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Large Shareholding Reports and Major Proposals

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Summary

- Two government ordinances and a cabinet order clarifying details of revisions made to the large shareholding reporting systems were announced on 8 December and 12 December respectively.

- They include details of what constitutes a "major proposal" of the sort that would make the submission of a special large shareholding report unacceptable.

- More specifically, they define a major proposal as a "submission to management and/or a general meeting of shareholders of a proposal that would result in the disposal or transfer of an important corporate asset, appointment or dismissal of a representative director, a material change in company personnel, a material change in a company's dividend policy, the initial listing of shares in a subsidiary, etc."

1. 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 "major proposals" of the sort that would make the submission of a special large shareholding report unacceptable.

2. Major Proposals that Would Rule Out the Submission of a Special Large Shareholding Report

1) In What Sort of Case Would the Submission of a Special Large Shareholding Report be Ruled out?—"Controlling Interest" and "Major Proposal"—

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 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." For a general report, a shareholding ratio of more than 5% must be fully explained, whereas, in principle, a special report need only be submitted if a shareholding ratio exceeds 5% on the base date[1].

However, there are circumstances under which institutional and other professional investors will not be permitted to submit a special report. The following chart compares provision under the law before and after revision with respect to cases in which the use of special reports is not permitted (Securities and Exchange Law; Article 27-26-(1).

[1] The revised Securities and Exchange Law provides for an increase in the frequency with which base dates for the submission of special reports occur from "every third month, in principle" to "every second week, in principle" (Securities and Exchange Law; Article 27-26-(3), and the associated Enforcement Ordinance No.14-8-2-(2)).

Before revision	After revision
(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*	(3) As left
(4) When the holding appears, all things considered, to fall within the ambit of the relevant cabinet order**	(4) As left

*Specified as 10% (Cabinet Order 12 relating to disclosure of the details of large holdings of shares and other securities). No change under the revised law.
**When joint shareholders, not defined as institutional investors, have holdings of more than 1% (Cabinet Order 13 relating to disclosure of the details of large holdings of shares and other securities. No change under the revised law). In addition to the above, the new large shareholding ordinance also specifies cases in which a shareholding ratio falls from more than 10% to less than 10% (in other words, cases in which a reduction in the size of a shareholding entitles the shareholder to switch from the general to the special large shareholding reporting system).

The main difference in the law before and after revision is the one shown at (2) in the above table. The primary object of these provisions is in each case to preclude shareholders, even institutional investors, from submitting special reports in cases in which their aim in securing the shareholding in question is to influence the way in which the issuing company is managed.

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

So how, then, does a "controlling interest" differ from a "major proposal"? In a word, the concept of a "major proposal" is broader than that of a "controlling interest." In short, the use of a special report will 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.

Moreover, by replacing the subjective element of "control" with the more objective "act of submitting a proposal," the revised law limits shareholders' scope for claiming they acquired the shareholding in question purely as an investment.

2) Scope of "Major Proposal"

The precise limits of a "major proposal" are specified in the latest government ordinance as follows (Securities and Exchange Law Enforcement Order No.14-8-2-(1); Large Shareholding Ordinance No.16).

The act of submitting a "major proposal" is defined as the submission of one or other of the following "proposals" to one or other of the following "targets."

Target: General meeting of shareholders, general meeting of investors*, key personnel**
Proposal: One or other of the following matters concerning an issuing company or its subsidiary

(1) Disposal or transfer of an important asset
(2) Large borrowing
(3) Appointment or dismissal of a representative director
(4) Material change in key personnel (incl material changes in the number of such personnel and/or their terms of office)
(5) Appointment or dismissal of executives and other key employees
(6) Establishment, modification, and/or closure of branch offices and other key parts of the organization
(7) Share swaps, share transfers, demergers, mergers
(8) Transfer in or out, suspension, and/or closure of some or all of the company's operations
(9) Material change in the company's dividend policy
(10) Material change in the company's policy on increasing/decreasing its capital stock
(11) Delisting, etc of issued securities
(12) Listing, etc of issued securities
(13) Other matters of the sort listed in (1) to (12) above. More specifically:
- Material change to the company's capital plan (excl (10) above)
- Dissolution of the company (excl dissolution by merger)
- application for the initiation of insolvency, rehabilitation, or reorganization proceedings

*Mechanism corresponding to that of a general meeting of shareholders in an investment company (closed-end fund; Securities Investment Trust Law; Article 89, etc).
**Key personnel include:
— Personnel with executive authority
— Directors
— Executives
— Accounting consultants
— Auditors
— Persons with comparable responsibilities
— Persons with comparable or higher degrees of control, regardless of whether they have a title such as "advisor"

3) Criteria for the Recognition of "Major Proposals"

In light of Section (2) above, activities such as the following, carried out by the so-called "activist funds" that have become quite notorious of late, would be deemed "major proposals."

◊ Call for large-scale reconstitution of a company's board of directors (falls within the scope of (3) or (4) above)
◊ Call for the sale of key assets (falls within (1) above)
◊ Call for a substantial dividend increase (falls within (9) above)
◊ Call for privatization by MBO (falls within (11) above)
◊ Call for the listing of a subsidiary (falls within (12) above)

However, it is not completely clear from the government ordinance just how far an "act" must be taken before it is deemed to be a "major proposal."

For example, there is little doubt that if a large shareholder were to "exercise his/her right as a shareholder to table a proposal" or to "approach the company's management directly with an urgent call for them to accept a proposal," this "act" would constitute a "major proposal." On the other hand, careful judgment would need to be exercised in deciding whether the "act" of "asking a question at a general meeting of shareholders," or "taking the opportunity of a meeting with management to discussing the possibilities surrounding a proposal," or "exchanging views on the subject of a proposal during an informal meeting with management" constituted a "major proposal."

In answer to comments raised by the public on this point, the Financial Services Agency (FSA) has clarified its own view. Relevant sections of its clarification are cited below.

While any decision as to whether an act constitutes a major proposal must be taken on a case-by-case basis in light of the relevant provisions, the following three conditions must always be met.

i) First, the objective content of a proposal must be one or other of the matters listed in Article 14-8-2-1 of the order (author's note: this refers to the Securities and Exchange Law Enforcement Order). Where matters in the list include terms such as "material" or "large amount," a trivial instance of such a matter will not constitute the act of submitting a major proposal.
ii) Next, under the terms of Article 27-26-1 of the law (author's note: this refers to the Securities and Exchange Law), the large shareholder's actions must be designed to make major changes to, or otherwise seriously influence, the company's business activities. The act of exerting outside influence quite unrelated to the issuing company's own managerial policy objectives thus clearly fits this description. Even an act that fulfilled condition i) above would be unlikely to fulfill the present condition (ii) if, for example, the large shareholder's opinion had genuinely been sought by the issuer or if his opinion was presented as part of an event set up by the issuer itself (conference call, investor presentation, etc).
iii) Finally, the act must indeed constitute a "proposal." Although conditions i) and ii) above may be met, the present condition (iii) may not be satisfied if the matter in question is simply alluded to in the context, for example, of an analyst's or fund manager's fact finding meeting with the issuer.

One way or another, each case will ultimately be determined on its own merits.

Source: Clarification issued by the Financial Services Agency concerning questions it had received on the subject and its response (13 December 2006)

The FSA's guidance, cited in part above, as to what might be considered the basic criteria for deeming an "act" to constitute a "major proposal" may be summarized as follows.

1. Matters listed in (1) to (13) above.
... matters that do not fall within the definitions of a "proposal" in (1) to (13) above do not constitute "major proposals."
2. The exercise of outside influence over the issuer's managerial policy objectives.
... opinions cited, for example, in response to a question from the issuer or as part of an event such as conference call or investor presentation meeting set up by the issuing company itself are unlikely to fall within the definition of a "major proposal."
3. A "proposal" must in fact be made.
... opinions cited during the course of analysts' or fund managers' fact finding meetings with the issuer are unlikely to fall within the definition of a "major proposal."

However, the FSA's final proviso, to the effect that "each case will ultimately be determined on its own merits," clearly suggests there may be areas that have still to be clarified. To judge from the criteria themselves, however, the FSA does not seem to be looking to use the new rules to inhibit analysts' and fund managers' hitherto robust research activities.

The authorities nevertheless appear to have failed to completely allay the concern among investment institutions that they may suddenly one day be forbidden to use the special large shareholding reporting system on the grounds that they have made a "major proposal," despite having done nothing more than carry out research activities in their accustomed manner.

It is only natural that the authorities should want to prevent unscrupulous funds from using special reports. It is to be hoped, however, that, to ensure the healthy tension that exists between investment institutions and issuers is maintained, the new rules are not exercised in such a way as to place excessive restrictions on investment institutions engaging in their normal fact finding activities.

3. After Submission of "Major Proposals"

The revised Securities and Exchange Law includes provisions to counter the ex post submission of "major proposals" by large shareholders who have submitted special reports on the grounds that they acquired their holding without any premeditated plan to make 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

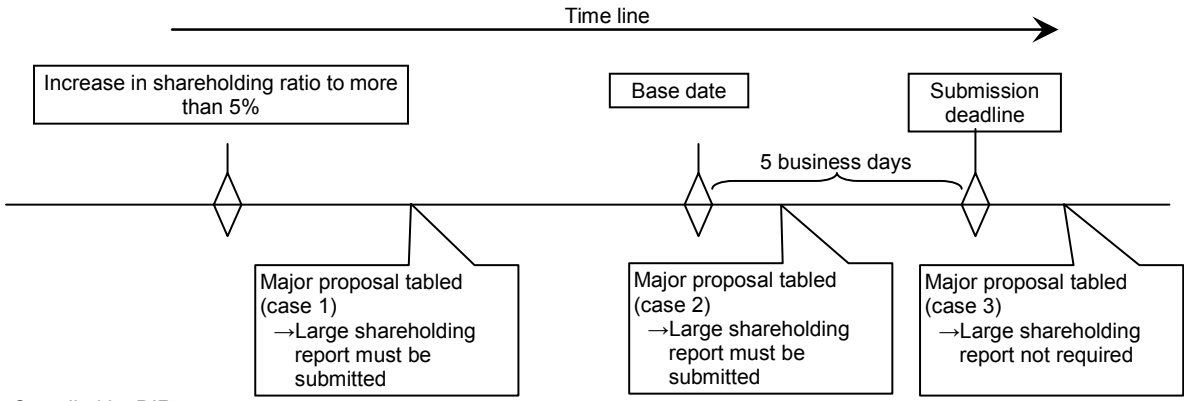
The objective of these provisions is more than likely to secure the proper disclosure of large shareholdings at least five business days prior to the tabling of a "major proposal." In other words, they are designed to prevent investors from seeking, under the pretense of having no intention of tabling a "major proposal," to make improper use of the special large shareholding reporting system to avoid their obligation to submit a large shareholding report.

The new government ordinance makes the following stipulation with respect to the "period prescribed in the relevant government ordinance" (Securities and Exchange Law Enforcement Order No.14-8-2-(3)).

Period not exceeding five business days after the first base date following the date on which an investor's shareholding ratio increases to more than 5% (or increases by 1% or more)

In other words, the target of the above provisions is "major proposals" tabled before a large shareholding is brought to light through the submission of a large shareholding report (or amended shareholding report). Diagrammatically, the situation looks as follows.

"Major Proposals" and Large Shareholding Reports



Source: Compiled by DIR.

If a major proposal were to be tabled at the point in time indicated in case 1 in the diagram, the shareholding ratio would already have risen beyond 5% but the special report base date would still be in the future with the result that the increase would remain undisclosed. The shareholder would therefore be obliged to submit a large shareholding report no less than five business days before tabling his "major proposal" to disclose the increase in his holding.

If a major proposal were tabled as per case 2, the shareholding ratio would already have risen beyond 5% when the special report base date arrived, obliging the shareholder to submit a large shareholding report. However, as the deadline for this submission would still be in the future[2], the required disclosure may not yet have been made. The shareholder would still therefore be obliged to submit a large shareholding report no less than five business days before tabling his "major proposal" (necessarily in advance of the base date) to disclose the increase in his holding.

If a major proposal were tabled as per case 3, the shareholding ratio would already have risen beyond 5% when the special report base date arrived and the deadline for submission of the special report would also have passed. The shareholding should therefore already have been disclosed. Under the circumstances, there would be no obligation on the shareholder (providing he had not further increased his shareholding by another 1% or more) to submit an additional large shareholding report.

4. Disclosure of the Tabling of a Major Proposal

In light of the situation regarding "major proposals," the scope of matters investors are required to disclose in a large shareholding report, such as their reasons for acquiring the holding, have been amplified as follows (Notes (10) and (11) on the completion of Form 1 of the Large Shareholding Report Government Ordinance).

(10) Reasons for acquiring the holding Investors are required to explain in as much detail as possible whether they acquired the shares in question as, for example, a "pure investment," a "strategic investment," or for the purpose of making a "major proposal." If they have more than one reason, they must disclose them all.

(11) Major proposal If any of the parties* listed in Notes (11)-1 to (11)-3 completes this form after having acquired shares for the purpose of tabling a major proposal, their intention to table said proposal must be made clear.

*Parties authorized to submit special reports, such as securities companies, financial institutions, and institutional investors.

[2] Under the revised Securities and Exchange Law, the time allowed for submission of a special report has been reduced from "not later than the 15th of the month following the month in which the base date falls" to "no more than five business days after the base date" (Securities and Exchange Law; Article 27-26-(1)-(2)).

Investors who intend to table a "major proposal" must declare the fact, and details, of their intention in the "Reasons for acquisition" column (this requirement came into force on 1 January 2007).

Institutional and other professional investors who are completing a general rather than a special report, having already planned to table a "major proposal," must also make their intention clear in the form (this requirement came into force on 13 December 2006).

5. Enforcement Date

The above government/ministerial ordinances came into force on 13 December 2006, except for the part relating to an investor's "reasons for acquisition."

The part relating to an investor's "reasons for acquisition" came into force on 1 January 2007 (see section 4. above).