The Introduction of Share Exchange and Share Transfer Systems

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Proposed revisions to the Commercial Code to introduce systems of share exchange and share transfer that should make the establishment of holding companies a much simpler and quicker process were put before the Diet on March 10th 1999. The ban on holding companies was lifted in December 1997, but present legal rules make them so costly and complicated to set up that there have been few instances to date.

These revisions would provide for a share-exchange system whereby a pre-existing company could be turned into a holding company, and a share-transfer system whereby a new parent company could be established as a holding company. With Japanese companies facing a period of genuine consolidation, these measures are being viewed as providing a way for drastic group reorganization.

1. Current Legal Provisions for the Establishment of Holding Companies and Associated Problems

There are several ways in which a holding company (a company that holds shares and does not run any business operations) can be set up, including (1) the "Shedding" method, (2) via Private Placement, (3) Stock purchase, and (4) under the Law on Special Cases for the Establishment of Bank Holding Companies. Current regulations pose problems for each method.

1) Establishment of Holding Companies under the Commercial Code

The "shedding" method is where a prospective holding company transfers its business operations to a subsidiary that it sets up via an "investment in kind". As well as the investment in kind having to be inspected, there are complicated procedures involved, such as where credit obligations are used as investment in kind, the transfer of the mortgage collateral requires the individual consent of each creditor etc.. Though they do not receive special tax treatment, there are other ways of setting up a holding company quickly that do not depend on investment in kind, as used by Daiwa Securities when it transformed its operations into a holding company structure in April of this year.

The share purchase method involves first the establishment of the prospective holding company, which then via tender offers or some such mechanism purchases the shares of the existing companies. Apart from needing large amounts of cash, minority shareholders who

oppose the shift to a holding company structure cannot be forced into offering their shares, making it difficult to obtain 100% control.

With the private placement scheme, the prospective holding company is first set up, and then places its shares with the shareholders of the existing companies, and requests an investment in kind from those shareholders. The problem with this method is that it depends on the will of the existing companies' shareholders to comply, so it is difficult to guarantee a complete holding company structure.

2) Establishment under the Law on Special Cases for the Establishment of Bank Holding Companies

Following the lift on the ban on holding companies by the Anti-Monopoly Law, the "Law on Special Treatment for Bank-Related Merger Procedures for the Purpose of Establishing Bank Holding Companies" (hereafter the "Law on Special Treatment for the Establishment of Bank Holding Companies"), is a law designed specifically for banks establishing holding companies. This law allows for a system whereby, via a "triangular merger," all the shareholders in the existing bank will become shareholders in the bank holding company, and where the shareholders can be forced to an investment in kind with the newly issued shares of the new bank holding company. As this is a coercive method of establishment, it recognizes shareholder appraisal rights, and the merger procedures involved are more strict than for a usual merger.

Under this law an existing bank ("Bank A") sets up a company ("Company H") that is to become the bank holding company, which in turn sets up a new "Bank S". Then banks A and S are merged, with Bank S being the surviving entity and A dissolved. The special treatment under this law is that, as a condition of the merger of S and A, the shareholders of A have to pass a resolution to the effect that the shares they will receive in S as part of the merger will be used as investment in kind in H, and H will receive the investment in kind as payment for a new issue of shares, and also that the investment in kind can avoid the usually required examination by inspectors

This method is also subject to special tax treatment. Transfer tax can be deferred, and no trading tax needs to be paid on the swapping of the new shares. Also permitted are a partial carrying over of losses brought forward belonging to the bank ceasing to exist, and lower registration and license tax rates for the investment in kind capital increase and the registration of real estate received by the surviving bank.

Despite the existence of this special treatment, there have not yet been any bank holding companies set up under this law. This is due to the fact that, as it involves a triangular merger, procedures have to be carried out for the setting up of 2 new companies, and as the existing financial institution ceases to exist subsequent processes regarding legal relations become complicated. In addition, special treatment is limited to a certain type of bank, and not applicable to business corporations.

Table 1 Reform Timetable

Date	Details
17/Dec/97	Ban lifted on establishment of holding companies (revisions to the Anti-Monopoly Law, June 12th 1997) Daiei sets up a holding company (first)
11/Mar/98	Special Treatment for the Establishment of Bank Holding Companies enacted, amended financial legislation due to the lifting of the ban on establishment of holding companies (Dec. 12th 1997)
16/Feb/99	"Draft Outline of Amendments to Sections of the Commercial Code" compiled by the Commercial Code group of the Legal System Council is approved by the Committee, and presented to the Minister of Justice (Jan 27th 1999)
10/Mar/99	Commercial Code Reform Bill presented to the Diet (to be implemented by December 1999)
26/Apr.99	Daiwa Securities moves to a holding company structure
July 1999	NTT plans to split up its business divisions and become a private company, and set up as a holding company

Source: Nomura Research Institute

2. Establishment of Holding Companies under the Current Legal Framework

With the current legal framework posing the types of obstacles to the establishment of holding companies explained above, Daiwa Securities shifted to a holding company structure using the relatively simple "shedding method". It is the first listed company in Japan to become a holding company.

1) Securities Houses as Holding Companies

At an extraordinary Shareholders' meeting held on Feb. 5th 1999, Daiwa Securities' shareholders decided to transfer its business operations to subsidiaries and to turn itself into a holding company in April of this year using the "shedding" method (c.f. Figure 1). This transformation was made to concentrate holding of shares in the group companies in the hands of the holding company, and to concentrate the various group companies in a centralized group management strategy, by doing which they would be able to greatly expand the value of the group companies and boost consolidated profits.

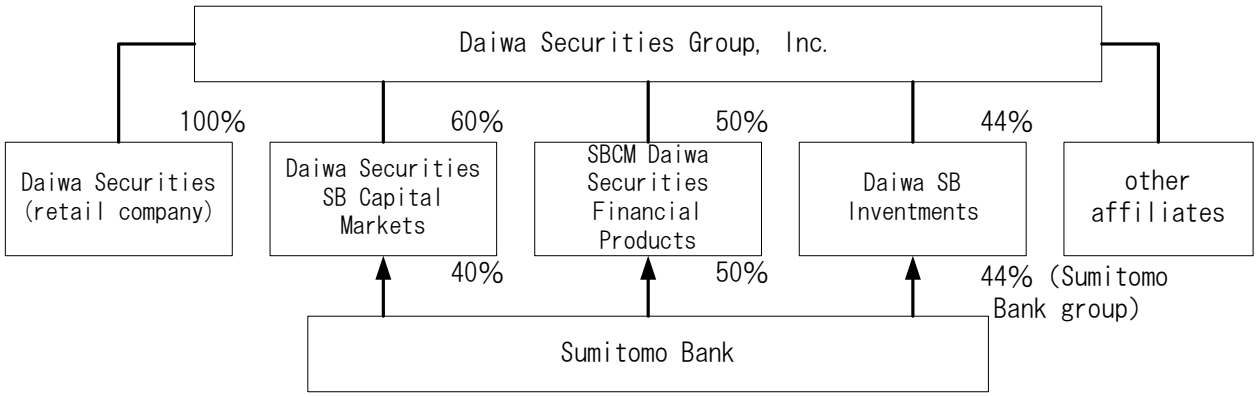
Daiwa Securities as a listed company ceased operating as a securities business on April 26th, the day it completed the transfer of its operations, changing its trading name to "Daiwa Securities Group, Inc."[1], maintaining its listing in the Securities section[2] of the exchange as a company with overall control of Daiwa's securities business. Existing Daiwa Securities business and clients as well as rights etc. will each be taken over by Daiwa Securities SB Capital Markets Co. Ltd. on April 5th, and Daiwa Securities (which handles retail business) on April 26th.[3] Both of the new securities companies have held 4 kinds of securities licenses.

1 The Securities and Exchange Law (Article 31) requires securities companies to use the word "Securities" in their trade name, but permitted the name of "Daiwa Securities Group, Inc." despite it not carrying out securities business itself, since it had securities business as the main focus of its operations.

2 Daiwa Securities' membership of the Tokyo Stock Exchange was passed on to the Daiwa Retail company, while the wholesale securities company that started business on April 5th received its membership via a merger with another securities house.

3 The first day of trading was set as after settlement operations for the end of March had been completed, due to its special status as a securities house.

Figure 1 The Holding Company Structure of Daiwa Securities



Source: Nomura Research Institute

2) Legal Problems

(1) How the Commercial Code and Tax Code Problems were Tackled

Following the announcement of the plan on July 28th 1998 to turn Daiwa Securities into a holding company structure, the actual migration of the group was completed in the space of 6 months by April 1999.

A "dormant company" was used as a subsidiary for the transfer of securities business operations. The minimum capital requirement for a securities company receiving contracts is ¥3 billion (Securities and Exchange Law Article 29-4, and Cabinet order 15-2 2(i)), so the subsidiary had to increase its capital. No investment in kind was carried out therefore the question of selecting inspectors or undergoing an inspection did not arise. In other words, the problems associated with the "shedding method" regarding the Commercial Code did not occur, and no special tax treatment was received.

Appraisal rights from opposing shareholders have to be met at a fair price (Commercial Code Article 245-3), but it is not clear in practice what price should be used as a benchmark. It seems that there were no appraisal rights from opposing shareholders in Daiwa's case, but there were wild fluctuations in the share price after the announcement, and the price slid steeply at one point in reaction to activities on the stock lending market[4]. In future it seems that listed companies converting to a holding group need to pay due care and attention to market price formation factors.

(2) Restrictions on Business Operations

The Daiwa Securities Group, Inc. did not fall into the category of "companies whose holdings of subsidiary shares exceed 50% of total assets," so is not a holding company

4 The share price at the time of the following events was: Operations transfer contracted (Dec. 18th 1998) ¥385; calling of the shareholders' shareholders' meeting (Jan. 18th 1999) ¥373; shareholders' meeting (Feb. 5th 1999) ¥414; date of first transfer of operations (April 5th 1999) ¥675

according to the Anti-Monopoly Law[5]. Consequently the affiliated Daiwa International Trust Bank is not subject to restrictions in its business operations as would normally be applied to a subsidiary of a financial holding company.

(3) Listing Implications

The conversion of listed companies into holding companies is recognized in a certain number of cases. The TSE (Tokyo Stock Exchange) amended its "Securities Listing Rules" in December 1997 in reaction to the lifting of the ban on holding companies by introducing the holding company structure to the listing system (effective from Jan. 1st 1998). The business of a holding company (controlling its subsidiary companies) is treated in the same way as the commercial business of its subsidiary companies, with both treated as making profits from their respective business operations - exercising control for the holding company, and commercial enterprise by the subsidiary companies. However, asset management companies whose purpose is purely to hold shares, even if they fall into the definition of holding companies according to the Anti-Monopoly Law, may not list their shares as holding companies as they are not fulfilling that function.

As Daiwa Securities is not a holding company according to the Anti-Monopoly Law, it cannot maintain its listing under the above regulations, but in amendments to its share listing requirements in December 1998 (effective from Jan. 1st 1999) the TSE also included effective holding companies under these listing rules.

3. Establishment of Holding Companies under the Revised Legislation

In order to make the establishment procedures faster and easier under the Commercial Code, the Commercial Code committee of the Legal System Council (an advisory group to the Minister of Justice, headed by Mr. Yo Maeda, professor at Gakushuin University) examined the establishment of share exchange and share transfer systems in a report entitled "A Legislative Outline of Partial Revisions to the Commercial Code" on Feb. 19th 1999. The report's recommendations were approved by the Legal System Council, formulated into a draft bill which was presented to the Diet on March 10th, and are currently being reviewed by the House of Representatives.

1) The Share Exchange System

(1) Procedures for Exchanging Shares

The share exchange system is where 2 companies, one the parent company and the other a 100% subsidiary, conclude a share exchange contract, where new shares of the parent are exchanged for the shares held by the shareholders of the subsidiary company (revised Commercial Code Article 352, Figure 2).

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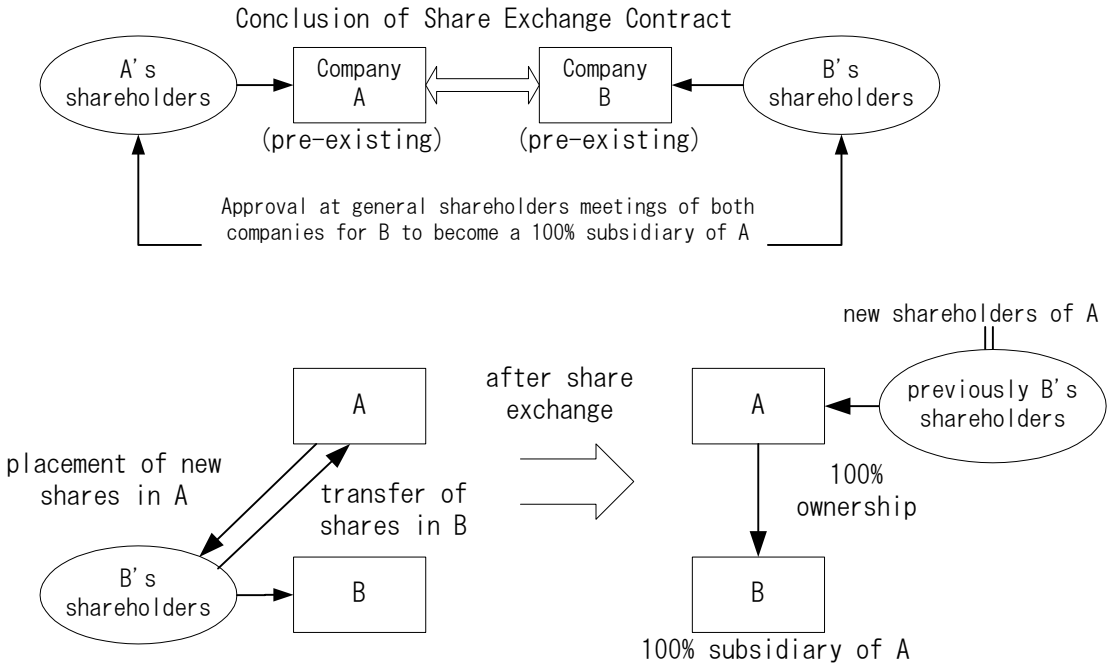
5 Some say that the adoption of formalized volume criteria for holding companies in the revised Anti-Monopoly Law of 1997 in a response to calls for more clarity by legislators, meant a narrower scope for their definition and as such was a major change in the law.

Figure 2　Share Exchange Structure



Source:　Nomura Research Institute

The procedures to be followed consist of the drawing up and signing of a Share Exchange Contract, and obtaining the approval of the shareholders at a shareholders' meeting (Revised Commercial Code, Article 353-1).　The Share Exchange Contract consists of:

Provisions for any change in the Articles of Incorporation of its parent company

Number of new shares to be issued by the parent company, par or non-par, type and number, and items relating to the placement of new shares with the shareholders of the subsidiary company

Items relating to the amount of capital increase of the parent company and capital reserve amounts

Provisions, if determined, for the amount that must be paid to the shareholders of the subsidiary company

The dates of the shareholders' meetings for all companies concerned

The date of the share exchange

Details of distributions of profits scheduled prior to the share exchange date

(Revised Commercial Code, Article 353-2).

Following which special resolutions need to be passed at shareholders' meetings of the companies concerned (with a 2/3rds majority in favor out of attendees representing over half of the issued shares), with a recognition of share appraisal rights at a fair price for shareholders opposing the share exchange (Article 355).

Disclosure requirements towards the shareholders consist of both pre-share exchange evaluation materials for the shareholders' meeting and a share exchange report.　Firstly, from 2 weeks before the shareholders' meeting and within up to 6 months after the share exchange date (Article 354) the following documentation has to be made available at the company head office:

Share Exchange Contract

Documentation detailing the share exchange ratios and the basis used for their calculation

A Balance sheet from within 6 months prior to the date of the shareholders' meeting (and the most recent Balance sheet)

Accompanying Profit and Loss statements

Also, after the exchange of shares has been performed, information on the following items relating to the share exchange have to be made available within 6 months after the share exchange date at the head office (Article 360):

The net assets of the wholly-owned subsidiary

The number of shares of the subsidiary that were transferred to the parent company as part of the share exchange etc.

If a company is holding its own shares that are to be retired, these can also be exchanged for new shares (Article 356).

In addition, a share exchange differs from a merger in that the non-exchanging company does not cease to exist, so procedures for protecting creditors (announcements and collateral provision, repayment etc.) are not required.

(2) "Short Form Share Exchange" System

The short form share exchange system is where a share exchange can be carried out without the approval of the parent company shareholders at a shareholders' meeting because it satisfies certain criteria (Commercial Code Article 358): the total number of new shares to be issued by the parent company for the share exchange do not exceed $1/20^{th}$ of its total outstanding issue, and the amount paid to the shareholders of the company becoming the wholly owned subsidiary in exchange for the shares does not exceed 50% of the net assets of the parent company according to the most recent balance sheet.

Share appraisal rights are recognized for any shareholders of the prospective parent company that oppose the share exchange. Their protests should be noted in the share exchange contract, though if over $1/6^{th}$ of the total issue of shares make an opposing protest, then the share exchange must proceed according to the full legal procedure, i.e. both companies must call a shareholders' meeting and obtain approval (Article 258-8).

The short form share exchange method is a recognition of a speedy process where the share exchange is of relatively minor financial impact on the parent company, and whether to use it or not is at the discretion of the company concerned. [6]

2) Share Transfer Method

Share transfer is where the shareholders of a company (Company B) that is to become the subsidiary, transfer their shares to a newly established parent (Company A). Shares in A are placed with B's shareholders, so that A is the parent company and B is the wholly-owned subsidiary (Revised Commercial Code Article 364, Figure 3). Regarding the setting up of the parent company A and the transfer to it of the shares from the pre-existing company B,

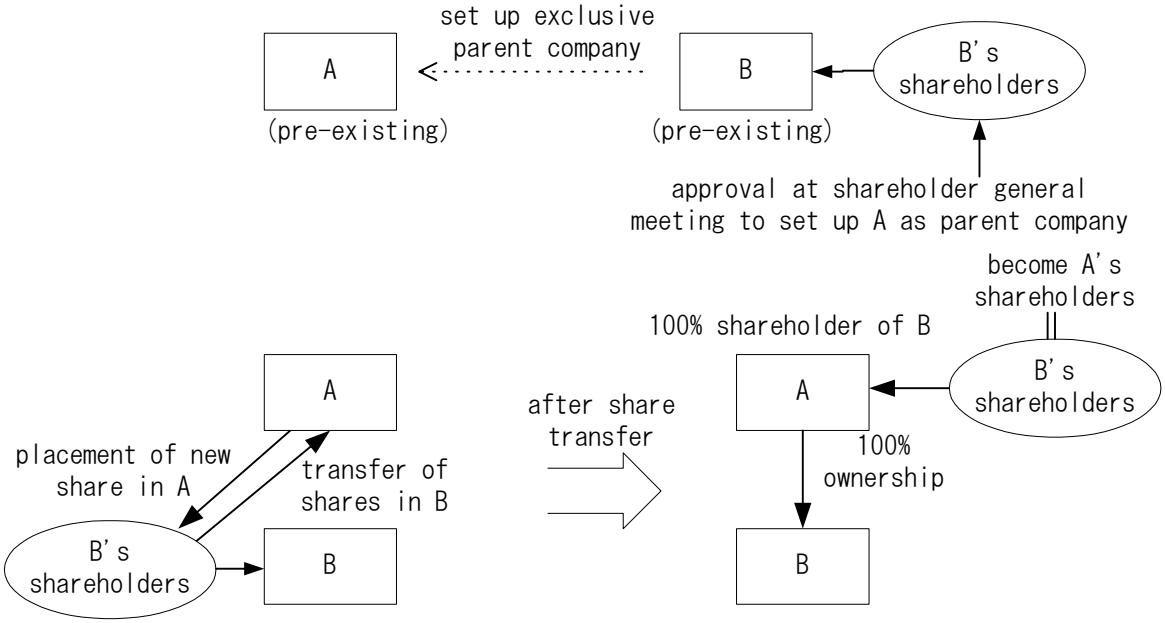
6 Under the 1997 Commercial Code revisions similar conditions were introduced regardig mergers for a "short form merger system."

approval at the shareholders shareholders' meeting is required in the form of a special resolution (Revised Commercial Code Article 365).

As with the share exchange system, appraisal rights for the opposing shareholders are recognized, and there are no procedures to protect creditors. In addition, prior disclosure of the outline of the planned measure, and subsequent disclosure requirements are the same as for share exchange (Article 366).

The share transfer method is similar to the investment in kind method, but as it is based on merger regulations, it is not an investment in kind type, but a new company merger type. Therefore, the problems of inspector appointment which are costly and time-consuming and existence of the originator that arise with the investment in kind method do not apply.

Figure 3 Share Transfer Method



Source: Nomura Research Institute

4. Other Related Legislative Revisions

1) Full Disclosure of Subsidiary Operations

The purpose of a parent holding company is the "control, supervision and financing of subsidiaries." With share exchanges and share transfers, the previous shareholders of the subsidiaries become shareholders of the parent company, and while previously they had a direct say in the operations of the companies, now they only have an indirect influence by deciding whether the parent company is acting in a fair manner. This change in the rights of the previous shareholders is a problem that was of major concern to the Legal System Council.

The revised legislation provides for 3 methods of disclosure in order for the old shareholders to maintain supervision over the activities of the subsidiaries.

Firstly, the parent company shareholders have the right to seek the permission of a court to view documents concerning the subsidiaries (minutes of the shareholders' meeting, the articles of incorporation, list of shareholders, accounting books etc.) (Revised Commercial Code Articles 244-4, 260-4-4, 263-4, 282-3, 293-8). The right to view the various accounting books is only held by shareholders holding 3% or over of the total issuance of shares. Also, the parent company auditor has the right to examine the subsidiaries, and if this right is exercised, then the methodology and results are detailed in an auditors report, that must be shown to the parent company shareholders. Also, shareholders with over a 3% stake can, when requesting the appointment of an inspection team, request that the inspection also cover the business operations of the subsidiary companies.

2) Special Tax Measures

There have been several problems pointed out regarding the tax treatment of setting up holding companies or their subsequent operation. Regarding which the following special tax measures regarding the establishment of holding companies have been put in place.

The revisions to the 1999 tax code formulated on March 24th 1999 and put into effect on March 31st provided for special measures regarding the taxing of share exchanges and transfers. These allow for the deferment if certain conditions are met of the transfer gain tax on shares in wholly owned subsidiaries transferred to a parent company (Special Taxation Measures Law Article 37-13-2). Also, subsequent to the share transfer, where the wholly owned subsidiary transfers shares to the parent company, if certain conditions are met then this is not subject to transfer gains tax (Article 67-4).

The above special tax measures will take effect along with the revisions to the Commercial Code.

One solution measure to the tax-related problems that arise after the shift to a holding company structure would be the introduction of a consolidated tax system allowing the aggregation of profit and loss across different companies corresponding to the aggregation of profit and loss that was previously carried out between departments. This was clearly written into the Outline of Revisions to the Tax System of 1999 as a subject for detailed

investigation, and discussions are well underway regarding its legal implementation at an early date.

3) Revisions to the Special Cases for the Establishment of Bank Holding Companies

The requirements for a shareholders' meeting resolution under the Bank Holding Company Establishment law have been relaxed in line with the new share exchange and share transfer system. Essentially, whereas previously the merger of the existing company and the new company were subject to stricter conditions than a regular merger,[7] these conditions have been abolished and it is now treated as a regular merger, requiring a special resolution for the approval of the shareholders as per share exchange or share transfer (Article 5-1 of the current Law on Special Cases for the Establishment of Bank Holding Companies has been abolished).

4) Current Value Accounting of Assets

Additionally, current revisions to the Commercial Code will allow for assets to be accounted for on a current market value basis.

In the Business Accounting Deliberation Council report of Jan. 22nd 1999 entitled "Opinion on Setting Accounting Standards for Financial Instruments," it was decided that from March 2001 securities will as a rule be accounted for on a current-value basis. Therefore, companies such as listed companies that are obliged to make continuous disclosure under the Securities and Exchange Law, will have to value their securities holdings at current-value when submitting their financial statements are part of their securities reporting.

While the Commercial Code is the underlying law governing calculation rules for financial statements for all companies, and is based on the principle of historical cost accounting for the valuation of assets, it will also allow (in the calculation of Balance Sheet amounts in the Commercial Code) for current-value accounting in order to bring itself in line with the International Accounting Standards and their applicability to the financial statements that come under the Securities and Exchange Law. In other words, this will permit current-value accounting for items such as debt, corporate bonds and shares etc. that have a market value (Revised Commercial Code Articles 285-4, 285-5, 285-6). Furthermore, where financial receivables have been purchased at a higher price than their face value, a corresponding increase in the book value is allowed.

As it is not actual cash-generating profit, the rise in net assets on the balance sheet resulting from valuation profits using current-value accounting cannot be used to pay out dividends (Article 290).

7 Requiring approval of 2/3rds or over of totally issued shares. However, if notification is made in writing of the opposition of a majority of shareholders of the company that will cease to exist, then the merger resolution cannot be passed.

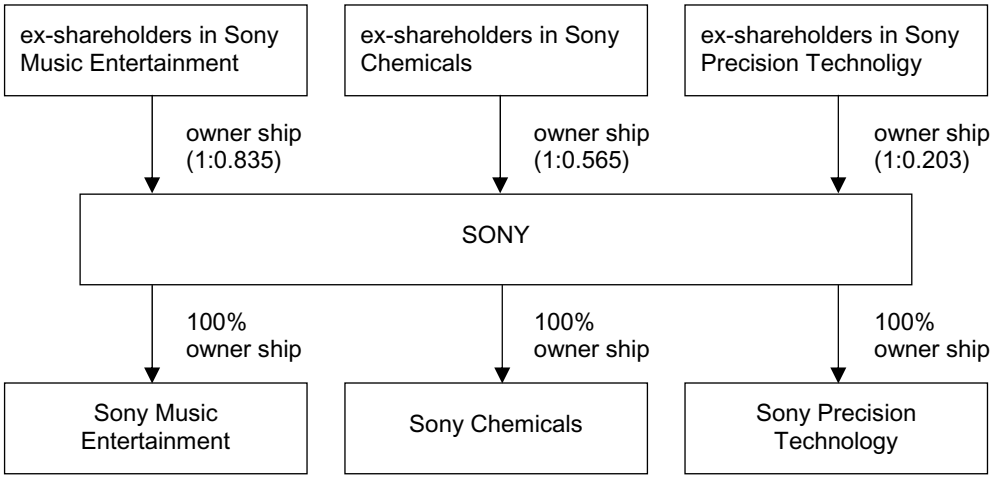
5. Future Prospects

What impact will these revisions to the Commercial Code have on the capital markets? The two major corporate finance changes in the capital markets have been the introduction of consolidated accounting (mainly affecting business groups), and the introduction of current-value accounting (principally for financial instruments). Alongside these, the Commercial Code provides new methods by which to make consolidated management more efficient by the introduction of share exchange and share transfer systems, and by the allowance of current-value accounting is moving towards the harmonization of financial documents produced under the Commercial Code and financial statements produced under the Securities and Exchange Law.

Already several companies are acting on these changes in the law.[8] Sony, with the current revisions in mind, has announced the reorganization of its 3 listed subsidiaries into wholly-owned subsidiaries by FY2000 (c.f. Figure 4). The Industrial Bank of Japan has also announced its intention to set up a financial holding company in FY2000.

The Japanese government is also starting to consider legislating the "Company Reform Assistance Law" (a provisional title) in order to broadly promote corporate reorganization. Also, the Corporate Law sub-committee of the Legal System Council Commercial Code Committee (that introduced the share exchange system) held its first meeting on April 14th to work on legislation for company partition laws enabling companies to spin off internal departments, and aim to have them in force in 2001. The pace of corporate reorganization is now more likely to gather speed supported by these changes in the system.

Figure 4 Sony plans 100% Control of its Listed Subsidiaries



Source: Nomura Research Institute

8 Toyota Motors, Itochu Corp., Ajinomoto, Jasco etc. have announced plans to shift to a holding company structure.