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Improvements to Listing Rules to Protect Minority Shareholders

Tokyo Stock Exchange, Inc.

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- At the study group so far, TSE has received various opinions on possible measures to improve the listing rules for the protection of minority shareholders, as well as their necessity and related challenges.

  ⇒ Given that protecting minority shareholders will require a combination of multiple measures across the entire system, TSE will continue to study what improvements to the listing rules will be necessary. (The study group will discuss this again once TSE has put together its research.)

Measures to improve the listing rules suggested in previous discussions

Item	Revision of rules targeting controlling shareholders	Extension of scope of rules to cover quasi-controlling shareholders
Ensuring the independence of independent directors	• Addition of independence standard (absence of business or economic relationship with a controlling shareholder) • Requirement of approval from a majority of minority shareholders for designation as independent director under the listing rules • Disclosure of percentage of approval and disapproval votes by minority shareholders for appointment of independent directors	• Extension of scope of the independence standards (absence of a relationship with a quasi-controlling shareholder)
Procedural regulations for transactions/ actions that pose a risk of conflict of interest	• Revision of transactions and actions subject to the procedure of obtaining opinions • Ensuring the involvement of independent directors in the procedure of obtaining opinions	• Extension of scope of the procedure of obtaining opinions to transactions/actions involving quasi-controlling shareholders
Rules for listed parent companies	• Clarification of duties of a listed company that is a controlling shareholder	
Other	• Mandatory appointment of independent directors • Rules on changing a group management policy	

Discussion by Issue 1/5

Addition of independence standard (absence of business or economic relationship with a controlling shareholder)

Necessity/effectiveness

- **There are times when the influence based on a business relationship cannot be ignored,** so this should be incorporated into the independence standards**.**
  - Looking at disclosure examples, law firms or lawyers that provide legal advice to the controlling shareholder or directors/employees of the controlling shareholder's group are close to the controlling shareholder. Such attributes should be considered as factors in the independence assessment.
  - It is necessary to consider not only independence from the controlling shareholder, but also independence within the controlling shareholder's group.
- **Rather than uniformly judging these people not to be independent** under the independence standards, it is better to **treat them on the premise that in situations when conflicts of interest arise, they cannot be expected to play a role in protecting minority shareholders**.
  - **The relationship between a subsidiary and the business partners of its parent company is doubly indirect, so it is not clear how much influence could be had between these two.** If independence is strictly required even in such cases, there is a concern that it could weaken the parent company's control over the subsidiary.
  - **It would be excessively restrictive to deny the independence of a parent company's business partner even if they have no connection to the subsidiary's business.**
- **Since there are limits to ensuring complete independence by making the independence standards more detailed,** other measures (e.g., pressure on the company based on approval ratios) should be considered.

Practicality

- This could make it more **difficult to find candidates for independent director positions.**
- **In practice, it is difficult for a subsidiary to confirm its parent company's business relationships**.

Methods of inclusion in the independence standards

- One possible way would be to classify the independence standards into two types: (1) mandatory standards and (2) standards that can be satisfied alternatively by a procedural requirement, such as approval by a majority of minority shareholders. The absence of a business relationship would be included in (2).

Discussion by Issue 2/5

Requirement of approval from a majority of minority shareholders for designation as independent director under the listing rules

Necessity/effectiveness

- **Without a certain level of support from minority shareholders, it may not be possible to justify that an independent director is an advocate for the interests of the general and minority shareholders.**
  - **This is a mechanism to ensure independence from the controlling shareholder as an objective attribute and also to have independent directors fulfill their fiduciary duty to minority shareholders.**
  - At a company without a controlling shareholder, independent directors are qualified through the independence requirements plus an appointment by the general meeting of shareholders, which is also independent. **This requirement is equivalent to requiring companies with a controlling shareholder to secure similar requirements in practice, and it follows naturally from the current Corporate Governance Code and listing rules.**
- **Whether a director can be labeled as an "independent director" under the listing rules is of no small practical significance** since many institutional investors incorporate this into their basic policy related to voting criteria.
- The benefits of this requirement could be limited, as it would mean that independence is denied ex post facto after the appointment, but **the director has still been elected as a director and can be reappointed in the same manner in following years**.
- **The concept of independent directors/auditors is to determine independence based on objective attributes, whereas the MoM ensures independence through focusing on the process. Mixing these two ideas is questionable** and only one of them should be taken.
- The conditions for application should be fully discussed.
  - **Problems are less likely to arise when there are a large number of small-scale minority shareholders.**
  - **There is a concern that if this is too broadly applied, it could weaken governance by the controlling shareholder**. Possible cases where it should be applied include where a subsidiary's independent directors are dismissed, resulting in a situation where conflicts of interest cannot be managed, or where the board ignores the opinion of a special committee consisting mainly of independent directors.

Impact on voting rights of controlling shareholders

- **Because the basic structure of the stock company is based on control backed by the share of voting rights, it would be excessive to always require approval by a majority of minority shareholders for independent director appointments, even in the ordinary course of business.**
  - We should go back and review the original concept of what shareholder rights and voting should mean. The perspective that **the voting rights themselves represent how much responsibility they have in investing in the company is also very important.**
  - **If the shareholding ratio of the controlling shareholder is high and the percentage of voting rights exercised by minority shareholders is low, a proposal could be decided only by a very small number of shareholders, which is a significant divergence from the principle of capital majority voting.**
- **Requiring a majority of minority shareholders' approval does not preclude a parent company from exercising its right to appoint or dismiss executive directors of the subsidiary.**

Discussion by Issue 3/5

Requirement of approval from a majority of minority shareholders for designation as independent director under the listing rules

Practicality

- **This requirement could result in a situation where minority shareholders who hold more than a certain percentage of voting rights can control the resolution, which may be abused.**
- There is a good chance that **some potential candidates may be reluctant to accept an offer due to the risk of being rejected by the minority shareholder vote**, placing an undue burden on companies in securing director candidates.

Methods of inclusion in the listing rules

- How to handle the voting rights of major shareholders other than the controlling shareholder will be an issue.
- TSE should consider a rule that if approval from a majority of minority shareholders in not obtained, the person will not be elected even as a director, although the validity of this rule under the Companies Act would need to be examined.

Disclosure of percentage of approval and disapproval votes by minority shareholders for appointment of independent directors

Necessity/effectiveness

- Since the results of resolutions are disclosed in the extraordinary report, if you can see the shareholding ratio of the controlling shareholder, it is possible to make a fair estimate of the approval ratio from minority shareholders. However, **there could be ways to improve information disclosure to make clearer how much an independent director candidate is supported by minority shareholders.**
- **We could expect that this would encourage independent directors to act with awareness of their expected role, as well as pushing institutional and other investors to change their mindset and vote against independent directors who are not fulfilling their expected role.**

Practicality

- **It may be misleading to exclude voting results on the day from the tally, but the burden on companies should be considered when including them in the disclosure.**

Other disclosures on the appointment of independent directors

- **If the percentage of minority shareholders in favor is low, the board should analyze and consider how to address this, and the nomination committee should advise the board on these actions.** In addition, **details should be disclosed** so that it is clear whether the board and the nomination committee are functioning.
- **If the parent company's nomination committee discusses the appointment of independent directors of the listed subsidiary, the details of this discussion should also be disclosed.**
- For reappointments of independent directors, **it is important to disclose information that will help minority shareholders evaluate how the director has fulfilled their role of protecting minority shareholders.**

Discussion by Issue 4/5

Revision of transactions and actions subject to the procedure of obtaining opinions

- The current rule was enacted against the background of the circumstances at the time of enactment, but **it is conceivable to expand the scope of the rule to cover a wider range of situations and different types of transactions**.
  - TSE should review whether the current rules, which are based on events that are subject to timely disclosure, are not either excessive or insufficient in their coverage of situations that could be problematic when monitoring the risk of conflicts of interest between controlling shareholders and subsidiaries.

Ensuring the involvement of independent directors in the procedure of obtaining opinions

- Minority shareholders would surely prefer to see an opinion given from an independent director perspective, rather than a board member perspective, so TSE could **set out a rule to require the involvement of independent directors in the procedure**.
- The provisions of the Corporate Governance Code are based on the idea that it is highly necessary to establish a special committee when the ratio of independent directors on the board is low. However, TSE should more proactively look into the **situations where a special committee can function effectively and consider incorporating them into the listing rules**.

Clarification of duties of a listed company that is a controlling shareholder

- There is a balance to be kept whereby the parent company is responsible for the governance of the subsidiary, but when conflicts of interest arise the subsidiary will address them to protect minority shareholders. Based on this, **TSE should explicitly stipulate how the parent company should behave in the Code of Corporate Conduct.**
- When a subsidiary makes disclosure of its relationships with the parent company (especially contracts between them), it is inevitable that it will be influenced by the parent company's intentions, so **TSE could stipulate in its regulations that the parent company is required to cooperate in the disclosure**.

Mandatory appointment of independent directors

- The discussion in the study group is based on the assumption that a subsidiary has one or more independent directors. Listed companies without independent directors are very problematic.
- Rather than entrenching and developing special committees in practice, it is more desirable to increase the number of independent directors.

Rules on changing a group management policy

- There are two types of group management: integrated management and independent management. A change to this policy while listed would catch investors and general shareholders off guard. TSE should consider this issue, including whether this is permissible.

Discussion by Issue 5/5

Extension of scope of rules to cover quasi-controlling shareholders

General remarks

- **Any regulation should be based on whether a shareholder has de facto authority to appoint directors. One possible way is to calculate, based on the average voting rights exercised in the past, the percentage of voting rights at which a shareholder can be deemed to have de facto authority, and use that percentage as the threshold.**
- **If the shareholder has entered into an agreement that relates to control over the company, this should be taken into account.**

Extension of scope of the independence standards (absence of a relationship with a quasi-controlling shareholder)

- The current external standards under the Companies Act and the independence standards under the listing rules (which are based on these) require the absence of a relationship with the controlling shareholder, but **not the absence of a relationship with the quasi-controlling shareholder**. This is an issue for consideration.
  - Given the current practice in the market, TSE should require independence from major shareholders.
  - One proposal is to deny independence if the shareholder owns more than 1% of the company, which is the threshold for shareholder proposals, and has an agreement regarding the appointment of directors of the subsidiary.

Extension of scope of the procedure of obtaining opinions to transactions/actions involving quasi-controlling shareholders

- **TSE should expand the scope of the procedure for obtaining opinions to cover quasi-controlling shareholders.**

(Reference) Regulations on Conflicts of Interest in Each Market

	Ex ante regulations		Ex post facto regulations (Liability for damages, etc.)
	Regulations on governance structures	Regulations on transactions	
U.S.	• **Companies with controlling shareholders are exempt from many governance structure regulations.** ➢ Appointment of a majority of independent directors, establishment of nomination and compensation committees, etc.	• In related party transactions ($120,000 or more) , ➢ **An audit committee or another independent body of the board of directors conducts a prior review and oversight and will prohibit the transaction if inconsistent with the interests of the company and its shareholders.** (NYSE) ➢ **An audit committee or a comparable body of the board of directors conducts a post facto review and oversight.** (Nasdaq)	• Based on **the fiduciary duty of a controlling shareholder to minority shareholders**, **the controlling shareholder is liable to the company for damages** if the company suffers damages as a result of transactions with the controlling shareholder or deprivation of opportunities by the controlling shareholder (case law).
U.K.	• The Articles of Incorporation of a company must **have a Majority of Minority rule** for the appointment of independent directors (if a shareholder becomes a controlling shareholder after listing, before the next general meeting of shareholders). – However, if the MoM is not obtained, the proposal can be re-proposed after a certain period of time, and if a majority of all shareholders approve the re-proposal, the appointment can be made.	• **An agreement is required to ensure that transactions with the controlling shareholder are conducted at arm's length** (if a shareholder becomes a controlling shareholder after the listing, within six months thereafter). * • **Approval by the general meeting of shareholders is required for transactions with related parties other than transactions in the ordinary course of business** (with exemptions based on numerical criteria). ** – Voting rights of related parties are excluded at the shareholders' meeting.	N/A
Japan	• **On a comply-or-explain basis**, one of the following is required ➢ **Appointment of a majority (Prime Market) or at least one-third (Standard Market) of independent directors** ➢ **Establishment of a special committee to manage conflicts of interest, including independent directors.**	• In a transaction with a controlling shareholder, companies are required to **obtain an opinion from an entity who has no interest in the controlling shareholder regarding whether the transaction would undermine the interests of minority shareholders**	N/A

* An amendment from rule-based to comply-or-explain-based is under consultation.
** Amendments (1) to relax the numerical criteria and (2) to require confirmation by a sponsor instead of approval at a general shareholders meeting are under consultation.