[English Translation]

[Supplementary Document]

September 11, 2015

Opinion on Cross-Shareholdings

Forum of Investors Japan

Purpose of this Opinion

The issue of cross-shareholdings is the theme that was discussed most vigorously during the first and second Investors Forums. The majority of the participants called for a reduction in cross-shareholdings.

From the investors' side, *comply* or *explain* on the premise that cross-shareholdings will continue, is not the point of this issue. Rather, the interest of the investors lies in the serious efforts to deal with the structural issue, which has become a legacy due to its historical background. That is, to settle the gap between the original purpose of cross-shareholdings and the "objective behind cross-shareholdings" and "economic rationale", which have been questioned in the CG Code, and to settle the issue of companies who "let their shares be held by other companies", the confusion with portfolio investment (pure financial return seeking investment), the conflict of interest with minority shareholders and the procyclicality with regard to financial institutions. We hereby introduce the opinions of investors with regard to these issues.

In the following, we list, for each point of issue, the main statements made by the participants during the two forums. Note that, the paragraphs in italics are supplementary explanation or reference information on the purpose/background of the statements. Please regard this as the common consensus of the participants.

I Statements Concerning Responses to the CG Code (Principle 1.4)

1. Policy for Cross-Shareholdings

- With regard to the policy for cross-shareholdings, merely stating that a company will "determine comprehensively" is not sufficient as a disclosure.
- Companies which state that they may sell their shares as the case may be, or will decrease their cross-shareholding in the long run, can be relatively appreciated. On the other hand, there are companies that apparently have no intention of selling their cross-shareholding shares.
- **Eisai Co., Ltd** clarifies within its business model its position of cross-shareholdings, and states that it holds the minimum number of cross-shareholding shares.

- We would like to know the exact transaction amount with the companies that a company strategically holds shares in.
- There are some companies which state that their directors in charge will review the necessity of the disposal of cross-shareholdings. Does this mean that cross-shareholdings will not be subject to the review by the Board of Directors if the director in charge decides so?
  Outside directors should establish a cross-shareholding supervisory committee to review this.
- Some companies state that the initial purpose of cross-shareholdings is the growth of their business partner, and the final purpose is the enhancement of their own corporate value. This is very far from the investors' points of view. **Aisin Seiki Co., Ltd.** states that it will hold shares of other listed companies if it becomes necessary for the enhancement of its own corporate value. This is a relatively convincing purpose of cross-shareholdings.
- We would like to ask the companies to disclose the results of the review by the Board of Directors with regard to the economic rationale of cross-shareholdings.
- Since cross-shareholdings are not portfolio investment, it is inappropriate to set the investment return as the basis of rationale.

2. Criteria for Exercise of Voting Rights Concerning Cross-Shareholdings

- With regard to exercise of voting rights, **Eisai Co., Ltd** states that it will oppose the proposed motion if it determines that such motion is detrimental to its corporate value.
- There are many companies that practically do not disclose the criteria for exercise of voting rights or criteria for the sale of shares, even if they state that they *comply*. **Daito Trust Construction Co., Ltd.** *explains* some matters that another company states it *complies* (with almost the same contents), which deserves appreciation. We do not welcome companies that pretend to *comply*.

II Statements Concerning Companies Who "Let Their Shares Be Held by Other Companies"

- In light of compliance with the CG Code, the focus is on the economic rationale of the companies that hold the cross-shareholding shares. However, it is in fact important to think about the activities of the companies whose shares are held by other listed companies.
- Banks claim that client companies are denied the sale of shares, even though the banks would like to sell them. Also, there is a rumor that the banks will be given lower priority in loans if they sell client company’s shares.

- If companies who hold shares cannot sell them at their own discretion, this might imply that the companies who "let their shares be held by other companies" intervene with the corporate strategy of the companies who are "made to hold shares of other companies".
- If any constraint is imposed by not responding to a request for cross-shareholdings, "letting other companies hold shares" may cause more problems than "holding the shares of other companies".

<Background of Cross-Shareholdings>

The cross-shareholding practice started soon after the war, but after the capital liberalization in the 1960's, cross-shareholdings has increased significantly due to the awareness of the acquisition risks by western companies, and it is believed that, in the "bubble economy" in the 1980's, cross-shareholdings started to expand among companies (such as close-relations and business partners) as the basis for financing. The background underlying this cross-shareholdings between companies was the prevalence of buying-up of shares in the 1950's, and the flaw in the transaction system in relation to hostile buy-outs. This implies that cross-shareholdings by companies were not motivated only by purely business reasons (such as a sign of business partnership) or profit increase. Rather, it was motivated as measures for shareholders such as stabilization of shareholding structure. In such case, the active agent of the cross-shareholdings would be the companies who "let their shares be held by other companies" rather than companies that "hold shares of other companies".* ***(* For more details, please refer to Supplement 1 below.)***

Participants shared the awareness that three aspects should be distinguished with regard to the cross-shareholdings issue. That is, the difficulty in reviewing the economic rationale of cross-shareholdings, the issue of conflict of interest with minority shareholders, and the effect of stock price fluctuations on the banks' financial base (the procyclicality issue), which is an issue that is unique to banks. The following summarizes the statements for each point in question.

III Statements Concerning the Difficulty in Reviewing the Economic Rationale of Cross-Shareholdings

1. Economic Effect of Cross-Shareholdings

- Does the economic effect of possessing shares of a business partner really exist?
- There are cases where the management states that the continuation of transactions with business partners that do not hold shares causes no problem.
- When Mr. Carlos Ghosn sold the majority of the cross-shareholdings upon the reorganization of Nissan Motor Co., Ltd., friction arose in the business relation temporarily,

but Nissan restored its financial health.

- If the purpose of cross-shareholdings cannot be explained from the economic effect perspective, it is important that the companies realize this difficulty.
- Banks use RORA (return on risk assets) to review the economic effect of cross-shareholdings, and compare and weigh the economic effect against costs such as capital costs; however, business companies tend to have less sense of capital costs.
- Foreign investors recognize shareholding, which is convertible into cash, as assets equivalent to cash and deposits, and correlates this with the excessive cash holding issue.

<Cost Benefit of Cross-Shareholdings>

Generally, cross-shareholdings are designed as a sign of business relationship and shareholder stabilization, and are expected to have positive effects on the management. However, this effect is difficult to measure. Meanwhile, cross-shareholdings will definitely incur capital costs. Of course, there will be cases where the benefit brought about by building a long-term business relationship exceeds the costs of cross-shareholdings. If, however, "high cost transactions" (transactions in which costs exceed benefits) are left untouched, this would be destruction of value for the stakeholders of the companies, including shareholders.

2. Confusion with Portfolio Investment

- It is wrong to explain the reasons for cross-shareholdings from the investment return perspective. Rather, the risk perspective is important.
- There are companies that review only the critical cross-shareholdings, but what are "cross-shareholdings" that are not critical?
- There are many cases where the reason for cross-shareholdings is confused with portfolio investment with respect to both of the review of economic rationale and exercise of voting rights. In fact, the reason for cross-shareholdings is not clear. It seems as if cross-shareholdings are merely an inheritance from the past.

IV Statements Concerning Conflict of Interests with Minority Shareholders

- Putting the theoretical benefit aside, which is difficult to evaluate, the concept of actual conflict of interests between cross-shareholdings and those of the minority shareholders is important.
- In a way, cross-shareholdings are a "hostage" for the continuation of business relationship.
- A preposterous movement may arise, where a party threatens to sell shares and puts pressure on having a business relationship.

- The practice where higher business priority is given to a holder of cross-shareholdings might mean that business transactions are used for measures for stable stockholding.
- If holding shares of a business partner yields special benefits, this might mean that companies who "let their shares be held by other companies" provide excessive benefits to companies who "hold shares of other companies".
- Persons relevant to shareholders who are identified as holding shares in other listed companies are not qualified for independent outside directors.
- There are some companies that explain that such companies rarely have a business relationship with the company to which their independent outside directors belong, but at the same time, explains that such companies have cross-shareholding shares of the company to which such directors belong, and such cross-shareholdings are important to maintain their business relationship. This is contradictory.

<Issue of Cross-Shareholdings from the Aspect of Maximization of Value>

Investors are concerned that cross-shareholdings by companies may hinder the activities to pursue value in the economy. For instance, cross-shareholdings have been conducted in order to reinforce the relationship between companies, which is called the order in the industry. Appointment of business partners and cross-shareholdings indicate the balance of power, which will reduce the possibility of pursuing the best opportunities of individual companies. In addition, we see comments such as "cross-shareholdings are not absolutely necessary to facilitate business, but its background over the years makes them untouchable". These comments imply that management resources, which are supposed to concentrate on the business, are not leveraged effectively. Moreover, if measures for stable shareholders are taken in exchange for business benefits, this will put a strain on the environment for the pricing mechanism of capital market to function appropriately.

V Statements Concerning the Effect of Stock Price Fluctuations on the Banks' Financial Base (the Procyclicality Issue)

- At the time of the economic bubble burst and the Lehman collapse, the lending capacity of the banks decreased (the so-called "*kashihagashi* (forcible redemption of outstanding loans)") due to loss caused by cross-shareholdings, and this resulted in a chain of vicious spiral, which affected the whole economy.

<Cross-Shareholdings by Banks>

- *Potential Conflict of Interest*

If a bank, which is a provider of loans, becomes a shareholder, we may call this potential conflict of interest. Banks tend to request stable periodic profit to companies, due to their business structure. In that case, the interest of banks is likely to conflict with those of the general shareholders.

- *Effect on Real Economy*
  Since the balance of shares held by banks is large compared to equity capital, stock price fluctuations will affect the banks' ability to offer credit. As the regulatory capital requirement after the Lehman collapse has tightened globally (such as the BIS regulations), large cross-shareholdings by financial institutions such as banks has become a big risk for the economic society.

- *Issue of Bank Governance*
  If there exists a business practice where companies receive financing from specific banks because such banks hold shares in the companies, such practice implies that companies do not select banks based on the quality and capacity of the banks' financial services. Looking at this point from the bank management perspective, given the little difference in services and their excess-supply nature, the banks are content with their isolated (from a global viewpoint) structure by preserving the status quo in the industry. In addition, if the companies in which the banks hold shares have the "right to permit" the sale of shares, banks will be unable to economically optimize the portfolio of shareholdings.

IV Conclusion/Proposal

At the outset, we introduced the opinions of investors with regard to information disclosure of cross-shareholdings. From the investors' point of view, the essence of the problem does not lie in whether to *comply* or *explain* on the assumption that cross-shareholdings will continue to take place. The majority of the participants of the forums were of the opinion that cross-shareholdings should be terminated. Most of the investors think that "after all, in reality, cross-shareholdings are a defense measure of the issuers against takeover bid by causing stable shareholders to hold shares." When companies try to submit to the fulfillment of reasonable accountability, Principle 1.4 of the CG Code is an important principle for them to realize that "cross-shareholdings are not reasonable" and to head voluntarily towards the termination of cross-shareholdings. Given the above, investors would like to ask companies, who engage in cross-shareholdings, to take some actions in order to improve their ability of "earning power", as the new growth strategy of the government provides for. Such actions include, first of all, representing a policy to reduce future cross-shareholdings, and establishing a system to monitor the interests of general shareholders so that they will not be impaired by operating activities through misuse of the position of a cross-shareholding. Such system could include the establishment of a supervisory board comprising of independent outside directors. Appropriate actions are different for every company (e.g., in the case of strategic partnership), so it is desirable that companies and investors deepen their shared understanding through dialogues.

In addition, investors are concerned about the procyclicality risk, a risk that the cross-shareholdings by financial institutions (mainly banks) will weaken the Japanese financial system amid global competition. In particular, it is insufficient for major banks, who are subject to regulations such as BIS, to reinforce their monitoring system on the assumption that cross-shareholdings will continue. Aggressive downsizing of cross-shareholdings is desirable. If financial institutions take the lead in the reduction of cross-shareholdings, it would be a signal for Japanese companies and will trigger a change.

End

* For more information on the activities of the Forum of Investors Japan, please refer to the following website.
http://investorforum.jp

<Supplement 1: Historical Background>

- *After the zaibatsu dissolution as part of the postwar reform, the shareholding structure mainly consisted of individual shareholders. In the 1950's, the active capital requirements by companies and stable financing by banks shared a mutual interest, and formed the basis of main financing banks[1]. This formed a group of emerging companies, such as the Fuyou Group, DKB Group and Sanwa Group.[2.]*
- *The liberalization of capital in the 1960's raised the hostile takeover risk by foreign companies. The amendment of the Commercial Code, which facilitated the acquisition of shares of other companies, partly promoted the stabilization of shareholders and cross-shareholdings. In 1975, the shareholding ratio of stable shareholders[3] exceeded 60%.[4] Subsequently, until 1990, it was on the increase but remained stable.[5]*
- *The cross-shareholding relationship is formed between a bank and a business company, or between business companies, but the former was the main relationship. Immediately after the economic bubble burst at the beginning of 1990's, 3/4 (in value terms) of the cross-shareholding relationship was between banks and business companies.[6]*
- *The shareholding structure changed drastically since the banking crisis in 1997. As the jusen (housing loan) problem became obvious (1995), the price of bank shares started to fall, and from the collapse of banks in 1997, the speed of bank share price decline became particularly serious, which increased the risk of holding bank shares. Moreover, the introduction of the consolidated accounting system (March 2000) and market-to-market accounting (March 2002), business companies became more and more conscious of the shareholding risk, which promoted the sale of bank shares.[7]*
- *On the other hand, banks who had to confront the bad debt problem started to sell bank-held shares from around 1997. The establishment of the Act on Limits for Share, etc. Holdings by Banks and Other Financial Institutions in 2001, which limits the size of shareholding by banks within the extent of Tier 1 core capital under the BIS regulations (implemented in January 2002), further accelerated the sale of bank-held shares.[7]*
- *From 2005 through 2008, with the rise of activist funds, increase in hostile takeovers, and the start of forward triangular mergers (May 2007)[8], cross-shareholdings, which had temporarily decreased, partly revived in the name of "strategic capital alliance" between business companies. Banks also started to restore cross-shareholdings since the banks' needs to win transactions and the companies' needs for buyout defense shared a common interest.[9]*
- *Due to the deterioration in the economic environment after the Lehman collapse, the main financing banks started to withdraw the funds actively from inefficient companies. The record cash reserves of listed companies (excluding financial institutions) of 105 trillion yen[10] implies that the significance of the banks' role in consistent financing, which the banks had assumed in the old days, have become less. Also, with the increase of equity capital of business companies, their dependence on bank loans has become less, and the governance function of the main financing banks to intervene at the time of financial crisis has lost its effectiveness. On the other hand, the role of the main financing banks as stable shareholders have significantly been pulled back, in contrast to the cross-shareholding relationship between business companies which is ceasing to fall.[11]*

1. *i) Banks commit to the stable supply of funds to borrowing companies, and on the other hand, companies cooperate with the banks to increase the banks' competitiveness, by concentrating the companies' settlement accounts in such banks, ii) banks cooperate with the companies to stabilize the companies' management right, and in case of decline in earnings, the banks will take the initiative for saving their client companies, and at the same time, the management right will be transferred to the banks, and so forth ("Contemporary Japanese Economy", co-authored by Hashimoto, Hasegawa, Miyajima and Saito [Third Version], p.87).*
2. *"The Banks' Strategic Investment Shareholding", Report by Japan Association of Corporate Directors, p.5*
3. *Stable shareholders shall mean shareholders who hold shares as amicable "insiders", who support the current management, and not as genuine investment. More specifically, stable shareholders, with regard to issuers, implicitly agree to the following three points: they will i) keep silent unless there is serious decline in earnings, ii) not sell shares to a third party (a hostile raider, speculator) who does not support the current management, and iii) notify the issuer of their intention to sell the shares when the need for disposition of shares arises. (Ibid. by Hashimoto and others, p.100).*
4. *Ibid. by Hashimoto and others, p.101*
5. *"Corporate Governance in Japan" written and edited by Hideaki Miyajima, pp.109-12*
6. *"Cross-shareholdings have Declined, Mainly by Banks – Estimate of Cross-shareholdings: Version 2010" written by Masaharu Ito, Daiwa Research Institute Quarterly Report, 2011 New Year's Issue, Vol.1, Diagram 7*
7. *Ibid. by Miyajima, p.114*
8. *Ibid. by Miyajima, p.117*
9. *Ibid. by Japan Association of Corporate Directors, p.9*
10. *"Kyou no Kotoba (Capital Reserves of Listed Companies)", Nihon Keizai Shimbun, August 24, 2015*
11. *Ibid. by Ito, Diagrams 7 and 8*

<Supplement 2: Procyclicality Issue, Excerpt from the Financial Monitoring Report July 2015 by the Financial Services Agency>

[Measures for Further Enhancement of Financial Base Including Reduction in Stock Price Fluctuation Risks]

Compared to G-SIFIs in Europe and the US, the three major bank groups have a higher rate of shareholdings to equity capital. This means that particular attention needs to be paid to the impact on equity capital due to a decline in the stock price.

Currently, soundness of equity capital of the three major bank groups is as sufficient as that of G-SIFIs in Europe and the US, partly due to the net unrealized gains from shareholdings.

In the past, economic/market downturns affected financial conditions of financial institutions through a drop in stock price, and restricted sufficient function of financial institutions. (occurrence of procyclicality)*

Under these circumstances, it is necessary for the three major bank groups to further strengthen their financial bases especially through reducing the risk of stock price fluctuation in order to be able to adequately respond to the economic/market changes and business support needs of enterprises during hard times.

** Here, it means the amplifying effect upon the business cycle (Note 32 of the original report).*