Opinion Concerning "Cross-Shareholdings (Mutual Shareholdings)"

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In lieu of my attendance at the Third Council of Experts Concerning the Follow-up of Japan's Stewardship Code and Japan's Corporate Governance Code held on November 24, 2015 ("the council" hereinafter), I submit my opinions on cross-shareholdings (mutual shareholdings) which has been scheduled as the topic of the said council as shown below.

No. 1 Cross-shareholdings, especially cross-shareholdings by financial institutions should be dissolved as soon as possible.

・ With regard to cross-shareholdings, in the Corporate Governance Code, it is stated that: "When companies hold shares of other listed companies as cross-shareholdings, they should disclose their policy with respect to doing so. In addition, the board should examine the mid- to long-term economic rationale and future outlook of major cross-shareholdings on an annual basis, taking into consideration both associated risks and returns. The annual examination should result in the board's detailed explanation of the objective and rationale behind cross-shareholdings. Companies should establish and disclose standards with respect to the voting rights as to their cross-shareholdings." (Principle 1.4)

However, **there is very little room for the existence of cross-shareholdings that truly contribute to the improvement of long-term corporate value, and cross-shareholdings should be dissolved in principle. In addition, in view of the evils, cross-shareholdings by financial institutions in particular should be dissolved as soon as possible.**

・ In Japan, until the 1970's, governance (debt governance) of companies by financial institutions including main banks played an important role, and cross-shareholdings by financial institutions served a function of supplementing debt governance. However, as companies gained strength in creating cash flow on their own, and furthermore, as it became easier to procure funds through the bond market and by increasing capital through public offering of new shares due to monetary easing starting in the 1980's, the function of debt governance by financial institutions gradually weakened. In addition, in the midst of an intensification of bad-loan problems in the 1990's, the financial constitution of financial institutions deteriorated, and as a result, their debt governance power declined further, and in parallel with that, cross-shareholdings also lost significance in terms of governance.

・ Currently, companies are expected to strengthen equity governance, which is the original state of stock companies in which supervision of the management is maintained through a board of directors made up of independent and outside directors who are elected at general meetings of shareholdings, and the Corporate Governance Code is also based on that kind of thinking. This is where **shareholders, especially shareholders who hold a large volume of cross-shareholdings over the long-term, are strongly expected to become shareholders of the responsible ruling party type who speak up and support the long-term improvement of corporate value through appropriate exercising of shareholders' rights.** In normal times, such shareholders are expected to give appropriate advice to the management, and in times of emergency, they are expected to play a role of making drastic cuts including exercising their rights to dismiss executive officers.

In that aspect, the opposition party type of shareholders with short-term holdings who speak up (activists) are also a problem, but the majority of cross-shareholders including financial institutions are expected to be "stable shareholders" according to the real intention of companies, and at this rate, such shareholders will degenerate into the "silent (irresponsible) ruling party type," which means that they

do not fulfill their original role in terms of governance. It has been said that the majority of companies have not changed their stance towards this kind of shareholdings by "silent ruling party shareholders." Recently, I have heard of cases in which companies are making strong requests of financial institutions to maintain cross-shareholdings on the pretext of "strengthening and maintaining business relations."

However, **in the midst of expectations for a shift from debt governance to equity governance, this kind of action to maintain cross-shareholdings is the same as making a request for "a security pact between incompetent managers" under the good name of "strengthening business relations." It is inconceivable that this will truly lead to an improvement of long-term corporate value.** [1]

・ In the first place, considering that business relations of modern companies are becoming increasingly globalized, relations with business partners are becoming more fluid, parts and materials are becoming more standardized and open innovation is increasingly expected, it is dubious the extent to which rationality in explaining "improvement of company profit by strengthening business relations" in relation to cross-shareholdings of listed stock companies, including cross-shareholdings by companies, can be maintained. This is because to link business relations with becoming stable shareholders means "to stabilize," and at the same time, "to fix" business dealings, and in such an age of dynamic mega competition, the cost and disadvantages of fixing business relations in terms of competition will only keep increasing.

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[1] To give examples of "explanations" concerning cross-shareholdings, besides "strengthening business relations," there are also cases that state "building business relations for operational and capital partnership." It is true that there may be situations where there is a certain level of rationality in building business partnerships based on capital tie-ups, but if the business partnership is not regulated through the appropriate exercising of shareholders' rights in a way that that matches the common benefits of shareholders with respect to the target company, ultimately this is also merely a case of forming "a security pact between incompetent managers" in another form.

· The argument that "stable shareholders" through cross-shareholdings are important in order to protect corporate value from vulture fund activists such as green mailer is losing validity with the increasing accumulation of appropriate countermeasures through court cases and on the part of companies.

For example, with the buildup of precedents for the purpose of restraining the rampancy of shareholders who want to prey on companies through the abuse of power, the introduction of rational strategies to prevent takeover bids is now recognized. In addition, systems are being put in place for independent committees made up of third party experts and independent outside executive officers to determine the propriety of stockholder proposals or takeover proposals with a hostile element to the existing management from the perspective of maintaining and improving long-term corporate value.

In the midst of such changing circumstances, there is little necessity or validity for the bulwark strategy of keeping cross-shareholders—who are in actual fact obliged to form connections in business relations and take the side of the existing management—as "stable shareholders." While I was engaged in the Industrial Revitalization Corporation, I was also involved in the acquisition of many listed companies such as Mitsui Mining, Kanebo and Daiei from a "hostile" position to an extent in the sense that the acquisitions were based on the assumption that the existing management of the companies to be acquired would step down. However, in reality, being a supporter of the existing management and maintaining/improving corporate value for all stakeholders including shareholders do not always go together hand in hand.

· If one tries to enjoy the benefit of "strengthening business relations" through shareholdings by making a connection with the exercising of shareholder rights as "stable ruling party shareholders," one must not overlook the fact that this may raise the suspicion of "giving benefits" which is punishable as a criminal offence."

Presence/strengthening of business relations" cannot be used as an excuse for continuing to be a silent ruling party shareholder.

・ In this way, with regard to cross-shareholdings in general that are related to listed stock companies, almost all of the advantages in terms of governance and long-term improvement of corporate value have been lost. In addition to the disadvantages in the form of a hollowing-out of governance becoming more prominent, in case of cross-shareholdings by financial institutions in particular, there will be more severe damage to the balance sheet of financial institutions holding the shares of listed companies if the stock prices of listed companies suddenly fall in the event of a financial crisis. Considering that this would lead to a great reduction in the ability to supply fluidity to companies, which is the most important role of financial institutions during an economic crisis, ultimately the results will actually come back to haunt the company itself and the negative effect of cross-shareholdings will become more prominent. In other words, cross-shareholdings involving financial institutions for the purpose of scheming to retain short-term stable shareholders will increase the probability of long-term systemic risks occurring and becoming more severe, and are liable to become a foolish act that destroys the sustainability of the company itself.

Actually, even in Japan, since the bursting of the bubble in the early 1990's, this problem has become increasingly prominent in the form of the so-called "withdrawal of loan credit," and following the Lehman Shock, in the midst of a strengthening of leverage regulations on financial institutions, the latent risk that such problems re-emerge or get worse has increased.

・ Following from the above discussion, cross-shareholdings among listed companies should in principle be dissolved, and in particular, cross-shareholdings by financial institutions should be dissolved as soon as possible. Even in cases where cross-shareholdings among business companies are maintained, as I will

describe below, it is necessary to strictly implement appropriate exercise of shareholder rights in a way that contributes to common shareholder benefits in the form of long-term corporate value improvement ("Release" or "Exercise") .

No. 2 Appropriate exercise of voting rights should be strictly required even for cross-shareholdings by companies.

・ If a listed company insists to hold the shares of another listed company, shareholder rights, particularly voting rights, should be appropriately exercised. A listed company which is the shareholder of another company should not simply stop at the fact that it can exercise its shareholder rights. Instead it should adopt the thinking that it has a strict "obligation" to exercise its shareholder rights appropriately from the perspective described below.

・ First, considering that listed companies carry out fund procurement from a wide range of shareholders in general and use the funds in their business operations, it can be said that they bear a fiduciary responsibility in the same way as institutional investors. Therefore, if they own the shares of other companies, particularly listed companies, they should try to increase the mid to long-term investment return of relevant investments, and consider that the same provisions as the Stewardship Code are potentially working. That being the case, the exercise of voting rights must in principle be carried out in a strictly fair and just manner, and even if the other party is an important business partner, in matters such as the approval or disapproval of resolutions, or more importantly, the election of directors who are expected to become managers, if one thinks that the other party is not a person who can truly contribute to long-term corporate value improvement by taking into consideration the mid to long-term performance, ROE trends and so on, one should cast an opposing vote without any hesitation. On the other hand, if one

is concerned about the risk of relations with a business partner deteriorating due to such exercise of voting rights, then the rational action to take in terms of policy is to unwind such cross-shareholdings.

・ In addition, the obligation to exercise voting rights should be derived from the duty of due care of directors. Naturally, the directors of a listed company have a duty of due care to their own company, and if the listed company has cross-shareholdings of another listed company, the directors have to "appropriately" exercise their voting rights in relation to the shareholdings based on their duty of due care. If the directors do not exercise their voting rights appropriately, and the company whose shares are being held suffers any damage in its long-term corporate value, this will lead to damage in the corporate value of the company that holds the shares, which means that the directors have not performed their duty of due care in their own company.

・ In addition, with regard to voting right which is a common benefit right, individual shareholders, particularly large volume shareholders who have an influence in terms of governance (this also applies to owners of cross-shareholdings in most cases), have a latent responsibility to exercise their voting rights in a way that contributes to the common benefit of shareholders. That is precisely why it is called a "common benefit" right. If shareholders who hold cross-shareholdings exercise their voting rights by giving priority to selfish motives, such as maintaining business relations with the company in question or good relations with the management, over the long-term improvement of the corporate value, this kind of behavior carries a high risk of becoming an exercise of voting rights that goes against the common benefit of shareholders. Since listed companies are themselves a form of public institution, those that own cross-shareholdings should not exercise their voting rights in a way that violates the common interest of shareholders. In countries such as the US, this way of exercising voting rights may carry the risk of

being sued for violation of fiduciary duty to minority shareholders depending on the circumstances. In Japan, this kind of legal principle is not stated in the laws, but one must say that this is an indication of our backwardness in terms of legal policies in relation to corporate governance.

No 3. Summary: Need to provide institutional support for dissolution of cross-shareholdings

As I have said above, **with regard to cross-shareholdings, as to the question of "Release" or "Exercise," in other words, whether they should be dissolved or whether to continue holding them, appropriate shareholder voting rights should be exercised.**

In Germany, to dissolve mutual shareholdings, a measure was taken to make capital gains tax non-taxable, and **in Japan, we should also have discussions about institutional support that will give a boost to the dissolution of cross-shareholdings.** This is the final additional remark I would like to make.