Financial Services Agency
Disclosure System Working Group Report
~ Development of Legal System for Rights Offering in Japan ~

January 19, 2011

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(In order of the Japanese syllabary)

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1. Introduction

Rights offering is one technique of a capital increase where share options are allotted to all shareholders without contributions, along with public offering and capital increase through third-party allotment.

In rights offering, a shareholder can exercise his/her allotted share options and pay money, acquiring shares. Meanwhile, instead of exercising these share options, the shareholder can sell them in the market. Therefore, it has the feature that a shareholder who does not want a decrease in his/her shareholding percentage can prevent such a decrease by exercising his/her share options, while a shareholder who does not want to invest additional capital can avoid that additional payment by selling his/her share options.

Rights offering is a capital increase technique widely used in Europe, especially for large capital increases. It has been pointed out that rights offering differs from public offering and capital increase through third-party allotment, in that rights to acquire shares are granted to the existing shareholders in proportion to their shareholding percentages, with the result that this can be a capital increase technique which pays attention to fair treatment of existing shareholders. In addition, because a capital increase through third-party allotment involves a large decrease in shareholding percentages of existing shareholders, and is becoming a problem from the viewpoint of investor protection, investors etc. are calling for active use of rights offerings.

In this environment, towards achieving the New Growth Strategy (June 18,

2010 Cabinet Decision), the Financial Services Agency of Japan (FSA) put together the Action Plan for the New Growth Strategy (published on December 24, 2010). This plan includes “Development of the Disclosure Rules for Smooth Implementation of ‘Rights Offering’ ” as a policy for “Flexibly Supply of Funds, etc.”

The Disclosure System Working Group has deliberated three times since December 2010 with regard to the development of a legal system to facilitate use of rights offerings as one possible capital increase technique while ensuring investor protections, together with Expansion of Scope of English-Language Disclosures System (report published on December 17, 2010).

This report delivers the results of the study by this Disclosure System Working Group. It is hoped that, based on the proposals of this report, related parties will appropriately advance the development of the legal system.

2. Development of Legal System concerning Rights Offering

(1) More Flexible Methods of Delivering Prospectuses

Under the current legal system, an allotment of share options without contribution according to provisions of Article 277 of the Companies Act corresponds to a public offering of securities, for which in principle, prospectuses must be delivered to investors.

Generally, in a public offering, investors are given a short period to decide whether to invest. In a possible situation in which investors can be strongly induced to invest, for investors to make proper investment decisions under their own responsibility, only indirect disclosure of company details by a securities registration statement would be considered insufficient. Based on this thinking, the current legal system obligates issuers to deliver a prospectus in a public offering of securities, thereby providing direct disclosure of company details to investors.

In rights offering, share options are automatically allotted to all shareholders. Therefore, the shareholders do not have to decide whether

they should acquire the share options. However, shareholders must decide whether to exercise their allotted share options. In this way, in rights offering, although the type of decision sought from shareholders differs from that sought in a usual public offering, from the viewpoint of providing information required for shareholders to make proper decisions, some kind of appropriate disclosure to shareholders would be considered necessary.

Under the current legal system, a prospectus must be delivered, even in a rights offering. However, it is pointed out that this case differs from a public offering or a capital increase through third-party allotment, in that prospectuses must be delivered to all existing shareholders, resulting in the practical difficulty that prevents the possibility of choosing to raise capital through rights offering for a company with a vast number of shareholders.

This situation creates a need for flexible means of delivering prospectuses, so that rights offering becomes a practical choice for companies to raise capital, while ensuring investors protection.

Regarding this point, in a usual public offering of securities, all investors who want to acquire those securities are not always able to do so. Therefore, there are strong demands for suitably providing investors with information for investment decisions. In contrast, in rights offering, share options are allotted to all shareholders in proportion to their shareholding percentages, and shareholders who want to invest additional capital can surely acquire shares by exercising their share options. Therefore, even in situations where shareholders are strongly induced to exercise share options, compared to a usual public offering, there would be less possibility of shareholders facing pressure to hurry to exercise. In addition, in rights offering, allocations are made to existing shareholders, many of whom have information on the issuer. Especially for a case in which the issuer’s shares are listed on a financial instruments exchange, diverse information would already be distributed. Considering these points, it is pointed out that it is relatively less necessary to deliver prospectuses in order to ensure a careful decision by shareholders.

Moreover, in cases where the share options are listed on a financial instruments exchange, shareholders can sell their share options at the market price instead of exercising them. This provides more choices for shareholders, and there may not necessarily be a great need to uniformly provide all shareholders with information in the form of prospectuses, in deciding whether to exercise share options.

Considering the above, it is appropriate to enable more flexible methods of delivering prospectuses in rights offering. Specifically, it is appropriate to not require delivery of prospectuses to shareholders, where (a) it is rights offering in which the share options are listed on a financial instruments exchange, (b) a securities registration statement is submitted (resulting in its posting in an electronic disclosure system (EDINET)), and (c) information such as EDINET's web site address is published in daily newspapers as soon as possible after submission of the securities registration statement (at the latest, by the time the share option allotment is made).

Even if more flexible methods of delivering prospectuses are allowed as described above, people are not familiar with rights offerings in Japan. Thus from the viewpoint of investor protection, it would be important for issuers and market participants to take practical actions in order to inform people about rights offerings. For this purpose, it is hoped that a specific study will proceed regarding enhancing issuers' information disclosure based on the timely disclosure system in financial instruments exchanges, and regarding whether knowledge about rights offerings can be provided by the market participants such as securities companies that make the commitments described in (2) below.

(2) Review the Scope of Underwriting of Securities, etc.

(a) Review the Scope of Underwriting of Securities

In rights offering, there could be a scheme in which share options which are not exercised are acquired by the issuer based on the call

provisions, then sold to securities companies, and those securities companies exercise these share options to acquire shares and sell them in the market or to others (referred to hereinafter as “commitment type rights offering”). A commitment type rights offering ensures that all the share options will be finally exercised, because the securities companies exercise them. Therefore, this scheme has the advantage that the issuer ensures in advance the amount of capital it needs to raise.

Under the current legal system, acts of a securities company in a commitment type rights offering are interpreted as not corresponding to an underwriting of securities. That is, in a commitment type rights offering, securities acquired by the securities company (share options) differ from the securities which it is to sell (shares), and therefore this does not correspond to the type of underwriting as defined in Article 2, Paragraph 6, Item 1 of the Financial Instruments and Exchange Act. In addition, as issued share options are allotted to shareholders, it does not correspond to a contract in which it promises to acquire all of the remaining securities which are not acquired by any other person, nor does it correspond to the type of underwriting as defined in Item 2 of the said paragraph.

However, from the viewpoint of acts of a securities company making a commitment, as the securities company makes a prior promise to acquire and exercise the portion of the issued share options which are not exercised by investors (including existing shareholders), its form of action and risk taking would indicate that there are similarities to the case of a securities company acting as an underwriter.

Therefore, it is appropriate that acts of a securities company which makes a commitment (acquisition and exercise of unexercised share options) are positioned as underwriting of securities, and that a framework to impose necessary regulations on securities companies is put in place to ensure investor protection.

For a securities company which performs underwriting of securities, it

is prohibited to underwrite by conditions such as quantity or price which are deemed remarkably inappropriate, and a securities company which performs wholesale underwriting is obligated to have a higher minimum capital and perform appropriate underwriting examinations on whether it is suitable to underwrite. In addition, the responsibility for false statements in the securities registration statement lies with a securities company which concludes a “Wholesale Underwriting Contract” with the issuer.

(b) Rules on Acts of Encouraging Exercise of Share Options

In order to conduct a smooth rights offering, as described in (1) above, market participants such as securities companies are expected to take practical actions to provide knowledge on rights offerings.

On the other hand, if holders of share options are inappropriately encouraged to exercise them, their investment decisions may be distorted, and thus, it is necessary to avoid such a situation.

Especially for a securities company which makes a commitment, an incentive is created to reduce the quantity of the share options which it acquires and exercises, leading to a situation where the securities company improperly induces holders of share options to exercise their rights.

From this viewpoint, in the case where a securities company making a commitment encourages the exercising of share options, it is appropriate to impose regulations such as prohibiting false indications, in order that such acts be conducted properly.

(3) Review of Treatment of Amendments in Cases of Ongoing Disclosure Documents Submitted

Under the current legal system, in a public offering of securities, even after the securities registration statement comes into effect, in a case in which ongoing disclosure such as the annual securities report is submitted until the time the application is closed, the submission of an amendment is

required. Also for rights offering, in cases where ongoing disclosure documents are submitted during the period until share options are exercised, the submission of an amendment is required.

The period from submission of a securities registration statement until it comes into effect is for ensuring a period of informing investors and deliberation by investors. However, after it comes into effect, there would be relatively less necessary to provide information by submitting an amendment.

In the case of a usual public offering, there is a relatively short time period from submission of the securities registration statement until the application is closed. Therefore, in practice, it is handled by setting that time period apart from the submission date of ongoing disclosure documents.

In contrast, in rights offering, there is generally a longer time period from when the securities registration statement comes into effect until the share options are exercised. Therefore, it is practically difficult to set that period apart from the submission date of ongoing disclosure documents. As a result, it is pointed out that submission of an amendment is required, and that this practical burden is one of the factors impeding rights offering.

In light of these characteristics of rights offerings, even if ongoing disclosure documents are submitted after the securities registration statement comes into effect, if the time of submission etc. of planned ongoing disclosure documents is stated in that securities registration statement in advance, it is appropriate that submission of an amendment not be required.

(4) Other Issues

(a) Regulations on Tender Offers and on Reports of Possession of Large Volume

For the application of regulations on tender offers and on reports of possession of large volume to the situation of commitment type rights offering, the following has been pointed out regarding shareholders who

receive allotments of share options and securities companies which make commitments.

Under the current legal system, at the time of receiving an allotment of share options, each shareholder adds the number of voting rights pertaining to those share options in calculating his/her Share Certificates, etc. Holding Rate and Holding Ratio of Share Certificates, etc., and checks whether obligations are imposed based on both regulations. At this time, in principle, the number of voting rights pertaining to share options each shareholder owns or holds are added to both the denominator and numerator (on the other hand, other parties' ownership or holdings are not added to the denominator). Therefore, each shareholder's Share Certificates, etc. Holding Rate and Holding Ratio of Share Certificates, etc. are increased.

Under the current legal system, when an allotment of share options without contribution is implemented, and share options are allotted to all shareholders, at the time when allotted, each shareholder's Share Certificates, etc. Holding Rate and Holding Ratio of Share Certificates, etc. are increased. In addition, each shareholder's final Share Certificates, etc. Holding Rate and Holding Ratio of Share Certificates, etc. change according to the exercise status of share options.

On the other hand, for example in the case of a commitment type rights offering, after a certain period is past, it is ensured that all share options which are issued will be exercised. Therefore, after a certain period is past, in calculating each shareholder's Share Certificates, etc. Holding Rate and Holding Ratio of Share Certificates, etc., voting rights pertaining to all share options including other parties' share ownership or shareholdings are added to the denominator, and it is assumed that these ratios will eventually decrease. In this case, shareholders who exercise their allotted share options, but who does not otherwise acquire or dispose of shares, will see their Share Certificates, etc. Holding Rate and Holding Ratio of Share Certificates, etc. return to the same ratios as before the allotment of

share options without contribution.

Regardless of the characteristics of these changes in Share Certificates, etc. Holding Rate and Holding Ratio of Share Certificates, etc. as described above, if based on the current legal system, obligations are imposed based on both regulations based on Share Certificates, etc. Holding Rate and Holding Ratio of Share Certificates, etc. when allotted, there are cases where it would be inappropriate from the viewpoint of providing proper information to investors. Therefore, it is pointed out that appropriate treatment with understanding of the characteristics of changes in Share Certificates, etc. Holding Rate and Holding Ratio of Share Certificates, etc. as described above is necessary.

Next, under the current legal system, regarding shares which securities companies own or hold through their underwriting operations, there are stipulated exceptions making them not subject to Share Certificates, etc. Holding Rate and Holding Ratio of Share Certificates, etc. until the day after the payment date. In a commitment type rights offering, in a case where the securities company's act of commitment is positioned as a underwriting of securities and the above exception is applied, it is pointed out that a longer grace period is necessary considering the period for the securities company to exercise share options and acquire shares, etc.

Based on the items pointed out above, appropriate treatment of regulations on tender offers and on reports of possession of large volume should be studied.

(b) Correspondence to Securities Regulations of Foreign Countries

In accordance with certain foreign country's securities regulations, due to the exercise of share options allotted in rights offering to shareholders who are residents of that country, it is possible that the issuer must register with that country's authorities and perform ongoing disclosure. It has been pointed out that there are cases in Europe where in order to

avoid such burdens required to abide these regulations, rights are not allotted to certain foreign resident shareholders, or restrictions are placed on the exercise of rights by these shareholders. Following this idea, also in Japan, regarding the lack of conflict between the shareholder equality principle and restrictions on the exercise of rights by foreign resident shareholders in order to prevent excessive application of foreign securities regulations, it is appropriate to work on arrangement of concepts under current laws.