Interim Report

of

Advisory Group on Improvements to TSE Listing System

March 27, 2007

Tokyo Stock Exchange, Inc.

Advisory Group on Improvements to TSE Listing System

CONTENTS

I. Preface 2

II. Deliberation by Advisory Group 2

III. Basic Policy for Improving Listing System 3

IV. Direction of System Improvements 4

1. Improvements to System relating to Corporate Actions 4

(1) Timely Disclosure 4

(2) Developing Codes of Conduct for Listed Companies 7

(i) Codes of Conduct for Corporate Activities 7

(ii) Rules for Stock Issuance 8

(iii) Corporate Governance 10

(iv) Conflict of Interest Transaction with Interested Parties 13

(v) Management Buy-Out Transaction or Acquisition by Parent or Controlling Shareholder 16

(vi) Enforcement Measures of Codes of Conduct for Listed Companies 18

(3) Listing System for Subsidiaries 18

(4) Listing system for class shares 21

(i) Background of the study 21

(ii) Adoptable Schemes 22

(iii) Overseas Environment 23

(iv) Perspective on Study 25

(v) Direction of System Improvements 27

2. Improving the Market System 29

(1) Marketplace sections 29

(2) Emerging-Stock Markets 30

(3) Combining trading units 32

(4) Reviewing criteria for liquidity 34

3. Enforcement Measures of the Listing Rules 36

V. How to Proceed from Here 39

Member List 40

Progress of Discussions 41

I. Preface

The significance of capital markets in society in recent years continues to grow dramatically. It is an important role expected to be played by the Tokyo Stock Exchange ("TSE"), as an operator of a market, to ensure a fair and sound market and to fulfill the function of a capital market while still respecting the free economic activity of listed companies. In this regard, events such as corporate accounting scandals or corporate activities creating confusion over the secondary market that are likely to severely damage market credibility by causing unexpected damage to shareholders or investors have been occurring all too often recently, which tells us we need to strengthen the rules of the capital markets from the perspective of enhancing protection of investors and appropriate functioning of secondary markets. And making TSE a more attractive exchange for market participants, such as investors and listed companies, and increasing TSE's competitiveness in the global markets will contribute to re-energizing capital markets in Japan.

In June 2006, TSE announced the Development of a Comprehensive Improvement Program for the Listing System (the "Program") as its execution policy for achieving these objectives, and the Advisory Group has put the discussion of these items high on its list of priorities among those items labeled in the Program as "items to be considered for practical approaches" and "items to be considered for deliberation." It has prepared this interim report to identify the direction that TSE should follow when putting the outcome of deliberations into practice in the future.

The Advisory Group hopes TSE will review the Program and use its best endeavors to promptly improve its listing system in light of the contents of the Interim Report.

Listing systems vary from one exchange to the next in Japan, as each has its own unique features and its own operations policies, so as a matter of course each of them is expected to use their own efforts to improve or enhance their respective listing systems regardless of the contents of the Interim Report. At the same time, however, there may be times when exchanges, as the collective market infrastructure, are all called on to improve their listings system across the board, so the Advisory Group decided, specifically with respect to such items, to refer in the Interim Report as should be implemented in concert with other securities exchanges.

II. Deliberation by Advisory Group

The Advisory Group has held a total of nine meetings since its first meeting on September 11, 2006, discussed each topic, such as the basic policy for improving the listing system, improvements to the system relating to corporate activities (timely disclosure, developing

codes of conduct for corporate activities, listing systems for subsidiary listings, listing systems for class shares), improvements to market systems (market sections, meaning of the Mothers market, integration of trading units, review of criteria for maintaining liquidity of listed shares), and enforcement measures of listing rules.

The Advisory Group decided to call this report an "interim" report because it has only focused on the items thought to be high on the list of priorities; it has not completely deliberated all items pointed out in the Program and there might also be other issues raised in the future that require its deliberation.

III. Basic Policy for Improving Listing System

TSE should comprehensively review its listing system from the perspective of appropriately fulfilling its secondary market function while also protecting and respecting shareholders and investors, increasing listed companies' corporate value, and improving listed companies' international competitiveness. Also, when engaging in that review, TSE should pay particular attention to enhancing management not only of companies to be newly listed, but also of listed companies, and it should take into account the importance of being consistent with international markets.

From these perspectives, the Advisory Group considers it desirable for TSE to establish the following five policies as its basic policy for improving the listing system:

- In working toward ensuring the market's soundness, TSE should make its system such that it will encourage market participants, such as listed companies, to develop an even greater awareness of themselves as one of the many important players who together make up the securities market.
- TSE should ensure market transparency by utilizing disclosure of corporate information to an even greater degree.
- TSE should respond appropriately to corporate actions from the perspective of appropriately ensuring investor protection and market performance.
- TSE should work toward making the market easier to use for its participants, such as listed companies.
- In working toward realizing the above policies, TSE should take into account an importance of being consistent with international markets.

IV. Direction of System Improvements

1. Improvements to System relating to Corporate Actions

(1) Timely Disclosure

Current State and Issues

The incessant barrage of all manner of corporate information can have a great impact on transactions taking place in securities markets, so TSE has established a timely disclosure system based on the Rules on Timely Disclosure of Corporate Information by Issuer of Listed Securities (the "Timely Disclosure Rules") as a set of rules to require listed companies to make timely and appropriate disclosure of corporate information that might have a material impact on investors' investment decisions. The timely disclosure system, together with disclosure systems prescribed by law (such as requirements for submitting securities reports under the Securities and Exchange Law), plays a material role in the disclosure system of securities markets in Japan.

Under the current timely disclosure system, TSE has established a list of individual events relating to the business, operation or performance of listed companies, and when any such an event occurs, the system requires prompt disclosure of the details of the event (unless the event falls under the standards set by TSE as immaterial to investors' investment decisions; the "Immateriality Standards"). TSE has also established catch-all provisions that aim to cover those events not specified in the list of individual events but that could have a significant impact on investors' investment decisions, requiring prompt disclosure of contents if any such event occurs.

It has been approximately seven years since the current framework[1] was introduced, and in this era of considerable changes in the corporate environment, growing trends toward diversification, and increasingly complex corporate activities, it is believed that further system improvements that facilitate investors to access accurate investment information is required and the importance of timely disclosure is more highly regarded than ever before. On another front, criticisms have been raised that there have been cases where companies have not proactively disclosed information that did not correspond to the formal disclosure requirements even though the information effectively was material for investors making investment decisions, and further demands have been made that details being disclosed be accurate and match the needs of investors. And taking into account that corporate actions are

[1] The timely disclosure of corporate information has been made a requirement pursuant to the request addressed to listed companies in June 1974 (TSE, "Request for Timely Disclosure of Corporate Information" (TSE Listed Company Regulatory Service and Compliance No. 525 issued on June 7, 1974)); however, in September 1999, TSE set out requirements, methods and other matters with respect to timely disclosure that at the very minimum issuers of listed securities should comply with, and it put into force the Timely Disclosure Rules, which make the listed companies responsible for timely disclosure.

becoming increasingly complicated and diversified heading into the future, it is desirable that any events actually important to making investment decisions be proactively disclosed in addition to disclosures made based on formal requirements.

In light of these circumstances, TSE has constantly reviewed its timely disclosure system,[2] but in order to maintain investors' confidence in securities markets and to allow the timely disclosure system to appropriately fulfill its functions, TSE should conduct counterchecks to test whether the current framework of timely disclosure is in line with actual practice and review the Immateriality Standards and the details being disclosed and the like in light of the actual circumstances.

Direction of System Improvements

Timely disclosure of corporate information is crucial for ensuring that prices are formed reasonably and fairly in the securities markets and is an important bedrock on which investors build their confidence in the securities market. Listed companies should therefore endeavor to immediately, accurately and fairly make their timely disclosure of corporate information important for making investment decisions, at all times keeping their investors in mind.

In looking into proper practices for timely disclosure, it is appropriate to once again take stock of the basic thinking underlying the concept of timely disclosure, to remember that the purpose for a timely disclosure system is to contribute to the investment decisions of investors, and to bring the system in line with, from the investor's point of view, the current state of timely disclosure by causing listed companies to accurately disclose their corporate information that is important for investors to make investment decisions.

More specifically, although it would seem desirable for listed companies to be able to decide whether or not information needs to be timely disclosed based on the actual materiality of the information for making investment decisions, at the same time there are fears that material information might not be disclosed because of bias decision-making on the part of listed companies or that practice for timely disclosure might be negatively affected. In light of these fears, and in order to ensure information that is material to making investment decisions is accurately disclosed while still placing due emphasis on smooth disclosure, it would be

[2] For example, in January 2005, TSE obliged listed companies to pledge to the effect that they will in good faith endeavor to make timely and appropriate disclosure of corporate information to investors, and in the Timely Disclosure Rules, TSE specified the basic philosophy of timely disclosure as being that "listed companies shall be fully aware that timely and appropriate disclosure of corporate information to investors is essential to maintaining a sound securities market, so listed companies should endeavor to conduct their operations in good faith by thoroughly promptly, accurately and fairly disclosing corporate information, keeping their investors in mind at all times." In December 2006, TSE further enhanced its practice by establishing a system for inspecting information contained in improvement reports concerning timely disclosure of corporate information and the like, which are reports that are submitted by a listed company that is not in compliance with the disclosure requirement.

desirable to set out events that should be disclosed in accordance with formal requirements of individual events and the Immateriality Standards, just as is set out in the present system, and then take measures that would encourage wide-ranging disclosure of events that are deemed to be of a high degree of practical importance for making investment decisions even if those events do not correspond to those formal requirements.

And because in taking those measures there is a fear of causing confusion among listed companies when it comes to deciding what information is required to be disclosed and what is not, a certain degree of care is required, such as showing a particularized description of what kinds of matters should be considered important or by showing in guidelines specific matters that should be disclosed.

Furthermore, as it is very important that listed companies receive accurate explanations of information that is material for making investment decisions and the individual details thereof, and also from the perspective of practicing smooth disclosure, TSE should incorporate, in the guidelines, the details of individual disclosure and timing thereof in the form of disclosure instructions or instructions on how to complete disclosing documents or in the form of Q&As.

TSE should re-check the Immateriality Standards as to whether the Standards are in line with the degree of materiality relevant for making investment decisions. In particular, it would be appropriate to revise the Immateriality Standards with regard to disclosure of listed companies to be made based on consolidated financial information, instead of the current framework of determining materiality in the light of non-consolidated financial values (except for information regarding stock dividends or other information of non-consolidated basis), as in recent years it is more common for investment and management decisions to be made on a consolidated basis and consolidated financial information became more popular in disclosure documents as well.[3] Also, from the perspective of appropriately disclosing information that is material for making investment decisions, it is desirable for TSE to review wherever necessary the Immateriality Standards with respect to, for example, profit levels in the case of small profits, dissolution of subsidiary, or forecast of listed subsidiary.

In addition, the understanding and awareness and proactive response of listed companies toward timely disclosure are required in order for timely disclosure to better fulfill its functions, so it is appropriate that TSE continues its activities of enlightening listed companies with regard to timely disclosure to promote further awareness of it. Moreover, TSE has improved its timely disclosure network (TDnet) and timely disclosure viewing service as infrastructures for prompt transmission of disclosure information to investors and for

[3] Recently, securities reports and earnings digests mainly use financial information prepared on a consolidated basis, and the statutory quarterly reporting system that is scheduled to be put into practice in FY 2008 is expected in principle to require disclosure based on consolidated financial statements.

immediate use by investors. In this connection, it is appropriate for TSE to further enhance the functions of these services in line with the needs of investors, in tandem with EDINET (the electronic disclosure system for disclosure documents such as securities reports under the Securities and Exchange Law), and in collaboration with other securities exchanges, particularly by introducing to TDnet the XBRL (eXtensible Business Reporting Language; the computer language that facilitates prompt analysis and processing of financial information).

(2) Developing Codes of Conduct for Listed Companies

(i) Codes of Conduct for Corporate Activities

Current State and Issues

Historically, TSE has maintained a neutral stance when it comes to being involved in the corporate activities of listed companies, because it has believed that listed companies will behave in the manner and exercise the discipline expected of public companies, in accordance with their own decisions. Under the current TSE listed company rules, timely disclosure is positioned in the center of the listed company rules and other rules such as rules for corporate activities are very limited.[4]

As a result of the recent changes in the form of liberalization and the deregulation of the Corporation Law or other laws and ordinances, an intensifying of competition in the global marketplace, and a greater increase of the role and importance of securities markets, there are several corporate activities which might impair the well-being of the markets. TSE, as a market operator, is required to appropriately respond to such corporate activities from the perspective of protecting shareholders and investors.

In foreign countries, securities exchanges establish their own rules for the corporate activities of listed companies and endeavor to keep investors' confidence in markets,[5] so high expectations are being placed on TSE to function as their equivalent in Japan, from the perspective of ensuring a fair and sound market as well.

Direction of System Improvements

As a securities-market operator, it is appropriate for TSE, in addition to enhancing corporate information disclosure, to develop codes of conduct for corporate activities and ask listed companies to operate properly in accordance with the codes, while taking care not to

[4] Specifically speaking, the Timely Disclosure Rules contain provisions dealing with such matters as efforts to change or maintain the level of investment units to or at a desirable level (Article 1-2), duties imposed when adopting takeover defense measures (Article 1-3) and efforts with respect to stock splits or other stock recombinations (Article 1-4).

[5] For example, NYSE sets out its rules on corporate governance and other corporate matters in NYSE Company Manual Section 3 "Corporate Responsibility."

excessively restrict the freedom of their conduct, from the perspective of protecting shareholders and investors and operating fair and sound market.

The Advisory Group believes TSE should improve the listing system by: (i) describing generally its expectation that the listed companies should respect the functions of secondary market and the rights of shareholders and investors, and (ii) explicitly stipulating the matters for which TSE asks listed companies to be responsible for as participants of a securities market; in addition to conventional imposition of obligation for appropriate timely disclosure.

For each code of conduct, it is appropriate to reorganize matters that TSE has historically requested of listed companies(*) and listed company rules containing codes of conduct(**) and rules for corporate activities to be newly established as discussed later in this section (2) of the Interim Report.

* The development of the environment so as to facilitate the exercise of voting rights at shareholders' meetings (including deconcentration of dates of holding shareholders' meeting, and early dispatch, posting on website and provision of English translation of convocation notice) and implementing a system that would prevent insider trading.

** The duties imposed when adopting takeover defense measures, efforts to change or maintain level of investment units to or at a desirable level, and efforts with respect to stock splits or other stock recombinations.[6]

(ii) Rules for Stock Issuance

Current State and Issues

Nowadays, criticisms are raised that the rights of ordinary shareholders are sometimes impaired by the dilution of shareholder value for reasons such as the issuance of future-priced convertible bonds (commonly known as MSCBs) or the issuance of shares in large volume by listed companies.

TSE, to date, has not established any rule that would restrict such an issuance of shares. Although the Corporation Law imposes a restriction that if a company intends to increase the total number of shares it is authorized to issue under its articles of incorporation only by amending the relevant articles, and the company must make the total number of shares to be authorized at or less than four times the total number of outstanding shares before such authorization[7] (the so-called "four-times" cap). To this extent, a priority is given to the benefit of financing rather than the benefit of maintaining shareholders' shareholding ratio and the company is allowed to freely issue new shares (or sell treasury stock) by obtaining a resolution of the board of directors as long as the issuance is made within the number set out

[6] See note 4 supra.

[7] Article 113, Paragraph 3 of the Corporation Law.

in the articles of incorporation (except for the case of an issuance of shares under favorable terms for particular shareholders or for unfair issuance, in either of which case a special resolution of shareholders' meeting is required).[8]

A look at restrictions imposed in foreign countries shows that in the United States there is no restriction similar to the "four-times" cap,[9] but there are rules imposed by securities exchanges (or registered securities associations) under which shareholder approval is required prior to any issuance of shares other than through a public offering if the issuance is made in a number equal to or in excess of 20% of the outstanding number of shares.[10] The countries within Europe, including the United Kingdom, in principle allow shares to be allocated only to existing shareholders, and both the Listing Rules and Companies Act 1989 of the United Kingdom require a special resolution of the shareholders' meeting be adopted before allocating shares to any person other than existing shareholders.[11]

Direction of System Improvements

As to this point, because the dilution of the shareholding ratio is not subject to a suspension of issuance under favorable terms or unfair issuance, a concern was raised by some members of the Advisory Group that the "four-times" cap under the Corporation Law is too lenient as a restriction on listed companies when compared with the restrictions applied by authorities of foreign countries. Also, from the perspective that shareholder approval should be required before issuance of a large number of shares, which may result in a change of control, a

[8] Article 201 of the Corporation Law.

[9] Although a number of states in the United States require a company incorporated within that state to set out its total number of issuable shares in its articles of incorporation (8 Del. C. §102(a)(4) for the State of Delaware, NY CLS Bus Corp §402(a)(4) for the State of New York).

[10] NYSE Company Manual §312.03. The provision states that shareholder approval is required (a) for equity compensation plans, (b) prior to the issuance of common (dividend) stock to a related party, (c) prior to the issuance of common (dividend) stock equal to or in excess of 20 percent of the voting power outstanding before the issuance of such stock or issuance of common (dividend) stock equal to or in excess of 20 percent of the number of shares of common (dividend) stock outstanding before the issuance of the common stock, or (d) prior to an issuance that will result in a change of control of the issuer. However, as to (c) above, it is set out that shareholder approval is not required in case of issuance by public offering or in case of "bona fide private financing" (which means a sale in which a broker-dealer purchases the stocks from the issuer or an acquisition in which no one purchaser acquires more than five percent of the shares or voting power before the sale) and in consideration for the price at least as great as each of the market and book value of the issuer's common stock. Nasdaq Manual §4250(i) sets out similar rules.

[11] LR 9.3.11R, Companies Act 1985 §89. However, in the investors guidelines (Pre-Emption Group "Disapplying Pre-Emption Rights — A Statement of Principles"), issuance of shares less than 5% in a one-year period and less than 7.5% in a three-year period is considered to be routine and pre-emption rights are likely to be disapplied at a general meeting of shareholders in advance. For regulations in European countries, see Weil, Gotshal & Manges, LLP. "Comparative Study Of Corporate Governance Codes Relevant to the European Union And Its Member States," p.38.

proposal was made that shareholder approval should in principle be required for any issuance of shares in a number in excess of the total number of outstanding shares before the issuance.

In the meantime, there were counterarguments that a securities exchange to establish a rule requiring such a shareholder approval, which is more than is required under the Corporation Law, would restrict listed companies' ability to gain flexible financing or business alliance opportunities.[12]

Therefore, the Advisory Group considers it would be acceptable for TSE just to enhance or otherwise enrich information disclosure systems as to issuance of shares. However, the Advisory Group believes that TSE's decision whether to establish a rule as a securities exchange to require shareholder approval as to issuance of shares requires more careful discussions, and the matters concerning issuance of shares should be given further consideration.

Incidentally, a working level group of the Japan Securities Dealers Association has reported on the treatment of future-priced convertible bonds (MSCBs) and TSE should consider its responses to requests made in the report by addressing securities markets as well.[13]

(iii) Corporate Governance

Current State and Issues

With recent corporate or accounting scandals and changes in economic or social conditions, and in the light of requests from society to set up a fair and sound market and increase its reliability, there is now a greater need to promote corporate governance among listed companies from the perspective of protecting shareholders and investors by improving listed companies' management ability.

To date TSE has simply asked listed companies to enhance their corporate governance themselves, but there is almost no rule referring to corporate governance in the listing rules, save for obligations to make disclosure.[14]

Under the Corporation Law, listed companies are required to establish boards of directors

---

[12] In addition, there was an indication that it is not desirable that a resolution of shareholders' meeting, as defined under the Corporation Law, is required for issuance of shares because in such case a company needs to stipulate it in the articles of incorporation under the Corporation Law (Article 295, Paragraph 2 of the Corporation Law).

[13] Discussions by the Japan Securities Dealers Association and its member firms with regard to proper practice of underwriting examination, "Proper Practice of Underwriting Examination, Treatment of MSCBs by Member Firms: Final Report of Working Group for Discussing Proper Practice of Underwriting Examination Used at Member Firms" (February 22, 2007) (http://www.jsda.or.jp/html/houkokusyo/hikiuke4.html).

[14] The establishment of a board of directors is set out in Article 4, Paragraph 1, Item 4 of the Criteria for Listing Examination of Stock.

and have corporate auditors (or committees in the case of a company with committees).[15] However, among companies with corporate auditors, only large corporations[16] are required to establish boards of corporate auditors,[17] and although large corporations and companies with committees are required to have independent auditors, companies with corporate auditors other than large corporations are not required to have them.[18] Also, as to outside officers, the Corporation Law simply provides that the board of corporate auditors in a company with a board of corporate auditors must be made up of a majority of outside auditors,[19, 20] and as to outside directors,[21] each committee of a company with committees must be composed of directors, a majority of which must be outside directors.[22]

At present, almost all of the companies listed on TSE are companies with corporate auditors (97.5%).[23] Also, although almost all of the companies listed on TSE who are companies with corporate auditors have elected outside auditors, only 40.8% of those have elected outside directors,[24] and it is apparent from these facts that many of these companies is oversight mainly by corporate auditors. In addition, while 23.6% of the companies listed on Mothers do not have a board of corporate auditors, merely 0.1% on the First Section and 1.8% on the Second Section do not have board of corporate auditors.[25]

With respect to other countries, the New York Stock Exchange ("NYSE") requires listed companies to (i) have a nominating/corporate governance committee, a compensation committee and an audit committee, (ii) compose each committee entirely of independent

---

[15] Article 327, Paragraphs 1 and 2 of the Corporation Law.

[16] "Large corporation" means a company that has reported 500,000,000 yen or more as stockholder's equity or 20,000,000,000 yen or more as liabilities (Article 2, Item 6 of the Corporation Law).

[17] Article 328, Paragraph 1 of the Corporation Law. As to the establishment of a board of corporate auditors, the Corporation Law stipulates measures to enhance the audit function of a company by requiring it to elect three or more auditors (Article 335, Paragraph 3), make up at least one-half of the board by outside auditors (Article 335, Paragraph 3), appoint a full-time auditor (Article 390, Paragraph 2), and the like.

[18] Article 327, Paragraphs 5 and Article 328 of the Corporation Law. The Securities and Exchange Law requires *all* listed companies to obtain an audit certificate for financial statements from certified public accountants or audit firms (Article 193-2), but the Corporation Law only requires a large corporation or a company with committees to have an independent auditor. The establishment of an independent auditor as an organization within a company has the effect of granting authorization under the Corporation Law to an outside independent auditor.

[19] "Outside auditor" means an auditor of a company who had never been in the past a director, employee or any other related person of the company or its subsidiary (Article 2, Item 16 of the Corporation Law).

[20] Article 335, Paragraph 3 of the Corporation Law.

[21] "Outside director" means a director of a company who is not and has never been in the past a director executing the affairs of the company, an employee or any other related person of the company or its subsidiary (Article 2, Item 15 of the Corporation Law).

[22] Article 400, Paragraph 3 of the Corporation Law.

[23] "TSE Listed Companies White Paper of Corporate Governance 2007" (the "White Paper"), p.12.

[24] See note 23 supra. The White Paper, p.14.

[25] See note 23 supra. The White Paper, p.22.

directors, and (iii) have a board of directors composed of a majority of independent directors.[26] The London Stock Exchange ("LSE") requires listed companies to disclose whether they comply with provisions set out in Section 1 of the Combined Code,[27] setting out standards of good practice in relation to issues such as establishment of committees and proportion of independent directors on the board, and LSE also requires them to set out the reasons for non-compliance if they are not in compliance with the Code.[28] These requirements have a substantial influence on practice.

Direction of System Improvements

The Advisory Group considers that, from the perspective of promoting the improvement of corporate governance among listed companies, it would be desirable for TSE to set out a code of conduct to listed companies as a guide to best practice. In light of how other countries are handling such matters, TSE, as a securities exchange, should contribute to better corporate governance in order to improve investors' confidence in the securities market as being fair and sound.

Nevertheless, there are two views as to whether TSE should clearly state its position on establishing outside directors and on the criteria for independence of outside officers. One is that TSE should not state its position, because a diverse range of corporate governance styles should be allowed; the other is that it would be ok to do so, because TSE's stating its desired form of best practice would not necessarily conflict with the concern about diversity. In addition, the Advisory Group, in considering such issues, needs to conduct more detailed analysis of the current state of corporate governance, and because these issues are significantly important, it would be preferable to have more time to discuss them carefully.

The Advisory Group therefore believes that it should continue to discuss the kinds of measures TSE should implement with respect to overall corporate governance issues, including having outside directors and testing the independence of outside officers. One way to continue the discussion is to establish subgroups within the Advisory Group and let them discuss the issues in conjunction with the code for issuance of shares mentioned above.

In this connection, especially from the perspective of improving the management ability of

---

[26] NYSE Company Manual §303A.

[27] Financial Reporting Council "Combined Code on Corporate Governance" (http://www.frc.org.uk/corporate/combinedcode.cfm.

The Combined Code recommends that (i) the chairman should meet the independence criteria (A.2.2), (ii) listed companies should have the nomination, remuneration and audit committees, (iii) a majority of members of the nomination committee and entire members of the remuneration and audit committees should be independent non-executive directors (A.4.1, B.2, C.3.1), and (iv) at least half (or at least two in a smaller company) of the board, excluding the chairman, should be composed of the independent non-executive directors (A.3.2).

[28] LR 9.8.6R(5)(6).

companies listed on Mothers, it would be appropriate to proceed with discussions with respect to making it a requirement (after setting a certain number of years as a grace period before the requirements come into effect) for the listed companies to at least have a board of corporate auditors (or a committee in the case of companies with committees) and an independent auditor.

Also, the Advisory Group believes that it is appropriate for TSE to require all listed companies to establish a system to ensure the appropriateness of operations (known as an internal control system under the Corporation Law), which is required only of large corporations or companies with committees under the Corporation Law.[29] It is also appropriate for TSE to require all listed companies to deliver reference materials for the exercise of voting rights at a shareholders meeting, which is required only of companies with 1,000 or more shareholders under the Corporation Law.[30, 31]

(iv) Conflict of Interest Transaction with Interested Parties

Current State and Issues

Criticisms have been raised that, in relation to the listing of a company with a parent company or held by controlling shareholders who have a majority of voting rights, minority shareholders might unjustly suffer a loss in the company's pursuit of the interests of its parent company or controlling shareholders in any transaction with interested parties, including the parent. In particular, it is common for listed companies to have a vast number of minority shareholders and such conflicts of interest transaction are important issues from the perspective of protecting ordinary investors, who are generally categorized as minority shareholders.

On this point, the Corporation Law prescribes that a disclosure to and an approval of a board of directors is necessary for any conflict-of-interest transaction between a director and a company,[32] but the scope of conflict-of-interest transactions is literally construed and does not generally include any transaction between a company and its parent or controlling

[29] Article 348, Paragraph 3, Item 4; Article 348, Paragraph 4; Article 416, Paragraph 1, Item 1(v); and Article 416, Paragraph 2 of the Corporation Law.

[30] Article 301 and Article 298, Paragraph 2 of the Corporation Law. As of July 2006, there are 61 companies listed on the TSE (53 on the Second Section and 8 on Mothers) whose respective number of shareholders holding one or more than one unit of shares is below 1,000. However, in practice, it is believed that all listed companies deliver the reference materials to their entire shareholders at the same time as they dispatch convocation notices of shareholders' meeting.

[31] This requirement does not preclude listed companies from delivering to all of its shareholders reference materials for solicitation of proxies under the Securities and Exchange Law upon any convocation of shareholders meeting, instead of reference materials for the exercise of voting rights under the Corporation Law.

[32] Article 356 of the Corporation Law.

shareholder.[33]

Also, oversight by outside auditors, or outside directors who serves as members of the audit committee, as to any transaction with interested parties is expected,[34] but if we take a look at the current state of outside auditors and outside directors of listed companies with parents, 54.9% of outside auditors of companies with corporate auditors with parents and 58.0% of outside directors of companies with committees with parents are from the parents[35] and so some are skeptical as to how effective the oversight of the outside officers of listed companies be over any transaction between the parents and the listed companies.

When we turn to foreign countries, we see that in the United States, the NYSE mentions that an oversight of potential conflicts of interest by an audit committee (or a comparable body) is appropriate,[36] and Nasdaq sets out that listed companies must be approved by their audit committee or other independent committee with respect to all transactions with interested parties subject to disclosure in their annual report.[37] Also, under the laws of the State of Delaware, the law under which a number of listed companies are incorporated, controlling shareholders owe a fiduciary duty directly to minority shareholders, and since strict standards apply such that any self-dealing with its controlling shareholders must be fair ("entire fairness" standards), it is common practice to obtain the approval of an independent committee.[38]

In the case of LSE, under the listing rules, an approval of shareholders other than interested

---

[33] In addition to disclosure pursuant to the requirements respectively from the Securities and Exchange Law and TSE, the Corporation Law requires a company to disclose in its supplementary statement to the business report a detailed statement of any transaction between the company and a third party that would cause a conflict of interest between the company and its controlling shareholders (Article 128, Item 2 of the Enforcement Regulations of the Corporation Law) and further an explanatory note regarding any transaction with related parties (Article 140 of the Corporate Calculation Regulations).

[34] The Corporation Law sets out the details of the internal control system, which under that law large corporations and companies with committees must have, as "a system to ensure the proper operation of a corporate group comprised of the company and its parent and subsidiary" (Article 98, Paragraph 1, Item 5 of the Enforcement Regulations of the Corporation Law). If a corporate auditor (or board of corporate auditors) or an audit committee determines that the outline of his or her or its company's internal control system set out in the business report contains anything improper, he or she or it must set out that fact and the underlying reason for it in the company's audit report (Article 129, Paragraph 1, Item 5; Article 130, Paragraph 2, Item 2; and Article 131, Paragraph 1, Item 2 of the Enforcement Regulations of the Corporation Law).

[35] See note 23 supra. The White Paper, p.20 and 26.

[36] NYSE Company Manual §307.00.

[37] Nasdaq Manual §4350(h).

[38] The burden of proof will shift if the approval of the independent committee or a majority of minority shareholders is obtained. However, the mere existence of an independent committee does not shift the burden of proof, and (i) the independent committee must be fully informed and (ii) the independent committee must be truly independent and have a true ability to negotiate with large company at arm's length (*Kahn v. Lynch Communication Systems, Inc.*, 638 A.2d 1110 (Del. 1994)).

parties is required for any material transaction with the interested parties,[39] and the definition of interested parties includes substantial shareholders who are entitled to exercise 10% or more of the outstanding voting rights.

Direction of System Improvements

It is appropriate for TSE to establish a code for transactions with interested parties, from the perspective of protecting minority shareholders.

If it is to do so, the following three levels of codes for transactions with interested parties could be considered. First, and least strictly, TSE should require listed companies to disclose their systems for securing fairness in transactions with interested parties; second, TSE, as a securities exchange, should set out best practice guides with respect to such systems and require listed companies to explain why they do not comply with such practice, if they do not; and third and most strictly, TSE should require listed companies to obtain the approval of a special committee or an equivalent body for any material transaction with interested parties. Determining which of those three levels TSE should require listed companies to comply with depends on, among other things, whether to limit the types of material transactions to those involving parent companies only or to include such transactions involving substantial shareholders other than parent companies as well. In short, the Advisory Group believes it is desirable to apply the third and strictest level of those three code levels only to the types of transactions that are material transactions with parent companies.[40]

So for any material transaction with parents (including other subsidiaries of the same parent company) or controlling shareholders, it would be appropriate for TSE to require listed companies with parent companies or controlling shareholders to implement measures preventing the harmful effects arising from conflicts of interest, such as by obtaining the approval of special committees composed of outside officers or equivalent bodies.

Also, in order to further enhance oversight by an outside officer (i.e., an outside auditor of a company with a board of corporate auditors or an outside director of a company with committees) over any transaction between a company and its parent, it would be desirable to require such companies with parent companies to elect to their boards or committees outside officers who are not from their parent companies.

Because with any material transactions with related parties,[41] listed companies make a

---

[39] LR11.1.7R.

[40] On the other hand, there is a view that it is in one sense difficult to require companies in Japan to comply with a uniform procedure to the effect that companies must always obtain approval of an independent committee comprised of outside directors, because companies in Japan do not always have independent directors, unlike companies in the United States.

[41] Article 8-10 of the Financial Statement Regulations [the Regulations Concerning Terminology, Forms and Method of Preparation of Financial Statements, Etc. (Ministry of Finance Ordinance No. 59 of 1963)]

disclosure through important notes in their securities report, fulfill statutory requirements for disclosure in statements of affairs of their parent companies or other related companies, and make disclosure concerning their parent companies[42] or other related companies as required by TSE,[43] it would be desirable for TSE to consider, with respect to the disclosure of details of such transactions, reviewing or otherwise revising, as necessary, matters to be disclosed based on the development of disclosure practice while making sure not to divulge trade secrets or to place excessive obligations or other burdens on companies.

(v) Management Buy-Out Transaction or Acquisition by Parent or Controlling Shareholder

Current State and Issues

MBOs[44] by listed companies and acquisitions of listed companies by their parent companies or controlling shareholders also involves conflicts of interest between directors or parent companies or controlling shareholders and minority shareholders, as has been the case with transactions with interested parties, and there are issues concerning the asymmetry of information and the possibility of unfairness involved in the decision making of boards of directors.

As to this point, amendments to the Securities and Exchange Law concerning tender offers have made it mandatory to submit a declaration of intent report and have strengthened the requirement for providing information, and the Law now requires concrete descriptions be provided with regard to measures securing the fairness of offer price and avoiding conflicts of interest. TSE also asks listed companies to enhance their disclosure of information regarding organizational restructuring (including mergers), tender offers and management buy-outs,[45] and we can see improvements in reducing to some extent the asymmetry of information.

In contrast, as to the possibility of unfairness involved in the decision making of boards of directors, more consideration needs to be given to whether a response under corporate governance should be required or not. In particular, TSE should consider management buy-out

---

and Article 15-4 of the Consolidated Financial Statement Regulations [the Regulations Concerning Terminology, Forms and Method of Preparation of Consolidated Financial Statements (Ministry of Finance Ordinance No. 28 of 1976)].

[42] Article 24-7 of the Securities and Exchange Law.

[43] Article 2, Paragraph 11 of the Timely Disclosure Rules.

[44] "MBO" stands for management buy out. In general, management buy-out means an acquisition of a company, etc., by the management of the company, etc. (see note 25 of instructions to complete Form No. 2 of the Prime Minister's Office Ordinance Concerning the Disclosure of Tender Offer by an Acquirer Other Than the Issuing Company).

[45] TSE, "Request for Enhancing Disclosure of Information on Organizational Restructuring Such As A Merger, Tender Offer Or MBO Transaction" (TSE Listed Company Regulatory Service and Compliance No. 1338 issued on December 13, 2006).

transactions more carefully, as much criticism has been raised recently that the interests of ordinary shareholders are not adequately protected and there are some who point out that there are cases where companies have engaged in activities that conflict with shareholders interests, such as by manipulating information to reduce share prices.

In foreign countries, for example in the United States, the laws of the State of Delaware apply a strict standard of "entire fairness" (mentioned above) to management buy-out transactions and tender offers made by controlling shareholders,[46] and the common and established practice is now to require approval from independent committee therefor. Also, in the United Kingdom, the board of the offeree company must obtain competent independent advice on any offer and the substance of such advice must be made known to its shareholders, and where a director has a conflict of interest, he should not normally be joined with the remainder of the board in the expression of its views on the offer and the nature of the conflict should be clearly explained to shareholders.[47]

Direction of System Improvements

The Advisory Group believes that because management buy-out transactions and acquisitions by parent companies or controlling shareholders might involve a possibility of unfairness in directors' decisions, TSE should establish certain rules to enhance corporate governance relating to these transactions in addition to those on information disclosure.

In implementing these measures, TSE should, from the perspective of protecting investors and minority shareholders, require listed companies to take some measures against management buy-out transactions and acquisitions by parents or controlling shareholders similar to those implemented to prevent the harmful effects of conflicts of interest in material transactions with parent companies or controlling shareholders.

Especially in the case of management buy-out transactions, the risk of conflicts of interest arising is extremely high, because the people in management themselves will directly or indirectly be involved in the transaction as the acquirers, and with the number of such transactions strongly expected to increase in the future, then it is worthwhile holding such a transaction subject to the codes of conduct and necessary and important for TSE to prepare its

---

[46] Any tender offer by a controlling stockholder would not be subject to the "entire fairness" standards if it fulfills all of the following: (i) the offer is subject to a nonwaivable majority of the minority tender condition, (ii) the controlling shareholder commits to consummate a short-form merger promptly after increasing its holdings above ninety percent, (iii) the controlling shareholder has made no retributive threats, and (iv) the independent directors are given complete discretion and sufficient time to react to the tender offer, by (at the very least) hiring their own advisors. (*In re Pure Res. S'Holders Litig.*, 808 A.2d 421 (Del. Ch. 2002))

[47] The Panel on Takeovers and Mergers "The City Code on Takeovers and Mergers" (http://www.thetakeoverpanel.org.uk/new/codesars/DATA/code.pdf).

responses. For this reason, it would be desirable for TSE to make even greater use of such codes of conduct with respect to management buy-out transactions in order to thoroughly prevent the future occurrence of any harmful effects due to such conflicts of interest.

(vi) Enforcement Measures of Codes of Conduct for Listed Companies

The Advisory Group believes the codes of conduct should be implemented generally in a way different from the measures traditionally implemented on the premise that any noncompliance therewith will result in delisting. This is because the codes should be implemented to encourage listed companies to develop an even greater awareness of themselves as players of a securities market in working toward ensuring a fair and sound securities market. Yet there are types of conduct that listed companies must comply with, from the perspective of protecting shareholders and investors and operating the market, and TSE should deal with any instances of noncompliance with those standards of conduct more strictly.

With that in mind, it would seem appropriate for TSE to set different standards for each noncompliance matter, such as from conduct that could end up in the delisting of shares, to conduct that ought to be made known to the public, and to conduct that TSE does not specifically set out enforcement measures for in order to encourage listed companies to regulate their own actions in accordance with best practice.

When TSE then determines what kind of enforcement measures should be applied to each category of conduct, TSE should first apply stricter enforcement measures against conduct (i) the compliance with which by listed companies is highly necessary and the cost of compliance to which is not too expensive when compared with the outcome thereof and (ii) with respect to which TSE can provide more specific terms on the types of conduct TSE expects listed companies to comply with.

On the other hand, for any conduct (i) the compliance of which by all listed companies is not always necessary (including cases where the cost of compliance would be far more greater than the expected outcome) or (ii) the types of which TSE expects listed companies to comply with are abstract, TSE should apply less strict measures to enforce the codes of conduct against the listed companies.

(3) Listing System for Subsidiaries

Current State and Issues

Of the companies listed on TSE, 13.5% are companies with parent companies (11.9% are those with parents that are also listed on any domestic securities exchange and 1.6% are those

with non-listed parents).[48]

The situations in foreign countries vary from country to country. For example, listed companies in the United States and the United Kingdom are more likely to have diverse shareholder bases, whereas majority listed companies in European countries other than the UK have controlling shareholders.[49] In the United States and the United Kingdom, it is general practice to list a subsidiary as a preliminary step toward spinning-off the subsidiary, but keeping a subsidiary listed on a continual basis is very rare. On the other hand, in European countries other than the UK, it is more general to have a company with a parent company or controlling shareholder to be listed, and this tells that such a listing practice is not unique to Japan. The current state of foreign countries is the result of each company determining for itself with its form of listing is right and wrong based on its voluntary managerial decision, and there is no securities exchange in the world that prohibits subsidiaries from listing their shares on the market.

The listing of subsidiaries has national economic significance in that it provides new investment opportunities to the market, and we may also find a positive significance in the sense that it maintains the synergy between it and its parent company and holds a parent company responsible for the discipline of its subsidiary. In contrast, relationships between parent companies and minority shareholders of the subsidiary contain potential conflicts of interest, and there is a risk that the subsidiary conducts its business for the benefit of the parent to the detriment of the interests of overall shareholders. Further, there are risks of a parent company listing its subsidiary mostly for the purpose of recording profits on sales of subsidiaries' shares at the closing of accounts, or a parent company acquiring full ownership in the subsidiary only a short period of time after its listing, or a parent company attempting to double gain the benefit of an initial public offering by listing its subsidiary that engages in the same core business as the parent company conducts. As just described, listing subsidiaries is not always an optimal capital policy for most market players.

TSE has implemented several institutional provisions in order to prevent the harmful effects in relation to listing subsidiaries. First of all, TSE has made a certain degree of independence of a company from its parent company or other related parties a requirement under the criteria for the listing examination[50] (however, once a company is listed, TSE does not require it to

---

[48] See note 23 supra. The White Paper, p.10.

[49] According to Barca & Becht, *The Control of Corporate Europe* (January 2002), the percentage of companies who have a shareholder (which includes companies and individuals) with majority of votes is 1.7% among NYSE listed companies and 2.4% in the UK, whereas they represent 64.2% of listed companies in Germany and 56.1% thereof in Italy (figures for the UK are based on 1992 data; the others are 1996 data).

[50] Criteria for the listing examination for the Main Market is as set out below (Supplementary Rules to Criteria for Listing Examination of Stock 1.(2)d). (i) Neither the parent company, etc., nor the applicant

comply with that requirement, with a few exceptions such as in the case of the examination for transferring the company to the First Section, and any listed company that comes to have a parent company would not be subject to an examination by TSE). Second, TSE, in addition to requiring of a listed company timely disclosure of material corporate information of its parent company or other related parties, requires disclosure on a regular basis of information such as the position of the listed company within a corporate group of its parent company or other related parties and current state of the listed company's independence from its parent or other related parties.[51] And third, TSE has stipulated that a company's planning to become a wholly-owned subsidiary of another company soon after its own listing is sufficient grounds for TSE not to accept, or to cancel an already-accepted, listing application.[52]

Direction of System Improvements

Subsidiary listing is not always an optimal capital policy for most market players, but the Advisory Group believes it is not appropriate for TSE to prohibit all subsidiary listings as the listing system of a securities exchange based on the facts that (a) information on issues of subsidiaries on the market is widely available and investors can make their own investment decisions based on that information, (b) assuming TSE prohibits all subsidiary listing from its listing practice, legal schemes such as those using the listing of a subsidiary as a preliminary step toward a future spin-off (a scheme commonly known as an "equity carve out") would be restricted, although they should not be, and (c) there is no securities exchange in the world that restricts or prohibits the listing of subsidiaries. However, from the perspective of encouraging investors and of any company considering future subsidiary listing to take care, TSE should clearly state its basic position that the listing of subsidiaries is not always an encouraged practice.

In addition, under the current listing system, TSE requires a company being newly listed to have a certain degree of independence from its parent or other related parties at the time of its listing, but in light of the fact that the actual operation of a subsidiary varies in accordance with the management policy of each corporate group to which the subsidiary belongs, it may

---

company forces or induces transactions which are disadvantageous to the applicant or parent company, etc. (ii) the applicant company and the parent company, etc., shall not conduct business or other transactions under significantly different terms than normal transactions. (iii) The applicant company cannot be considered a de facto business unit of its parent company, etc. (iv) The stock issued by the parent company, etc., has been listed on a securities exchange in Japan (if it's not listed in Japan, then the applicant company shall ensure that the corporate information of that company is disclosed fairly in the same manner as such information is disclosed by a company listed in Japan). The criteria for listing examinations of the Mothers market are (i), (ii) and (iv) above.

[51] Article 2, Paragraph 11 of the Timely Disclosure Rules.

[52] Supplementary Rules to Security Listing Regulations 9.b. There is no rule in the Listing Rules prohibiting a listed company from becoming a wholly-owned subsidiary.

not always be appropriate to focus attention only on ensuring independence from a parent. Accordingly, the Advisory Group believes that TSE, for subsidiary listing, should not only examine the independence at the time of the new listing examination, but also enhance the responses to cases where a listed company that became a subsidiary of a parent company, the continual preventive measures against any harmful effects of conflicts of interest, and the measures to widely spread information to investors of the risks involved when investing in a listed subsidiary.

Specifically, TSE should publicly announce its basic policy on subsidiary listing, and in the meantime, improve the listing system in the direction of enhancing measures to prevent any harmful effects of conflicts of interest between a parent company and minority shareholders that are likely to surface as a result of the subsidiary listing. For example, TSE could, as a code of conduct for corporate activities, implement measures to prevent harmful effects of conflicts of interest in a material transactions between subsidiaries and their controlling shareholders, require election of outside officers not from its parent company or take over measures.[53]

Moreover, since it is far less meaningful for a subsidiary engaging in a core business substantially the same as the business conducted by its listed parent company, it would be desirable that TSE implements restrictive measures for such a listing in concert with other securities exchanges in Japan.

In any case, it would be desirable to continue discussions on the listing examinations relating to the listing of subsidiaries in the light of these discussions of the Advisory Group.

(4) Listing system for class shares

(i) Background of the study

Recently, class share regulations have become flexible due to amendments to the Commercial Code and the establishment of the Corporation Law, leading to the introduction of class shares becoming easier, and there has been an increase in threats of hostile takeovers. Under these circumstances, various sectors have made proposals on the listing of class shares especially in relation to takeover defense measures.[54]

In contrast, TSE sets out that issue of class shares with veto rights may be delisted upon certain conditions.[55] However, there is no other express provision with respect to the class of

---

[53] See Section 1.(2)(iv) Conflict of Interest Transaction with Interested Parties (p.13)).

[54] Such as “Further Revision of M&A Legislation is Needed” (December 12, 2006) issued by Nippon Keidanren and “Publication of points of discussion on modalities for equitable takeover defense measures” (November 10, 2005) issued by the Corporate Value Study Group, the Ministry of Economy, Trade and Industry.

[55] Article 2, Paragraph 1, Item 17 of Criteria for Delisting of Stock and Supplementary Rules thereof

shares to be listed and listed shares are traditionally assumed to be shares of common stock.[56], [57]

Class shares can be categorized in respect to (i) economic rights such as surplus dividend and residual asset distribution, (ii) voting rights such as shares with restricted voting rights and shares with a structure similar to multiple voting shares using the number of shares composing a basic lot ("Voting Class Shares"), and (iii) others such as being acquirable shares, fully acquirable shares, and transfer restricted shares. In the Interim Report, the Advisory Group gives preferential consideration to Voting Class Shares as the pressing issue among these categories.

In the meanwhile, we believe that TSE should permit the listing of preferred stock without voting rights on certain conditions as before because preferred stock is free from risk bearing mentioned below. In addition, if TSE allows the listing of Voting Class Shares without the listing of common stock, it would be necessary to consider whether to allow the listing of preferred stocks without the listing of common stock.

(ii) Adoptable Schemes

Before considering what the listing system for Voting Class Shares ought to be, let us review the schemes to be adopted under the Corporation Law of Japan.

Firstly, it is expected that the "conditions of exercise of voting rights"[58] will set out that "the number of shares held by a shareholder is less than a specified portion of the total number of outstanding shares (e.g. 20%)" as a scheme using shares with restricted voting rights ("Voting Restrictions Plan"). In this case, even if an acquirer emerges, he may not exercise his voting rights at a general shareholders meeting if the number of shares he holds is equal to or greater than the specified portion of the total number of outstanding shares.[59]

1.(14)a(c).

[56] With respect to the term "common stock", in the Interim Report, it means shares whose details are automatically set out under the Corporation Law where a company does not have any provision in its articles of incorporation in accordance with Articles 107 and 108 of the Corporation Law (Kanda, Hideki (2007) *Kaishahou* [Corporation Law] 9th Edition, Kobundo, p.68) and "common (dividend) stock" means shares having the same priority as other shares with respect to surplus dividend and residual assets distribution.

[57] TSE has established an independent listing system for preferred stock and tracking stock on the assumption that the issuer has already listed its shares (Article 3, Paragraph 1, Item 1-a of the Special Regulations of Securities Listing Regulations concerning Preferred Stock and Preferred Securities, etc.).

[58] Article 108, Paragraph 2, Item 3 (ii) of the Corporation Law.

[59] A similar scheme is to set out the number of shares held by a shareholder to be more than a specified portion of the total number of outstanding shares (e.g. more than 20%) as a "certain event" (Article 107, Paragraph 2, Item 3(i) of the Corporation Law) for delivering non-voting shares in exchange for such shares. In this case, an acquirer may exercise its voting rights up to the certain amount of shares, and the excess amount of shares will be converted to non-voting shares. This structure is similar to voting caps adopted in foreign countries.

Characteristics of the Voting Restrictions Plan include that corporate acquisition becomes extremely difficult,[60] a shareholder cannot exercise any voting right represented by shares he holds when it is more than the specified portion of shares,[61] and major shareholders may not exist unless an exception is set out in the articles of incorporation.[62]

It is important to note that there are contrary views on the Voting Restrictions Plan, namely that (i) voting restriction by shareholding ratio is unequal treatment of shareholders permitted by law, and raising no issues with respect to Article 115 of the Corporation Law,[63] and (ii) voting restriction by shareholding ratio is not permitted by law in general and is invalid unless it is clearly necessary and reasonable.[64]

Next, a structure similar to multiple voting shares adopted in foreign countries is foreseeable. For example, a company issues Class A shares and Class B shares, both with voting rights, and the number of shares composing a basic lot (i.e. the number of shares composing one vote) is 100 shares and 1,000 shares respectively. Class A shares are held by management, the parent company and the like and only Class B shares are listed ("Multiple Voting Share Plan"). Under this scheme, if a company makes the number of Class A shares 9.1% of the total number of outstanding shares of Class A and Class B shares, then voting rights represented by Class A shares may constitute the majority of total voting rights.[65]

Characteristics of the Multiple Voting Share Plan include that some shareholders may secure control rights with a relatively small contribution, a hostile takeover may not be achieved without the consent of the major shareholders (in the abovementioned example, shareholders holding Class A shares), or conversely a company may be acquired with the major shareholders' consent.

(iii) Overseas Environment

In the U.S., NYSE maintained the policy of "One Share – One Vote" until the 1980s.[66] However, each securities exchange has different rules - for example NASD has no restrictions.

---

[60] For a takeover, an acquirer needs to pass a special resolution required to amend articles of incorporation in collaboration with other shareholders when its shareholding is still under the specified ratio.

[61] Voting caps adopted in foreign countries usually allow an acquirer to exercise voting rights up to the specified ratio even when the portion of shares held by such acquirer exceeds that ratio.

[62] It is possible to set out objective termination conditions and provisions to allow an acquirer to exercise its voting rights by resolution of a general meeting of shareholders.

[63] Hadama, Masami (2005) "Takeover Defense Measures Using Shares With Restricted Voting Rights", *Shojihomu* Vol.1742, p.28.

[64] Egashira, Kenjiro (2006) *Kabushiki Kaisha Hou* [Laws of Stock Corporations], Yuhikaku, p.126.

[65] A similar scheme is that (i) a company issues and lists non-voting shares while its management, parent company or the like continue to hold unlisted voting shares of common (dividend) stock, or (ii) a company issues and lists both Class A Shares and Class B Shares (or both voting shares of common (dividend) stock and non-voting shares).

[66] There were some exceptions, such as Ford Motor Company.

Therefore, in order to standardize the rules of each securities exchange, the U.S. Securities and Exchange Commission established Rule 19c-4. Although the court ruled it unconstitutional, it was later reflected in the rules of each securities exchange.

Under Rule 19c-4, listed companies are, in principle, prohibited from (i) imposing any restrictions on the voting power of shares based on the number of shares held, (ii) imposing any restrictions on the voting power of shares based on the length of time such shares have been held , (iii) any issuance of securities through an exchange for shares of an outstanding class of the common (dividend) stock, in which the securities issued have voting rights greater than or less than the per share voting rights of listed shares, and (iv) any issuance of securities pursuant to a stock dividend, or any other type of distribution of stock, in which the securities issued have voting rights greater than the per share voting rights of any listed share. However, companies are not prohibited from (i) issuing securities pursuant to an initial registered public offering, and (ii) issuing any class of securities with voting rights not greater than the per share voting rights of any listed share through a registered public offering or a bona fide merger or acquisition. Under these rules, it has become an established practice in the U.S. to issue multiple voting shares upon initial public offering.

Currently, approximately 10% of companies making public offerings in the U.S. list dual class shares.[67] Approximately 10% of all listed companies in the U.S. issue dual class shares,[68] and Google Inc. received attention when it issued multiple voting shares upon initial public offering in 2004.

On the other hand, in the EU, the Directive on Takeover Bids finally came into effect in May 2004 after years of discussion. The Breakthrough Rule,[69] which invalidates Voting Class Shares under certain conditions, was adopted. However, the Directive sets out that the Member States may reserve the right not to require companies to apply the Breakthrough Rule ("Optional Arrangements").

---

[67] Smart, S. and Zutter, C. "Control as a motivation for underpricing: a comparison of dual and single-class IPOs" 69 J. Fin. Eco. 85 (2003)

[68] Investor Responsibility Research Center Inc., "Corporate Takeover Defenses 2004"

[69] The Breakthrough Rule provides that (i) any restrictions on the transfer of securities provided for in the articles of incorporation of the offeree company shall not apply vis-à-vis the offeror during the time allowed for acceptance of the bid (Article 11, Paragraph 2), (ii) restrictions on voting rights provided for in the articles of incorporation of the offeree company shall not have effect at the general meeting of shareholders which decides on any defensive measures and multiple-vote securities shall carry only one vote each at such general meeting of shareholders (Article 11, Paragraph 3), (iii) where, following a bid, the offeror holds 75% or more of the capital carrying voting rights, no restrictions on the transfer of securities or on voting rights referred to in paragraphs 2 and 3 nor any extraordinary rights of shareholders concerning the appointment or removal of board members provided for in the articles of incorporation of the offeree company shall apply, and multiple-vote securities shall carry only one vote each at the first general meeting of shareholders following closure of the bid, called in order to amend the articles of incorporation or to remove or appoint board members (Article 11, Paragraph 4).

Although the listing of class shares used to be active in European countries, now such listings are on the decline and some countries are eliminating multiple voting shares and shares with restricted voting rights.

(iv) Perspective on Study

The listing system for Voting Class Shares can be considered from the following perspectives.[70]

The first perspective is concerned with whether shares with no change in control should be listed. This is the view that change in control should not be restricted, as it has social and economical advantages in that it (i) offers shareholders the opportunity to sell their shares at a price above the prevailing market price, (ii) creates wealth by exploiting synergies, and (iii) serves to discipline the management. In particular, listing under a Voting Restrictions Plan is considered inadequate from this perspective because it makes a takeover difficult and discipline by major shareholders does not work.

With respect to this view, there would be a counterargument that listing under a Multiple Voting Share Plan is the same as listing subsidiaries in that takeovers require the consent of controlling shareholders.[71] There would be another counterargument that it is possible to set out objective termination conditions or termination conditions by resolution of a general meeting of shareholders to allow an acquirer to exercise its voting rights with respect to a Voting Restrictions Plan,[72] which may reduce the effect of takeover defense to some extent.

The second perspective concerns minority shareholders being more likely to incur damage due to conflicts of interest with controlling shareholders, especially with respect to a Multiple Voting Share Plan. In other words, this is the view that a Multiple Voting Share Plan is

---

[70] The following perspectives are based on "The report of the high level group of company law experts on issues related to takeover bids" (2002) ("High Level Group Report"), and G. Ferrarini, "One Share – One Vote: A European Rule?" (2006) (available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=875620) and its relevant cited papers (especially J. Gordon (1988) and S. Grossman and O. Hart (1988)).

[71] (Regardless of a possible counterargument that there are dual class of shares under a Multiple Voting Shares unlike listing subsidiaries, a listed class of shares is not to be acquired in tender offer and no opportunity is given to sell the shares even if the controlling shareholder transfers their other class of shares) as the amended Securities and Exchange Law partly requires a tender offeror to acquire all the tendered share certificates (Article 27-13, Paragraph 4 of the Securities and Exchange Law and Article 14-2-2 of the Cabinet Order for Enforcement of the Securities and Exchange Law), if the "ownership ratio of share certificates, etc." (Article 27-2, Paragraph 8 of the Securities and Exchange Law) equals or exceeds two thirds of the total number of share certificates, etc. after the tender offer, the acquirer, with certain exemptions, must tender all the "share certificates, etc." issued by an issuer of such share certificates, etc. through the same tender offer (Article 8, Paragraph 5, Item 3 of the Cabinet Order for Enforcement of the Securities and Exchange Law, Article 5, Paragraph 5 of the Ordinance concerning Disclosure upon Tender Offer by Offeror other than Issuer), and shareholders of listed shares will have an opportunity to sell the shares they hold.

[72] Note 63 supra, at 35.

inadequate as it makes listing of companies with controlling shareholders easier and causes greater conflicts of interest, and minority shareholders are more likely to incur damage due to misuse of power by controlling shareholders.

With respect to this view, there would be a counterargument that conflicts of interest occur even when listing subsidiaries, and just as in the case of listing subsidiaries, conflicts of interest should be satisfactorily handled through a listing examination, enhanced corporate governance, enhanced disclosure after listing and the like. There would be another counterargument that although the Multiple Voting Share Plan would cause greater conflicts of interest, it is a matter of degree, and the degree of conflicts of interest would be able to be adjusted, for example, by restricting proportion of the number of shares composing a basic lot.

The third perspective concerns proportionality between risk bearing and control. This is the view that bearing the ultimate economic risk should confer proportionate control rights because the decisions ultimately affect risk bearing shareholders (holders of rights to the residual profits and of assets of the company) ("one share – one vote" principle with respect to common (dividend) stock). In other words, it is considered that if risk bearing is disproportionate to control rights, it is difficult for non-risk bearing shareholders to monitor and control operations of the company at their own cost, meaning corporate governance by shareholders becomes ineffective.

However, there would be a counterargument that at least if shareholders acquire shares based on sufficient information disclosure upon initial public offering, no issues will arise because such shareholders take the risks whether or not risk bearing is disproportionate to control rights, and founder and parent companies incur the cost of a decline in the stock price. In addition, there would be another counterargument that if TSE applies the principle of proportionality between risk bearing and control to listed companies, founder and parent companies that wish to maintain control rights may choose not to go public, which would result in a loss of potential investments from the perspective of national economy. Moreover, there is a criticism that prohibiting a Multiple Voting Share Plan is inconsistent with allowing cross-shareholding [73] and pyramid structures, [74] both of which also offer control disproportionate to the risk borne.

---

[73] There are certain restrictions on cross-shareholding as the Corporation Law of Japan prohibits a company from exercising voting rights against another company holding one-quarter or more of the total voting rights of the former company (Article 308, paragraph 1 of the Corporation Law, and Article 67 of the Cabinet Order for Enforcement of the Corporation Law).

[74] Pyramid structures means structures that make it possible to control a company through a cascade of holding companies, each owning a controlling stake in the next one, with the company at the bottom of the hierarchy being ultimately controlled through a relatively small economic stake. As there are minority, non-holding shareholders in every holding company in the chain, the ultimate shareholder with a limited economic investment in the company can exercise control over the company through this pyramid of holding companies. (High Level Group Report, p.38)

The fourth perspective concerns whether Voting Class Shares should be allowed to be introduced after listing. This is the view that the introduction of Voting Class Shares after listing may cause unexpected damage to ordinary shareholders holding listed shares, and therefore it should be considered separate from the introduction of Voting Class Shares upon initial public offering where the market investors unanimously agree to acquire shares.

However, there is an opinion that the introduction of Voting Class Shares requires a special resolution at a general shareholders meeting in order to amend a company's articles of incorporation and it is not determined arbitrarily by the board of directors. However, there would be a counterargument that a special resolution at a general shareholders meeting on amendments to the articles of incorporation does not sufficiently reflect the true intention of shareholders because (i) it is costly and difficult for minority shareholders to oppose the board of director's proposals collectively (collective action problems) and (ii) the board of directors may create a situation where its proposals tend to be approved by controlling the contents and timing of making proposals (strategic choice problems). Another reason for restricting listed companies to exploiting Voting Class Shares is that the person obtaining control rights to the listed companies does not bear capital costs, while founder and parent companies having control rights to companies bear capital costs to cover reduced stock prices in the case of an initial public offering as described above. In addition, there would be another counterargument that a special resolution is insufficient compared to the introduction of Voting Class Shares upon initial public offering where the unanimous consent of market investors is obtained.

There is a view that listed companies should be allowed to issue shares with fewer voting rights than those of already listed shares as it does not harm existing rights of ordinary shareholders.

In addition to the above, it has been pointed out that the introduction of various kinds of shares to securities markets may cause confusion among investors. There would be a counterargument that (i) TES already established a preferred securities market and no confusion has arisen in foreign markets where class shares are listed, and (ii) it is possible to respond to investors' confusion with investor protection by ensuring information disclosure and providing independent indicators so that investors can clearly differentiate between various kinds of shares.

(v) Direction of System Improvements

As mentioned above, listing Voting Class Shares is not necessarily adequate as it prevents change in control and results in distorted corporate governance of listed companies due to disproportion between risk bearing and control.

At the same time, social needs with respect to listing Voting Class Shares are increasingly reflected in enhanced flexibility of class share regulations under the Corporation Law and growing interest in takeover defense measures, and we consider it inadequate to uniformly regulate the listing of Voting Class Shares when we take into account investors' needs and current circumstances in the U.S. where class shares may be listed mainly upon initial public offering.

With respect to whether TSE should allow listing of Voting Class Shares only in the case of initial public offering, some of the Advisory Group members claimed that listed companies should be allowed to list Voting Class Shares if it does not harm (minority) shareholders' interests or if there is public notice period. However, most of the members agreed that TSE should allow companies to list class shares only upon initial public offering with the view of protecting the interests of ordinary shareholders who have already made investments.

We believe that even among Voting Class Shares, TSE should in principle allow listed companies to issue (and list) shares with fewer voting rights than those of already listed shares as it does not harm the rights of existing ordinary shareholders. However, some of the members claimed that it requires careful judgment whether such issue (and listing) does not constitute restraint on the rights of shareholders and investors as there may be various schemes for class shares.

Based on the above study, the Advisory Group believes it would be appropriate to proceed with discussions along the lines of allowing listing of Voting Class Shares, in principle, only upon initial public offering.[75] It would be appropriate to allow the issuing (and listing) by listed companies of shares with fewer voting rights than those of already listed shares, to the extent that doing so does not constitute "unreasonable restraint on the rights of shareholders."[76] When allowing listing of Voting Class Shares, it would be desirable to take measures to allow investors to make selective investments.[77]

In addition, if listing of Class Voting Shares is allowed upon initial public offering, we

[75] It would be appropriate to treat the initial listing of a company listed via another security exchange or a company newly listed due to merger with an already listed company separately from initial public offerings of class shares where no ordinary shareholders exist. (Further consideration is required with respect to relisting of companies once delisted.)

[76] Current delisting criteria set out that listed shares shall be delisted when a corporate action constitutes "an unreasonable restraint on the rights of shareholders" (Article 2, Paragraph 1, Item 17).
Restraint of ordinary shareholders' rights resulting from conversion of listed shares into few voting shares would be a case where the issuing by listed companies of shares of common (dividend) stock with fewer voting rights than those of already listed shares becomes unreasonable restraint on the rights of shareholders.

[77] Expected measures are to provide marketplace sections and independent indicators by which the investor may easily understand that it is a listing of class shares.

believe it appropriate to allow only the listing of Voting Class Share where the scheme respects shareholders' rights, focusing on alleviating disadvantages accompanying Voting Class Shares ((i) fewer opportunities to sell shares and weakened corporate governance due to limited change in control, and (ii) distorted corporate governance due to disproportion between risk bearing and control).[78] With respect to listing Voting Class Shares, it is appropriate to keep in mind adequate disclosure, transparency and effects on secondary market, as well as respect for shareholders' rights as it is considered takeover defense measures.

In addition, it is a matter of course that the legal stability of such a scheme would need to be separately confirmed.

With respect to details of schemes "respecting shareholders' rights", it is desirable for TSE to make the result of the study public as a guideline, as there may be a great variety of schemes with respect to class shares. In this case, taking into account the significant impact of its introduction, it is desirable to aim towards improving guidelines with respect to a scheme with fewer disadvantages that accompany Voting Class Shares.

2. Improving the Market System

(1) Marketplace sections

Current State and Issues

TSE operates two markets: the Main Markets for companies having an established business administrative structure and revenue sources and Mothers for emerging entities. The Main Markets are separated into the First Section and Second Section where the First Section is the section specially for more liquid stocks.[79] First Section listed stocks are, in principle, added to TOPIX.

Under the current system, it is determined that markets are separated based on stock liquidity, however, this is a significant deviation from the general perception that markets are separated based on the quality of entities. In addition, in light of the intended objective of marketplace sections to provide information to investors, it would be meaningless to separate market sections based purely on liquidity. Moreover, it is difficult to say that actual examinations implemented when a company is designated to the First Section, which are

[78] Issues of conflicts of interest with controlling shareholders may be considered the same as issues of proportionality between risk bearing and control when compared to listing subsidiaries. It is also necessary to comply with a code of conduct for corporate activities as with in the case of listing subsidiaries (please see 1(3) Listing System for Subsidiaries (p.18ff) and 1(2)(iv) Conflict of Interest Transaction with Interested Parties (p.13ff)).

[79] Among formal requirements of listing criteria, TSE sets more stringent requirements only on the liquidity for a company to be transferred from the Second Section to the First Section (Article 3, Paragraph 1 of the Criteria for Assignment to the First Section).

similar to new listing examinations, are consistent with current separation of marketplace sections.

Direction of System Improvements

In the light of above issues, it would be appropriate to review current marketplace sections that are based on the liquidity such as the number of shares and shareholders, taking into account that it is not necessarily appropriate to assess the quality of listed companies by TSE's detailed criteria and examinations as it should be ultimately assessed by markets, and that as marketplace sections and TOPIX are widely known amongst investors, simple integration of market sections would have harmful effects such as investors being confused and a lack of continuity of TOPIX.

Specifically, it would be desirable to proceed with discussions along the lines of redesigning marketplace sections currently based on liquidity, focusing particularly on clear and quantitative standards coupled with market assessment (such as total market value of floating stock).[80]

In such discussions, it would also be desirable to consider (i) not continuing the examinations for eligibility requirements that are currently in place for when a company is designated to the First Section considering marketplace sections are defined based on quantitative standards, and (ii) continuously verifying business administrative structures of listed companies when they merge with larger non-listed companies, when there is a breach of rules on timely disclosure due to willful misconduct or gross negligence, when there is a significant change in shareholders and officers, or when a company's business has materially changed in a short period of time.

(2) Emerging-Stock Markets

Current State and Issues

Mothers is the market established for the purpose of providing risk money to emerging entities having lower performance results than the entities listed on the Main Markets but expecting future growth, and upon being listed on Mothers entities can hope for further growth through leverage from raised funds. Thus, Mothers requires that these entities have high growth potential[81] and disclose risks, rather than requiring performance results, and Mothers also requires investors to take responsibility on the premise of enhanced risk disclosure and the like as there are greater investment risks compared to the Main Markets.

---

[80] There is a view that TSE will not set a hierarchy of the First Section over the Second Section.

[81] This is confirmed by a letter of recommendation that the administrative security firm provides to TSE (Article 3, Paragraph 2, Item 7 of the Securities Listing Regulations, and 2.(2)-2 of the Guideline for handling the Securities Listing Regulations).

The listing system holds Mothers and the Main Markets in apposition, and entities may apply to be listed on one market or the other. The listing system allows entities to change markets from the Main Markets to Mothers or from Mothers to the Main Markets.

Seven years have passed since Mothers was established, and it has fulfilled its role of providing risk money to growing entities, with the gross number of companies listed on Mothers surpassing initial expectations and exceeding 200 companies, and the number of entities transferring to the Main Markets increasing.[82]

As stated, it remains important for TSE to operate emerging markets to give sound support to growing entities, but it is also preferable to overcome the following problems and issues in order to enhance the reliability of Mothers.

Firstly, current positioning of Mothers in apposition with the Main Markets is inconsistent with the fundamental nature of Mothers providing a growth opportunity to emerging entities which are not eligible to be listed on the Main Markets. In reality, there are many entities that have changed markets from Mothers to the Main Markets once they have grown after being listed on Mothers and established a business administrative structure and revenue sources, while there are no entities that have changed markets from the Main Markets to Mothers since the establishment of Mothers.[83]

Second, a Mothers-listed entity is not required to have a business administrative structure as required to establish for listing to the Main Markets at the time of initial listing. However we believe that it should achieve a higher level business administrative structure than the structure required at the time of initial listing as numerous investors come to invest in the entity and its business expands.

In addition, there is the issue that a Mothers-listed entity which is expected to grow at the time of listing may not always achieve the expected growth. If a Mothers-listed entity with no performance results fails to grow, the stock price of such entity is likely to decline due to lack of profitability and continuity,[84] and appropriate measures should be taken in order to protect

---

[82] Article 12-3 of the Securities Listing Regulations. When transferring to the Main Markets, Mothers-listed entities may be designated to the First Section if they meet the same eligibility requirements for a company to be transferred from the Second Section to the First Section. However, when any entity listed on an emerging-stock market managed by another securities exchange is newly listed on the TSE Main Markets, it must meet the exceptions to list newly listed companies directly on the first section (weighing up the number of listed shares and total market value of listed shares) to be designated to the First Section. Please refer to the TSE website for the criteria details.
(Market transfer from Mothers to the First Section)
http://www.tse.or.jp/english/rules/transcriteria/index.html
(Market transfer from other securities exchanges to the TSE First Section)
http://www.tse.or.jp/english/rules/listcriteria/index.html

[83] At a hearing with Mothers-listed entities, most companies recognize listing on Mothers as a step towards their aim of being listed on the First Section in the future.

[84] Some companies may take corporate action ignoring shareholder value or sometimes become a source of

the investors.

Direction of System Improvements

First of all, it is desirable for the current positioning of Mothers in apposition with the Main Markets to be reorganized according to the reality.

Specifically, it would be appropriate for TSE to position Mothers as a market that provides an opportunity for access to capital markets in the early stages for businesses still in their initial stages of growth who aspire to list in the future on the Main Markets, and for TSE to improve the system so as to make it clear that TSE operates Mothers as a unified whole with the Main Markets (such as by reviewing TSE's regulations concerning change of markets from Mothers to the Main Markets, abolishing provisions concerning change of markets from the Main Markets to Mothers, encouraging companies with growth potential to list their shares on Mothers, and so on).[85]

New measures such as to confirm a Mothers-listed entity's business administrative structure should be considered in order to enhance the reliability of Mothers.

Specifically, in working toward enhancing the reliability of Mothers, it would be appropriate to improve the system by introducing measures to strengthen efforts to improve the operating and management system of companies (such as by examining companies listed on Mothers after a certain period of time has passed since they were listed, using examinations corresponding to the examinations for eligibility requirements undertaken on companies to be newly listed on the Main Markets).

In addition, it is necessary to take any measures to maintain the quality of Mothers taking into account that not necessarily every emerging entity continues to have high potential or can transfer to the Main Markets.

Specifically, it would be appropriate to improve the system by applying delisting measures to any entity not achieving predetermined growth after a set period of time after being listed on Mothers (for example, any entity not recording a certain amount of sales or current profits even after being listed on Mothers for five years).[86]

(3) Combining trading units

Current State and Issues

---

funding for antisocial forces.

[85] It would be desirable to conduct an appropriate review on the fact that criteria for designation to the First Section via Mothers is less strict than the criteria for designation via other securities exchanges (See note 82 supra) taking into account the future positioning of the First Section.

[86] Implementation of such measures is subject to progress in working towards ensuring the liquidity of delisted issues (see 3. Enforcement Measures of the Listing Rules below (p.36)).

Currently there are seven trading units[87] with respect to domestic stock listed on the TSE. Adoption of multiple trading units is unusual among the world's major securities exchanges[88] and investors claim that it is complicated.[89] It has also been pointed out that multiple trading units are one cause of erroneous sell orders. Under these circumstances, there is a greater need to reorganize trading units from the perspective of market usability.

Direction of System Improvements

It is desirable to integrate the current trading units into one trading unit taking into account investors' convenience and the listed company's response as a direction to improve the system.[90] However, it should proceed with sufficient consideration of the current status of listed companies as such change affects listed companies.

Considering that (i) TSE sets the desirable range of investment units between 50,000 yen and 500,000 yen and investors request fewer investment units, (ii) an increasing number of companies recently reorganized the number of shares comprising a unit from 1,000 shares to 100 shares in order to reduce investment units, and (iii) it is necessary to leave some freedom for when issuing class shares, it would be desirable to aim to combine one unit to comprise 100 shares in the future.

However, taking into account the reality that most listed companies make the trading unit comprise 100 shares or 1,000 shares[91] and the highest proportion of companies make the trading unit comprise 1,000 shares, certain effects can be expected if there are improvements in the convenience in the early stages by aiming to combine trading units into two types (100 shares and 1,000 shares)[92] for the time being. It would be appropriate for TSE to start making adjustments by formulating a basic policy (an action plan) under which the trading units would be eventually integrated but in the preliminary stage combined into two units, one of 100 shares and the other of 1,000 shares, and then publicly announce that policy this year. The

[87] The seven trading units are 1 share, 10 shares, 50 shares, 100 shares, 500 shares, 1,000 shares and 3,000 shares.

[88] The major trading unit in the U.S. is 100 shares, and in Europe 1 share.

[89] Investors claim that stock prices are complicated as each stock price is indicated in a different unit, but such complicated indication is expected to improve with the reorganization of trading units.

[90] Combining and integrating trading units is aimed towards domestic common stock and it would be appropriate to be flexible when handling class shares.

[91] Approximately 38% of companies listed on the TSE adopt a trading unit of 100 shares and approximately 46% adopt a trading unit of 1,000 shares (As of November 6, 2006).

[92] It seems that some of the companies recently listed adopted a trading unit of one share (not adopting shares composing a basic lot). However, it would be appropriate to exclude the trading unit of one share from combination of trading units taking into account that listed companies will not be able to conduct a stock split in a ratio less than integral multiples due to restrictions on handling fractional shares after the Electronic Share Certificate System is introduced in 2009 and there is a movement that some of the companies that have issued fractional shares are adopting shares composing a basic lot.

policy should undergo further review with related parties regarding specific points of issue and timing of the final combination to achieve the policy.

In particular, it would be appropriate to implement the immediate aim of combining two trading units, one of 100 shares and the other 1,000 shares, taking into account practice trend, promptly after 2009 when the Electronic Share Certificate System will commence and corporate action required for combination will become easier on the cost and process front. However, it would be appropriate to apply this earlier than the abovementioned time to newly listed companies, companies newly adopting shares composing a basic lot, and companies changing the number of shares composing a basic lot.

As to combining and integrating trading units, it is imperative that TSE undertakes these efforts not by itself but in cooperation with other Japanese securities exchanges. Also, listed companies are expected to constructively cooperate as members of the securities exchanges in order to improve convenience of markets although combining and integrating trading units put a strain on listed companies.

(4) Reviewing criteria for liquidity

Current State and Issues

TSE currently has four criteria for liquidity: number of shares to be listed, number of shareholders, ratios of stock ownership by the special few, and trading volume,[93] with respect to listing criteria and delisting criteria**.**

Among these, reorganization is required with respect to criteria for number of shareholders and ratios of stock ownership by special few[94] adopted in 1982 from the perspective of liquidity and promoting correction of excessive stock ownership by entities and seeking diversified ownership.

Firstly, criteria for number of shareholders is complicated with (i) the system that the number of shareholders increases based on number of listed shares, (ii) incentives based on criteria for investment units, and (iii) incentives based on trading volumes. Due to patchy amendments made in response to situations such as establishing incentives in line with the policy to promote decline in investment units, consistency in criteria has been lost and the purpose of the provision becomes difficult for listed companies and market participants to understand. With respect to the number of shareholders, it would also be necessary to consider

---

[93] Criteria for trading volumes are not applied to listing criteria.

[94] Please refer to the TSE website for an outline of criteria for the number of shareholders and criteria for ratios of stock ownership by the special few.
(Criteria for the Number of Shareholders)
http://www.tse.or.jp/english/rules/delisting/shareholders/index.html
(Criteria for Ratios of Stock Ownership by the Special Few)
http://www.tse.or.jp/english/rules/delisting/few/index.html

that increases in the number of shareholders do not directly link with management efforts as some of the shareholders sell the shares when business performance improves and stock price increases, and some companies in certain industries get less recognition from individual investors.

Criteria for ratios of stock ownership by the special few is also complicated. For example, delisting criteria requires that the ratio of shares held by the top 10 major shareholders, officers and the company itself is less than 75% of the number of listed shares but exclude the shares clearly deemed as not being fixed such as portfolio shares, even when held by the top 10 major shareholders. In addition, as the criteria for ratios of stock ownership by the special few requires not quantity but a certain ratio, it becomes more demanding than other delisting criteria. As a result, there is the concern that stocks without major problems of liquidity may conflict with the criteria and a system review is requested.

On the other hand, Mothers does not establish criteria for ratios of stock ownership by the special few and has less strict criteria than that of the Main Markets, however, it has been pointed out that insufficient public offering and sales result in stock price volatility immediately after initial public offering.

Direction of System Improvements

It would be appropriate to reorganize the criteria for the number of shareholders and ratios of stock ownership by the special few in the delisting criteria taking into account that the original purpose of the criteria is to ensure liquidity and that it would be desirable to provide wide sales opportunities to the extent that it does not damage the smooth operation of a secondary market from the perspective of protecting minority shareholders. Specifically, with respect to delisting criteria, it is expected that the method to increase required number of shareholders based on the number of shares will be abolished and fix on certain criteria, and instead of having criteria for ratios of stock ownership by the special few, listed companies will be required to have a certain number of floating shares[95] and a certain amount of the aggregate market value of floating shares.[96]

In addition, it would be considered necessary to review listing criteria as well as delisting criteria. As there are calls to make listing criteria more stringent, it would not only be necessary to improve delisting criteria but also to keep the concept of criteria for ratios of

[95] Generally speaking, “floating share” does not mean stable shares held by shareholders but circulating shares traded in markets. A more detailed definition requires further review.

[96] There also is a view that in the case of a listed company that has an extremely low ratio of floating shares against listed shares (for example, when the ratio of stock ownership by the special few exceeds 95%) such company should be delisted regardless of the number of floating shares or aggregate market value of floating shares.

stock ownership by the special few that limits the shareholding ratio of major shareholders and the like for a certain period from the perspective of securing smooth circulation by moderating stock volatility immediately after listing and encouraging companies to be listed to be more self-aware.

It is desirable to establish the listing criteria for Mothers similar to those used for the Main Markets but TSE should bear in mind upon introduction of the criteria that the companies to be listed on Mothers are emerging entities at a stage of growth in their development.

3. Enforcement Measures of the Listing Rules

Current State and Issues

These days, although companies are enjoying increasingly greater liberty to choose in advance what kind of actions they would prefer to take, including in the form of radical reforms of corporate law, the trend is for the rules demanded of listed companies to become increasingly diverse, from the perspective of ensuring the fairness and soundness in markets. On the other hand, however, the methods, in addition to delisting, for ensuring the enforcement of listing rules in the current listing system are limited to such things as the cautions and warnings system[97] and improvement reports system.[98, 99] In particular, the discipline listed companies are expected to exercise these days is getting stricter, and criticisms have been raised that there are no appropriate means of enforcement that can be employed in response to material breaches of regulations that do not deserve to lead to delisting. On this matter, a look at what methods are employed overseas shows that, for example, in the United States they have not only delisting as a way of enforcement, but also systems for suspension followed by application for delisting and public reprimand letters,[100] and in the United Kingdom they have not only measures for cancelling and suspending

---

[97] Article 24 of the Timely Disclosure Rules. A system providing for the right to issue cautions and warnings when a listed company makes a misstatement in its securities report whereby whenever such a caution or warning is given, a public announcement is made to that effect. This system was implemented on December 2006 from the perspective of distributing to investors the information of, and preventing listed companies from repeating, flaws in the disclosure mandated by statute.

[98] Article 22 of the Timely Disclosure Rules. If an issuer of listed securities is not appropriately carrying out its timely disclosure requirements with respect to corporate information based on the Timely Disclosure Rules and improvement can be shown to be very necessary, then that issuer can be demanded to produce a report setting out how that situation came to be and measures it will take to improve the situation.

[99] Other methods of enforcement can be seen in systems where, for example, when a listed company fails to observe matters it ought to respect, public announcement of that failure is given.

[100] See, for example, §802.02 of the NYSE Company Manual for delisting and suspensions of trade leading to applications for delisting. Public reprimand letters were introduced in 2004 in association with the moves to strengthen corporate governance through listing regulations (see §303A.13 of the NYSE Company Manual).

listings, but also rules for imposing financial penalties.[101]

One of the measures used to enforce listing rules is the rule whereby a listed company is withdrawn from the market, in other words, is delisted. This is different from the statutory framework for sanctions and penalties, as it has a material effect on parties related to the delisted company, including shareholders, such as by reducing the opportunity for general shareholders to cash out their stock in the company. Consequently, it seems necessary, in moving toward more appropriate operations, to take another look at this rule in terms of how it can best be applied and the processes involved in applying it. On this issue, we note that some overseas markets make express provision for the evaluation of, and the use of procedures to follow up on, companies that violate listing criteria,[102] and some have incorporated processes that allow for companies to file applications for objection to procedures followed to determine delisting.[103]

Under the present system, when a concern arises that a listed stock might fall under any of TSE's delisting criteria, that stock is assigned to the “supervision post” (*kanri posuto*) to alert investors to its status as such a concern. Criticisms have been raised, however, that the original purpose of this supervision post system is no longer being served, because the general investing public simply perceive TSE’s publicly announcing that the stock has fallen under one of its delisting criteria itself as the sanction.

Direction of System Improvements

In correspondence with intended expansion of the target scope of TSE’s listing rules that is in line with diversified rules and codes required of listed companies by securities exchanges and based on expected increases in cases of monetary retributions by the administration, it would be appropriate to strive for diversification of enforcement measures of the listing rules rather than focusing on traditional delisting criteria. In this regard, the scope of regulations for listing subject to diversification and the specific details of their diversification will need to be well organized.

Among the current delisting criteria, criteria relating to corporate activities especially for timely disclosure and matters that contain judgments on the degree of breach should be considered in the scope of the regulations for listing that are subject to the diversification of enforcement measures.

In addition to the established cautions and warnings system and improvement reports system, the introduction of certain systems that impose monetary sanctions should be

[101] With respect to cancelling and suspending listing, see LR 5.2.1R and 5.1.1R. With respect to financial penalties, see ENF 21.7.

[102] See, for example, §802.02 and §804.00 of the NYSE Company Manual.

[103] See, for example, LR 5.5.1R.

considered in the actual substance of the diversifications in response to breaches to the listing rules. The imposition of monetary sanctions on listed companies by TSE is considered possible even under current listing agreements, but it can be said that it is desirable for TSE to establish guidelines with a view to avoid TSE misusing the measures. Assuming that the actual system is put into effect, it would be appropriate to introduce a monetary sanction system after preparing guidelines prescribing the procedures and maximum monetary amount principally for breaches to the listing rules that do not deserve to lead to delisting.

Even if a company does not deserve to be delisted for a misstatement in its securities report etc., a case of material breach of the Timely Disclosure Rules or the like, it would be reasonable to consider the introduction of new separated marketplace sections other than the current Main Markets and carrying out continual checks of the breaching companies assigned to those sections in order to prompt an improvement to the internal systems of those companies.

Under the trading halt system that TSE currently uses, if information arises that might materially affect investors' investment decisions and the information is unclear or TSE believes it is necessary to disclose the details of the information to the public, then TSE implements a temporary trading halt and asks the relevant company to confirm and officially announce the information. A look at examples overseas shows us that basically their systems are structured for the purpose of ensuring the public is thoroughly informed or focusing on the stages before steps are taken to delist a company, so they are not structured for the purpose of imposing sanctions or the like. Also, because trading halts seriously affect shareholders yet do not directly harm the interest of the company itself, they do not seem to be appropriate as an enforcement method.[104]

With respect to the process to be followed in effecting enforcement, it would be desirable to take another look at how enforcement should be effected and the processes to be taken leading up to enforcement, keeping in mind the significant effect it will have on delistings and the like. It would also be appropriate to work toward improving transparency and fairness in decisions on measures to be taken against a listed company adverse to that company's interests, such as a decision to delist it and so on. On this matter, upon implementation of the Financial Instruments and Exchange Law this year, transparency and fairness is expected to be greatly enhanced by delegating such decisions to a highly independent, self-regulatory organization. Also, in relation to the processes leading to delisting, it is necessary to continue to proactively add to the discussions of the entire securities industry, with an eye to ensuring the liquidity of issues that have been delisted.

Although there is no need to change the basic functions of the supervision post system,

[104] Article 29 of the Business Regulations Of Tokyo Stock Exchange, Inc.

which is a system that warns the public of possible delistings, there is still room for improvement in terms of making it easier to understand. Specifically, the name of the *supervision post* could be changed, and measures could be introduced to explain to investors more clearly, when stock is assigned to the post for determination on whether to delist it or not, that the stock so assigned is being so examined, such as by naming that process with a term that is clear and easily distinguishable from other events.

V. How to Proceed from Here

The Advisory Group would hope that TSE immediately revises the Comprehensive Improvement Program for Listing System dated June 22, 2006, based on the details of the Interim Report and prepare an action plan to implement the Program on and after fiscal 2007.

To specifically implement these initiatives, it would be appropriate for TSE to improve the listing system after hearing opinions of parties related to the market through means such as calling for public comments, the process TSE had been using when establishing other listing rules.

In addition, the Advisory Group intends in the future to continue to consider, as necessary, matters that it was unable to discuss enough this time.

Member List

Chairman	Hideki KANDA	Professor of Law The University of Tokyo, Graduate Schools for Law and Politics
Members	Kazuhito IKEO	Professor of Economics Keio University, Faculty of Economics
	Sadakazu OSAKI	Executive Fellow Nomura Institute of Capital Markets Research
	Yuji KAGE	Managing Director Pension Fund Association
	Etsuro KURONUMA	Professor of Law Waseda Law School
	Hiroto KODA	General Manager Mizuho Securities Co., Ltd.
	Yoshiko SATO	Program Director and Chief Research Fellow Japan Investor Relations Association
	Noriaki SHIMAZAKI	Director, Executive Vice President Sumitomo Corporation
	Hiroyuki SUZUKI	Executive Officer and Senior Managing Director Nomura Securities Co., Ltd.
	Tetsuo SEKI	Senior Corporate Auditor Nippon Steel Corporation
	Kazuhiro TAKEI	Attorney-at-law Nishimura & Partners
	Shigeru NAKAJIMA	Attorney-at-law Nakajima Transactional Law Office
	Toshio HOSHINO	Representative Director, Senior Executive Vice President Kao Corporation
	Noriyuki YANAGAWA	Associate Professor of Economics The University of Tokyo, Graduate School of Economics

(in the order of Japanese syllabary)

Progress of Discussions

1st Meeting (September 11, 2006)
- "Development of a Comprehensive Improvement Program for the Listing System"
- How to proceed from here

2nd Meeting (October 11, 2006)
- Basic Policies in Improving TSE's Listing System
- Marketplace Sections and Mothers Market

3rd Meeting (October 31, 2006)
- Listing of Subsidiaries

4th Meeting (December 12, 2006)
- Codes of Conduct for Corporate Activities
- Standards for Liquidity

5th Meeting (December 25, 2006)
- Codes of Conduct for Corporate Activities (Cont'd from 4th Meeting)
- Class Shares and Listing System

6th Meeting (January 1, 2007)
- Class Shares and Listing System (Cont'd from 5th Meeting)
- Enforcement Measures of Listing Rules
- Combining Trading Units

7th Meeting (February 22, 2007)
- Combining Trading Units (Cont'd from 6th Meeting)
- Timely Disclosure
- Outline of Opinions Expressed for Each Item

8th Meeting (March 7, 2007)
- Timely Disclosure (Cont'd from 7th Meeting)
- Organizing Interim Report

9th Meeting (March 19, 2007)
- Organizing Interim Report (Cont'd from 8th Meeting)