Lifting of Ban on Establishment of Holding Companies and, Financial Holding Companies

Sadakazu Osaki

The revised Anti-Monopoly Law which was approved last June came into force on Dec. 17, 1997. As a result, a ban on establishment of holding companies which has been in place throughout the postwar era has finally been removed. Furthermore, on Dec. 5, 1997, the House of Councilors approved revisions to the Banking Law and other related laws opening the way for the establishment of financial holding companies, as well as a law concerning special treatment of mergers lead to the establishment of bank holding companies. These laws were promulgated on the 12th of the same month and became effective on March 17, 1998.

1. Revision of Anti-Monopoly Law to Allow Establishment of Holding Companies

Before World War II, Japanese industry was controlled through holding companies operated by Zaibatsu-financial combines. After the war, the establishment of holding companies was prohibited, in principle, with the enactment of the Anti-Monopoly Law (Article 9). This regulation was very strict in that it uniformly prohibited specific forms of corporations irrespective of their adverse impact on competition. However, this regulation was substantially changed with the revisions to the Anti-Monopoly Law approved in June, 1997.

In short, under the revised Anti-Monopoly Law, the establishment of a holding company is allowed, in principle, and only the establishment of a "holding company having an excessively concentrated power to control business activities" is prohibited. The meaning of these provisions is defined in Paragraph 5, Article 9. This can be summarized as applying in the following three cases:

Article 9 of the old Anti-Monopoly Law

*1 A holding company shall not be established.

*2 A company (including a foreign company, the same shall apply hereinafter) shall not exist as a holding company in Japan.

*3 A holding company as referred to in the preceding two paragraphs shall mean a company which is mainly engaged in the control of business activities of other companies in Japan by means of share holding (including the holding of staff, the same shall apply hereinafter).

Article 9 of the revised Anti-Monopoly Law

Article 9

A holding company which has an excessively concentrated power to control business activities shall not be established.

*2 A company... shall not exist as a holding company which will have an excessively concentrated power to control business activities in Japan.

*3 a holding company shall be defined as a company in which the ratio of the total acquisition cost... of the shares of subsidiary companies... to the amount of total assets....exceeds fifty over one hundred (50/100).

4 Omitted.

5 an excessively concentrated power to control business activities shall mean that the overall scale of business activities of a holding company, its subsidiaries, and other companies in Japan whose business activities are controlled by the holding company through shareholding is markedly large in a considerable number of industry sectors, that the impact of these companies' financial transactions over other companies is significant, or that each of these companies holds predominant positions in a considerable number of interrelated industry sectors and thereby exerts a large influence on the national economy and prevents fair and free competition.

6 A holding company shall submit a report on its business ... to the Fair Trade Commission within three months of the day on which the business year ends if the aggregate sum ... of the respective amounts of the total assets of the holding company and its subsidiaries ... exceeds the amount provided by a cabinet order.

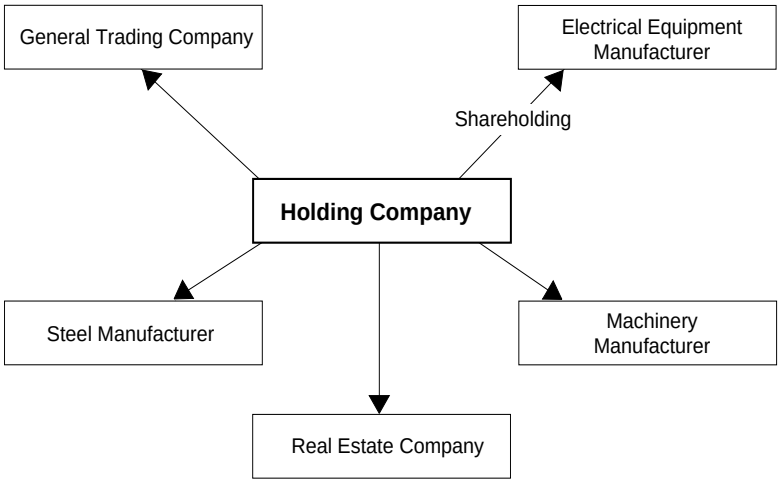
7 If a newly established holding company falls under the provisions of the preceding Paragraph at the time of its establishment, the holding company shall report to that effect to the Fair Trade Commission....

*1 A holding company whose group's "overall scale of business activities is markedly large in a considerable number of industrial sectors...thereby exerting a large influence on the national economy and preventing fair and free competition."

*2 A holding company whose group's "influence on other companies caused by the group's financial transactions is significant... thereby exerting a large influence on the national economy and preventing fair and free competition."

*3 A holding company whose group's "member companies hold predominant positions in a considerable number of interrelated industry sectors, thereby exerting a large influence on the national economy and preventing fair and free competition.

1. Overall scale of business activities is markedly large in a considerable number of industrial sectors

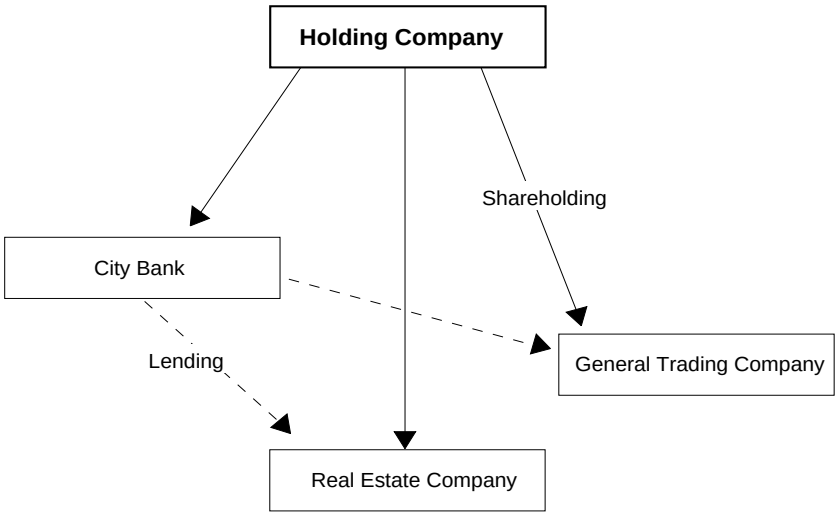


Souce: Nomura Research Institute.

Specific types of holding companies which fall under the above three definitions are given in a document titled “Evaluating whether holding companies have an excessively concentrated power to control business activities” (dated Dec. 8) published by the Fair Trade Commission prior to enforcement of the revised Anti-Monopoly Law.

As shown in the chart above, a holding company controls subsidiaries in a broad range of industries. The so-called “six major corporate groups” including Mitsubishi, and Sumitomo, supposedly fall within the category of prohibited holding companies. Falling under this definition would be a group with total assets exceeding 15 trillion yen which is active in five or more industry sectors through group companies which each have total assets exceeding 300 billion yen. Major industry sectors may be defined as having total sales exceeding 600 billion yen and which have been assigned a three-digit classification number under the Standard Industrial Classification system in Japan. However, as in the case with domestic and international telecommunications, restrictions on new entries and actual business conditions may warrant treatment of different industrial sectors as if they belong to the same industry sector.

2. Influence of the group's financial transactions on other companies is significant



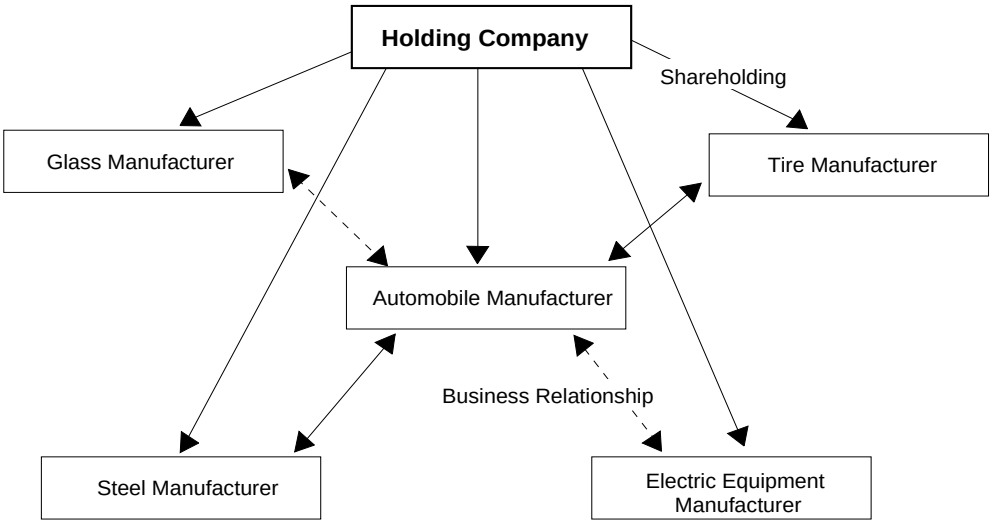
Souce: Nomura Research Institute.

In the case shown in the chart above, a large-scale financial institution (under the Anti-Monopoly Law, those companies engaged in the banking, trust, insurance, mutual financing, and securities businesses will be regarded as financial institutions) and large-scale business companies are grouped together, and the lending business of the group's financial institution coupled with the activities of the general companies within the same group exerts a large influence over every aspect of the industry. Here, a large-scale financial institution is defined as having total assets exceeding 15 trillion yen. A large-scale business company is defined as having total exceeding 300 billion yen.

However, a company "engaged in financing or in businesses closely related with financing" is not subject to this regulation. To be concrete, this definition indicates a company which is engaged in *1 businesses which a financial institution itself may engage in (guarantee affairs, etc.), *2 businesses which naturally derive from or which can share management resources with the businesses a financial institution is currently engaged in (running of a VAN for settlement of funds with customers, an economic research business, a venture capital business, etc.), *3 businesses where the transactions are similar to financial transactions (investment advisement, trustor of securities investment trust, leasing, etc.). A large-scale financial institution forming a group with companies each having total assets exceeding 300 billion yen is not in direct violation of the Anti-Monopoly Law.

However, it must be noted that a financial holding company is subject to regulations applicable to banking, insurance and securities businesses, mentioned later.

3. Companies in a group hold predominant positions in interrelated industry sectors



Souce: Nomura Research Institute.

As shown in the chart above, a holding company forms a group with top-ranking companies in five or more major interrelated industry sectors. As to whether or not the activities of these companies are interrelated is "to be judged taking into consideration the actual degree of interdependence in each industry sector, user selection tendencies, and other factors." As to "major industry sectors," the same standards for judgment is applied as in the case of *1 above.

As to which companies may be considered "top ranking," they shall have a 10% or higher share of all revenues for a specific industry sector or be ranked in the top three of a specific industry sector in terms of sales."[1].

The establishment of a holding company of one of the above three types is prohibited and, if actually established, will be subject to a cease-and-desist order, such as an order to release shares. In order to prevent the establishment of such an illegal holding company, a holding company larger than a certain scale is obliged to submit a report at the time of establishment and a business report every subsequent year (Article 9, Paragraph 6 of the Law). The scope of holding companies subject to regulation is stipulated in Article 8 of the Anti-Monopoly Ordinance to be those with total assets exceeding 300 billion yen.

On the other hand, as a rule, holding companies that *1 were created by the split-up of an existing company, *2 involve venture capital, *3 were established by financial institutions for the purpose of entering into each other's business fields, or *4 have total group assets of less than 300 billion can be freely established, the reason being that such holding companies do not fall within the definition of "having an excessively concentrated power to control business activities."

1 With respect to this third type, Professor Masahiro Murakami points out that "if the standard is applied inflexibly and uniformly, it may cause problems of excessive regulation" (p.59, *Lifting of a Ban on Holding Companies and Regulation of Corporate Complexes*).

2. Legislation surrounding Financial Holding Companies

1) Revision of Business Laws

Under the revised Anti-Monopoly Law, the establishment of a financial holding company (that which has a subsidiary qualifying as a financial institution under the Anti-Monopoly Law) is prohibited "up to the day separately provided by law" (Article 116)[2]. In response to this provision, possible new legislation regarding financial holding companies has been discussed in three separate finance councils. The matter was fully discussed in the extraordinary session of the Diet in 1997 and a "Bill relating to Legislation concerning Financing following the Lifting of a Ban on Establishment of Holding Companies" was approved by a plenary session of the House of Councilors on Dec. 5, 1997. This law was stipulated "to come into force on a day fixed by a cabinet order within a period of three months counting from the day of promulgation" (Article 1 of Supplementary Provisions), and became effective on March 17, 1998.

This law is not in the form of a new single law such as a law concerning financial holding companies; rather, it is a revision of separate laws for specific business types, examples of which include the Banking Law, Long-Term Credit Bank Law, Foreign Exchange Bank Law, Insurance Business Law, and Securities and Exchange Law. To illustrate, in the Banking and Insurance Business laws, separate chapters entitled "Bank Holding Company" and "Insurance Holding Company" have been added. The main content of the law is as follows[3].

(1) Approval of Establishment of Financial Holding Companies

The establishment of a financial holding company or an insurance holding company is subject to the approval of the Minister of Finance (following the setup of a Financial Supervisory Agency, the Prime Minister). On the other hand, the establishment of a securities holding company does not require approval. However, since a securities company is obliged to report on its major shareholders, it will have to submit a report at the time of its establishment.

(2) Business Scope of Financial Holding Company

A financial holding company shall only be engaged in the control of its subsidiaries and other business ancillary to it (Article 52-6 of the Banking Law and Article 271-5 of the Insurance Business Law). As for a securities holding company, no such restrictions are provided. However, since a holding company is defined as "a company whose holding of subsidiary shares exceeds 50% of its total assets," it is unlikely that a securities holding company would ever engage in a broad range of businesses other than the control of its subsidiaries.

(3) Restriction on the Scope of a Financial Holding Company's Subsidiaries

The scope of business of a financial institution has been restricted by laws regulating each sector of financial business. Holding of subsidiaries by a financial institution has also been strictly restricted by the Anti Monopoly Law[4]. These restrictions will become meaningless if the scope of

2 This article 116 was deleted in the latest legislation.

3 In the following explanation, we will take up only the revision of the Banking, Insurance, and Securities and Exchange laws. As for the Long-Term Credit Bank Law and Foreign Exchange Bank Law, it may be safely said that their revisions are similar to those for the Banking Law.

subsidiaries a financial holding company can hold under its control is not restricted. For this reason, the scope of subsidiaries of a bank holding company is restricted to a certain degree.

The business scope of subsidiaries of a bank holding company is as follows (Paragraph 7, Article 52 of the Banking Law; Figure 1).

*1 Bank (including long-term credit bank and foreign exchange bank),

*2 Securities company,

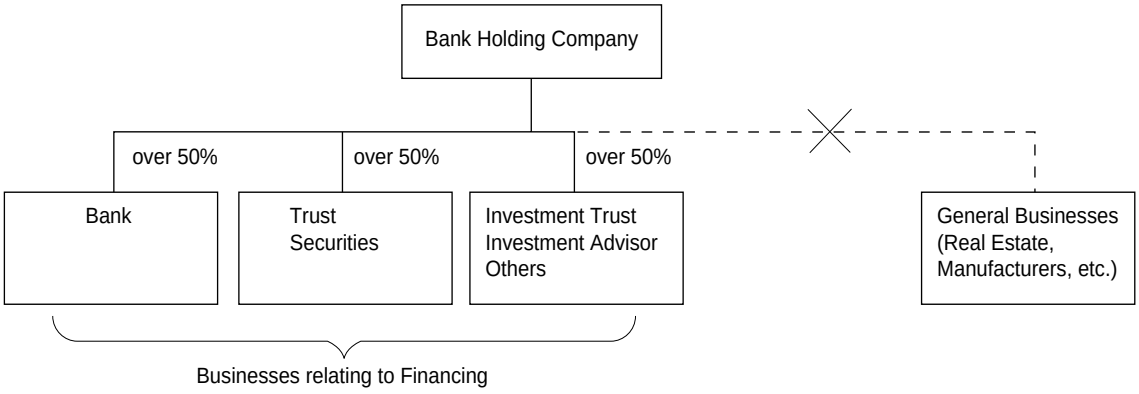
*3 Foreign bank and foreign securities company,

*4 Company which is engaged in "businesses which are subordinate, ancillary, or related to banking... or securities business,"

*5 "Company which is intending to open up a new business,"

*6 Holding company which has only those subsidiaries coming under *1 to *5 above.

Figure 1. Scope of Subsidiaries of Bank Holding Company



Souce: Nomura Research Institute.

In other words, in addition to the ancillary businesses which a bank or a securities company itself has been permitted to engage in, a bank holding company is now permitted to engage, through its subsidiaries, in such businesses as the "businesses ancillary to the business of its own" which a bank or a securities company has been permitted to engage in through its subsidiaries. Finance related businesses such as trustor of investment trust or investment advisement are also permitted[5].

On the other hand, since general businesses such as real estate or manufacturing are not included in the above-mentioned categories, subsidiaries of a bank holding company may not engage in such general businesses. As for the insurance business, since the start of entry into each others' business is put off until the year 2001 according to the schedule of the so-called "Big Bang" reforms, the scope of business of subsidiaries is not clearly mentioned[6].

---

4 Article 11 of the Anti-Monopoly Law stipulates that, as a rule, a bank, securities company, trust company, or mutual company can hold only 5% or less of the outstanding shares of a domestic company and an insurance company can hold only 10% or less of the outstanding shares of a domestic company.

5 The actual content of the above (*3 and *4) is to be provided by an ordinance of the Ministry of Finance. Such businesses as trustor of investment trust should be clearly mentioned in this ordinance.

6 However, a report by the Insurance Council urged that "the formation of a bankrupt insurance company as a sister company of a bank or a trust bank" should be permitted in the near term, and that legislation making it possible for a bank holding company to own a bankrupt insurance company as a subsidiary is expected soon.

The scope of subsidiaries of an insurance holding company is as follows (Paragraph 6, Article 271 of the Insurance Business Law).

*1 Life insurance company and non-life insurance company,

*2 Securities company,

*3 Foreign insurance company and foreign securities company,

*4 Company which is engaged in "businesses which are subordinate, ancillary, or related to insurance business or securities business,"

*5 "Company which is intending to open up a new business,"

*6 Special company which has only those subsidiaries coming under *1 to *5 above,

*7 Companies other than those mentioned in *1 to *6 above approved by the Minister of Finance.

In the case of an insurance holding company, even a company which is engaged in businesses other than insurance and securities can be made a subsidiary subject to prior approval. Moreover, it is provided that this approval cannot be denied except in cases where the content of business is against the public order and standards of decency, or presents a danger to sound development of the national economy, or the soundness of management of an insurance company (Item 3, Paragraph 6, Article 271). Therefore, it is possible for an insurance holding company to engage in a broad range of businesses through its subsidiaries.

It should also be noted that in the latest legislation, no special provisions were made for the 'downstream holding company' where an insurance company in the form of a mutual company establishes a holding company as a subsidiary. For the time being, only the holding company which owns a subsidiary insurance company in the form of a joint-stock company will be approved.

As to a securities holding company, no provisions to limit the scope of business of a subsidiary are made. A report by the Securities and Exchange Council is suggesting a large-scale deregulation, including a change from a licensing system to a registration system of the establishment of a securities company, and also urges that a securities holding company "should be free to expand businesses as far as possible." It can be said that the latest legislation is an embodiment of such an idea.

(4) Regulation and Supervision of Financial Holding Company

As for a financial holding company, the regulation and supervision of subsidiary financial institutions shall be extended to cover the entire holding company group. Regulation is planned to be applied as follows.

*1 Application of capital adequacy ratio requirements to the holding company group (Article 52-9 of the Banking Law),

*2 Requirement for consolidated-base disclosure of the financial holding company (Articles 52-11 through 52-13 of the Banking Law; Articles 271-8 and 271-9 of the Insurance Business Law)

*3 Requirement for the financial holding company to submit reports or other materials (Article 52-15 of the Banking Law; Article 271-11 of the Insurance Business Law; Item 1, Article 55 of the Securities and Exchange Law),

*4 Authorization to enter and make an inspection of a financial holding company group (Article 52-16 of the Banking Law; Article 271-12 of the Insurance Business Law; Item 1, Article 55 of the Securities and Exchange Law),

*5 Provision for requesting that a financial holding company submit an improvement plan (Article 52-17 of the Banking Law; Article 271-13 of the Insurance Business Law),

*6 Revocation of a financial holding company's license and measures for suspending a subsidiary's business activities (Article 52-18 of the Banking Law; Article 271-14 of Insurance Business Law).

The actual content of these regulations extending over a whole group are now being discussed at such meetings as the "Conference on Risk Control for Bank Groups" conducted by the Committee for Financial System Research, beginning in October 1997. The results of these discussions are to be embodied in future ministerial and cabinet ordinances.

(5) Restriction of Stock Holding of Financial Holding Company

Financial institutions' holding of other financial institutions' stocks has been considered to be subject to the restrictions provided in Article 11 of the above-mentioned Anti-Monopoly Law. However, with the holding company system, a financial institution can create an indirectly controlled group by forming other financial institutions or other companies which are engaged in finance-related businesses as sister companies. It should also be noted that, under the on-going financial system reforms, the so-called subsidiary company system by business category was approved and it has been made possible to establish a financial institution in the form of a 100% owned subsidiary of the existing financial institution.

Under such circumstances, the Fair Trade Commission set forth a policy to broadly approve exceptions to the restriction of stock holding by Article 11, which the Commission had interpreted very narrowly[7]. According to this policy, the Fair Trade Commission has made it clear it will approve *1 the subsidiaries for subordinate businesses which have heretofore been approved as exceptions, *2 financial institutions[8] and *3 companies engaged in businesses ancillary to the proper businesses of a financial institution. Here, the "businesses ancillary to the proper businesses of a financial institution" are as stated below.

---

7 Paragraph 1, Article 11 of the Anti-monopoly Law provides for, as exceptions to the restriction of stock holding by financial institutions, "cases in which a prior approval of the Fair Trade Commission has been obtained according to the provisions of the Fair Trade Commission Rules." In June 1994, the Fair Trade Commission announced the operating standards of this approval system entitled "Guidelines concerning Approval of Stock Holding of Financial Institutions." In these guidelines, "a company engaged in businesses which are subordinate to the business of its own or a company which intends to hold stocks for the purpose of entering into the financial businesses other than the financial businesses it is now engaged in" were cited as cases that would be approved. Incidentally, the latter indicates the so-called subsidiary company system by business categories. The Fair Trade Commission has recently replaced these guidelines with a ruling entitled "Concerning the Approval of Stock Holding of Financial Institutions based on the Provisions of Article 11 of the Anti-Monopoly Law"(dated Dec. 8).

8 Therefore, a bank's holding of a banking subsidiary is approved.

*1 Businesses which a financial institution itself may engage in: guarantee affairs, paying agency of the profit on beneficiary certificates of securities investment trust, and businesses such as trading in gold bullion.

*2 Businesses which naturally derive from or which can share management resources with the businesses the financial institution is currently engaged in: running of a VAN for settlement of funds with customers, a comprehensive research business, venture capital business, selling of financial commodities, offering agency, and others.

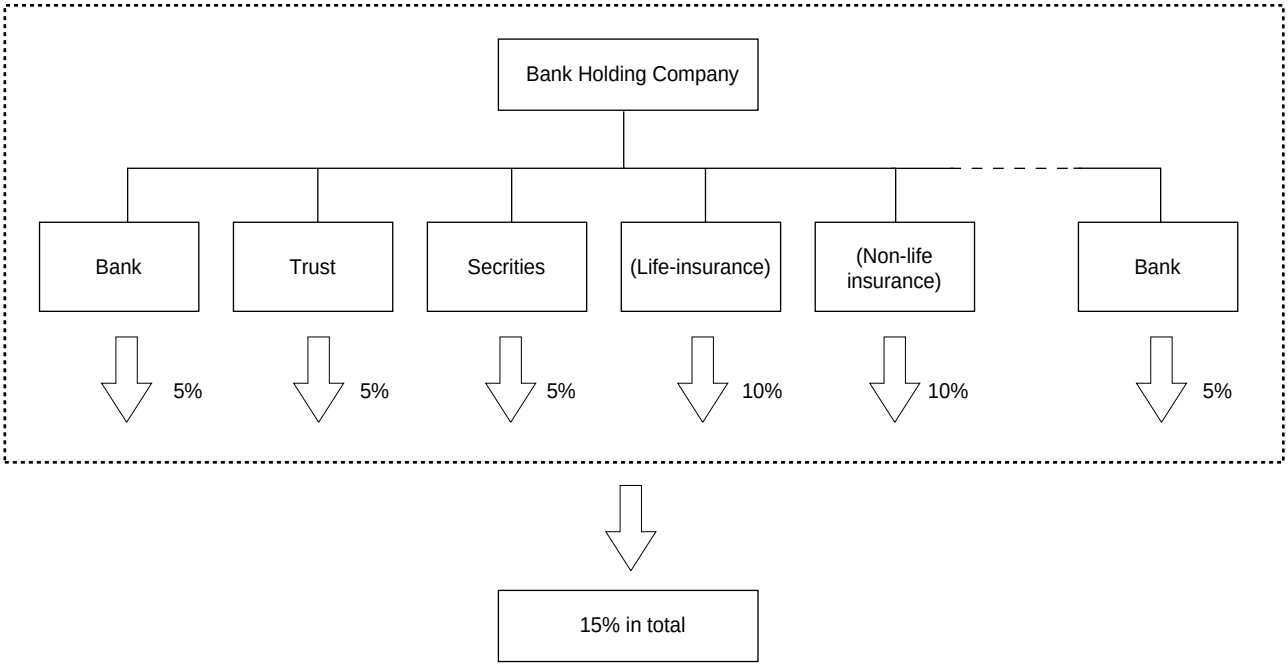
*3 Businesses whose transactions are similar to financial transactions: investment adviser, trustor of securities investment trust, leasing, and others.

This is considered to be almost the same concept as the "finance-related businesses" referred to in the law on financial holding companies.

In short, it will become possible for a financial institution to engage in the same scope of business through direct subsidiary companies, as in the case of establishing a holding company.

However, in addition to the restriction of stock holding provided in Article 11 of the Anti-Monopoly Law, a bank holding company shall be subject to a restriction that the stock of a domestic company held by the holding company and its subsidiaries may not exceed 15% of the outstanding stock of that company (Paragraph 8, Article 52 of the Banking Law; Chart 2). This is considered to be aimed at preventing banks from extending their controlling power over business companies, and is also meant to secure the sound management of such companies and the protection of depositors.

Figure 2 . Restriction of Stock Holding of Bank Holding Company



Souce: Nomura Research Institute.

9 Therefore, a bank's holding of a banking subsidiary is approved.

2) Introduction of Special Cases concerning the Establishment of a Bank Holding Company

In addition to the revision of business laws concerning the introduction of a financial holding company system, a "Law Concerning Special Cases in which Banks and other Similar Organizations Establish a Bank Holding Company through Merger" was enacted.

There are roughly two methods by which an existing company shifts to a holding company system: one is the establishment of a subsidiary by investment in business assets (shedding method) and the other the establishment of a receiving company and to place all stock in this receiving company (stock concentration method). The latter is further divided into the TOB method in which stock is bought up with cash and the stock exchange method in which shareholders are requested to invest their stock and receive the new stock of the receiving company in return.

There are certain difficulties with each one of these methods as applied to the establishment of a holding company.

*1 Shedding method: When a credit obligation is invested, the procedure for transferring a floating mortgage as a security is very complicated, and when overseas advancement is done through a branch office, as in the case of a bank, the procedures for transferring the credit obligation are subject to local legislation.

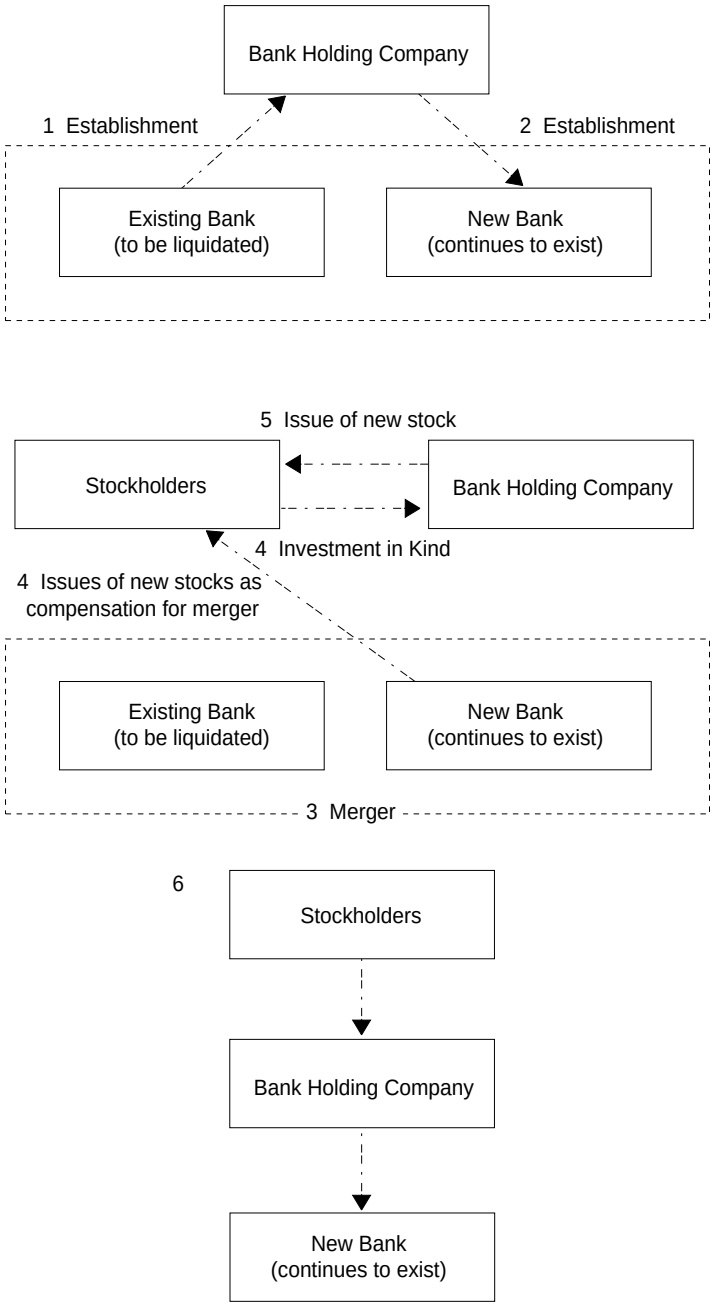
*2 TOB method: In the case of a large publicly held company, this method is very difficult from the viewpoint of obtaining necessary funds, and the stockholders who accept the bid are likely to be subject to the capital gain tax.

*3 Stock exchange method: It is impossible to force minority stockholders who are opposed to a holding company to offer their stock, and the stockholders who accept the exchange are likely to be subject to the capital gain tax.

Therefore, in the special case law, special measures are provided that enable banks to use the stock exchange method to shift to a holding company. The procedures are as follows (the so-called Triangular Merger Method).

Incidentally, for the merger of the existing bank and the new bank, it is required that the terms and conditions of the merger be approved by the resolution of a majority of the stockholders representing at least two-thirds of the total number of outstanding stock.

It should also be noted that the "Outline of Tax Reforms for Fiscal 1998" decided by the Liberal-Democratic Party on Dec. 16 incorporated special measures to be taken for taxes arising from the establishment of a bank holding company in accordance with this special case law. These



1 An existing bank establishes a company which will become a bank holding company.

2 The company which will become the bank holding company establishes a new bank.

3 Merges with the new bank which has the status of a new company and which will continue to exist.

4 As a condition of this merger, the stockholders of the existing bank make a resolution to the effect that the stock of the new bank issued through this merger shall be invested in the bank holding company. (This part is a special measure).

5 The bank holding company issues new stocks as compensation for the investment. On this occasion, inspection by an inspector may be omitted (This part is a special measure).

6 All the stockholders of the existing bank become the stockholders of the bank holding company. (However, stockholders who are opposed to the merger can exercise the appraisal right of stockholders.)

special measures include the postponement of taxation on capital gains incurred as a result of stock exchange through the carrying over of the acquisition price, the reduction of the registration fee and license tax for such investment in a bank holding company, and exemption from the transfer tax at the time stock is delivered to stockholders.

3. Future Prospects

The enforcement of the revised Anti-Monopoly Law and the enactment of legislation in favor of financial holding companies have prepared the way here in Japan for the diversification of business management. Daiei Inc., a major player in the distribution industry, has already moved forward to establish a holding company for the control of its group companies.

However, many companies seem to think it difficult to shift to a holding company unless a measure devised to deal with taxation, such as a consolidated tax return system, is taken. To be sure, if a consolidated tax return system is not permitted, the shift to a holding company by the split-up of an existing company will increase the tax burden. However, the question of whether to adopt a consolidated tax return system should be considered from the larger perspective of what the corporation tax system should be, i.e. not just from the perspective of what is best for implementation of a holding company system.

A special case law has been enacted and tax measures devised in order to facilitate the establishment of bank holding companies by banks as it has been determined that this is necessary to accelerate financial reforms. However, financial reform is not just an issue for the banking circle: it also has an important meaning for financial institutions belonging to other business categories. As noted in the supplementary resolution of the joint committee of the House of Representatives and the House of Councilors, there is a pressing need to examine measures that would facilitate the establishment of other types of financial holding companies.