For Creating Better Market Environment

Where Investors Feel Secure

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Advisory Group on Improvements to TSE Listing System
for Tokyo Stock Exchange, Inc.

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Summary of Recommendations

I Creating Better Environment Where Investors Feel Secure

From the secondary market' perspective of ensuring protection of shareholders and investors as well as market credibility, TSE need to show norms which the listed companies should conform to, while respecting general framework of the Companies Act as the premise.

A Recommendations Concerning Private Placements to a Third Party

a. Consideration for interests of existing shareholders

Private placements of new shares, etc. are not always desirable financing method for listed companies, as they cause dilution of existing shareholders' rights. Listed companies should prudently consider whether or not they implement such method. It is necessary for TSE to require listed companies to provide sufficient explanation to the shareholders on necessity and reasonableness of such private placement, in case they made a decision for implementation.

b. Elimination of unreasonable restriction on shareholder rights

Private placements with dilution ratio in excess of 300% extremely or even unreasonably impair the rights of existing shareholders and materially affect market credibility. Such private placement should not be allowed as corporate activities of listed companies as a general rule. It is necessary for TSE to set up examination procedures for prevention.

c. Measures to be taken against dilution of shareholder rights and selection of large shareholders

Authority of corporate management is entrusted by shareholders. It is, by nature, undesirable for companies to easily dilute voting rights of the shareholders being fundamental authority of corporate management, or to select large shareholders. In case of private placement involving 25% or more dilution or change in control, it is necessary for TSE to impose procedures to obtain a higher level of shareholders' understanding in principle.

d. Elimination of placements to inappropriate parties

Involvement of anti-social forces with private placements should be definitely eliminated in order to secure credibility and fairness of the market. It is necessary for TSE to set up procedures such as confirmation of third parties which receive new share allocation for the purpose of prevention.

e. Ensuring soundness of transactions with allocated parties

From the perspective of ensuring shareholder/investor protection and market credibility, soundness of transactions with related parties including controlling shareholders should be maintained after initial listing as well. In case of a change of controlling shareholders caused by a private placement, it is regarded as change of the prerequisites for initial listing by a company decision. Therefore, it is necessary for TSE for the purpose of prevention to set up ex-post examination procedures to check whether there are any unreasonable transactions with a controlling shareholder.

f. Ensuring of compliance with Favorable Issue restrictions

There are some cases vague to shareholders and investors whether a private placement falls under the category of "Favorable Issue" which requires a resolution of shareholder meeting. It is necessary for TSE to require companies to disclose sufficient information such as calculation basis of the amount to be paid in and statutory auditor's opinion based on such calculation basis in order to ensure legality.

g. Confirmation of finance

Information on private placements without proper financing not only confuses the market but also could be used by certain parties to gain unfair profits. From the standpoint to secure fairness of the market, it is necessary for TSE to require companies to confirm and disclose finance of the parties to whom they are going to allocate shares.

B Recommendations Concerning Reverse Stock Split

a. Elimination of unreasonable restrictions on shareholder rights

To deprive many shareholders of their position as shareholder by conducting reverse stock splits which generate fraction less than one share without any reasonable ground materially affects market credibility. In order to eliminate unreasonable restrictions on shareholder rights, it is necessary for TSE to set up examination procedures for prevention.

b. Consideration for shareholder interests

Listed companies are expected to respect their shareholder interests as much as possible, even in case reverse stock splits which generate fraction less than one share may not be unreasonable restriction on shareholder rights. If they have an alternative method to secure the shareholder rights to demand purchase of their shares at fair value, it is necessary for TSE to request listed companies to select such an alternative.

II System Improvement for Facilitating Dialogues between Shareholders and Listed Companies

A Recommendations Concerning System Improvement to Facilitate Exercise of Voting Rights

Exercise of voting rights is the foundation of corporate governance, and thus need further efforts for improving the system relating to exercise of voting rights. It is desirable for TSE to conduct a survey of implementation status of the listed companies with regards to system improvement for exercise of voting rights, and strengthen the system gradually from an effort ready for enforcement in order to further improve the system.

B Recommendations Concerning Disclosure of Voting Results

From the perspective of enhancing transparency in the procedures related to the exercise of voting rights, it is desirable for TSE to set up the system enabling shareholders easily get access to the voting results.

I Introduction

Recently, with globalization of corporate activities and borderless securities market in the background, listed companies have taken positive steps in their overall efforts to improve and enhance corporate governance. As a market provider, Tokyo Stock Exchange ("TSE") has been supporting and facilitating such efforts of the listed companies, among others, by formulating the Principles of Corporate Governance (2004) and introducing the system of Report on Corporate Governance (2006) ("Corporate Governance Report") from the perspective of ensuring investor protection and fulfillment of market functions. However, there have been some situations where past efforts for improving and enhancing corporate governance in Japan are questioned to be genuine: an increasing number of listed companies have taken corporate activities which seriously damage the shareholder interests. Under such circumstances and amid falling stock prices worldwide due to the recent financial crisis, some point out that investors are rapidly losing confidence and interest in Tokyo market, and that our country as well as the market players including the listed companies are facing an urgent need to restore investor confidence and interest.

The Advisory Group on Improvements to TSE Listing System ("the Advisory Group") is a body established in September 2006 for the purpose of holding highly transparent discussion on improving TSE listing system to reflect diverse stakeholders' opinions. In the fiscal year 2008, as TSE identified improvement of environment associated with corporate governance as a top priority issue,[1] we have had extensive discussion on it since autumn in 2008.[2] Upon TSE's solicitation for investors' opinions in July 2008,[3] many investors' requests were associated with two issues shown below, which we recognized as pressing issues from the perspectives of protecting investors and ensuring investors' confidence in the secondary market. Consequently our discussion has been centered on these issues.

The first issue is to create a better environment where investors feel secure in investing: that is to address i) the case where shareholder interests are not respected (e.g., the case where existing shareholders' rights are suddenly reduced), ii) the case where a company deprives investors of trading opportunities of the shares; and iii) the case where information necessary to make investment decisions are not sufficiently provided to shareholders and investors. It was pointed out that these cases would surface in the situations such as private placement to a third party, reverse stock splits

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[1] Tokyo Stock Exchange Group Medium-Term Management Plan (For English version, http://www.tse.or.jp/english/about/ir/financials/index.html; for Japanese version, http://www.tse.or.jp/about/ir/financials/plan/plan_08-10.pdf)
Listing System Improvement FY2008
(For English version, http://www.tse.or.jp/english/rules/ls-improvements/080527.pdf; for Japanese version, http://www.tse.or.jp/rules/seibi/2008program.pdf)

[2] Progress of Discussion http://www.tse.or.jp/rules/seibi/discussion.html (Japanese version only)

[3] Opinion Summaries Received from Investors in Response to TSE-Listed Company Corporate Governance Questionnaire for Investor
(For English version, http://www.tse.or.jp/english/rules/ls-improvements/opinions_summary.pdf; for Japanese version, http://www.tse.or.jp/rules/seibi/2008toushika_iken.pdf)

causing fractions of less than one share, MSCB, takeover defense measures, and MBO. The Advisory Group's discussion focused on private placement to a third party and reverse stock splits, with which many investors requested for improvement.

The second issue is system improvement to facilitate dialogues between shareholders and listed companies. Requests from investors varied from early provision of convocation notices of general shareholders meetings, to introduction of electronic voting system, to disclosure of voting results at general shareholders meetings. The Advisory Group's discussion focused on disclosure of voting results, which many investors requested but there is no institutional rules at the moment.

The Advisory Group prepared this Report to summarize the discussion and recommend directions for TSE's system improvement in the future. We would be pleased if our recommendations in this Report would contribute to improving corporate governance environment in Japan including those of TSE-listed companies, restoring market credibility, and revitalizing the market.

II Creating a Better Environment Where Investors Feel Secure about Investment

A Underlying Concept

Considering the current situation where investors are rapidly losing confidence and interest in Tokyo market, it should be the primary task for exchange markets to create an environment where investors feel secure to invest. Among others, corporate activities which lack respect for shareholder interests are problematic from the secondary market's perspective of protecting shareholders and investors and maintaining market credibility. While respecting the framework of the Companies Act as the premise, TSE is required to take actions as a market provider immediately.

Among issues to be considered for creating an environment where investors feel secure to invest, the Advisory Group identified improvement of private placements to a third party and reverse stock splits, which many investors voiced the needs for, as the primary tasks and discussed mainly about them.

B Private Placements to a Third Party[4]

a. Issues to be addressed

As a listed company falls under the category of a public company under the Companies Act, it can issue new shares within the limit of authorized shares and allocate them to a specific third party solely on the basis of a resolution of the board of directors, unless new shares are to be issued at a favorable price (Article 199, Paragraphs 1 and 2; Article 201, Paragraph 1 of the

[4] For definition of private placement concerning stocks, see Rule 429, introductory clause of Paragraph 1 of the Enforcement Rules for the Securities Listing Regulations.

Companies Act). While such a framework meets corporate needs for flexible financing on one hand, it could dilute voting rights of existing shareholders and/or allocate shares to parties whom the board of directors selected on the basis of their resolution. Even though a company does not intend to do so, existing shareholders' rights could be diluted and even control of the company could be changed in some cases. Voting rights of shareholders are the most fundamental rights under the stock company (*kabushiki kaisha*) system, where shareholders elect management personnel whom they entrust with management of the company. Securing voting right is the prerequisite for smooth supply of risk money to companies. In that sense, it is essentially undesirable for companies to dilute voting rights of shareholders easily or take initiatives to select large shareholders. If companies take such actions without any limitation, it may create a situation where existing shareholders' interests are substantially impaired by corporate decisions. Consequently, not only investment incentives would be reduced, but also corporate governance of listed companies would be of no real value.

A look at the situations in foreign countries shows that in the United Kingdom, pre-emption rights are granted to existing shareholders under the Companies Act. Such pre-emption rights may be disapplied by the articles of incorporation or a special resolution of shareholders at general meeting. Nonetheless, on the basis of principles for disapplying pre-emption rights formulated by listed companies, investors and securities companies, disapplications of pre-emption rights allowed by the Companies Act are carried out by listed companies in a limited manner.[5] In the United States, the regulations of Stock Exchange stipulate that private placements exceeding a certain percentage of outstanding shares/voting rights require approval of general shareholder meetings.[6] Consequently, the current situation in Japan is strongly criticized particularly by foreign investors.

Needless to say, it is not necessary to introduce all of the same system as such countries, yet protecting interests of shareholders and investors as well as maintaining market credibility are essential factors to retain environment for flexible financing. As mentioned above, depending on volume and who a third party is upon private placements, dilution of voting rights of existing shareholders and a company's subjective decision on who its shareholders are may substantially impair existing shareholders' interests and affects investors' motivation to invest. Therefore, TSE, as a market provider, needs to place the top priority on this issue from the perspectives of protecting interests of shareholders and investors as well as securing market credibility.

In addition, many investors criticized private placement to a third party whose information is

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[5] Disapplying Pre-emption rights; A Statement of Principles July 2008
http://www.pre-emptiongroup.org.uk/documents/pdf/Statement%20of%20Principles%20July%202008.pdf.
For details see page 21 of Reference Materials (Appendix 1 Outline of system relating to private placement in Japan, the U.K. and the U.S. [omitted in this English version]).

[6] For details, see page 21 of Reference Materials (Appendix 1 Outline of system relating to private placement in Japan, the U.K. and the U.S. [omitted in this English version]).

not adequately disclosed. Specifically, the investors doubt that a company may have allocated to an anti-social force or the like which took advantage of the company's financial difficulties, or that a company may have carried out unfair transactions with the allocated party after such a private placement. There is a pressing need to address these concerns from the standpoint of ensuring fairness in market and sound business management of the listed companies.

b. Approach for considering the issues

To take measures to address the issues by reflecting the reality, the Advisory Group conducted specific case studies (the "Case Studies") from the following viewpoints: how many cases were in fact affected; whether there are private placements with substantial need to restrain to the extent practical ban is required; whether there are private placements which require some sort of measures, if not practically banned; whether there are any cases which require exceptions when such measures are adopted; whether there are need and reasonableness to modify restrictions by market section; how much the potential impact of restriction. The Advisory Group had discussion based on the results of the Case Studies, which covered 116 private placements (76 for stocks, 14 for bonds with subscription warrants , and 26 for subscription warrants) practiced by TSE-listed companies from April 2007 to March 2008 ("the Study Period").

c. Directions of system improvements

(a) Response to dilution and management's selection of shareholders

1) Basic Concept

Upon issuing new shares through private placement to a third party, it is inevitable that shareholder rights are more or less diluted. Because of that, among other reasons, such private placements would not always be desirable as a financing method of listed companies from the standpoint of protecting interests of shareholders and investors as well as securing market credibility.[7] In case of public offerings[8], although the issue of dilution still remains, opportunities are open to general investors, including existing shareholders, and basically companies do not select shareholders. Furthermore, under the existing system, public offerings always involve Japan Securities Dealers Association members who conform to the Association's regulations, including those on subscriptions of securities, and thus it is highly probable that any allocation to an

[7] In this regards, some point out that because shareholders may acquire shares of listed companies in the market, any legal protection is not necessary for maintaining shareholding ratios of existing shareholders. However, allocation of high volume of new shares to a third party significantly affects shareholder interests as it is highly likely to incur qualitative changes in control and profitability, or even the same effect as mergers or other organizational restructuring in some cases. For existing shareholders, measures to maintain their shareholding ratios, specifically by acquisition of the shares in the market, are money/time consuming and often difficult in reality.

[8] For definition of public offering of stocks, see Rule 2, Item 35 of the Securities Listing Regulations.

unsound party is to be eliminated. In that sense, public offering is very different from private placement to a third party with systematically-embedded problems such as likelihood of selecting a third party which is convenient for the company or unsound. Considering these points, listed companies, as users of public market, should respect interests of existing shareholders, who are mainly general investors, and prudently consider implementation of private placements together with alternative financing methods with less influence on shareholder interests. When companies decide to pursue private placements, it is recommended to sufficiently explain need for and reasonableness of choosing equity financing through private placements. The cases during the Study Period show the tendency of insufficient explanation in this regard.

Therefore, it is adequate for TSE to actively promote the above-mentioned views to the listed companies and make a systematic response which leads listed companies to provide investors with sufficient explanation on need for and reasonableness of private placements to a third party.

2) Private placements in great need for restraint

To judge whether there are private placements with a high need to restrain, it is appropriate to examine whether conducting such private placements deserve to lead to delisting, that is a practical ban of such activities.

TSE currently recognizes, in the listing-related regulations, certain corporate activities which fall under the category of "unreasonable restriction on shareholder rights" as causes for delisting (Rule 601, Paragraph 1, Item 17 of the Securities Listing Regulations). The underlying logic here is that even if they are approved under the Companies Act, or even if they were approved by general shareholders meetings, there are certain activities which listed companies are not allowed to take, in order to protect existing shareholders; that certain market rules are required for ensuring protection of shareholders and investors as well as market credibility; and that listed companies, which use public market unlike other general companies, are in a position to conform to norms of the listed companies. On that ground, private placements with substantial dilution are problematic in terms of ensuring the protection of existing shareholders and confidence in the securities market, and thus it is adequate to restrain them.

The issue here is the extent of dilution caused by private placements in terms of whether or not to be restricted. There are various views, yet considering that the Companies Act essentially stipulates that the total number of authorized shares may not be more than four times the total number of the issued and outstanding shares (Article 37, Paragraph 3, and Article 113, Paragraph 3 of the Companies Act) ("4 times cap"),

shareholders usually make investments on the premise that dilution does not exceed 300%.[9] It is assumed that dilution exceeding 300% overturns such premise and substantially impairs shareholder rights. Therefore, a private placement causing dilution in excess of 300% by taking advantage of the situation where the number of authorized shares exceeds 4 times the number of issued and outstanding shares as a result of reverse stock splits, etc.[10] could be regarded as betrayal to the shareholders' investment premise; regardless whether it was based on the resolution of the board of directors or that of general shareholder meetings, it is considered to be very problematic in terms of ensuring minority shareholder protection and market credibility. Hence it is adequate for TSE to take strict measures including delisting in order to prevent violation of shareholder rights.

Uniform restriction by dilution ratio, however, may result in excessive restriction. Consequently, from the perspectives of ensuring protection of minority shareholders and market credibility, it is appropriate for the Exchange to make practical decisions by restricting only the cases where shareholders' interest is unreasonably impaired.

Even if TSE prohibits cases circumventing 4 times cap, considering the Case Studies found no violation but one during the Study Period, such prohibition, with exception to be applied to cases which do not threaten existing shareholders' interests, is not considered to impair financing needs of the listed companies.

3) Private placements appropriate for imposing certain procedures

(i) Basic Directions

Even in case of private placements which the Exchange finds not necessary to restrain, thoughtless dilution of shareholder rights being fundamental authority to manage a company as well as selection of shareholders are not desirable from the standpoint of the secondary market to ensure protection of shareholders and investors as well as market credibility. Therefore, those causing dilution exceeding a certain percentage of outstanding shares/voting rights, and those affecting control of a company due to a change of large shareholders should go through procedures to obtain a higher level of shareholders' understanding; that is, requirements for higher level of accountability to obtain shareholders' understanding.

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9 Dilution ratio herein is calculated by the following formula: the number of votes concerning shares to be issued by the private placement in question (including the number of potential voting rights) / the number of votes concerning issued and outstanding shares before private placement x 100.

10 Under the registration practice prior to the enforcement of the Companies Act, it was understood that the number of authorized shares naturally decreases as a result of reverse stock split. However, under the Companies Act, unless a company amends its articles of incorporation, the number of authorized shares will not decrease naturally. (Hideki Kanda "The Companies Act (the 11th edition)" (Kobundo) p. 125; Tetsu Aizawa, Tomohiko Iwasaki 'Stocks: General Rules, List of Shareholders, Transfer of Shares, etc.' Supplementary Volume of *Shoji Homu* vol. 295, p. 28.)

(ii) Private placements appropriate for imposing certain procedures

There would be various views on the extent of dilution or changes of large shareholders which deserve for such procedures.

Regarding dilution, for instance, the following criteria can be considered: 20% or more dilution of the total votes - the standard equivalent to that of New York Stock Exchange ("NYSE") (57 out of 116 cases in the Case Studies); 25% or more dilution of the total votes (meaning that the ratio of votes associated with new shares is 20% or more after the placement) - the standard equivalent to a general trigger for invoking takeover defense measures in Japan (47 cases); more than 50% dilution of the total votes (meaning that the ratio of votes associated with new shares exceeds one third after the placement) - the standard equivalent to takeover bid regulations (22 cases); and 100% or more dilution of the total votes which inevitably accompany with changes of the controlling shareholders (9 cases).

The Advisory Group reached a general agreement that it is appropriate to apply the said procedures to private placements with 25% or more dilution of the total votes for the following reasons: takeover defense measures of many companies are triggered by such events that a party is going to hold 20% or more of the total votes after the acquisition, and there would be general perception that acquisition exceeding the said percentage significantly affects business management; while the cases covered by the Case Studies with 25% or more dilution includes the cases conducted for the purpose of business and/or capital alliance between the listed companies, such companies have not sufficiently explained to the general shareholders the rationale of undertaking such alliance with sacrifice of diluting existing shareholders' rights, and thus there is a need for obtaining a higher level of shareholders' understanding.

According to the Case Studies, 47 out of 116 cases fall under the category of 25% or more dilution, and it seems impact of the new rule is not very small. However, many cases we studied show that a reasonable time is given from time of decision on implementation to expected time of payment. Accordingly, it is considered that time constraint due to additional procedures would be minimal. In addition, exceptions could be stipulated to address emergency cases. Furthermore, companies' burden could be reduced further by tailoring procedures to be imposed. Taking these points into consideration, we believe it is adequate to impose certain procedures on private placements causing 25% or more dilution.

In the meantime, regarding a company's arbitrary selection of its shareholders, it is necessary to consider a change of large shareholders in certain sizes, in addition to the

level of dilution.

Concerning the level of change of large shareholders, we consider it appropriate to impose certain procedures to cases with a change in control[11] with the following reasons: it is assumed that presence or absence of a controlling shareholder and attributes of such a controlling shareholder, if any, tend to be the premise for investment decision by shareholders and investors, and thus the situation where transactions causing change in control are carried out solely on the basis of a resolution of the board of directors is considered to be problematic from the standpoint of general shareholders.

Some members argued that such problematic cases may take place in a specific market section, and if so, imposing uniform procedures to all market sections would be unreasonable. The breakdown of 47 private placements causing 25% or more dilution is as follows: 15 in TSE 1st section, 15 in TSE 2nd section, and 17 in TSE Mothers. Considering the number of companies listed on each market section, Mothers shows the highest incidence ratio. Nonetheless, the numbers of such private placements are almost the same across the market sections, and not negligible in terms of ensuring market credibility and protection of shareholders and investors. Therefore, it is appropriate to impose the procedures to all market sections.

(iii) Procedures to obtain a higher level of shareholder consent

With regards to specific procedures to obtain a higher level of shareholder's understanding, for the purpose of convincing shareholders further, first of all, it is fundamental that a company sufficiently proves to its shareholders the need for and reasonableness of financing through private placement. As for such a method, considering that the Companies Act places an emphasis on flexibility of listed companies' financing and grants the board of directors the authority to make decisions on private placements, it is considered essential to take a process to make shareholders convinced that financing through a private placement is objectively necessary and reasonable for the company, while respecting the framework of the Companies Act. For instance, one potential method is that a company asks for an opinion on the private placement in question from its special committee, outside director, or the like which/who maintains certain independence from the company management so that one can guarantee reasonableness of the company's explanation.

Another potential method would be, as in the case of invoking takeover defense measures, to ask for shareholders' opinions directly; that is, to confirm opinions of

[11] As for definition of change in control, it is appropriate to set a general guideline that the number of total votes to be held by the allocated party exceeds a half of the number of the total votes as a result of the private placement to the third party.

shareholders, as the interested parties, by way of advisory resolution or formal resolution at general shareholders meetings.

As for enforcement measures for listing regulations to be taken against companies which fail to go through such procedures, it is desirable to apply penalties such as public announcement[12] and listing agreement violation penalty,[13] and also measures to facilitate quality improvement of the listed companies in question such as requests for improvement reports and designation of securities on alert, from the perspective of ensuring protection of shareholders and investors as well as market credibility.

(iv) Cases applicable for exceptions

There was an argument that among private placements involving 25% or more dilution or change in control, there should be emergency cases with a difficulty to comply with the above-mentioned procedures to make shareholders convinced. For instance, there should be cases which require immediate financing due to sudden liquidity crisis.

Imposing the procedures on such emergency cases may cause an adverse effect against shareholder interests. Therefore, exceptions should be made for such cases by waiving the normal procedures.[14]

However, preparation of several options for the procedures to make shareholders convinced would allow flexibility for companies. Furthermore, the Companies Act requires at least 2 weeks from the date of a resolution of the board of directors to the effective date of new stock issue (Article 201, Paragraphs 3 and 5 of the Companies Act).[15] Consequently, such exceptions would be given only to extremely exceptional cases.[16]

(b) Addressing issues concerning allocated parties

1) Elimination of private placements to inappropriate parties

One of the reasons for controversy concerning parties to receive share allocation is that investors cannot confirm non-existence of relations with anti-social forces or the like. According to the Case Studies, 63 out of 116 parties which received allocation were TSE-listed companies or TSE trading participants under certain control mechanism with

[12] Rule 508, Paragraphs 2 and 4 of the Securities Listing Regulations

[13] Rule 509 of the Securities Listing Regulations

[14] There are opinions that subscription warrants do not necessarily have an effect of immediate financing, and it would be necessary to examine thoroughly to judge whether they are in emergency.

[15] In addition, it is necessary to consider a waiting period before the effective date of securities registration report (15 days or approx. 7 days) in accordance with the Financial Instruments and Exchange Law.

[16] It is necessary to note NYSE's practice: while the Listed Company Manual requires general shareholder meetings in certain cases and allows exceptions for the cases where the delay in securing stockholder approval would seriously jeopardize the financial viability of the enterprise, even the exceptions to time and cost consuming shareholder meetings occur only once or twice a year in average, which is extremely rare.

regards to relations with anti-social forces. On the other hand, in 53 cases including the cases where new shares were allocated to overseas funds, the attributes of the third parties in question were not always clear.

No one would deny that involvement of anti-social forces or the like with private placements should be definitely eliminated in order to secure credibility and fairness of the market. It is highly recommended to set up preventive procedures to confirm absence of involvement of anti-social forces or the like at least at the same standard as initial listing examination, backed by possible delisting.

Another issue associated with undisclosed parties allocated would be potential cases where new shares are allocated to offshore funds or the like for the hidden purpose of increasing shareholding ratios of large shareholders, in addition to the cases allocated to anti-social forces. Considering anonymity protected by such funds, there would be limitations for disclosing all of the real parties allocated. Hence, it is appropriate to address this issue by ex-post confirmation on soundness of transactions with the parties allocated, in case of private placements causing large influence on existing shareholders, including those involving changes of controlling shareholders as mentioned below.

2) Doubts about soundness of transactions with the parties allocated

Another reason why issues associated with the parties allocated is pointed out, is potential doubts about soundness of transactions with such parties.

Upon initial listing examination, TSE confirms, in order to protect shareholder interests, whether an applicant's enterprise group is conducting business in a fair and faithful manner. As a part of such examination, TSE confirms whether the applicant's enterprise group provides or receives unfair profits through transactions with related parties including its controlling shareholder. In terms of ensuring protection of shareholders and investors interests as well as market credibility, it is desirable to confirm such transaction after listing, when appropriate, from the same viewpoint. In particular, private placements which cause changes of controlling shareholders[17] and alter the premise of initial listing by a company decision would pose a serious problem.

Accordingly, in case private placements cause changes of controlling shareholders, it is appropriate to conduct ex-post confirmation on soundness of transactions with the controlling shareholders, and apply delisting measures if the transactions found problematic from the viewpoint of ensuring protection of shareholders and investors

[17] For definition of controlling shareholder, see Rule 2, Item 42-2 of the Securities Listing Regulations, and Rule 3-2 of the Enforcement Rules for the Securities Listing Regulations. "Change of controlling shareholders" is subject to timely disclosure (Rule 402, Item 2 g of the Securities Listing Regulations).

interests as well as market credibility. Such procedures would prevent such events.[18]

(c) Addressing cases which is vague whether they fall under the category of Favorable Issue

The Advisory Group identified another issue during discussion; that is, to respond to the cases with difficulties to judge whether or not the amount to be paid in is "particularly favorable" (Article 199, Paragraph 3 of the Companies Act) ("Favorable Issue").

As for applicability to Favorable Issue, it is generally understood that even if the stock price in question is approx. 10% lower than the market price, it cannot be recognized as "particularly favorable" (Supreme Court, April 8, 1975, Civil vol. 29 No. 4, p. 350; Tokyo High Court, January 28, 1971, High-Civil vol. 24 No. 1, p. 1). When the stock price is showing a temporary surge, it is approved to employ an average stock price during a certain period before such a sharp rise as a base value (Tokyo District Court, April 27, 1972, *Hanrei-Times* No. 679, p. 70; Osaka District Court, November 18, 1987, *Hanrei-jihou* No.1290, p. 144).[19]

New share issue without a resolution of general shareholder meeting in spite of Favorable Issue violates the Companies Act, and the existing shareholders may demand the company to cease the new issue (Article 210, Paragraph 1; Article 201, Paragraph 1; and Article 199, Paragraph 3 of the Companies Act). Yet, for that purpose, they need the ground to determine whether or not it is Favorable Issue, and sufficient disclosure of information on the basis of price calculation is the prerequisite.

However, in many cases of private placements which may fall under the category of Favorable Issue, the calculation basis of the amount to be paid in has not been sufficiently explained. Such cases include the cases where discount ratio changes depending on calculation method. For instance, while a discount ratio is 10% or less compared with a monthly average closing price, the discount ratio may be 10% or less compared with a closing price of previous day.

Therefore, possible responses would be to require companies to provide sufficient explanation on the calculation basis of the amount to be paid in; and a certain assurance for its legality by, for instance, disclosing opinions of statutory auditors (or audit committee in case

[18] Concerning how to treat change of controlling shareholders for reasons other than private placements to a third party, it would be sufficient to limit to those caused by the private placements for the time being, as the important point here is elimination of arbitrary selection of large shareholders by management decision.

[19] Under self-regulatory rules in the securities industry concerning capital increase by private placement of shares to a third party, it is the basic principle to set an issue price to 90% or more of the price as of one day prior to the date of resolution of the board of directors, except for the cases subject to special resolutions of general shareholder meetings. However, taking into account prices or trading volume until the most recent date or one day prior to the date, it is also allowed to calculate the issue price to 90% or more of the average price during the following period: from the date preceding (a reasonable time to determine the amount of money to be paid in; max. 6 months) the date of the relevant resolution to the date prior to the relevant resolution (Japan Securities Dealers Association 'Guidelines for Private Placements to a Third Party' May 1, 2006).

of a company with committees) on legality, if the discount ratio exceeds 10% depending on the calculation method.

In case of private placements of bonds with subscription warrants and subscription warrants, it is rather difficult to judge whether or not they are Favorable Issues, and we found relatively many cases doubtful about applicability to Favorable Issues. Accordingly, it is suggested to require the calculation basis of the amount to be paid in and disclosure concerning legality for all the private placements of bonds with subscription warrants and subscription warrants.[20]

(d) Addressing private placements without proper financing

In addition to the above-mentioned issues, we found some cases where proposed capital increases were cancelled after announcements of private placements, because of non-payments by the parties allocated. Providing information on private placements without ensuring finance may sometimes confuse the market, damage the market credibility, and even abuse the market by manipulating stock prices on purpose. There is a high risk for causing unforeseeable damages to a large number of diverse investors.

Therefore, to ensure fairness of the market and protect shareholders and investors, the listed companies are expected to confirm finance of the parties which they allocate new shares in advance. To ensure that, it is appropriate for TSE to require the companies to go through the procedures to confirm finance of the counter parties, and adopt the system to require disclosure of methods and results of such confirmation.

(e) Summary

The following chart shows the measures to be taken concerning private placements as mentioned earlier:

[20] As there is no established calculation method for exercise price and issue price for bonds with subscription warrants and subscription warrants, it is pointed out that statutory auditors may face difficulties to present their opinions. Taking this point into account, some stated that it is appropriate to request for enhanced disclosure on factors used for calculating an issue price which the statutory auditors used for the basis to judge the legality, and some argued that it is desirable to formulate certain guidelines for conditions for issuing bonds with warrants and subscription warrants, similarly to the Guidelines for private placements of shares to a third party (see footnote 19).

Issues	Target	Procedures/Examination	Note
Dilution / change in control of a company	Dilution exceeding 300%	Subject to examination	No regulatory action will be imposed to the cases with low risk of damaging shareholder interest
	Dilution of 25% or more or with change in control of a company	Obtaining opinions from person(s) independent from corporate management; or Confirming shareholder opinion by a resolution of shareholder meeting, etc.	When TSE finds it an emergency case requiring immediate finance and facing difficulty to comply with the procedures in the left, the procedures will be waived.
Issues with the allocated third party	Change of controlling shareholder	Ex-post confirmation of transaction with a controlling shareholder	
	Allocating to a party other than a listed company or trading participant	Confirming whether the allocated third party has any relation with anti-social forces or the like	
Applicability to Favorable Issue	Discount ratio exceeding 10% depending on calculation method	Disclosure of opinion on legality from statutory auditor or those with the similar function	Mandatory for bonds with subscription warrants and subscription warrants.
Finance of the third party	All private placements	Listed company's confirmation on finance of the party to be allocated; and disclosure of method and result of such confirmation	

C Reverse Stock Splits

a. Issues to be addressed

The Companies Act [21] allows a company to conduct a reverse stock split on the basis of a special resolution of general shareholders meeting (Article 180, Paragraph 2, and Article 309, Paragraph 2, Item 4 of the Companies Act).

Reverse stock splits which generate fractional shares, however, significantly affect minority shareholders who consequently find themselves holding less than one share and thus lost their positions as the shareholders.[22] For instance, some listed companies carried out reverse stock splits depriving shareholders' positions from approximately 80% of the shareholders, followed by private placements causing substantial dilution, taking advantage of authorized capital limit virtually enhanced by the reverse stock splits. As reverse stock splits, especially those

[21] Before revision of the Commercial Code in 2001, reverse stock split was allowed only in the following situations: (i) in case of mergers and other organizational restructuring; or (ii) for making book value per share 50,000 yen or more (Article 214, Paragraph 1 of the old Commercial Code 2001 [2001, Law No. 79]).

[22] An effect of depriving shareholders of their positions also occurs upon utilization of class shares subject to wholly call (Article 108, Paragraph 1, Item 7 of the Companies Act). Concerning voting rights, change in the number of shares per unit may deprive some shareholders of their voting rights. From the perspective to ensure protection of shareholders and investors as well as market credibility, it would be necessary to address these cases with the similar effects. Nonetheless, as discussed later, reverse stock splits involves many issues such as non-existence of appraisal rights under the Companies Act, and therefore discussion here is focused on the cases where minority shareholders lose their positions as shareholders due to fraction less than one share.

depriving the majority of shareholders' positions, significantly affect interests of shareholders and investors and damage the market credibility, the Exchange needs to strengthen its systematic responses.

Furthermore, concerning reverse stock splits, there are some cases with a problem of financial arrangements for fractions. If any fraction less than one share is generated, a company is supposed to sell the number of shares equivalent to the total sum of the fractions by auction and deliver the proceeds from such an auction to the shareholders in proportion to the fractions attributed to them (Article 235, Paragraph 1 of the Companies Act). As for listed shares, although a company may sell its listed shares at a market price (Article 235, Paragraph 2, and Article 234, Paragraph 2 of the Companies Act), unlike the case where appraisal rights are given to dissenting shareholders, there is no guarantee that the shares are purchased at "fair price." Furthermore, as it is rather difficult to sell all fractions at once while avoiding a drop of the stock price due to disposal by sales, smooth financial arrangement for the fractions tends to be impeded.

b. Current Situation

In the Code of Corporate Conduct set forth in the Securities Listing Regulations, TSE prohibits "reverse stock splits .. which may confuse the secondary market" (Article 434 of the Securities Listing Regulations).

In case of violation of the above rule, TSE may make a public announcement (Rule 508, Paragraph 4, Item 1 of the Securities Listing Regulations), or impose listing agreement violation penalty in some cases (Rule 509 of the Securities Listing Regulations).

Public announcement, however, has an effect only to alert investors depending on circumstances, and may not have sufficient effect for prevention. As the penalty charge was originally introduced to bridge the gap between public announcement and delisting, it would be effective for problematic corporate activities, which are not so serious as taking such a regulatory action as delisting. Yet as for problematic corporate activities which need to be practically banned, it is necessary to take a preventive measure by incorporating such activities in the delisting criteria.

c. Measures to be taken

As reverse stock splits, which generate fraction less than one share, impair minority shareholder rights, a company is required to prudently consider rationale for a goal to be achieved by a reverse stock split, and its need for and reasonableness of choosing reverse stock split in lieu of the goal.

There are various views concerning the above. For example, in case of using a reverse

stock split for the purpose of excluding minority shareholders by making their shares less than one share unit, one considers that the relevant resolution of shareholders meeting for such an unfair case will be nullified due to abuse of the majority vote under the Companies Act,[23] and another considers that it is applicable to a cause for nullification of the relevant resolution by recognizing as an extremely unfair resolution due to exercise of voting rights by a party of special interest (Article 831, Paragraph 1, Item 3 of the Companies Act).[24] In addition, there is a view that in case one share unit after the reverse stock split becomes so large that the majority of shareholders except certain large shareholders lose their positions of the shareholders, it would breach a principle of equality of shareholders.[25] From the standpoint of the secondary market, considering that such corporate activities may cause market confusion or damage the market credibility, it is adequate to impose some restrictions in a way to virtually ban the extreme cases.

Consequently, reverse stock splits which deprive shareholders' positions by generating any fraction less than one share should be subject to TSE's examination from the perspective of unreasonable restriction of shareholder rights. Furthermore, TSE should take a further preventive measure by including the case a company deprives many shareholders' positions without any rationale in the delisting criteria, from the perspective of ensuring the market credibility and shareholder protection.

As for reverse stock split, there is no stipulation about appraisal rights. Accordingly, regarding a fraction less than one share unit is generated, a company is supposed to sell the number of shares equivalent to the total sum of the fractions by auction and deliver the proceeds from such an auction to the shareholders in proportion to the fractions attributed to them (Article 235, Paragraphs 1 of the Companies Act, refer also to Article 235, Paragraph 2 of the same). There is no guarantee for purchase at "fair price" from the dissenting shareholders.[26] Consequently, the listed companies are expected to respect their shareholder interests as much as possible, even in case reverse stock splits in question may not be unreasonable violation of shareholder rights; and if they have an alternative method to secure the shareholders' appraisal rights, it is desirable to select such an alternative.

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[23] Hideki Kanda "The Companies Act [the 11th edition]" (*Kobundo*) p. 110

[24] Kenjiro Egashira "The Stock Company Act [the 2nd edition]" (*Yuhikaku*) p. 263 note 2

[25] *Ibid.* Egashira p. 126 note 6

[26] Concerning demand to purchase fraction less than one share unit, see Articles 192 and 193 of the Companies Act; concerning dissenting shareholders' appraisal rights upon mergers, etc, see Article 785, etc. of the same.

III System Improvement to Facilitate Communications between Shareholders and Listed Companies

A Issues to Be Addressed

Under the Stock Company (*kabushiki-kaisha*) System where shareholders elect management personnel whom they entrust with management of the company, the shareholders' monitoring of the management through voting rights and the elected management's accountability for the shareholders who entrust them of business are playing significant roles as the backbone of the system.

Especially, under the recent rapid changes of business environment, the company management needs to ensure that shareholders and investors understand and evaluate the current situation of the company more adequately and to fulfill their accountability about process of management decisions from time to time. There is growing recognition on importance of enhanced communications between shareholders and the listed companies, as well as importance of communications with investors through IR activities.

As for IR activities, TSE requires the listing companies to describe implementation status of IR activities in the Corporate Governance Report, and Japan Investor Relations Association (JIRA) provides with guidelines by formulating IR Activities Charter.[27] In this way, a certain progress in system improvement is observed.

In the meantime, shareholders exercise of voting rights is the fundamental right under the stock company system, and ensuring active general shareholders meetings and smooth exercise of voting rights form the foundation of the stock company system. Despite of that, voting rights have not always been actively exercised by shareholders, including institutional shareholders, in Japan. Some point out that such a situation is improving, triggered by recent changes in the circumstances such as emergence of activist funds. Yet investors are still making wide-ranging requests, including early submission of convocation notice, introduction of electronic voting system, and announcement of voting results at general shareholder meetings: that means environment for exercising voting rights can be improved further. Therefore, the Advisory Group discussed how to address the issue.

B Creating Environment for Easy Exercise of Voting Rights

TSE requested listed companies, in the Code of Corporate Conduct set forth in the Securities Listing Regulations, to improve environment for easy exercise of voting rights. (Rule 438 of the Securities Listing Regulations; Rule 437 of the Enforcement Rules for the Securities Listing Regulations). Specifically, obligations to make the following efforts are stipulated: (i) scheduling of general shareholder meetings avoiding the peak day, (ii) early submission of convocation notice of general shareholder meetings, (iii) submission of convocation notice, etc. by electromagnetic

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[27] Japan Investor Relations Association "IR Activities Charter - For Enhancement of Corporate Value and Further Development of Capital Market" December 2008 (https://www.jira.or.jp/jira/jsp/usr/outline/pdf/IR_gensoku.pdf)

means, (iv) translation of convocation notice, etc. into English, and (v) introduction of electronic voting.

As shown in Reference Materials starting from p.22 (Appendix 2 System Development to Facilitate Dialogues between Shareholders and Listed Companies), the implementation status are generally improving, and listed companies' efforts have shown certain achievements.[28]

Nonetheless, as exercise of voting rights is essential for corporate governance, companies need to make efforts for further improvement. It is suggested that TSE will conduct a survey of implementation status of the listed companies with regards to system improvement for exercise of voting rights, and strengthen the system gradually from an effort ready for enforcement in order to further improve the system.

C Disclosing Results of Exercise of Voting Rights

In connection with exercise of voting rights, there is a strong request from investors; that is disclosure of the voting results. At the moment, TSE does not have any particular rule in this regard.[29]

Investors are requesting for disclosure of the voting results, by expressing the following reasons: it will contribute to making investors realize the importance and achievement of exercise of voting; to show the extent of shareholders' concurrence with proposals made by the board of directors will be a good start of dialogue between shareholders and the listed companies; and it will remove doubts about fraud interpretation concerning letters of proxy and/or voting forms for written votes.

In this regard, the Companies Act stipulates that the letters of proxy and voting forms for written votes shall be kept at the head office of a company for 3 months from the date of the shareholder meeting and provided for shareholders' inspection in order to ensure adequacy in the exercise of voting rights (Article 310, Paragraphs 6 and 7 of the Companies Act regarding letter of proxy, and Article 311, Paragraphs 3 and 4 of the same regarding forms for written votes). In this way, the minimum measures to achieve the above-mentioned purposes are prescribed in the Companies Act.[30]

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[28] There are opinions demanding further actions including: posting documents such as convocation notices of shareholder meetings on TSE website in order to provide investors with at-a-glance view of necessary information and easy search environment; and requesting the listed companies to describe more about improving system concerning exercise of voting rights in the Corporate Governance Report.

[29] In UK and elsewhere, the listed companies already have a legal obligation to disclose the result of exercising votes (Article 341 of the Companies Act 2006 for disclosure of results of "poll (resolution under one-share-one-vote rule) (Article 284 of the Companies Act 2006)"; Combined Code on Corporate Governance, June 2008, D.2.2 for disclosure of results of exercising votes by letter of proxy). In EU, it is obligated for member countries to regulate disclosure of voting results on company websites no later than 15 days from shareholder meetings, by August this year (DIRECTIVE 2007/36/EC OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 11 July 2007 on the exercise of certain rights of shareholders in listed companies; http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2007:184:0017:0024:EN:PDF).

[30] According to a survey covering 2562 domestic companies (except start-up companies and foreign companies) listed on 5 stock exchanges in Japan, 7 out of 1962 respondent companies reported the cases of receiving requests for inspection/copy of documents evidencing exercise of voting rights (Shoji Homu Kenkyukai "Shareholder Meeting White Paper [2008]" *Junkan Shoji Homu* vol. 1850, p. 75). In case a company refuse such requests without a reasonable ground, fine will be imposed (Article 976, Item 4 of the Companies Act).

However, even if shareholders can inspect the voting results, it is not easy for them to count the votes. From the perspective of enhancing transparency in the procedures related to the exercise of voting rights, it is desirable to set up the system enabling shareholders easily get access to the voting results.

IV Conclusion

This Report was prepared to make recommendations for certain rules concerning use of the Exchange Market from the perspective of ensuring shareholder/investor protection and market credibility, aiming to restore investors' confidence in Tokyo market, revitalize the market, and consequently strengthen the premise of smooth financing for listed companies in the market. While American capitalism and market mechanism have been questioned by some since the financial crisis, in order to restore market confidence and revitalize the market, it is essential to continue active dialogues between listed companies and investors, and further enhance transparency of the market. The Advisory Group expects TSE to improve the system by reflecting the recommendations presented in this Report and referring to opinions from various parties including public comments.

Corporate governance of the listed companies is discussed not only within TSE, but also by all related organizations. Especially, within the Sectional Committee on Financial System of the Financial System Council, Study Group on Globalization of Japanese Financial/Capital Markets has been holding discussion on corporate governance of the listed companies and other, covering a wide range of matters including those covered in this Report.

The Advisory Group will continue to study the subject such as the matters which have not been fully discussed, as needed.

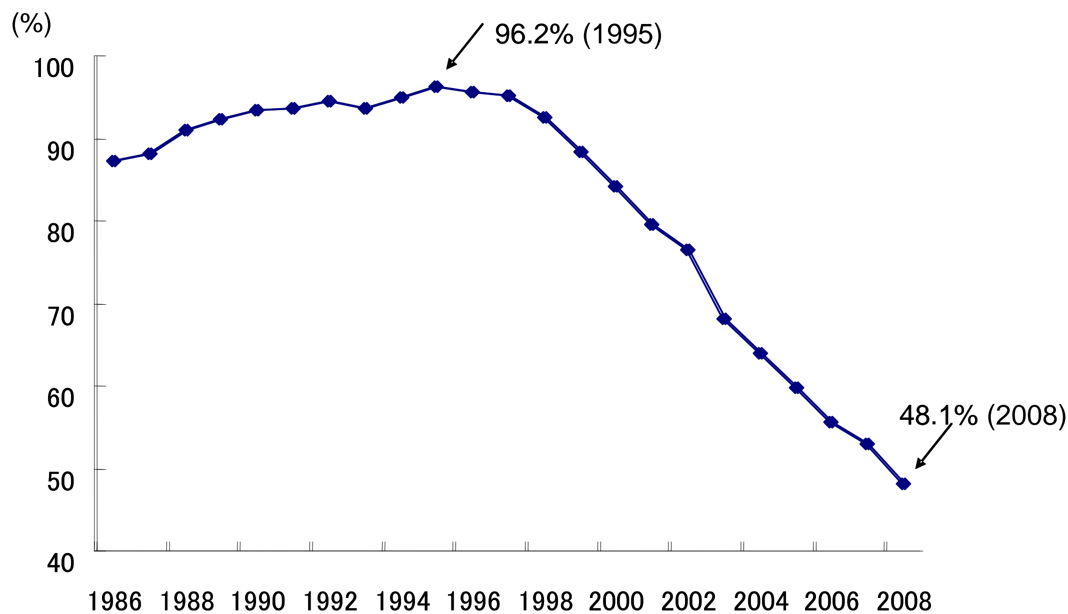
Reference Materials

Appendix 1 Outline of system relating to private placement in Japan, the U.K. and the U.S.

[Omitted]

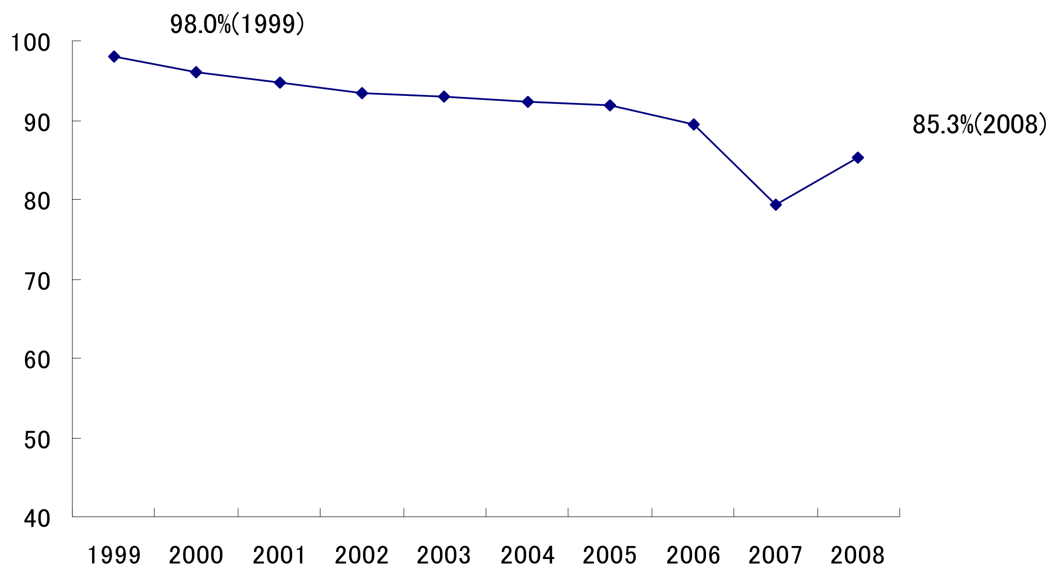
Appendix 2 System Development to Facilitate Dialogues between Shareholders and Listed Companies

2-1 Concentration of the general shareholder meeting (daily basis)



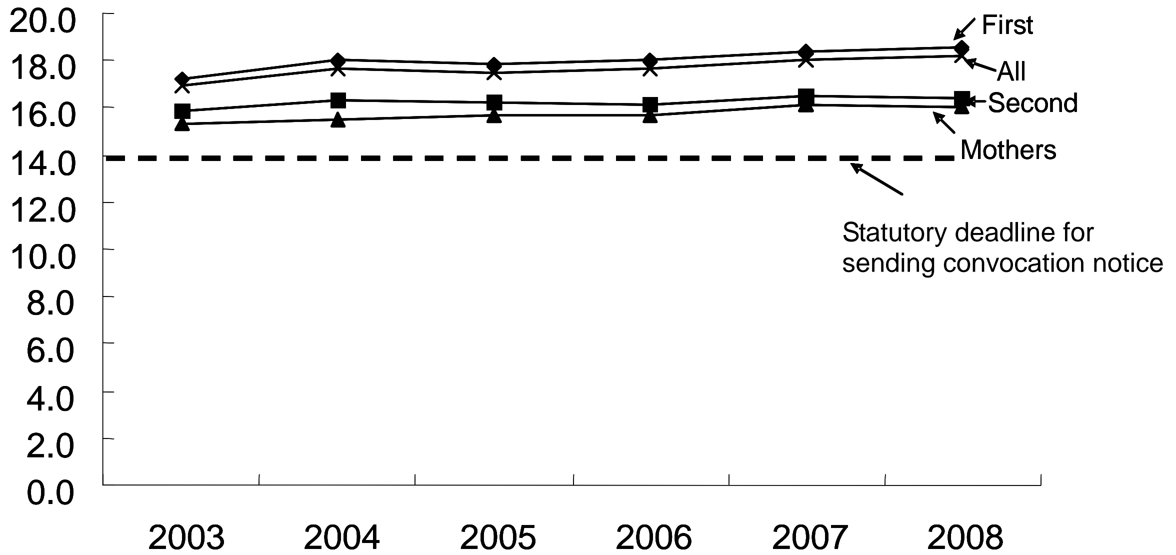
Source: TSE Home page (http://www.tse.or.jp/listing/sokai/shuchu/graph.pdf)

2-2 Concentration of the general shareholder meeting (weekly basis)



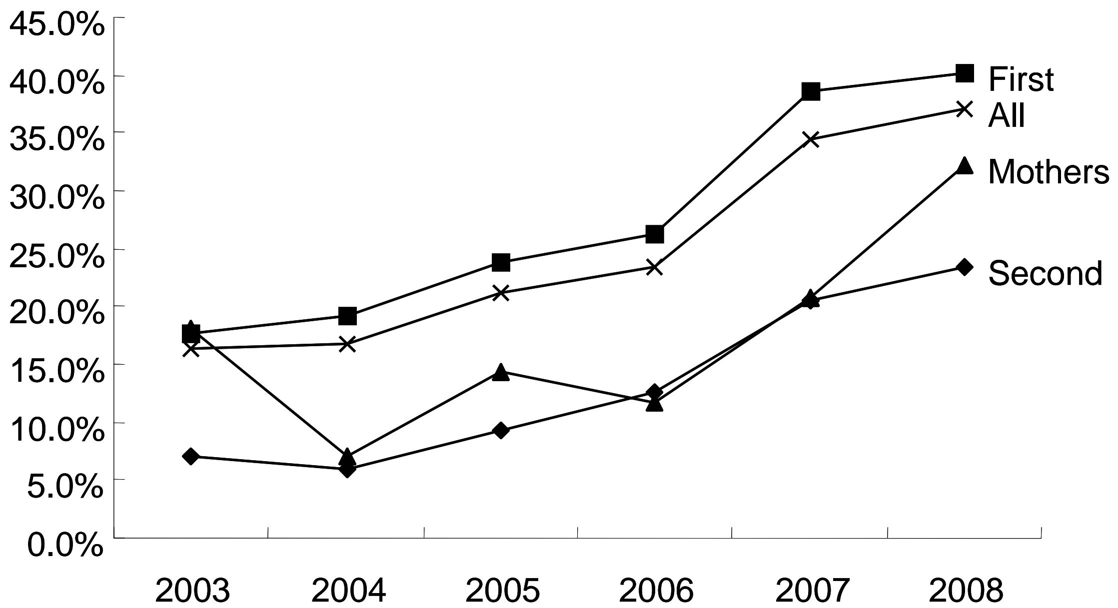
Source: Prepared by TSE from the results of the questionnaire survey conducted by TSE

2-3 Number of days between the date of sending general shareholder meeting convocation notices and the date of general shareholder meeting



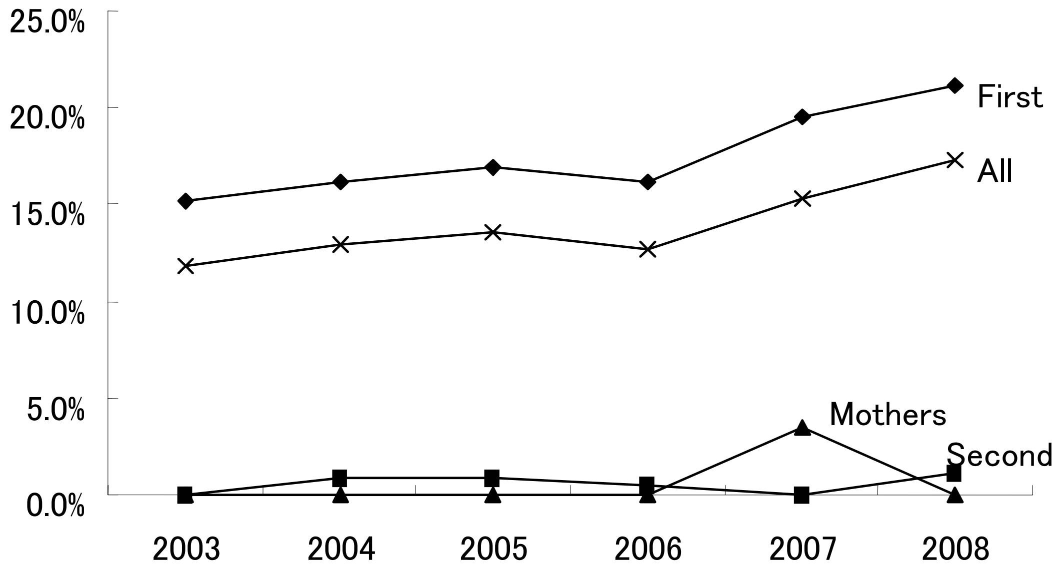
Source：Prepared by TSE from the results of the questionnaire survey con ducted by TSE

2-4 Posting general shareholder meeting convocation notices on company's website



Source：Prepared by TSE from the results of the questionnaire survey conducted by TSE

2-5 English translation of general shareholder meeting convocation notices



Source: Prepared by TSE from the results of the questionnaire survey conducted by TSE

2-6 Introduction of electronic voting

Source: Prepared by TSE using Data used for Corporate Governance Report

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(in the order of Japanese syllabary)