchange Law (provision of across-the-board legal protection for investors) (7) Protection of independent self-regulation function in exchange	Date designated by government ordinance within one and a half years of promulgation date
	(8) Amplification of disclosure system - Introduction of internal control system - Establishment of quarterly reporting system etc	As above (plans to enforce these procedures with effect from business years starting on or after 1 April 2008)

We focus in this report on the provisions listed under "(5) Revision of large shareholding reporting system" above.

For explanatory purposes, we start, in section (1.) below, by summarizing the features identified as problems under the current large shareholding reporting system. Next, in section (2.), we explain the revisions introduced in the Securities and Exchange Law revision bill.

1. Problems with the Current Large Shareholding Reporting System

1) What is the Large Shareholding Reporting System?

Under the large shareholding reporting system, any person with a holding of more than 5% (large shareholder) in a listed company is required to submit a "large shareholding report" to disclose details such as the size and purpose of the holding along with a breakdown of the shares that comprise the holding and the funds used to acquire those shares (First Cabinet Order concerning Securities and Exchange Law, Article 27-23: Disclosure of Information on Holding of Large Amount of Share Certificates, etc; Form 1).

Information on who has large shareholdings in a listed company is an important part of an investor's decision-making process insofar as it could affect the way a company is run. The system could thus be said to be designed to protect investors by providing them with fast access to the names of persons taking large shareholdings in listed companies, thereby increasing market fairness and transparency.

[1] Original text on FSA website at http://www.fsa.go.jp/common/diet/index.html

2) General Reporting and Special Reporting

The large shareholding reporting system provides for the submission, in principle, of a "general report" or, in the case of institutional and other professional investors, of a simplified "special report". The main points of comparison between these two types of report (as used under the current system) are summarized below.

Comparison of General and Special Reports as Used under the Current System

	General report		Special report[1]	
	Shareholding ratio[2]	Submission deadline	Shareholding ratio[2]	Submission deadline
Large shareholding report	More than 5%	Within 5 business days	More than 5% as at 3-monthly base date[3]	By the 15th of the month following the month in which the base date falls
Amended shareholding report	Increase/decrease of 1% or more since previous report[4]	Within 5 business days	Increase/decrease, as at the 3-monthly base date, of 1% or more since the previous report	As above
	Other important changes		Increase/decrease, as at the end of a month other than a base date-month, of 2.5% or more since the previous report	By the 15th of the month following the end of the month in question

Notes: 1) Special reports may be submitted by securities companies, banks, trust companies, insurance companies, investment trust management companies, investment advisory companies (discretionary only), the Central Cooperative Bank for Agriculture and Forestry, the Central Co-operative Bank for Commerce and Industry, persons managing securities, banking, trust, insurance, investment trust, and investment advisory (discretionary only) businesses overseas in conformity with overseas laws, the Banks' Shareholdings Purchase Corporation, and the Deposit Insurance Corporation of Japan (hereafter, "securities companies, etc". Special reports may also be submitted by persons who hold shares jointly with securities companies, etc).
Special reports may not be submitted by securities companies, etc under the following circumstances.
- Shareholding exceeds 10%
- Report not submitted on base date
- There is a joint shareholder, with a holding of more than 1%, that is not a securities company, etc

2) Shareholdings are calculated by totaling residual shares, in the shape, for example, of new share acquisition rights, in addition to actual shares.

3) The base date is the date when securities companies, etc that are authorized to use the special reporting system make their submissions.

4) In the case of large short-term transfers, information such as the counterparty's name and agreed price must be disclosed. Large short-term transfers fall into the following categories:
- Reductions to less than 50% of the maximum shareholding ratio in 60 days or less, and
- Reductions of more than 5 percentage points from the maximum shareholding ratio in 60 days or less.

In other words, individual investors and business corporations that are obliged to use the general reporting system must submit their reports within five business days of acquiring a holding of more than 5%. On the other hand, institutional investors that are authorized to use the special reporting system are required to submit their reports by the 15th of the month following their 3-monthly base date.

Institutional investors are generally held to be authorized to submit simplified special reports for the following reasons[2].

(1) To lighten the burden of paperwork that would otherwise be placed on them due to the constantly repeated share-related transactions they are obliged to undertake as part of their daily business routine.

(2) Securities companies trade shares and institutional investors undertake daily share-related transactions on a large scale but rarely with the aim of taking control of the companies in whose shares they are dealing. If reports were required for each such transaction, it would inevitably invite conjecture and, in so doing, adversely affect the market.

However, doubts about the special reporting system for institutional investors have been raised of late, particularly in the context of M&A.

[2] 5% rule study group's "5% rule—Q&A" (Okura Zaimu Kyokai, 1991) p.51.

3) Why is the Special Reporting System a Problem?

As noted above, the special reporting system is predicated at bottom on the assumption that securities companies trade shares and institutional investors undertake daily share-related transactions on a large scale but rarely with the aim of taking control of the companies in whose shares they are dealing.

In recent years, however, funds active in the field of M&A have emerged. Formally speaking, these funds are classed as institutional investors and have, as such, the right to submit special reports[3]. However, there has been growing criticism to the effect that funds actively engaged in M&A are unlikely to be doing so without any view to acquiring control over the companies in whose shares they are dealing, with the result that permitting such funds to use the special reporting system is unfair to general investors and distorts the whole system.

It has been pointed out in this connection that use of the special reporting system by the so-called "activist funds" involved in various M&A activities in 2005 gave rise to the following situation.

◊ Information as to whether funds with large holdings of shares in M&A target companies had already sold their holdings to the buyer, or were maintaining their holdings, or were increasing their holdings to thwart the buyer was not disclosed quickly enough.

◊ The special reporting system allowed funds that had not disclosed the fact that they were large shareholders to suddenly emerge as buyers initiating takeover attempts in connection with large quantities of shares they had already acquired.

The emergence of situations of the sort outlined above prompted all sorts of speculation about the funds engaged in M&A, thereby also heavily influencing related investment decisions by general investors.

From this standpoint, a report on the tender offer system, published in December 2005 by the tender offer system working group, established under the aegis of the First Subcommittee of the Sectional Committee on Financial System of the Financial System Council (hereafter, the "WG Report"), recommended revising the large shareholding reporting system along the following lines to make it more transparent to investors.

(1) Prohibition of the use of special reports, which distort the system's ultimate objectives
→ use of special reports should not be permitted "in cases in which the aim is to make major changes to, or otherwise seriously influence, a company's business activities" (major proposals)

(2) Reduction of deadlines for the submission of special reports (increase in the frequency with which reports must be submitted)
→ reporting period/submission frequency of special reports should be reduced from every third month, in principle, to every second week.

(3) Large shareholding reports must be submitted via the EDINET online disclosure system

The latest Securities and Exchange Law revision bill contains provisions based broadly on the above recommendations, as explained below.

[3] Discretionary investment advisory companies often fit this description.

2. Use of Special Reporting Prohibited When Major Proposals Involved

1) Summary—When is the Use of Special Reports Not Permitted?

There are times when institutional investors are not permitted to use the special reporting system. The following chart compares the current law with the system provided for in the revision bill with respect to cases in which the use of special reports is not permitted (Securities and Exchange Law; Article 27-26-(1).

Current law	Revision bill
(1) When notice of the special report base date has not been submitted	(1) As left
(2) When the object of the holding is to secure a controlling interest in the issuer	(2) When the object of the holding is to make major changes to, or otherwise seriously influence, the issuing company's business activities, as specified in the relevant government ordinance
(3) When the shareholding ratio exceeds the figure specified in the relevant cabinet order[1]	(3) As left
(4) When the holding appears, all things considered, to fall within the ambit of the relevant cabinet order[2]	(4) As left

Notes: 1) 10% under the law as it stands (cabinet order 12 relating to disclosure of the details of large holdings of shares and other securities).
2) Under the law as it stands, joint shareholders not defined as institutional investors that have holdings of more than 1% (Ditto 13).

Current legislation and the revision bill differ on condition 2 in the table above.

Current legislation and the revision bill are both predicated on the assumption that although institutional investors undertake daily share-related transactions on a large scale, they rarely do so with the aim of taking control of the companies in whose shares they are dealing, and should therefore be permitted to submit special reports. Put another way, there is no reason why special reports should be permitted in cases in which shares dealings are undertaken with the aim of influencing the way in which the issuing company is managed.

However, where use of the special reporting system is prohibited under current legislation when the aim of acquiring a shareholding is "to secure a controlling interest in the issuing company" (hereafter, "secure a controlling interest"), it is prohibited in the revision bill when the aim of acquiring a shareholding is "to make major changes to, or otherwise seriously influence, a company's business activities" (hereafter, "major proposal").

2) "Controlling Interest" and "Major Proposal"

The WG Report mentioned above explains the difference between a "controlling interest", as specified under the current law, and a "major proposal", as specified in the revision bill, in the following terms.

> From the standpoint of preventing the use of special reports in cases in which such use would distort the basic aims of the system, further consideration should be given to modifying the circumstances under which institutional investors are currently required to submit a general report, namely "when a shareholding is obtained for the purpose of securing a controlling interest in a company", to include cases in which a shareholding is obtained for the purpose of making major changes to, or otherwise seriously influencing, a company's business activities.

This explanation may be said to introduce a broader interpretation in the shape of a "major proposal" than was present in the previous term "controlling interest". In short, the use of a special report would not be permitted when, rather than acquiring a large

shareholding in a company with the intention of securing a controlling interest, an investor has acquired the large shareholding with a view to tabling major proposals to influence the company's business activities.

The precise limits of a "major proposal" are as yet unclear but will be specified in due course by government ordinance.

3) Procedure in Case of Subsequent Submission of a “Major Proposal”

The revised bill also provides against situations in which an investor with no initial intention of tabling a "major proposal" submits a special report, then subsequently decides to table a "major proposal". These provisions are summarized below (Securities and Exchange Law revision bill; Article 27-26-(4)/(5).

In the event that a "major proposal" is tabled, within the period prescribed in the relevant government ordinance, following an increase in an investor's shareholding to more than 5%	Large shareholding report to be submitted at least 5 business days beforehand
In the event that a "major proposal" is tabled, within the period prescribed in the relevant government ordinance, following an increase of 1% or more in an investor's shareholding	Amended shareholding report to be submitted at least 5 business days beforehand

The details will not be made clear until a relevant government ordinance is issued with the result that it is difficult to get a full picture at this point. However, the objective is more than likely to secure proper disclosure of large shareholdings at least five business days prior to the tabling of a "major proposal". In other words, this provision is designed to prevent investors from seeking, on the pretext of having no intention of tabling a "major proposal", to avoid the requirement to submit a large shareholding report.

3. Reduction of Time Limit for Special Reporting—from Every Three Months, in Principle, to Every Two Weeks

Deadlines and frequencies for the submission of special reports, as provided for under the existing law and the revision bill, are compared in the following chart.

Comparative Deadlines and Frequencies for the Submission of Special Reports

	Current law		Revision bill	
	Shareholding ratio[1]	Submission deadline	Large shareholding[2]	Submission deadline
Large shareholding report	More than 5% as at 3-monthly base date[2]	By the 15th of the month following the month in which the base date falls	In principle, more than 5% as at 2-weekly base date[3]	Within 5 business days of the base date
Amended shareholding report	Increase/decrease, as at the 3-monthly base date, of 1% or more since the previous report	As above	In principle, an increase/decrease, as at the 2-weekly base date, of 1% or more since the previous report	As above
	Increase/decrease, as at the end of a month other than one in which a base date falls, of 2.5% or more since the previous report	By the 15th of the month following the end of the month in question	—	—

Source: Compiled by DIR Legal and Tax Research Department

Notes: 1) Shareholdings are calculated by totaling residual shares, in the shape, for example, of new share acquisition rights, in addition to actual shares.
2) The base date under existing legislation is the last day of every third month after which securities companies, etc that are authorized to submit special reports are required to do so.
3) The base date provided for in the revision bill is a combination of two or more dates each month after which institutional investors that are authorized to submit special reports are required to do so. The way in which base dates are to be set is as yet unclear but will be specified in due course by government ordinance.

In other words, under the present law, a special report must, in principle, be submitted by the 15th of the month following a month in which a 3-monthly base date falls to disclose the details of shares held on that date. Under the terms of the revision bill, details of shares held on a 2-weekly base date must be disclosed within five business days of that date.

This represents the government's response to recommendations included in the above-mentioned WG Report to the effect that "deadlines and frequencies for the submission of special reports should be shortened as much as possible ... [abridged] ... to make the system more transparent to investors."

The way in which 2-weekly base dates are to be set is not clearly specified in the revision bill, except to say that it will involve a combination of two dates per month, but will be spelled out in due course by government ordinance.

4. Submission of Large Shareholding Reports via EDINET

1) Summary—Requirement to Report via EDINET

Under the terms of the revision bill, investors will be required to submit large shareholding reports and amended shareholding reports online, in the same way as their annual securities reports, via the EDINET electronic disclosure system (Securities and Exchange Law revision bill; Article 27-30-2).

It is hoped that this will result in information relating to large share acquisitions being made available earlier to general investors.

2) What is EDINET?

EDINET, an acronym for "Electronic Disclosure for Investors' NETwork", is an electronic system for the online submission of documentation such as annual securities reports, as provided for under the terms of the Securities and Exchange Law. The network was launched in June 2001 to enable everything from the online submission of previously paper-based documentation, such as annual securities reports and registration statements, to their online perusal by members of the public[4].

EDINET provides those with information to disclose with a means of submitting relevant documentation to (the local branch office of) their Regional Finance Bureau online via the Internet, and members of the public that wish to peruse such disclosed data with the means of doing so via monitors located in the reading-room of (the local branch office of) their Regional Finance Bureau. The system thus enables submitted disclosure data to be made readily available to the public at large via the Internet.

EDINET has been widely welcomed not only because it has reduced the burden of office work placed on the staff of companies that have information to disclose by eliminating the need for paper-based disclosure, but also because it provides investors with fast, fair access to corporate data.

3) Large Shareholding Reports and EDINET

Most disclosure documentation required under the present system can be submitted via EDINET. However, disclosure documentation is subdivided into two types depending on whether its submission via EDINET is required (annual securities reports, registration statements, etc) or whether it is merely optional (securities notifications, issuance registration notices, etc).

[4] The transfer was completed and the system fully implemented with effect from June 2004.

The problem is that the online submission of large and amended shareholding reports via EDINET is optional under the present system. In other words, there is a risk that investors with relevant information to disclose might choose to do so in paper-based form to avoid the early disclosure that would result from submitting the data online.

The Financial Services Agency (FSA) is, of course, aware of this problem and has devised a system to facilitate same-day access via the Internet to all paper-based large shareholding reports submitted on or after 3 October last year (2005)[5].

According to information obtained in interviews with the FSA, however, disclosure data submitted via EDINET is recorded directly onto a server with the result that it can, in principle, be accessed (provided there is nothing wrong with it) almost immediately via the Internet. On the other hand, paper-based large shareholding reports must first be input into a computer before they can be accessed via the Internet.

The volume of data to be transferred from paper to computer is thus particularly large whenever substantial numbers of large shareholding reports are submitted in paper-based form, which means that there is in practice a time lag before general investors are able to access the data for themselves via the Internet.

Under the circumstances, it makes sense for the submission of large shareholding report data via EDINET to be made mandatory under the terms of the revision bill.

5. Other Important Revisions

1) Elimination of Double-counting Between Joint Shareholders

The revision bill suggests a method for the elimination of double counting between joint shareholders when calculating shareholding ratios to determine whether large shareholding reports need to be submitted or not.

Under the current system, if shares have been lent by one investor to another (under the terms of a loan for consumption), those same shares are counted in the hands both of the lender and the borrower and then aggregated to ascertain the relevant shareholding ratio[6] .

Thus, if shares are loaned by one company to another within a group, the shares in the hands of the lender and those same shares in the hands of one or more borrowers will be counted more than once when calculating the group's shareholding ratio, thereby inflating the ratio several times over, despite the number of shares held within the group being in practice unchanged.

Take the case, for example, of Securities Company A that lends shares it holds in Company X (4%) to its subsidiary A Asset Management, which in turn lends them to its overseas subsidiary A International. In practice, the Securities Company A group of companies still holds the same number of shares (4%) in Company X. However, when calculating the group's shareholding ratio in Company X, the same number of shares is counted for Securities Company A (original holder), A Asset Management (borrower of shares from Securities Company A), and A International (final borrower). As a result of this triple-counting of the same shares, the group's shareholding ratio is calculated to be 12% (4% x 3).

[5] Published on the FSA website at http://www.fsa.go.jp/news/newsj/17/syouken/f-20050916-1.html. See also Mitsuru Yoshikawa and Takashi Furuto's report "Towards same-day access to large shareholding reports via EDINET" (21/9/2005, DIR Legal and Tax Research Dept).

[6] Ichiro Kawamoto, Kaname Seki. "Securities and Exchange Law [New revised edition]; clause-by-clause commentary" (2002, commercial law) p.346, etc.

It has been pointed out that this system is extremely difficult for investors to understand, creating a risk that the market could be misread. The revision bill thus includes the following remedy.

(1) When calculating a shareholding ratio, shares that are to be returned to the lender must in principle be deducted (from the shareholding ratio) while shares that are jointly held must not.
(2) When calculating a shareholding ratio, shares held by a joint shareholder must in principle be added (to the shareholding ratio), except when one or other of the joint holders has the right to call for their return.

The calculation method will be explained in more detail by government/ministerial ordinance in due course, but it is difficult as yet to get a full picture of the mechanism from points (1) and (2) above from the revision bill. It seems clear, however, that when joint shareholders have a loan relationship with each other in respect of those shares (obligation on the one part to return shares and right on the other to call for their return), those shares will not be included for shareholding ratio calculation purposes.

The revised method of calculating a shareholding ratio may thus be assumed to have been included to avoid the problem of double-counting.

2) Switching Between Special and General Reporting

The revision bill provides for institutional investors authorized to use the special report system to submit an amended shareholding report within five business days under the following circumstances (Securities and Exchange Law revision bill; Article 27-26-(2)-3).

When a shareholding ratio falls to a specified level, making the investor eligible to submit special reports

The above provision does not specify the system in detail with the result that we must await the relevant government/ministerial ordinance that will presumably be formulated once the revised Securities and Exchange Law is enacted.

As explained above, even institutional investors with authority to submit special reports are not permitted to use the special report system with respect to shareholdings whose ratio exceeds a specified level (currently 10% under the law).

Put another way, if a share transaction raises an investor's shareholding ratio above 10%, the investor will be obliged to switch from the special to the general system for the reporting of large shareholdings. Conversely, if a share transaction pushes the shareholding ratio below 10%, the investor will be entitled to switch from the general to the special large shareholding reporting system.

Switches of this sort between the special and general reporting systems are handled as follows under the current system[7].

In the event that a shareholding ratio increases from, say, 9.5% to 11%, such that the investor is obliged to complete a general rather than a special report
→ said (general) report must, in principle, be submitted within five business days[1].
In the event that a shareholding ratio decreases from, say, 10.5% to 9%, such that the investor is entitled to complete a special rather than a general report
→ said (special) report must be submitted by the 15th of the month following the month in which the base date falls.

Note: 1) To be more precise, if an investor's shareholding ratio, declared in the previous report, increases by 1% or more, it must be reported within five business days of that date.

[7] 5% rule study group's "5% rule—Q&A" (Okura Zaimu Kyokai, 1991) p.55, Chuo Trust and Banking, Securities Division "5% rule Q&A", ("commercial law" No.1233) p.32 etc.

In short, if a share transaction raises a shareholding ratio above 10%, it must be disclosed within five business days. This provides general investors with comparatively early access to such data.

On the other hand, if a share transaction leads to a decrease in a shareholding ratio to less than 10%, this need not be disclosed immediately. General shareholders may consequently be obliged for a lengthy period to make investment decisions without knowing whether the institutional investor in question has disposed of those shares or not.

The WG Report points out that this situation is problematic "from the standpoint of securing clear disclosure of the trading situation", and suggests that it "should be revised" to ensure proper disclosure when investors switch from the general to the special reporting system.

An amendment in the revision bill to the effect that "though a shareholding ratio may have fallen to a specified level, enabling the investor to switch to the special reporting system, said investor must submit a report" reflects the recommendation in the WG Report.

3) Information Disclosed in a Large Shareholding Report

The abovementioned WG Report suggested that greater clarity should be sought in large shareholding reports in areas such as the following.

(1) More detailed information about why a shareholding was acquired, based on individual circumstances, should be asked for.
(2) When some of the shares acquired take the form of a loan, the circumstances must be clearly explained.

The precise details that would need to be included in a large shareholding report have been left for a subsequent cabinet order (cabinet order on large shareholding-related disclosure).

These details are thus not referred to directly in the current revision bill. However, we expect them to be included in a government/ministerial ordinance that will likely be formulated once the revised Securities and Exchange Law is enacted.

6. Enforcement Date

With the exception of the part concerning "major proposals", revisions to the large shareholding reporting system are scheduled for enforcement "on a date to be specified by government ordinance not more than one year from the date on which the revised Securities and Exchange Law is promulgated" (Supplementary Provision 1-4 of the Securities and Exchange Law revision bill).

The part concerning "major proposals" is scheduled for enforcement "on a date to be specified by government ordinance not more than six months from the date on which the revised Securities and Exchange Law is promulgated" (Supplementary Provision 1-3 of the Securities and Exchange Law revision bill).