

**Clarification of Legal Issues Related to the Development of the
Japan's Stewardship Code**

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Financial Services Agency

Introduction

About this Material

- On February 26, 2014, the Council of Experts Concerning the Japanese Version of the Stewardship Code (the “Council”) formulated and published “Principles for Responsible Institutional Investors” «Japan’s Stewardship Code»- To promote sustainable growth of companies through investment and dialogue - (the “Code”).
- The Code requests institutional investors to conduct constructive dialogues with investee companies to enhance medium- to long-term investment returns for their clients and beneficiaries by promoting the sustainable growth of the investee companies. Going forward, institutional investors are expected to incorporate the purpose of the Code and actively take measures to further enhance dialogue with their investee companies.
- Regarding dialogue between institutional investors and investee companies, it was pointed out in the Council’s discussions that, in terms of encouraging institutional investors to incorporate the purpose of the Code, legal clarification is necessary so that there is no confusion in relation to Japan’s existing legal framework when institutional investors conduct dialogues with investee companies.
- This material is intended to clarify the interpretation of legal issues stated below based on the points raised in the Council’s discussions as described above.
 1. Relationship between “Act of Making Important Suggestions” under the large shareholding reporting system and ”dialogue with investee companies” under the Code.
 2. Relationship between (i) the “Joint Holder” concept under the large shareholding reporting system and ”a Person in a Special Relationship” under the tender offer rules (TOB rules) and (ii) collective engagement under the Code.
 3. Relationship between “undisclosed Material Facts” under the insider trading regulations, etc., and “dialogue with investee companies” under the Code.

«Notes about this material»

- * Details of this material are intended purely to describe the general interpretation of laws, etc. at the time of writing, not to provide specific answers as to whether to apply the relevant laws and regulations to individual businesses. It should be noted that whether to apply relevant laws and regulations to each business should be decided substantially in view of the purpose of the relevant laws and regulations based on all facts in relation to the business in question.
- * Details of this material are not intended to restrict the decision-making process of the investigating authorities and legal judgments including application of penalties. Neither are the details of this material intended to guarantee the FSA's future legal interpretation.

1. Relationship between “Act of Making Important Suggestions” under the large shareholding reporting system and “dialogue with investee companies” (1)

Matters pointed out in the Council meetings

- Under the large shareholding reporting system, a special reporting system is in place for financial instruments business operators, etc., who repeatedly and continuously execute buy/sell transactions in their daily operations, etc.
 - In this system, the frequency of and deadline for submissions of the large shareholding report and the change report relating to the large shareholding report are relaxed for eligible investors. (See next page.)
 - However, in view of preventing the use of such special treatment ignoring its originally intended purposes, a holder of shares, etc. may not use the special reporting system if it commits to the Act of Making Important Suggestions.
 - As such, when conducting dialogues with investee companies, institutional investors need to be aware of what actions are subject to the Act of Making Important Suggestions.
- ⇒ In past meetings, we were advised of the following in order to promote dialogues between institutional investors and investee companies:
- It is necessary to further clarify and specify what constitutes an Act of Making Important Suggestions, in order to eliminate uncertainties.

(Note) This issue matters only when an institutional investor with more than a 5% shareholding of a specific listed company conducts a dialogue with the company, and therefore does not cover dialogues between institutional investors and listed companies in its entirety.

<Reference: Outline of the large shareholding reporting system and the special reporting system>

[Outline of the large shareholding reporting system]

- **The large shareholding reporting system** is:

The following requirements imposed on large shareholders, aimed at increased market transparency and fairness, and ultimately investor protection by promptly providing information concerning large shareholdings to investors, since such information is important in terms of influence over management, as well as supply and demand in the market:

<Obligations for large shareholders>

1. If an investor becomes a large shareholder (more than a 5% stake):
The investor must submit a large shareholding report within five business days of acquiring more than a 5% stake in a company.
2. If there are any significant changes such as a 1% or greater increase/decrease in the percentage of shareholdings following the submission of the large shareholding report :
The investor must submit a change report within five business days of the change.

[Outline of the special reporting system]

- **The special reporting system** is:

A system that allows financial instruments business operators, etc., who repeatedly and continuously execute buy/sell transactions of shares, etc. in their daily operations, etc. to report under relaxed frequency of and deadline for submissions of the large shareholding report and the change report relating to the large shareholding report, in consideration of the excessive clerical burden on such investors if detailed disclosure on a trade-by-trade basis is required.

- In ordinary circumstances, the large shareholding report and the change report must be submitted within five business days from the day the cause of the submission occurs. However, those eligible for the special reporting system need only to judge whether to assume reporting obligations on the pre-registered bi-monthly reference date and submit the report within five business days of the reference date.

<Qualifications of the use of the special reporting system>

1. The investor's ownership ratio does not exceed 10%.
2. The investor is not committing to the Act of Making Important Suggestions. (See next page.)

- **The Act of Making Important Suggestions** is:

Suggestion of matters specified in the relevant Order as those that will cause material changes or materially influence the issuer's business activities at the general shareholders meeting of investee companies or to their corporate directors.

- **Corporate director:**

A corporate director means a managing member, a director, an executive officer, an accounting advisor, a statutory auditor, or an equivalent thereof, and includes those deemed to possess control that is either equaling or surpassing the foregoing, regardless of name (Article 14-8-2 of the Order for Enforcement of Financial Instruments and Exchange Act ("Order")).

- **Matters specified:**

The following matters concerning the issuer or its subsidiary (Article 14-8-2 of the Order):

1. Disposal of and acceptance of assignment of important assets
2. Borrowing in a significant amount
3. Appointment or dismissal of Representative Directors
4. Material changes to the composition of corporate directors
5. Appointment or dismissal of managers or other important employees
6. Establishment, change, or abolition of branches or other important organizations
7. Share exchange, share transfer, company split or merger
8. Assignment, acceptance of assignment, suspension or abolishment of all or part of business
9. Material changes to the company's dividend policy
10. Listing or delisting
11. Material changes to the company's capital strategy
12. Dissolution
13. Declaration to commence bankruptcy proceedings, rehabilitation proceedings, or reorganization proceedings

1. Relationship between “Act of Making Important Suggestions” under the large shareholding reporting system and “dialogue with investee companies” (2)

Interpretation already indicated

- With regard to what actions are considered an Act of Making Important Suggestions under the large shareholding reporting system, for which special reporting system is not applicable, the following interpretation has been indicated in the “Response to Public Comments” that was published by the Financial Services Agency (FSA) in 2008 when the concept of the Act of making Important Suggestions was established:

<Excerpts from the Response to Public Comments>

Outline of the comment	View of the FSA
<p>There may be debates as to whether an act is considered an Act of Making Important Suggestions, etc., depending on the situation of the suggestion, such as making a suggestion at the request of the issuer. Please indicate what you consider as criteria for Acts of Making Important Suggestions.</p>	<p>Whether an act is classified as an Act of Making Important Suggestions, etc., is determined on a case-by-case basis according to related regulations, but must fulfill the following three criteria:</p> <p>i) Firstly, <u>the objective contents of the act in question matches any one of listed items of Article 14-8-2 (i) of the Order.</u> If any of the listed matters contains terms such as “important” or “a large amount of,” such matters for which the degree is mild do not fall under an Act of Making Important Suggestions, etc.</p> <p>ii) Secondly, the act in question <u>is intended to cause material changes to or materially influence the issuer’s business activities,</u> in accordance with the text in Article 27-26 (i) of the Financial Instrument and Exchange Act. Thus, any act that exerts heteronomous influence regardless of the issuer’s proactive business policy is classified as such an act. However, even if the act fulfills criterion i), it is unlikely to fulfill this criterion ii) when, for example, the issuer simply requested an opinion, or it is a statement of opinions at dialogues with shareholders that the issuer proactively set (e.g. in results reporting, IR presentations, etc.).</p> <p>iii) Finally, the act in question <u>is a “suggestion.”</u> Even if the act fulfills criteria i) and ii), it is unlikely to fulfill this criterion iii) when, for example, an analyst or fund manager simply asked a question as part of their research activities. In any case, the matter will ultimately be judged on a case-by-case basis.</p>

1. Relationship between “Act of Making Important Suggestions” under the large shareholding reporting system and “dialogue with investee companies” (3)

Clarification of Interpretation

- Based on the “Response to the Public Comments” above, the FSA further clarified the legal interpretation as follows in order to remove confusion as to what specific actions are considered as the Act of Making Important Suggestions under the large shareholding reporting system.

(Question) In dialogue with investee companies, will the following actions of institutional investors with more than a 5% holding ratio of share certificates, etc. be considered as the Act of Making Important Suggestions?

- (1) Request for an explanation regarding the investee company’s management policy, etc. (including policies regarding governance, capital strategy, etc.)
- (2) Explanation regarding their policy for exercising voting rights and disposing of/holding shares, and specific plan for exercising voting rights and disposing of/holding the investee company’s shares
- (3) Request for an explanation of the investee company’s stance given (2) above
- (4) Asking questions at a general shareholders’ meeting
- (5) Request for resolution of specific matters at a general shareholders’ meeting
- (6) Requesting the investee company to change their business policy, etc. if the investee company’s explanation for (3) & (4) above does not match their policy
- (7) Requesting the investee company to change their business policy, etc. in a situation other than that described in (6) above

(Answer)

1. An action is considered the Act of Making Important Suggestions if all of the following conditions are satisfied.
 - (i) The objective contents of the matters suggested match any one of items listed under Article 14-8-2 of the Order for Enforcement of Financial Instruments and Exchange Act

- (ii) The act in question is **intended to cause material changes to or materially influence** the issuer's business activities
 - (iii) The act in question is classified as a **"suggestion"**
2. It should be noted that **actions (1) through (4)** listed above are basically **highly unlikely to be classified as the Act of Making Important Suggestion** because these are viewed as the act of sharing knowledge with the investee company, not as a "suggestion" as in (iii) above.
 3. On the other hand, **actions (5) through (7)** above are the actions of a large shareholder with more than 5% holding ratio of share certificates, etc. requesting changes to the investee company's business policy, etc. and resolutions at general shareholders meetings.

Therefore, basically, as long as the contents of these actions are as listed under the Order (criteria (i) above), **it is highly likely that they will be deemed as "suggestions" (criteria (iii) above) that are "intended to cause material changes or materially influence the issuer's business activities" (criteria (ii) above).**

4. It should be noted, however, that, **depending on an individual situation, some actions are less likely to be identified as the Act of Making Important Suggestions, even though they are classified as actions (6) and (7) described above.**
5. Specific examples of above paragraph 4 include **cases where a shareholder provides its own opinion in response to an issuer's request, or where a shareholder meets with an issuer at a meeting that was set up voluntarily by the issuer^(*) and provides its opinion, etc.** In this situation, **the investor's actions are intended to respond to an independent request by the issuer** whose intention is to refer to the shareholder's opinion or to acquire the shareholder's support by enhancing the shareholder's knowledge of the company's earnings, strategies, etc., through dialogue. Thus, **these cases are less likely to be regarded as acts with an intention to materially change or influence the issuer's business activities (criteria (ii) above).**

^(*) Earnings results briefings, Investor Relations meetings (including small meetings), etc.

2. Relationship between (i) the “Joint Holder” concept under the large shareholding reporting system and “a Person in a Special Relationship” under the tender offer rules (TOB rules), and (ii) collective engagement under the Code (1)

Matters pointed out in the Council meetings

- Under the large shareholding reporting system, shareholders are required to calculate their shareholding percentage by including the shareholding of a Joint Holder.*
 - * A Joint Holder is defined as a shareholder who has agreed with another shareholder to jointly exercise voting rights and other shareholder rights. (See page 9)
- In addition, under the TOB rules, purchasers are required to calculate their ownership percentage by including the ownership of a Person in a Special Relationship.*
 - * A Person in a Special Relationship is defined as a person who has agreed with a purchaser to jointly exercise voting rights and other shareholder rights. (See page 9)
- Subsequently, in a situation where an institutional investor takes action against an individual investee company in a joint effort with other investors and they have agreed to exercise voting rights and other shareholder rights:
 - Such an investor is required to take into account the ownership of the other investors in complying with the large shareholding reporting system (i.e., to submit the large shareholding report and the change report relating to the large shareholding report), since such other investors are considered as Joint Holders under large shareholding reporting system.
 - Such an investor is required to take into account the ownership of the other investors in complying with the TOB rules (i.e., to purchase shares, etc., through TOB), since such other investors are considered as Persons in a Special Relationship under the TOB rules.

⇒ Therefore, as pointed out by some council members in past meetings:

- It is necessary to further clarify the definition of “person who has agreed to jointly exercise voting rights and other shareholder rights” to avoid confusion when an institutional investor takes action toward an individual investee company jointly with other investors.

(Reference) The Code does not adopt the principle that encourages institutional investors to act collectively with other investors towards the individual investee companies as in the UK Stewardship Code. Of note, the Japanese Version of the Stewardship Code does refer to the benefit of exchanging views with other investors as a means for conducting better engagement with investee companies (Guidance 7-3, Principle 7).

<Reference: Outline of “a Joint Holder” under the large shareholding reporting system and “a Person in a Special Relationship” under the TOB rules>

[Outline of “a Joint Holder” under the large shareholding reporting system]

- Under the large shareholding reporting system, a shareholder, etc., is required to calculate its shareholding ratio by including the shareholding of a person that corresponds to any one of the following (“Joint Holder”) (Article 27-23 of the Financial Instruments and Exchange Act):
 1. A person that has agreed to obtain or assign shares, etc., in cooperation with the shareholder
 2. A person that has agreed with the shareholder to jointly exercise voting rights and other shareholder rights.
 3. A person that has a special relationship with the shareholder, such as a certain capital relationship or a family relationship.

[Outline of “a Person in a Special Relationship” under the TOB rules]

- The TOB rules is:

A rule that requires prior disclosure and provision of fair selling opportunities to all shareholders with regard to a purchase, etc., of a large amount of shares, etc., primarily outside the market, from the viewpoint of securing transparency and fairness in transactions that may influence the control of a company (i.e., transactions that will lead to a certain shareholding percentage through the purchase, etc.).
- Under the TOB rules, a purchaser of shares, etc., is required to calculate its ownership ratio by including the ownership of a person that is classified as any one of the following (“**Person in a Special Relationship**”) (Article 27-2 of the Financial Instruments and Exchange Act):
 1. A person that has agreed to obtain or assign shares, etc., in cooperation with the purchaser.
 2. A person that has agreed with the purchaser to jointly exercise voting rights and other shareholder rights.
 3. A person that has agreed with the purchaser to mutually transfer or receive the shares in question after the purchase of the shares.
 4. A person that has a special relationship with a purchaser, such as a certain capital relationship or a family relationship.

2. Relationship between (i) the “Joint Holder” concept under the large shareholding reporting system and “a Person in a Special Relationship” under the tender offer rules (TOB rules), and (ii) collective engagement under the Code (2)

Interpretation already indicated

- The FSA have published its interpretation regarding under what circumstances an investor is deemed as a Joint Holder in the Q&A for the large shareholding reporting system as below.

<Excerpts from the Q&A for the large shareholding reporting system>

(Q) Will the concept of Joint Holder apply if shareholders discuss the exercise of voting rights at the general shareholders meeting?

(A) As far as it is a discussion, the Joint Holder concept will not apply.

However, if an agreement is reached to exercise voting rights jointly as a result of such discussion, the concept will apply.

(Q) Will the Joint Holder concept apply if shareholders jointly exercise their rights to propose?

(A) In this case, investors are clearly in agreement as to collectively exercising shareholder’s rights to propose, thus the concept will likely apply.

2. Relationship between (i) the “Joint Holder” concept under the large shareholding reporting system and “a Person in a Special Relationship” under the tender offer rules (TOB rules), and (ii) collective engagement under the Code (3)

Clarification of interpretation

- In order to remove confusion regarding in which specific cases the concepts of Joint Holder under the large shareholding reporting system and a Person in a Special Relationship under the TOB rules are applicable, [the FSA further clarified the legal interpretation as follows](#).
- The explanation below uses the Joint Holder concept under the large shareholding reporting system. The same interpretation is considered to be applicable to the specific cases for the concept of a Person in a Special Relationship under the TOB system.

(Question) If a holder of shares, etc., exchanges opinions with another investor about exercising voting rights in terms of a specific investee company, or agrees with other investor to jointly request the investee company to set up a dialogue and to change the company’s business policy, etc., will the other investor be considered a Joint Holder under the reporting requirements for large shareholdings?

(Answer) The concept of a Joint Holder applies when an investor agrees with another investor to **execute voting rights and other shareholder rights** jointly (Article 27-23 of the Financial Instruments and Exchange Act).

The “voting rights and other shareholder rights” most likely include, **the legal rights of shareholders including rights to propose, rights to inspect books and records, rights to request that the company file a lawsuit against erring directors, etc. in addition to voting rights.**

Therefore, basically, as long as the agreement between an investor and another investor remains within the scope of **shareholders’ general activities that are unrelated to the exercise of legal rights**, the other investor **will unlikely be considered** a Joint Holder.

(Reference) The term “rights” legally means the legally guaranteed powers available to a legal entity for claiming certain interests for its own.
 (“Legal Dictionary, 9th Edition” Gakuyo Shobo)

(Question) When a holder of shares, etc. communicates to another investor its plan for the exercise of voting rights, and such plan matches with that of the other investor, will the other investor be considered a Joint Holder under the reporting requirements for large shareholdings?

(Answer) The concept of a Joint Holder applies when an investor **agrees** to execute voting rights and other shareholder rights **jointly** (Article 27-23 of the Financial Instruments and Exchange Act)

The FSA's view is that the agreement referred hereto means **an agreement containing the element of a mutual or unilateral promise to act in future (written or verbal and explicit or implied); and differs from a mere exchange of views.**

Therefore, basically, in the situation where an investor, in the discussions, etc. with another investor, **communicates their plan for the exercise of voting rights and finds that the plan is the same as the other investor,** the other investor **will unlikely be considered** a Joint Holder.

3. Relationship between “undisclosed Material Facts” under the insider trading regulations, etc., and “dialogues with investee companies” under the Code (1)

Matters pointed out in the Council meetings

- Insider trading regulations

These regulations prohibit trading of shares, etc., of a listed company by a corporate insider who has come to know undisclosed Material Facts concerning the businesses of the company (only when such facts were obtained in the course of his/her duties), or an individual who received such facts from such corporate insider, before such material facts were made public.

- Regulations against the disclosure of inside information and trading recommendations

These regulations prohibit a corporate insider who has come to know undisclosed Material Facts concerning the businesses of a listed company (only when such facts were obtained in the course of his/her duties) from disclosing inside information or recommending trading to another person with the intention to encourage the person to make a profit by trading before such material facts were made public.

⇒ Therefore, some council members pointed out in past meetings that it is possible that insider trading regulations unnecessarily interfere with in-depth dialogues between institutional investors and investee companies.

3. Relationship between “undisclosed Material Facts” under the insider trading regulations, etc., and “dialogues with investee companies” under the Code (2)

Outlining ways of thinking

- There are two aspects to the opinion regarding the possibility of the insider trading regulations, etc., interfering with in-depth dialogues between institutional investors and investee companies.
 1. Viewpoint of investee companies
 - Disseminating undisclosed Material Facts to institutional investors will potentially breach the regulation against the disclosure of inside information and trading recommendations.
 - ⇒ In turn, if the undisclosed Material Facts are not communicated to institutional investors in fear of breach, an in-depth dialogue might not be achieved.
 2. Viewpoint of institutional investors
 - If an institutional investor comes to know undisclosed Material Facts, and enters into trading shares etc. of listed companies before such information is made public, such investor is potentially in breach of the insider trading regulations.
 - ⇒ If the investor refuses to receive such information completely in order to avoid the risk of breaching the regulations, an in-depth dialogue might not be achieved.

3. Relationship between “undisclosed Material Facts” under the insider trading regulations, etc., and “dialogues with investee companies” under the Code (3)

Interpretation already indicated and clarification of interpretation

- In terms of the afore-mentioned 1.:
 - The FSA have already published the following interpretation in the “Q&A regarding the regulations against the disclosure of inside information and trading recommendations” (published in 2013):

<Excerpts from the “Q&A regarding the regulations against the disclosure of inside information and trading recommendations”>

(Q) Will investor relations activities by officers and employees of a listed company, etc., who have knowledge of undisclosed Material Facts, be subject to regulations against the disclosure of inside information and trading recommendations?

(A) It is considered that public relations activities concerning the company’s managerial and financial statuses are widely conducted with investors, among others, at listed companies, etc., as part of the company’s investor relations activities. General recommendations to invest in the company conducted as a part of such IR activities, in principle, will not be subject to the regulations, because they generally do not involve the intention to encourage another person to make a profit by trading prior to publication of Material Facts.

⇒ Thus, it is considered that the intention to encourage another person (institutional investors) to make a profit by trading prior to publication of Material Facts is generally not involved in the in-depth dialogues between institutional investors and investee companies. Therefore it is also considered that the dialogues between institutional investors and investee companies, in principle, will not be subject to the regulations against the disclosure of inside information and trading recommendations.

- In terms of the **afore-mentioned 2.**
 - The insider trading regulations prohibit trading of shares, etc., of a listed company by a corporate insider who has come to know undisclosed Material Facts (only when such facts were obtained in the course of his/her duties), or an individual who received such facts from such corporate insider, prior to publication.
 - ⇒ Therefore, when there is a possibility that an institutional investor considers it necessary to receive undisclosed Material Facts in order to conduct an in-depth dialogue with an investee company, it is considered necessary for the investor to take specific measures, such as halting the trading of shares of such investee company prior to conducting the dialogue, to avoid breaching the insider trading regulations.
 - ⇒ In view of the above, the Code maintains that institutional investors should essentially remain cautious about receiving undisclosed Material Facts through dialogue with investee companies; and when an institutional investor needs to receive undisclosed Material Facts based on a special relationship with an investee company, they should first take necessary steps to secure compliance with insider trading regulations before having dialogue with the company (Guidance 4-3 to Principle 4 and Note 10).

3. Relationship between “undisclosed Material Facts” under the insider trading regulations, etc., and “dialogue with investee companies” under the Code (4)

- It should be noted that institutional investors are generally able to have constructive dialogue with investee companies based on public information without receiving information on undisclosed Material Facts; thus, a statement to that effect is inserted at the beginning of Guidance 4-3, Principle 4 in the Code.