Report by the "Working Group on the Provision of Risk Money to Emerging and Growing Companies" of the Financial System Council

December 25, 2013

Working Group on
the Provision of Risk Money to Emerging and Growing Companies
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As of December 25, 2013

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Introduction

As has long been pointed out, even though our country is said to possess world-class technologies and ideas, it has not achieved sufficient success to put it in the world's top level in terms of entrepreneurship and new ventures creation. For example, in 2010 there was an approximately twofold difference in the new business launch rate between the U.S. and Japan, with the U.S. rate at 9.3% and Japan's at just 4.5%.[1]

Some say that one of the factors behind this gap between Japan and the U.S. in entrepreneurship and new ventures creation may be the problem of a shortage in the provision of risk money to emerging and growing companies in Japan. In fact, the annual amount of money invested by venture capitals in 2012 was 26.7 billion dollars (around 2.7 trillion yen when translated at a rate of 100 yen to the dollar) in the U.S. but just 102.6 billion yen in Japan. Even taking into account the difference in the size of the Japanese and U.S. economies, the financial sector is not adequately meeting the funding needs of emerging and growing companies.

Although cultural differences between Japan and the U.S. may be a background factor, it is important, from the perspective of encouraging entrepreneurship and new ventures creation, to further expand policy initiatives for promoting the provision of risk money to early-stage emerging and growing companies. This is because Japan's relative economic position in international society is declining and strategic structural reforms are needed to deliver sustainable economic growth. And at the same time, from the standpoint of diversifying exit strategies for emerging and growing companies, continuing efforts will be needed to improve the system for new stock listings and fund-raising by listed companies.

In recognition of these issues, in June this year the Financial System Council was asked to explore the following topics: (1) provision of risk money to emerging and growing companies, (2) measures to promote the new listing of companies (e.g. reducing the administrative burden), (3) revision of the disclosure system to provide more flexible access to funding for listed companies and (4) other regulatory changes that are essential given conditions in financial and capital markets in recent years.

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[1] The source of the figure for Japan's new business launch rate is the Ministry of Health, Labour and Welfare's "Year Book of Employment Insurance Business," while that of the U.S. is the Small Business Administration's "Small Business Economy."

After receiving this request, the Financial System Council established the "Working Group on the Provision of Risk Money to Emerging and Growing Companies," which has met 11 times since June this year and has studied issues relating to fund procurement by companies in various phases of development, from early-stage companies to companies on the verge of listing, as well as companies that have already been listed. This report presents the results of the Working Group's investigations.

Chapter 1: Measures to Promote Provision of Risk Money to Emerging and Growing Companies (Measures to Promote Provision of Risk Money at an Early Stage, such as the Commercialization Stage)

At present, the promotion of entrepreneurship and new ventures creation is regarded as an important task in Japan, and to achieve this task it will be important to promote the provision of risk money, which is essential for businesses wishing to commercialize their technologies and ideas.

Given this situation, the Working Group investigated a number of measures to promote the provision of risk money to emerging and growing companies. These included crowdfunding, a framework for trading and selling non-listed shares, and the promotion of investment in start-ups by venture capital providers that are subsidiaries of insurance companies.

For the provision of risk money to be smooth, it is first essential to ensure that investors have trust in financial and capital markets. Therefore, when exploring measures to promote the provision of risk money, it is important to not only consider deregulation, but also to give adequate consideration to investor protection.

1. Crowdfunding

Although there is no fixed definition of crowdfunding, it is generally considered to refer to "a scheme in which emerging and growing companies and providers of funds are connected via the Internet so that funds are collected from a large number of fund providers who contribute a small amount each." Crowdfunding can be broken down into three types based on the form of the returns to fund providers: donation-type, purchase-type, and equity-type. The equity-type crowdfunding, which is regulated under the Financial Instruments and Exchange Act, can be further broken down into partnership-rights-based and share-based.

Under the current Financial Instruments and Exchange Act, in the case of the partnership-rights-based equity crowdfunding, Type II Financial Instruments Business Operators can deal in public offering or private placement of partnership rights, and in fact some operators have been using this format already. On the other hand, in the case of the share-based equity crowdfunding, dealing in public offering or private placement

of non-listed shares is generally prohibited under the Japan Securities Dealers Association's self-regulatory rules. Additionally, the current Financial Instruments and Exchange Act only allows Type I Financial Instruments Business Operators to deal in public offering or private placement of shares, and the registration requirements for Type I Operators are stricter than those for Type II Operators. For these reasons, the share-based crowdfunding is basically not being used at present.

Amid these circumstances, in April last year the Jumpstart Our Business Startups Act (JOBS Act) was passed in the U.S. This act includes provisions for exemptions from application of Sec. 5 of the Securities Act of 1933, which states that "unless a registration statement is in effect as to a security, it shall be unlawful for the issuer to offer to sell the security." This has opened the way for fund procurement through investment crowdfunding, which was difficult in practice before. Later, in October this year, the U.S. SEC announced proposed rules for the enforcement of the JOBS Act.

Taking these regulatory changes in the U.S. into consideration, the Working Group explored the possibility of establishing a system for both partnership-rights-based and share-based equity crowdfunding.

When designing a system for equity crowdfunding, it will be important, given the objective of promoting the provision of risk money, to make it as easy as possible for intermediaries to enter and make the burden on issuers as small as possible. On the other hand, another key task will be to take necessary measures to protect investors while taking into account regulatory trends by overseas government authorities, in order to prevent equity crowdfunding from being used maliciously for fraud and trust in equity crowdfunding as a whole from being lost.

(1) Relaxing Entry Requirements for Intermediaries

As mentioned above, to promote the provision of risk money it will be important to make the system such that it is as easy as possible for intermediaries to enter. It would therefore be desirable to take a special measure concerning registration for Type I and Type II Financial Instruments Business.

To this end, from the standpoint of investor protection, it will be appropriate to take the special measure concerning registration only for limited scope of business: for example, it will be appropriate to set upper limits on amount of investment per person and the

total value issued, and to impose the requirement that intermediaries do not engage in such business as the trading or underwriting of securities. Specifically, those that conduct, among Type I Financial Instruments Business, only dealing in public offering or private placement of non-listed shares in small amounts[2] via the Internet would be positioned as "Special Type I Financial Instruments Business Operators," while those that conduct, among Type I Financial Instruments Business, only dealing in public offering or private placement of partnership rights in small amounts[2] via the Internet would be positioned as "Special Type II Financial Instruments Business Operators," and regulations such as capital requirements would be relaxed.

When implementing such measures, it will also be appropriate to relax the self-regulatory rules of the Japan Securities Dealers Association, which generally prohibit the dealing in public offering and private placement of non-listed shares. It will be appropriate to relax such prohibitive rules to allow current Type I Financial Instruments Business Operators and Special Type I Financial Instruments Business Operators to deal in public offering and private placement of non-listed shares in small amounts[2] via the Internet.

(2) Necessary Measures for Investor Protection

Given that crowdfunding is a system that enables businesses to easily procure funds from large numbers of people via the Internet, it will also be necessary to implement regulatory methods for preventing the system from being used maliciously for fraud. With regard to this point, the current Financial Instruments and Exchange Act does not include any special provisions that reflect the distinctive characteristics of dealing in public offering or private placement of shares or partnership rights via the Internet.

For this reason, it will be appropriate to require intermediaries that deal in public offering or private placement of non-listed shares or partnership rights via the Internet (existing Financial Instruments Business Operators and the Special Financial Instruments Business Operators referred to in (1) above) to establish systems for conducting due diligence of issuers and providing appropriate information via the Internet. It will also be appropriate to require the intermediaries to provide information on issuers and themselves via the Internet, with penalties imposed for failure to provide the relevant information. If intermediaries are required to provide information on issuers via the Internet, it will also

[2] The scope of small amounts could be that "the total value issued is 100 million yen or less and the maximum amount of investment per person is 500,000 yen."

be appropriate to take additional measures such as simplifying the documents prior to conclusion of contract, in order to prevent the duplication of information provided by intermediaries to investors and ease the burden on intermediaries in the case of dealing in public offering and private placement of shares or partnership rights conducted via the Internet.[3]

(3) Appropriate Self-Regulation by Self-Regulatory Organizations

To prevent the malicious use of equity crowdfunding for fraudulent behavior or its use by antisocial forces, and thereby create an environment in which investors can invest with trust, government authorities should not be relied upon alone for regulation and supervision. Instead, it will be important to combine their functions with the appropriate self-regulatory functions of self-regulatory organizations.

It is therefore expected that self-regulatory organizations (the Japan Securities Dealers Association and the Type II Financial Instruments Firms Association) will work with government authorities to conduct investigations concerning the establishment of self-regulatory rules aimed at achieving an appropriate expansion in equity crowdfunding.

At the end of September this year only 2.6% of Type II Financial Instruments Business Operators are members of the self-regulatory organization. To enable the self-regulatory organization to properly fulfill its self-regulatory functions, it will be essential to increase the rate of membership for the Type II Financial Instruments Business Operator's self-regulatory organization.

To this end, it will be appropriate to establish regulations aimed at promoting membership of the self-regulatory organization. For example, operators that attempt to register as Type II Financial Instruments Business Operators yet do not join the self-regulatory organization could be required to establish internal rules that take into account self-regulation by the self-regulatory organization, and they could be required to

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[3] Documents provided before contracts are concluded that are applied to public offerings, etc. of shares are, when compared with those that are applied to public offerings, etc. of partnership rights, already considerably simplified (only a summary of the financial instruments transaction agreement and information on basic matters such as fees and risks need to be included), so duplication of the information provided by intermediaries to investors would basically not occur. As a result, further simplification is probably unnecessary and inappropriate.

establish a structure for ensuring compliance with these internal rules.[4] It will also be necessary to strengthen the structure of the Type II Financial Instruments Firms Association.

(4) Other

Besides the above, it will also be appropriate to conduct investigations and take necessary measures regarding whether intermediaries should be allowed to receive deposits of cash or securities from investors, and if they should not, what treatment should be applied concerning their joining the Japan Investor Protection Fund.

2. A framework for Trading and Cashing Non-listed Shares

The Green Sheet system operated by the Japan Securities Dealers Association is a system that enables Type I Financial Instruments Business Operators to trade non-listed shares. Under this system, Type I Financial Instruments Business Operators are permitted to solicit investment in non-listed shares provided that their issuers, non-listed companies, meet similar disclosure requirements to those for listed companies (e.g. produce and publish an explanatory note on business conditions that is similar to an annual securities report).

In recent years, however, the number of companies using Green Sheet has declined, and trading in Green Sheet shares has plunged significantly. Reasons that have been pointed out for this situation include the easing of listing criteria on newly established capital markets, which has made it more difficult for Green Sheet to define itself as complementary to the regular markets. Despite this situation, it has been pointed out that the burden placed on Green Sheet issuers (e.g. insider trading regulations and accompanying timely disclosure requirements and disclosure requirements similar to those for listed companies) is little different to that imposed on listed companies.

On the other hand, although there is some need for trading and cashing of non-listed shares of, for example, companies that are firmly rooted in their local communities, the Japan Securities Dealers Association's self-regulatory rules do not generally allow Type I Financial Instruments Business Operators to solicit investment in non-listed shares other than Green Sheet issues, etc., so this need is not being properly met at present.

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[4] If such duties are imposed on Type II Financial Instruments Business Operators, it would be appropriate to also impose similar duties on Type I Financial Instruments Business Operators and Investment Management Business Operators.

Given this situation, and with the aim of helping locally-rooted companies, etc. procure funds, it would be desirable to establish a new trading platform to meet the need for trading and cashing of non-listed shares. It will be appropriate, while designing this new system for non-listed shares, that it provides lower levels of liquidity than markets, so that the burden on issuers, such as disclosure requirements, is eased as much as possible.

(1) New Trading System for Non-listed Shares

Like Green Sheet, it would be appropriate to establish the new trading system for non-listed shares as one based on the self-regulatory rules of the Japan Securities Dealers Association, the self-regulatory organization. Type I Financial Instruments Business Operators should only be able to solicit investment to members of an "investment group" they put together and manage for each issue, so that only just enough liquidity is provided to meet certain trading and cashing needs.

The members of each investment group may be, for example, directors/employees of the non-listed company and their families, stockholders, and long-term business partners, as well as customers (and persons who wish to become customers) of the company. Because it would be difficult to limit admission to the investment group to parties with specific attributes, it would be appropriate to let investors who wish to invest in each issue make a self-declaration to the Type I Financial Instruments Business Operator and join the investment group that is put together and managed for the issue. It is also appropriate for a system to be established under which Type I Financial Instruments Business Operators gain the understanding and consent of investors concerning the characteristics and risks of the new trading system for non-listed shares.

In addition, it is expected that details concerning the design of the new trading system for non-listed shares, such as the role of Type I Financial Instruments Business Operators, who will administer the system, will continue to be studied by the Japan Securities Dealers Association in conjunction with the establishment of the required self-regulatory rules.

(2) Application of Insider Trading Regulations to the New Trading System for Non-listed Shares

Under the current Financial Instruments and Exchange Act, non-listed shares are generally exempt from insider trading regulations, given that they are not widely traded by ordinary investors and are not traded frequently. On the other hand, although Green

Sheet is a trading system for non-listed shares, insider trading regulations are applied considering the high liquidity level of the shares. Given this situation, whether the new trading system for non-listed shares should be exempt from insider trading regulations or not will depend on the level of liquidity expected for the system.

With regard to this point, as mentioned earlier the new trading system for non-listed shares will be designed not as a market, but just as a platform for meeting certain trading and cashing needs with respect to non-listed shares. Not many ordinary investors will participate, and transactions are not expected to be frequent. As a result, it would be appropriate to exclude the new trading system for non-listed shares from insider trading regulations.[5]

(3) Disclosure Requirements for Issuers under the New Trading System for Non-listed Shares

Under the current Financial Instruments and Exchange Act, listed companies are subject to disclosure duties, such as having to produce and publish an Annual Securities Report (which must have been audited externally), while non-listed companies are generally[6] not subject to such obligations. However, the Green Sheet system administered by the Japan Securities Dealers Association, while a trading system for non-listed shares, imposes similar disclosure duties on non-listed companies, the issuers, to those for listed companies, considering the high liquidity level of the shares. For example, issuers of Green Sheet shares are required to produce and publish Company Explanation Documents (which must have been audited externally) that are similar to the Annual Securities Reports that listed companies must produce and publish.

With regard to this point, as mentioned above, the new trading system for non-listed shares will be designed not as a market, but just as a platform for meeting certain trading and cashing needs with respect to non-listed shares. Given that it will be designed in such a way as to limit liquidity, it would not be necessary to impose the same level of disclosure duties as those for Green Sheet. In light of this, it is expected that the Japan Securities Dealers Association will give further consideration to the degree of disclosure required of issuers participating in the new trading system for non-listed

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[5] Naturally, however, general provisions prohibiting unfair trading, such as the prohibition of Spreading Rumors or Using Fraudulent Means (Article 157 and 158 of the current Financial Instruments and Exchange Act), will be applied to the new trading system for non-listed shares.

[6] Non-listed companies must make public-inspection-type disclosures if (1) they issue shares, etc. requiring the submission of a Securities Registration Statement or (2) their shares, etc. are held by a large number (1000 persons or more) of investors.

shares.

3. Promotion of Investment in Start-ups by Venture Capital Providers That Are Subsidiaries of Insurance Companies.

The restrictions on the holding of voting rights by insurance companies (the so-called 10% rule) provide an exemption for stakes taken in start-ups by venture capital providers that are subsidiaries of insurance companies. On the other hand, when the start-ups grow and exceed the criteria of small and medium enterprises (SMEs) , they no longer qualify for the exemption, which means that even when they need new funding, the subsidiaries are unable to provide additional capital. Furthermore, if the subsidiary is the lead venture capital provider,[7] not only can it not provide additional capital, but this can also affect the provision of additional capital by other stockholders.[8] As a result, in cases where the subsidiary takes a stake as the lead venture capital provider, it would be appropriate to ease[9] the requirements for the exemption to enable the subsidiary to provide additional capital to the target company until it is listed, even if it exceeds the criteria of an SME.[10]

4. Other Issues Concerning Support for Start-ups

The Working Group also studied various other issues concerning support for start-ups, such as the role that venture capitals should play, the diversification of exits from support for start-ups, and human-resources-related support for start-ups.

(1) The Role that Venture Capitals Should Play

Although venture capitals will probably continue to be the main suppliers of risk money

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[7] The top stockholder (excluding the founder) of a start-up is referred to as the lead venture capital provider. The lead venture capital provider generally provides various types of hands-on support during each phase of its growth, particularly in relation to fund procurement and capital policy, such as strategy for capital increase and support for listing. Various situations can exist, for example, there may be more than one lead venture capital provider (in which case they are referred to as co-leads), while a party that was not initially the lead venture capital provider can, due to changes in the situation such as the target company's growth, become the lead venture capital provider midway.

[8] Unlike the lead venture capital provider, the other venture capital providers do not generally take the initiative in providing additional capital. Rather, they passively provide additional capital in response to requests from the target company or the behavior of the lead venture capital provider.

[9] Specifically, if a venture capital subsidiary of an insurance company is the lead venture capital provider or is playing a similar role, the requirement that the target company should be an SME could be scrapped (with other requirements maintained).

[10] Similar regulations also apply to banks, so it would be appropriate to review these, too.

to emerging and growing companies in the future, Japanese venture capitals, which tend to invest small amounts in a number of companies, are failing, when compared with their U.S. counterparts, to provide adequate support for companies at the seed stage or just after.

In addition, venture capitals are failing to gather sufficient funds because there are no fixed criteria for assessing them and because not many of them have thus far achieved success. It has also been pointed out that this has resulted in a vicious cycle in which venture capitalists are failing to be developed.

To nurture emerging and growing companies, venture capitals require knowledge of and the ability to assess the technologies possessed by the companies. They also need to get their hands dirty hunting around for uses for the technologies.

Whereas such so-called hands-on types of venture capitals, which are equipped to nurture emerging and growing companies, are the norm in the U.S., few of them exist in Japan.

Despite this, while their number remains small, new venture capitals with a preference for "hands-on" investment are gradually on the increase, and some well-established venture capitals are deploying new ideas, such as improving their ability to assess technology by, for example, forging partnerships with manufacturing companies. It is expected that this trend will be bolstered and venture capital will improve their abilities to enable them to serve as "intermediaries" for the provision of risk money to emerging and growing companies in Japan, too.[11]

As mentioned above, because venture capital providers are expected to continue to be the main suppliers of risk money to emerging and growing companies in the future, it is desirable that the debate concerning their roles should continue on an ongoing basis while reflecting the situation concerning the business of venture capital providers, etc.

(2) Diversification of Exits from Support for Start-ups

In the U.S., there are various exits from support for start-ups, including not only IPOs (initial public offerings) but also M&A (mergers with or acquisitions) by large companies. In Japan, on the other hand, it is said that the exits are skewed toward IPOs, and that venture capitals are evaluated on how many of their investment targets have achieved

[11] With regard to this point, it was pointed out that because there is a lack of understanding in Japan concerning investment in start-ups and a lack of an environment for supporting such investment, new venture capitals are facing major difficulties in initial fund procurement, and that it is therefore important to change attitudes concerning investment in start-ups.

IPOs. It has also been pointed out that this approach to evaluating venture capitals may have led to the practice of employing buyback clauses.[12]

It would be desirable to ensure that a variety of choices, including M&A, is available for exiting support for start-ups. In particular, to encourage M&A in Japan to a greater extent than in the past, it will be necessary, for example, to minimize differences between buyers and sellers in views on the purchase price by ensuring that the sellers, i.e. start-ups, have solidly designed business models, or to transform the "not invented here" corporate culture of the buyers, which views M&A negatively. And with regard to buyback clauses, it would be desirable for organizations such as the Japan Venture Capital Association to conduct a detailed investigation of whether the clauses constitute an impediment to entrepreneurship and for there to be a debate including whether they are necessary or not.

(3) Human-Resources-Related Support for Start-ups

It has been pointed out that although Japan can come up with technologies and ideas, the number of people who can help turn such seeds into businesses is small. Until now, providing support with commercialization in this way has been regarded as being the role of venture capitals, but given the view that not only is there a shortage of funds for commercialization, but also a lack of the various types of support it requires, venture capitals should not necessarily be relied upon alone. Rather, it would be desirable for other entities to also be involved, and for a system to be found for enabling top-class experts to provide assistance from an early stage, soon after the start-up is founded.[13]

It was pointed out that what emerging and growing companies lack particularly is Chief Financial Officers (CFOs) who can turn technologies and ideas into businesses and profits, and it has been argued that a mechanism should be established for enabling companies to receive support from people with specialist capabilities such as certified public accountants (CPAs), lawyers, and patent attorneys. With regard to this point, the fact that large audit firms are putting together systems for supporting entrepreneurs

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[12] A buyback clause is a contract provision that gives the venture capital the right to demand that the management of the investment target repurchase its shares if it is unable, for example, to list within a certain timeframe. It has been argued that buyback clauses, because they expose the entrepreneur to a large level of risk, constitute a psychological impediment to entrepreneurship. However, it was also argued that the practice of including buyback clauses no longer really exists, and that even if it did, it would not constitute an impediment to the provision of risk money.

[13] With regard to this point, it was argued that what would be even more useful for young entrepreneurs than receiving support from experts would be receiving advice from people who have succeeded in launching businesses.

should be welcomed, and it would be desirable for such initiatives to be developed even further.

Chapter 2: Measures to Promote the Provision of Risk Money to Emerging and Growing Companies (Measures to Promote the New Listing of Companies)

To promote the provision of risk money to emerging and growing companies, measures to make the barriers to listing by such companies that are considering it as low as possible will also be important. The Working Group therefore studied, from the perspective promoting the new listing of companies, ways of reducing the requirements on new stock listings and the minimum shareholder number requirement in markets for emerging stocks.

1. Reduction of Requirements on New Stock Listings

When the shares of companies are listed and traded on financial instruments exchanges, it is important that adequate information concerning the companies is disclosed to investors and that they properly understand the companies' situation in order to ensure that the investors do not suffer unexpected losses.

However, it has been pointed out that a factor behind emerging and growing companies being hesitant about listing is the heavy burden required for the disclosure system. It would therefore probably be appropriate to reduce the requirements associated with new listings to the extent that investors are still protected.

(1) Reduction of Requirements at the Time of New Stock Listings

When a company is newly listed, it normally makes offers of its securities to investors after submitting a securities registration statement concerning the securities. The securities registration statement is required to contain financial statements for the past five fiscal years.

However, for the newly listed companies, it would probably be appropriate to change the rules so that financial statements for only the past two fiscal years need to be included.[14] This is the reason (1) the prospectus provided to investors contains financial statements

[14] Since there is no need to prevent newly-listing companies voluntarily including financial statements for the past five fiscal years, it would be appropriate to allow them to submit them in the form of an attachment to the securities registration statement.

for only the past two fiscal years, (2) investors who invest in newly listed companies usually focusing on the company's future prospects, so securities registration statements have come to contain a lot of future-related information, (3) the international situation concerning disclosures by newly-listed companies is also changing, and so on.

(2) Reduction of the burden Following New Stock Listings

At present, listed companies are required to submit an internal control report each fiscal year, and this report must have been audited by a Certified Public Accountant (CPA). Since this obligation to submit an internal control report is imposed on all listed companies, even newly-listed companies must also submit an internal control report that has been audited by a CPA after the end of the first fiscal year following their listing.

The heavy burden of submitting this internal control report is pointed to as a factor behind start-ups and growth companies being hesitant about listing, so the Working Group studied the possibility of reducing the burden associated with the obligation to submit internal control reports.

Given that a listed company's shares or other securities are publicly traded based on the financial reports submitted by the company, as long as the company is listed, its management needs to assess the effectiveness of its internal control systems and report its effectiveness in order to ensure the credibility of the financial reports. It would therefore probably not be appropriate to exempt newly-listed companies from the obligation of submitting internal control reports.

On the other hand, when we studied the obligation to have internal control reports audited by a CPA, we recognized that (1) financial instruments exchanges perform a strict listing examination, including that their internal control systems, and the lead managing security company and CPAs also check the internal control systems, (2) newly-listed companies typically tend, compared with those that have already been listed, to have a lower financial capacity on the whole, (3) even in the U.S., which is known for having the strictest systems for reporting on internal controls, there are measures to exempt newly-listed companies from audit of their internal controls, in order to encourage new listings, and so on.

Moreover, when we examined how corporate affairs changed after listing, we recognized that with most companies there were no major changes in their size of business, as measured by sales, number of employees, etc. during the first three years after listing.

Given these circumstances, to reduce the burden associated with the obligation of

newly-listed companies to submit internal control reports, it would probably be appropriate to exempt those companies from the obligation to have their internal control reports audited by a CPA for three years after listing.[15]

However, in the case of newly-listed companies that, from the standpoint of their size etc., are deemed to exert a strong influence over the market or over society or the economy, there is a strong need for particularly strict checks to ensure that their internal controls are functioning properly. It would therefore probably not be appropriate to exempt such companies from the obligation to have their internal control reports audited by a CPA.

2. Lowering of the Minimum Shareholder Number Requirement When Newly Listing on Markets for Emerging Stocks

To encourage new listings on markets for emerging stocks, it is hoped that financial instruments exchanges will conduct whatever reviews of criteria for new listings are necessary, while still ensuring smooth trading and market trust.

In particular, minimum shareholder number requirements for markets for emerging stocks are established to ensure smooth trading of the stocks on the market after they are listed, and there is probably room for reducing the required number of shareholders, though this should be done in such a way as not to hinder smooth trading given the circumstances of each financial instruments exchange.

Chapter 3: Facilitation of Fund-Raising by Listed Companies

To ensure that the Japanese economy can achieve sustainable growth, it will be important not only to provide start-ups and growth companies with risk money, but also to enable companies to procure funds smoothly from the capital markets after they have been listed.

With regard to this point, in recent years some listed companies conducting public offerings have seen the price of their stock fall more than they anticipated, meaning that they have been unable to raise the money they expected and been forced to partially revise their business plans. One of the reasons the share prices of companies who have

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[15] Because there is no need to prevent newly-listing companies from having their internal control reports audited by CPAs voluntarily, it would be appropriate to allow them to attach an audit report to their internal control reports.

announced they are going to issue new stock are unstable may be that in Japan it takes a long time for listed companies to raise funds or there is a lack of deep mutual understanding between companies planning to raise capital and investors.

1. Shortening the Period of Fund-Raising by Listed Companies (Abolition of the Waiting Period)

Under the current Financial Instruments and Exchange Act, listed companies must wait for seven days after submitting their securities registration statement before they can issue their securities to investors. This waiting period is designed to give investors time to decide, based on the information disclosed, whether to acquire/purchase the securities. When investors make such investment decisions, they are believed to consider two types of information: "corporate information," which concerns the business condition, etc. of the company raising capital, and "securities information," which concerns the securities information itself regarding public offering/secondary distribution.

With regard to "corporate information," in recent years, in particular, by developing the information and communications technology (ICT), improving the contents of annual securities reports and introducing quarterly securities reports, better-quality information can now be obtained more easily and quickly. Above all, with respect to the companies that are particularly well known (the "well-known companies") because of their large market capitalizations or the fact that their shares are traded frequently in the market, etc., securities analysts with professional abilities analyze the corporate information of such companies and provide relevant information to investors. In addition, such companies are also featured frequently in the business news, for example, in the media. Given this situation, if attention is paid only to the time required to consider corporate information, then with regard to the well-known companies, if a special exemption is provided to abolish the waiting period under the current Financial Instruments and Exchange Act, this would probably not produce major problems from the perspective of investor protection.

On the other hand, with regard to "securities information," it needs to be kept in mind that investors cannot consider such information until after the securities registration statement has been submitted.

Taking such points into account, it would probably be appropriate to provide a special exemption abolishing the waiting period for the "well-known companies" only in cases where it is comparatively easy to make decisions concerning the acquisition/purchase of

the securities. Specifically, it would probably be appropriate to abolish the waiting period when the impact on investment decision-making would be limited, such as if the target securities of public offering/secondary distribution have a simple and standardized structure, as is the case with common stock, investment securities (REITs), etc., and the ratio of stock dilution by capital increase is no more than, say, 20%.

2. Clarification of Acts That Do not Constitute "Pre-Filling Offer"

Although it is prohibited to begin offering securities to investors before a securities registration statement has been submitted (so-called pre-filling offer), the legal scope of what constitutes solicitation is unclear under the laws and related regulations. For this reason, it has been pointed out that companies planning to raise capital often hesitate to provide even general corporate information as they are afraid that doing so would constitute a pre-filling offer. When the waiting period following the submission of the securities registration statement is abolished in order to enable listed companies to raise funds smoothly, it would appear important to ensure as many opportunities as possible for investors to receive corporate information concerning companies raising capital before the securities registration statements are submitted.

The prohibition of pre-filling offer is generally considered to be aimed at preventing sales tactics using advantageous position from solicitation forcing investors to make investment decisions based on uncertain or inadequate information. In light of this, there is probably no need for the following acts to be subject to the prohibition of pre-filling offer. For this reason, it would be appropriate to clarify the said effect as soon as possible.[16]

- The act of an issuing company or underwriting securities company investigating perspective market demand for the securities before submitting securities registration statements in order to determine the pros and cons of public offering or secondary distribution of the securities, when such companies target qualified institutional investors, professional investors, or major shareholders and take appropriate steps to ensure that the information is not disseminated to parties other than such targeted parties before the submission of securities registration statements

  (so-called pre-hearing).

- The act of distributing corporate information at least one month before the

[16] Revise the "Points to Be Considered Regarding Disclosure of Corporate Affairs Etc." (Corporate Affairs etc. Disclosure Guidelines)

submission of securities registration statements without reference to the public offering or secondary distribution (limited to cases where reasonable measures are taken to prevent the information from being distributed again within one month prior to the submission of securities registration statements).

- Disclosure based on the Financial Instruments and Exchange Act and related regulations or financial instruments exchange rules.
- The act of a company distributing information in the normal course of business, and periodically distributing corporate information in the normal course of business following a previous procedure.
- The act of a company distributing information in the normal course of business, and announcing a new product or service.
- The act of responding to voluntarily questions from journalists, analysts, investors, etc. with information on the condition of operations or finances or on products or services.
- The act of publishing analyst reports concerning listed companies as done before following a previous procedure, when the underwriting company contains appropriate so-called Chinese walls.

3. Review Concerning the Submission of Amended Shelf Registration Statements

Under the current Financial Instruments and Exchange Act, if the content of the shelf registration statement needs to be amended or continuous disclosure documents such as an annual securities report or quarterly securities report have been submitted while the shelf registration statement is still in effect, an amended shelf registration statement needs to be submitted. This measure is aimed at preventing investors making investment decisions based on old information by informing them that the corporate information referred to in the shelf registration statement has been updated.

However, given recent advances in ICT, the obligation to submit disclosure documents through EDINET, and the fact that investors can forecast the submission of annual securities reports, etc., there is probably not a particularly strong need to submit an amended shelf registration statement whenever continuous disclosure documents such as an annual securities report is submitted. It will therefore probably be appropriate to revise the system to waive the obligation to submit amended shelf registration

statements in conjunction with the submission of continuous disclosure documents provided that certain conditions are met.[17]

Chapter 4: Other Regulatory Improvements to Reflect Recent Changes in Financial and Capital Market Conditions

With the aim of promoting the provision of risk money to start-ups and growth companies, debate within the Working Group has focused on the facilitation of fund-raising by companies from the start-up stage, through the growth stage, and to the maturity stage.

In order to consider issues regarding companies at the maturity stage, we also held discussions to review whether obligations borne by listed companies and investors under the Financial Instruments and Exchange Act were excessive or not, and specifically, whether revisions should be made concerning large shareholding report rules and liability for damages concerning false statements, etc. in the secondary market.

1. Review of Large Shareholding Report Rules

Information about large shareholding is important for investors as it shows them how much influence on the company each shareholder wields and tells them about supply and demand of the share certificates, etc. in the market. Large shareholding report rules were introduced in 1990 with the aim of providing this information to investors. In recent years, however, it has been pointed out that parts of the rules may be failing to keep up with changing circumstances, such as expanded disclosures under other systems, a rise in the awareness of the protection of personal privacy, and the establishment of EDINET. It has also been argued that the current large shareholding report rules include a provision that is not necessarily easy to comply with, and that creates an excessive administrative burden according to the original objective of the rules.

In light of this situation, the Working Group studied ways of easing the burden on submitters of a large shareholding report, while giving adequate consideration to the objectives of large shareholding report rules.

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[17] To ensure the protection of investors when waiving the obligation to submit amended shelf registration statements, it would be appropriate to require that the legal submission deadlines of continuous disclosure documents be written in a shelf registration statement so that investors can know exactly when these documents are going to be submitted; and it would be appropriate to require that an amended shelf registration statement be submitted in the case that such deadline is overdue.

(1) Treatment of Treasury Stock under Large Shareholding Report Rules

Under the current Financial Instruments and Exchange Act, treasury stock is subject to large shareholding report rules, and if a listed company holds over 5% of its stock as treasury stock, it must submit a large shareholding report and a change report after that. It has been pointed out that this rule hinders the smooth implementation of capital strategies involving the acquisition or disposal of treasury stock.

Treasury stock does not carry voting rights, and so it cannot be used to influence the company's management. Moreover, in a case where an acquisition or disposition of treasury stock affects the supply and demand in the market, important information concerning the trading is usually disclosed to investors through other systems, such as Share Buyback Reports. In the light of these points, it would probably be appropriate to exempt treasury stock from large shareholding report rules.

(2) Matters to Be Included in Large Shareholding Reports when the Submitter, etc. Is an Individual

Under the current Financial Instruments and Exchange Act, if the submitter of a large shareholding report or a joint holder (hereinafter, "submitter, etc.") is an individual, his/her name, address (including the *banchi* (house number)), date of birth, etc. must be included in the report.

Because large shareholding reports are submitted by a large number of entities in relation to various different shares, it is essential to be able to identify the submitters, etc., i.e. not to confuse them with other submitters, etc. On the other hand, there is probably little need to make detailed personal information available for public inspection at the expense of the protection of personal privacy or security. In light of this situation, if the submitter, etc. is an individual, it would probably be appropriate to exclude the *banchi* component of his or her address and date of birth from the subject of public inspection.[18]

(3) Scope of Application and Matters Included in the Short-Term Large Volume Transfer Report

[18] On the other hand, if the regulator conducts enforcement by ordering an amendment report to be submitted, it will need to obtain enough information to identify the target of the order, so even if the *banchi* component of their address and their date of birth is excluded from the subject of public inspection, it will still be appropriate to allow the regulator to require the submission of this information.

Under the current Financial Instruments and Exchange Act, if a party who submits a change report due to a decrease in his or her shareholding ratio meets certain criteria for when "a large number of share certificates, etc. have been transferred within a short period" (short-term large volume transfer), information on the other parties and considerations for all transfers within the preceding 60 days must be included in the change report (short-term large volume transfer report).

The criteria for short-term large volume transfer focuses solely on the shareholding ratio. Therefore, it has been pointed out that a report may have to be submitted by meeting the criteria formally even though a transfer has not actually occurred. It has also been argued that even though only a small number of share certificates, etc. are transferred, the burden of disclosing highly-detailed information on the other parties and considerations for all transfers is excessive.

Given that the purpose of short-term large volume transfer reports is to enable investors to decide whether trading activity by greenmailer has actually occurred, it would probably be appropriate to limit declines in shareholding ratios, which form the criteria for short-term large volume transfers, to "declines resulting from transfers." In addition, it would probably be appropriate to revise disclosure items concerning "parties to whom a small number of share certificates, etc. are transferred," in a way that allows to fill out the information on the consideration by date, as is the case with ordinary change reports, instead of filling it out by date and by parties involved in each transfer.[19]

(4) Simultaneous Submission Obligation for Change Reports

Under the current Financial Instruments and Exchange Act, if a new cause for submission of further change report arises before the date a large shareholding report or change report is to be submitted (e.g. a shareholding ratio has increased by a further 1% or more), a "change report relating to a new cause for submission" must be submitted at the same time as the "large shareholding report or change report relating to the original cause for submission" (simultaneous submission obligation).

This means that a large shareholder must submit a change report on the day before the submission date after confirming its own and the joint holders' holdings. However, investors with large numbers of subsidiaries, etc. require time to confirm their shareholdings, and sometimes find it practically impossible to do this. As a result, it can

[19] Regarding the criteria for determining recipients of a small number of share certificates, etc., given that 1% is used as the criteria for a change in the holding ratio of share certificates, etc. under large shareholding report rules, and as there is little need to submit a change report for a change of less than 1%, the criteria could be made 1% or less.

be unclear whether the content of the change report is based on the most recent information, in line with the simultaneous submission obligation, or based on the information for five business days earlier, which could actually mislead investors. In light of this situation, it would probably be appropriate to abolish the simultaneous submission obligation for change reports.

(5) Method of Notifying the Issuer of Large Shareholding Reports

Under the current Financial Instruments and Exchange Act, a party who submits a large shareholding report or a change report must send the copies of the reports to the issuer without delay. However, the issuer nowadays can easily access large shareholding reports due to wide use of the Internet and the establishment of EDINET since the rules were introduced. Therefore, it would probably be appropriate to make it unnecessary to send the copies of the reports to the issuer, with their filing on EDINET as an alternative.

(6) Period of public inspection of Amendment Reports

Under the current Financial Instruments and Exchange Act, the regulator must, as with large shareholding reports and change reports, make amendment reports available for public inspection for five years from the date it receives them. However, amendment reports have little value as information on their own because they merely alter the content of their original large shareholding reports and change reports. Therefore, it would probably be appropriate to make the last day of the period of public inspection of amendment reports the same as those of the original reports to which the amendments relate.

2. Compensation Liabilities Relating to False Statements, Etc. in the Secondary Market

Under the current Financial Instruments and Exchange Act, if a document legally obligated to be disclosed, such as a securities report, contains a false statement, etc., the company that submitted the document bears liability for damages arising from the false statement, etc. to the parties that acquired the securities in the secondary market without knowing the fact there is the false statement, etc. during the period when the document was made available for public inspection.

The Working Group studied some issues relating to these compensation liabilities relating to false statements, etc. in the secondary market.

(1) Reformation of compensation liabilities of Submitting Companies

Under the current Financial Instruments and Exchange Act, the compensation liability of the submitting companies as described above is strict liability (i.e. no-fault liability), but it has been argued that the adequacy of this should be examined.

"Intention or negligence" by the defendant is a condition for general tort liability under the Civil Code, and fault liability is a general principle for compensation liabilities. Strict liability, meanwhile, is limited to exceptional cases where it is deemed particularly necessary for policy purposes, and the strict liabilities of the submitting company to the secondary-market investors under the Financial Instruments and Exchange Act is considered to be aimed to make it easy to seek damage recovery through civil action, so that unlawful conduct will be deterred, and that fairness and transparency of the securities markets will be promoted.

With regard to this point, given that the deterrent effect on unlawful conduct has been strengthened in recent years with the enactment of the administrative monetary penalty rules and the implementation of internal control systems, the current system, which imposes strict liability on submitting companies of going beyond the general principle of compensation liabilities, has probably become less significant than it was in 2004 when it was introduced. Although some members of the Working Group were anxious about going from strict liability to fault liability, it would probably be appropriate to adhere to general principles of fault liability for the compensation liabilities of submitting companies in the secondary market, to the extent that the purpose or objectives of the current system will not be compromised.

In doing so, although fault liability would apply to compensation liabilities, it would be appropriate to switch the burden of proof of intention or negligence and make the submitting company itself to have to prove that it was not at fault, as like the burden of proof on officers, etc. relating to their compensation liabilities under the current system, so that investors do not incur excessive costs in a lawsuit.

It was also debated whether no fault of submitting company should mean that of its officers, etc. or that of everyone in the company, including employees.

With regard to this point, given that persons with a duty of care, which is a prerequisite for fault, can differ considerably from case to case, and that a provision giving specific examples of persons who should be judged to have intent or negligence for a tort committed by a corporation is rarely met in other laws, at the present time it would probably be appropriate, from a legislative policy standpoint, to avoid such clarification

including special provisions in laws and regulation, and instead to leave such matters to rational interpretation depending on the individual circumstances.

Compensation liabilities under the Financial Instruments and Exchange Act arise only in limited cases, such as where there has been a false statement concerning a "material" matter in the relevant securities report, etc. In such cases, one of the officers will usually have breached their duty of care in some way, so major differences are probably unlikely to emerge from either standpoint.

(2) Expansion in Damages Claimants

Under the current Financial Instruments and Exchange Act, only investors who have acquired the securities issued by the company that submitted the securities report, etc. containing a false statement, etc. during the period the document was made available for public inspection ("acquirers") can claim damages arising from the false statement, etc.

However, for example, if a false statement aimed at making the company's business performance appear worse has been made in a securities report, investors who have sold securities during the period the document was made available for public inspection without knowing that the statement is false ("disposers") could suffer a loss from the false statement just as acquirers would in the case of a false statement aimed at making the company's performance appear better. In recent years there has been an increase in MBOs (management buyouts: buyouts of company by its management), and in cases like an MBO, management could have an incentive to try to improperly reduce the price of their company's share by making its business performance appear to have deteriorated. Given this situation, it would probably be appropriate to add "disposers" to "acquirers" as parties that can claim damages for false statements, etc. under the Financial Instruments and Exchange Act.

(3) Expansion of the Scope of the Provisions for presuming Amounts of Damages

The current Financial Instruments and Exchange Act has provisions for presuming the amounts of damages in cases where an "acquirer" claims damages from the submitting company.

It was therefore argued that in the process of reforming the provisions concerning compensation liabilities, we should also consider expanding the scope of application of these provisions for presuming the amounts of damages to include cases where a

“disposer” claims damages from the submitting company and from a “person other than the submitting company” (officer, etc.)

However, these provisions, which allow for the amount of damages to be presumed based on average market prices, are exceptional and extremely powerful, so it is probably necessary to consider carefully the advantages and disadvantages of expanding their scope, and it would therefore be appropriate to continue studying this.

Conclusion

The Working Group has investigated the provision of risk money to emerging and growing companies, etc. but it remains a fact that the number of emerging and growing companies, which are the recipients of risk money, is small in Japan. With regard to this point, it would be important to change the way people view entrepreneurs, lower the hurdles to entrepreneurship, and nurture a social culture that does not discourage people from launching businesses.

Amid this situation, it has been argued that in Japan many of the technologies that constitute the seeds to entrepreneurship are dormant in large corporations, and that commercialization that involves "carving out" could play an important role. To encourage this, it would be necessary to transform certain aspects of corporate culture. Recently, a new trend is being seen in Japan such as the inclusion of measures to promote "carving out" in the "JAPAN is BACK" strategy, and it would be desirable for this trend to take root and for a society in which large numbers of people aim to become entrepreneurs to be established.

A look at success stories from other countries reveals that to generate new businesses in a sustainable fashion, an "ecosystem," i.e. an organic interconnection or clustering of research, corporations, and human resources, must exist. In Japan, too, such ecosystem is being established in the field of IT, and a task going forward will be to also establish ecosystems in other fields. It would be desirable for the various measures debated by the Working Group and the initiatives of the relevant government departments to be linked together and for the construction of ecosystems to progress.

The above are the results of the Working Group's deliberations. The issues we have highlighted all need to be addressed swiftly in order to promote the provision of risk money to emerging and growing companies, and deliver sustainable economic growth. We hope that those in charge will move quickly to establish appropriate systems based on the views articulated in this report.