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Revised Provisions for Large Joint Shareholdings

Legal and Tax Research Dept
Jun Yokoyama

Summary

- Two government ordinances and a cabinet order clarifying details of revisions made to the TOB and large shareholding reporting systems were announced on 8 December and 12 December respectively for enforcement with effect from 1 January 2007.

- They included details of revised provisions for joint shareholders under the large shareholding reporting system.

- Specifically, any "partnership" effectively controlled by the shareholder is to be treated as a "deemed joint holding" with shares to be included for calculation purposes when submitting a large shareholding report.

- Otherwise, when the shares are subject to fixed contractual rights, double-counting between joint shareholders can be avoided by offsetting the counts against each other.

Introduction (revisions to the TOB and large shareholding reporting systems)

Government ordinances concerning revisions to the TOB and large shareholding reporting systems, included in the Law for Partial Revision of the Securities and Exchange Law of June 2006 (hereafter, "revised law"), have been announced as follows.

(1) 8 December 2006: Government ordinance for partial enforcement of the Law for Partial Revision of the Securities and Exchange Law (Government Ordinance No.376)

(2) 8 December 2006: Government ordinance for partial revision of the Securities and Exchange Law Enforcement Ordinance (Government Ordinance No.377)

(3) 12 December 2006: Cabinet order for partial revision of the cabinet order concerning TOBs for shares by parties other than the issuer (Cabinet Order No.86)

(1) is a government ordinance specifying the enforcement dates for revisions to the TOB and large shareholding reporting systems, details of which are provided in (2) and (3).

We focus in this report on those parts of (2) and (3) that pertain to the revised provisions for joint shareholders under the large shareholding reporting system.

1. The Large Shareholding Reporting System, and "Joint Shareholders"

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" disclosing 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).

The question of whether a large shareholding ratio has exceeded 5% or not is to be determined not only by calculating the holding of the main shareholder but also by adding in the holdings of "joint holders" (Securities and Exchange Law, Article 27-23-(4)). The object is to prevent shareholders from avoiding their responsibility to submit large shareholding reports by using joint holders to diversify their shareholdings and make them look smaller than they actually are.

Under the law, "joint shareholders" are defined as agreeing with the "party that acquired the shares" to carry out the following acts together (Securities and Exchange Law, Article 27-23-(5)).

◊ To acquire shares
◊ To transfer shares
◊ To exercise voting and other rights

Put another way, any party that agrees with the party that acquires the shares in question to purchase them jointly, for example, or to exercise their voting rights jointly are deemed to be "joint shareholders." In cases of this sort, the existence or otherwise of an obligation to submit a large shareholding report (shareholding ratio in excess of 5%) will be determined by aggregating each party's holdings.

2. Deemed Joint Shareholder

1) Scope of Definition of Deemed joint Shareholder

As explained above, the question of whether a party is to be regarded as a joint shareholder or not is determined, in principle, on a case-by-case basis depending on whether the parties have conspired with each other to acquire the shares in question, for example, or to exercise associated voting rights.

However, in cases in which joint shareholders are close relatives or are in a close capital relationship with each other, they will be deemed to have effectively worked together to acquire a large holding in the shares in question, regardless of whether there was a "clear agreement" between them to this effect or not.

Under the law, therefore, a party that stands in a close relationship (more precisely, a "special relationship") with the party acquiring the shares is, in principle, to be treated as a "joint shareholder," regardless of whether there is any specific agreement to this effect between them (Securities and Exchange Law, Article 27-23-(6)), and referred to as a "deemed joint shareholder."

The scope of the sort of "special relationship" that warrants treatment as a "deemed joint shareholder" has been extended by the new government ordinance (Securities and Exchange Law Enforcement Ordinance 14-7-(1); Large Shareholder Government Ordinance 5-3).

Before revision	After revision
(1) Relationship between husband and wife[1]	(1) As left
(2) Relationship in which a controlling shareholder and a controlled company own more than 50% of the voting rights[2]	(2) As left
(3) Relationship between companies (sometimes called sister companies) under the control of the same shareholder	(3) As left
New	(4) Parent/subsidiary relationship (partnerships only) based on the actual locus of control[3]

Notes: 1) When a husband and wife (X, Y) together own more than 50% of the voting rights in a company (Z), they (X, Y) are each deemed to have a controlling interest in Z.
2) When a shareholder (A) and a company (B) in which he/she has control together own more than 50% of the voting rights in a third company (C), company C is deemed to be under the control of shareholder (A) (sometimes referred to as indirect ownership).
3) More correctly, judged to be so under the terms of Financial Statement Regulation 8-(3)

A direct interpretation of the new government/ministerial ordinances suggests that a "partnership" effectively under the control of the main shareholder is to be treated as a "deemed joint holder." In other words, although an individual agreement may not exist, a holding in the hands of what is in effect a controlled "partnership" is to be aggregated with that of the shareholder to determine the need or otherwise for submission of a large shareholding report (shareholding ratio in excess of 5%).

However, this interpretation is questionable in that "if a clear majority of voting rights is required in the case of a stock issuing corporation, why is a controlling interest all that is required in the case of a partnership?"

Although there is no clear answer to this question, interviews with various interested parties suggest that, for the reasons outlined below, the existence or otherwise of a "deemed joint holder" will be determined in accordance with the letter of the law based on the presence of an effective controlling interest in the case of "partnerships" only[1].

[1] It is also possible that rather than a "partnership," a corporation (with no more than 50% of a company's voting rights) that has a controlling interest in the company but is not treated as a "deemed joint shareholder" may nevertheless be determined on a case-by-case basis to be a

◊ The ordinance speaks only of "partnerships," with nothing to suggest any extension of the scope beyond this point.
◊ This latest revision of the large shareholding reporting system has also been undertaken in response to a succession of incidents associated with partnership funds (in other words, to strengthen the regulation of funds of this type).

2) Persons Exempted from Classification as a Deemed Joint Shareholder ("minimal" criterion)

As noted in (1) above, a party that stands in a close relationship ("special relationship") with the party acquiring shares is to be treated as a "deemed joint shareholder," regardless of whether there is any specific agreement to this effect between them. However, where the influence is minimal, the party in question is exempted from classification as a "deemed joint shareholder" (Securities and Exchange Law, Article 27-23-(6)–proviso).

More specifically, a shareholder is exempted from classification as a "deemed joint shareholder" when his holding is equal to, or smaller than, the prescribed number (on the grounds that his influence is minimal). The criterion for determining influence to be minimal has been changed as follows (Large Shareholding Ordinance No.6).

	Before revision	After revision
Domestic company	20 shares (20 minimum trading units) or less	Independent shareholding ratio 0.1% or less[1,2]
Overseas company	1% or less of issued shares	As left

Notes: 1) Independent shareholding ratio calculated as follows (Securities and Exchange Law Enforcement Ordinance 14-7-2-(2)).
Independent shareholding ratio = Number of (independently held) shares / (Issued shares + Number of CBs, etc held by main shareholder and joint shareholder)
2) If the ratio (A) of the aggregated shareholdings of other holders in "special relationships" with the main shareholder, whose holdings are smaller than that of the holder in question, is more than 0.9% of the issued share capital, the above criterion is restated as "(1 - A)% or less.".
3) Securities in question assumed to be shares.

In other words, the original criterion for domestic companies of 20 shares (20 minimum trading units) as the absolute limit has been revised to a ratio (0.1%) of independently held shares.

3. Elimination of Double-counting Between Joint Shareholders

The revised Securities and Exchange Law includes provisions 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.

The problem of double-counting between joint shareholders is as follows. Under the large shareholding reporting system, if, for example, shares are 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[2]. In other words, shares are double-counted in the hands both of the lender and the borrower.

Under this system, 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. The ratio can thus be inflated several times over, despite the number of shares held within the group being in practice unchanged.

"joint shareholder" in the event, for example, that it conspires with the main shareholder to acquire shares in the company in question or exercise voting rights.
[2] Ichiro Kawamoto, Kaname Seki. "Securities and Exchange Law [New revised edition]; clause-by-clause commentary" (2002, commercial law) p.346, etc.

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 (the three companies are deemed to be "joint shareholders" with respect to each other).

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, Securities Company A group's Company X shareholding ratio is calculated to have swelled to 12% (4% x 3).

It has been pointed out that this approach to the calculation of shareholding ratios is extremely difficult for investors to understand, creating a risk that the market could be misread. The revised Securities and Exchange Law thus includes the following remedy (Securities and Exchange Law, Article 27-23-(4)).

(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 or such other rights as may be specified by government ordinance

In short, shares held under the terms of a loan agreement (obligation on the one part to return shares and right on the other to call for their return) between the main shareholder and a joint shareholder will not be included in the joint shareholder's share tally[3]. Theoretically, therefore, this should eliminate the double-counting of shares held under the terms of a loan agreement.

The latest government ordinance makes the following provisions for the exemption from double-counting of shares held subject to the "right to call for their return or such other rights as may be specified by government ordinance" (Securities and Exchange Law Enforcement Ordinance No.14-6-2).

(1) Right to recall shares under the terms of a trading contract
(2) Right, based on the terms of a money trust contract or of the law itself, to exercise voting rights or to direct others as to how to exercise their voting rights
(3) Right to invest based on the terms of a discretionary investment contract or of the law itself
(4) Right, based on terms and conditions, to terminate a transaction and assume the role of buyer
(5) Right, through the exercise of an option, of the exerciser (of the option) to assume the role of buyer

One problem in the case of share loan agreements between joint shareholders relates to whether it is the lender or the borrower that is entitled to deduct those shares from his holding. Responding to public comments on the subject, the FSA has indicated that "it is the lender that is entitled to deduct the shares in the case of a loan of shares."

4. Enforcement Date

The above government/ministerial ordinances came into force on 1 January 2007.

[3] Once actual documentation is completed to show a share count calculated according to the above rules, shares held between the joint shareholders that are available for recall are effectively deducted (Note (12)-1 on the completion of Form 1).