

Investors' Evaluations and Expectations
On
the Companies' Response to the Corporate
Governance Code

Forum of Investors Japan

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1. REPORT ON THE FIRST/SECOND INVESTORS FORUMS

Purposes:

- To identify and publish good examples of *comply or explain* disclosure under the Corporate Governance Code (the "CG Code") from the viewpoint of institutional investors.
- We want to avoid a situation to converge in narrow definition of the "best practice", and other companies simply imitate such model superficially. From this perspective, we will present multiple good examples of disclosure and *explanation*.
- In addition, only focusing on insufficiency or dissatisfaction may discourage each company's own initiative. Since this is the first year for complying with the CG Code, we will focus only on good examples.

1) New Corporate Governance Report in General

Attitude toward disclosure

1. **Method of Disclosure/Composition**
2. *Comply or Explain*
3. **Significance: Providing Information and Making Appeals as Part of Investor Communication Policy**
4. **Viewpoint: Do Not Accept the Present Situation, But Get Conscious About An Ideal Company**
5. **Uniqueness**

Priority Principles for Investors

1. **Principle 1.4 Cross-Shareholdings**
2. **Principle 5.1 Policy for Constructive Dialogue with Shareholders**
3. **Principle 4.8 Independent Outside Directors**

The Report is disclosed at the Forum of Investors Japan HP <<http://investorforum.jp/>>

2. Supplementary Document : Opinion on Cross-Shareholdings

Note that, the following awareness of the cross-shareholdings was shared during the discussions, so we have summarized such awareness as a separate volume of this Report.

- From the investors' side, *comply* or *explain* on the premise that cross-shareholdings will continue, is not the point of this issue.
- Rather, the interest of the investors lies in the serious efforts to deal with the structural issue, which has become a legacy due to its historical background.
- That is, to settle the gap between the original purpose of cross-shareholdings and the "objective behind cross-shareholdings" and "economic rationale", which have been questioned in the CG Code, and to settle the issue of companies who "let their shares be held by other companies", the confusion with portfolio investment (pure financial return seeking investment), the conflict of interest with minority shareholders and the pro-cyclicality with regard to financial institutions. We hereby introduce the opinions of investors with regard to these issues.

1) Statements Concerning Companies Who "Let Their Shares Be Held by Other Companies"

Companies who hold the shares of their trade partners cannot sell them at their own discretion, because selling their trade partners' shares will be a hindrance to their business.

This implies that the companies who "let their shares be held by other companies" intervene with the corporate strategy of the companies who are "made to hold shares of other companies".

Evidence :

- In order to sell the shares, companies who hold the shares of their trade partners need to 'seek for agreement' from the issuer in advance.
- Since this has been a long-standing business practice, it is hard to reach agreement, or the issuer would impose a tougher trading condition.
- It is often heard that client companies are denied the sale of shares, even though supplier companies would like to sell them.

2) Statements Concerning Companies Who “Own the shares”/ is “Being made to hold the shares”

This could be, however, just an excuse that client companies are denied the sale of shares, even though supplier companies would like to sell them.

Nobody takes the initiative to act first, in other words, there may be a system of irresponsibility or a problem of omission, or failure to act, obscuring the responsibility.

Evidence :

- There are cases where the management states that the continuation of transactions with business partners that do not hold shares causes no problem.
- Although company sold the majority of the cross-shareholdings, there were no particular problem for doing business with the trade partners.

3) Structural Issues that Do Not Make Incentives for Dissolving Cross-Shareholdings

Chart 1 : Implied relationship of trade partners by their share holding/being held status

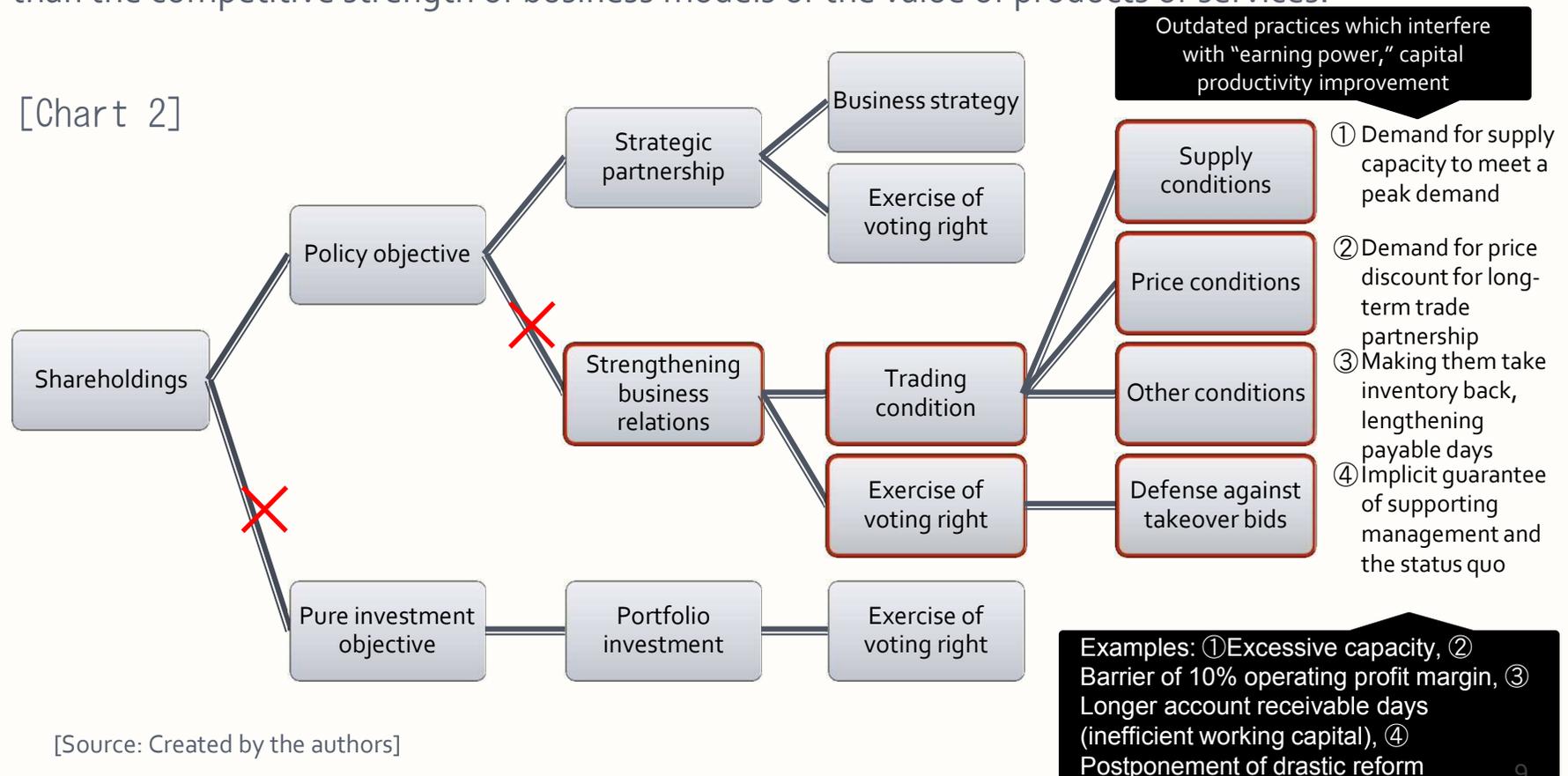
	Active/passive attitude	Negotiation power	Trading condition	Voting	Selling decisions
Being held	Making their trade partner hold the shares	Strong	Favorable	Having a secure supportive voting	Influential
	Being owned by their trade partner	Weak	Inferior	Trade partners' negotiation tool	—
Holding	Owning the shares	Strong	Favorable	Using as a tool for negotiation	Having an influence
	Being made to hold the shares	Weak	Inferior	No choice – supporting management	No free hands

[Source: Created by the authors]

4) Theoretical Contradiction between “Objective behind Cross-Shareholdings” and “Economic Rationale”

Negotiations of transactions terms and conditions using shareholdings (exercise of voting right) as a lever may be one of the causes that destroys international competitiveness rather than the competitive strength of business models or the value of products or services.

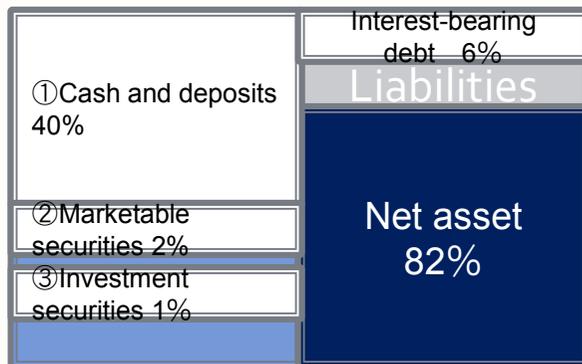
[Chart 2]



[Source: Created by the authors]

5) Statements concerning capital productivity

Chart 3: B/S of Company A (FY ended March 2015)



Note: ③Investment securities (Equity)= so-called cross-shareholdings [Source: Created by the authors based on the securities report of Company A]

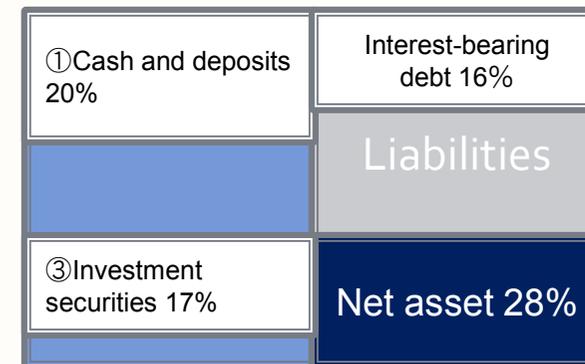
1. Operating assets to total assets

- Cash and cash equivalents (①+②) =42%
- ①+②+listed shares (③) =43%
⇒**Operating assets that create value is just 57%**

2. Capital cost and allocation

- Negative spread in which the return from risk-free (①) or low-risk financial products (②) falls below cost of capital.
- ③ is a risky asset, and an appropriate portion of shareholders' equity will be allocated as a buffer.
⇒**Waste of capital**
(However, for ① and ②, appropriate amounts as working capital are required)

Chart 4: B/S of Company B (FY ended March 2015)



Note: ③Investment securities (Equity)= so-called cross-shareholdings [Source: Created by the authors based on the securities report of Company B]

1. Operating assets to total assets

- Cash and cash equivalents (①+②) =20%
- ①+②+listed shares (③) =37%
⇒**Operating assets that create value is just 63%**

2. Capital cost and allocation

- Negative spread in which the return from risk-free financial products (①) falls below cost of capital.
- ③ is a risky asset, and an appropriate proportion of shareholders' equity will be allocated as a buffer.
⇒**Waste of capital**
(However, for ① and ②, appropriate amounts as working capital are required.)

6) Statements Concerning Conflict of Interests with Minority Shareholders

- If holding shares of a business partner yields special benefits, this might mean that companies who "let their shares be held by other companies" provide excessive benefits to companies who "hold shares of other companies".
- Persons relevant to shareholders who are identified as holding shares in other listed companies are not qualified for independent outside directors.
- There are some companies that explain that such companies rarely have a business relationship with the company to which their independent outside directors belong, but at the same time, explains that such companies have cross-shareholding shares of the company to which such directors belong, and such cross-shareholdings are important to maintain their business relationship. This is contradictory.

7) Conclusion/Proposal

The majority of the participants of the forums were of the opinion that cross-shareholdings should be terminated. Most of the investors think that "after all, in reality, cross-shareholdings are a defense measure of the issuers against takeover bid by causing stable shareholders to hold shares.

" When companies try to submit to the fulfillment of reasonable accountability, Principle 1.4 of the CG Code is an important principle for them to realize that "cross-shareholdings are not reasonable" and to head voluntarily towards the termination of cross-shareholdings.

Investors would like to ask companies, who engage in cross-shareholdings, to take some actions in order to improve their ability of "earning power", as the new growth strategy of the government provides for.

7) Conclusion/Proposal

Such actions include, first of all, representing a policy to reduce future cross-shareholdings, and establishing a system to monitor the interests of general shareholders so that they will not be impaired by operating activities through misuse of the position of a cross-shareholding. Such system could include the establishment of a supervisory board comprising of independent outside directors.

Investors understand the needs of strategic partnership in some cases, so it is desirable that companies and investors deepen their shared understanding through dialogues.

In addition, investors are concerned about the pro-cyclicality risk, a risk that the cross-shareholdings by financial institutions (mainly banks) will weaken the Japanese financial system amid global competition.

7) Conclusion/Proposal

In particular, it is insufficient for major banks, who are subject to regulations such as BIS, to reinforce their monitoring system on the assumption that cross-shareholdings will continue. Aggressive downsizing of cross-shareholdings is desirable.

If financial institutions take the lead in the reduction of cross-shareholdings, it would be a signal for Japanese companies and will trigger a change.

3. Appendix

Mission Statement – Forum of Investors Japan

< <http://investorforum.jp/> >

Mission Statement

With the aging and decreasing population in Japan, how to maintain and generate national wealth has become a crucial issue for the Japanese. In order to deal with this issue, a more effective use of capital to create value, that is, a more effective combination of human capital, intellectual capital and financial capital will be required. Companies are the stage for this. Reinforcement of the competitiveness and earning power of every company is believed to be the condition necessary for building the strength to create value in Japan as a whole.

On the other hand, the role of investors is to provide finance to companies that take on such task (internal reserve is one way to accomplish this, in addition to IPOs and capital increase). Return from invested capital will be reinvested, which will promote the creation of more value to companies. As the main body of the investment chain that creates such virtuous cycle, investors are expected to assume the crucial role of “stewardship responsibilities”.

From these perspectives, we want to understand in more depth measures taken by the companies to create values in the long-term, and to hold straight-forward talks with listed companies about the issues that the companies encounter.

With regard to our interests as mentioned above, the implementation of the Corporate Governance Code is expected to create a better environment for “dialogue with shareholders”, but at the same time, as the Japan’s Stewardship Code and Ito Review point out (Notes 1 and 2), institutional investors are required to enhance their “capability” to share knowledge and experience in order to have better dialogue with companies and make better judgments.

We operate the “Forum of Investors Japan” for the purpose of supporting institutional investors acquire skills to appropriately fulfill their stewardship responsibilities toward their investee companies, and thereby realize constructive dialogue between the institutional investors and investee companies, and contribute to the sustainable growth of such companies.

(Note 1) Japan’s Stewardship Code, Principle 7-3

Exchanging views with other investors and having a forum for the purpose may help institutional investors conduct better engagement with investee companies and make better judgments.

(Note 2) Ito Review (p.90)

“In order to enhance their capability for having dialogue with companies, it is important for a platform to be established in which institutional investors can share knowledge and experience, and have frank discussions on this matter. It is expected that this platform will help to provide a shared intellectual basis for dialogue and engagement, including issues such as the depth, appropriate counterparty at the company, and focus of dialogue.

Important note

The views and proposals expressed here are solely those of the author based on their participation in the “Forum of Investors Japan,” and do not represent the views and proposals of the firms that the authors belong to or any other entity that belongs to the same group (“author’s affiliated organization” hereinafter). Therefore, please take note that the author’s affiliated organization does not accept any responsibility for the views and proposals expressed here.