Top priority issue on group governance

Calling for immediate incorporation of dominant shareholders' duties to protect minority shareholders into the Corporate Governance Code

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In connection with Japan's Growth Strategy, the most important and pressing issue concerning group governance currently lies in listed companies with "dominant shareholders". That is, there is a risk of conflict of interest between the general shareholders, especially minority shareholders, of a listed company (typically, a listed subsidiary) and its "dominant shareholder" (typically, its parent company), in other words a risk of impeding the growth of listed subsidiary, which could lead to the share of the listed subsidiary being traded at discount.

1. Economic mission of a listed company, and ideal relationship with its dominant shareholder (typically, the parent company)

The economic mission of a listed company is to maximize its corporate value , in other words to continue earnings growth. It is not to contribute to specific interests of certain large shareholders, including its parent company. In terms of governance, there are structural risk factors specific to listed companies with dominant shareholders. For example, in case of a business alliance or a transaction between a listed company and its dominant shareholder, which was initiated by the latter, it brings about benefits to the dominant shareholder, but may not necessarily increase corporate value of the listed company. For instance, a Japanese listed automaker is forced by its dominant foreign shareholder, which is also an automaker, to manufacture cars at an underproductive factory located in the home country of the dominant shareholder; and there is no economic rationale for the Japanese automaker.

The whole premise of "listed shares" is that even absolute beginners can purchase them, and that common interest of shareholders is protected regardless of the ownership ratio. The common interest of shareholders is in essence a matter of continued growth in corporate value of the listed company over the long term. Therefore, countries with mature and sophisticated capital markets have established

legal principles and rules stipulating that dominant shareholders have fiduciary obligations to protect minority shareholders' interest. Furthermore, the threshold of "being dominant" is often set at a much lower level than the majority. In contrast, Japan has not established such explicit legal principle and rules, and that is the root cause of the problem.

Triggered by a recent corporate scandal, the issues of the listed parent-subsidiary pairs and of the listing of subsidiaries have come under close scrutiny. Consequently, in an attempt to minimize the above-mentioned risk of conflicts of interest, they may try to address the issue only by imposing formal and meticulous regulations or blaming companies' decision-making procedures [instead of discussing the real nature of the issue]; and complicated protocols, which are unlikely to be feasible in a real business setting, may be imposed on the companies and shareholders concerned. There is a fear that such excessive regulations would eventually impede growth in corporate value of concerned companies.

Essentially, the legitimate reason for the dominant shareholder to have the shares of a controlled company listed should be that it would contribute more to the persistent growth in corporate value of the controlled company; leading to the increase in the value of controlled company shares over the long term, and thus the increase in corporate value of the controlling shareholder on a consolidated basis. If there is no impure motives beyond the above, and both the controlling shareholder and the controlled company act in accordance with the legitimate motive, they will not have any inconvenience with legal principles and rules stipulating that dominant shareholders have fiduciary duties to protect the interests of minority shareholders; conversely, there will be no need to introduce meticulous regulations to avoid the conflicts of interest. To put it the other way around, because there are no such legal principles and rules in Japan, the very form of parent-subsidiary listing or listing of subsidiary draws attention, but actually the form itself is not problematic. In fact, as a kind of incubation model, there have been many successful cases in Japan, including those spin-out companies, which [typically had been a business unit of the parent and] is now separated to become a listed subsidiary, that grow and develop to outstrip their parent and grandfather companies.

2. No more need for "true" reasons to have subsidiaries listed

In the meantime, speaking of their true intention, in large corporate groups in Japan

during the era of "lifetime employment and seniority system", it was a common practice to offer the post of President of listed subsidiaries to excellent executives, who had made a lot of contribution to the group for many years but did not make it to become the president of the headquarters, as their "final post". Probably, it was also true that such a practice was necessary to motivate people in an organization and maintain morale. However, while the forms of Japanese companies and Japanese management style are drastically changing, the managerial rationale and the need for such a practice no longer exist. In order for the Japanese companies to survive and achieve growth in the wave of global revolution and disruptive digital transformation innovation, such a practice is nothing but harmful.

After all, **for decent companies and shareholders, the only reason for staying as a dominant shareholder of a listed company would be found in the expectation for and contribution to a continued growth in corporate value of the listed company over the long term.**

3. Indispensability of incorporating duties to protect minority shareholders into the Corporate Governance Code

Then, **the ultimate solution to this issue is to establish legal principles and rules concerning the protection of minority shareholders by dominant shareholders as soon as possible. As for specific methods with regards to implementing the legal principles and rules and avoiding various risks of litigation by minority shareholders, in principle, the autonomy of individual companies should be respected. In other words, the establishment of such legal principles and rules makes it unnecessary to impose binding detailed regulations on individual companies, and decreases the degree of concerns about impeding the freedom and dynamism of corporate management. Furthermore, through continued listing of subsidiaries despite such legal principles and rules as well as litigation risks, dominant shareholders are sending a signal to show their confidence that the continued listing of subsidiaries would increase the corporate value of the subsidiaries, and their intention that they would not exploit their subsidiaries out of the conflicts of interest. Accordingly, there would be a positive impact on share prices (meanwhile, the number of listings that do not contribute to increasing the corporate value of the controlled companies is due to decrease). If this happens, listed subsidiaries remaining on the market will significantly contribute to the growth of Japanese**

economy, which is the most important goal.

I'm certainly aware that the legislation takes time, so it is practically adequate to go ahead with soft law for the time being. In that sense, I believe that the CGS Study Group should proceed with the ongoing formulation of the guidelines concerning group governance in the current direction, but it is extremely important to clearly state in the Corporate Governance Code, a kind of soft law with a relatively high degree of enforceability, that dominant shareholders have duties to protect minority shareholders, to the same extent as general rules, in order to fundamentally solve this issue. In other words, unless general rules are incorporated into the Corporate Governance Code, and unless further legislation is enacted, this issue has risks of gradually going toward a very unproductive direction as mentioned above. Accordingly, **I suggest immediately start the legislation process with a clear deadline, while the incorporation into the Corporate Governance Code aligned with and preceding the legislation process.**

4. Additional benefit from establishing the legal principles and rules: prevention of emergence of "malicious" activists who act as they want

The lack of established legal principles and rules concerning dominant shareholders' duties to protect minority shareholders in Japan, on contrary to the U.S. and Germany, is apt to provide an environment allowing a certain type of activists to indulge in pursuing only their own short-term benefits (not being loyal to long-term common interests of shareholders). Under common law systems such as the U.S. and others, by conducting a practical interpretation, even a shareholder with only 10-15% of ownership could be identified as "dominant". Then if an individual activist increases his/her ownership up to 30% or above, the level where he/she would be able to individually exert his/her influence on the management of the company in question, he/she will bear the risks to become regarded as a dominant shareholder and to be possibly sued by minority shareholders, and then will be exposed to severe pressure to be loyal to the long-term common interests of shareholders, especially the interests of minority shareholders. In other words, he/she cannot be a "malicious" activist any longer.

The largest side-effect risk of strengthening corporate governance is "malicious" activists who act as they want. From the viewpoint of preventing their emergence and encouraging the development of healthy engagement (let good money drive out bad), it is very meaningful to establish legal principles and rules concerning duties to protect minority shareholders.

5. Concerns of some "legal experts" are not real concerns

If we are to strive to ultimately enshrine into hard law (the Companies Act), I understand that some legal experts assert that because the legal practices and rules in question do not have strong enforceability, they do not fit in legislation. However, **in many positive laws, especially those close to general rules, there are many cases where an article alone does not have enforceability (e.g. although Article 1, Paragraph 1 of the Civil Code stipulates "private rights must conform to the public welfare", it is not clear how to enforce this provision in the event of a civil dispute in a specific manner), and as for the ongoing legislation concerning an obligation to secure External Directors, enforcement through legal procedures does not seem to be made in a straightforward manner. The important thing is the economic impact of such rules, and I'd like to add that we should not stick to the pointless legal arguments just for the form's sake.**

Furthermore, some express their concern that such legal principles and rules might cause abuse of the right of petition by minority shareholders. However, even in the litigation-happy U.S., it is not generally recognized that there is such abuse of the right of petition. In the first place, in a lawsuit where the burden of proof, which is highly technical, specialistic and difficult, is on the plaintiff side who needs to prove the existence of any breach of protection duty by the dominant shareholder and the damage caused thereby, the litigation risk virtually taken by the dominant shareholder cannot be so heavy. **If concerns about the risk of abuse of the right of petition remain, I suggest exclude dominant shareholders from standing to be sued in a representative action so that it will not be easy to file a large-scale shareholders action, and the risk of abuse of the right of petition will be reduced. On the other hand, the purpose of legalizing the duties as general rules is to discipline higher-level corporate governance. Accordingly, even if litigation risks decline, I do not believe that its legal and policy impact would be significantly reduced or eliminated.**

Even more so, such concerns are not relevant at all for incorporating general rules into the Corporate Governance Code, which is soft law.