Disclosure of large shareholdings

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Summary

1. When the Murakami Fund amassed large stakes in Hanshin Electric Railway and in Tokyo Broadcasting System (TBS), it triggered criticism of the rules requiring the reporting of large shareholdings, referred to as the 5% rule.

2. In principal, an investor must file a large shareholdings report within five business days of acquiring more than a 5% stake in a company. There is an exception to this rule, however, for securities companies, banks, life insurance companies, investment advisory companies, and other institutional investors that own stock without seeking control over the company's business activities. In this case, there is a quarterly reporting requirement for disclosure of the percentage of shares held at the end of each designated quarter by the 15th day of the month following.

3. This exception to the rule was included because if securities houses, investment advisors and other investors who trade large volumes of stock on a regular basis as part of their business were to disclose large-scale ownership of shares held without the objective of controlling business activity, the reports would be so frequent as to border on the meaningless.

4. The equivalent of Japan's reporting exception in the US requires reporting only once a year within 45 days from the end of the year. Under current EU regulations, disclosure is only required when ownership exceeds 10%. Japan therefore already has the world's most stringent reporting requirements.

5. If this exception were eliminated, institutional investors would find it practically impossible to comply, since the rules would demand reports on hundreds of stocks on a daily basis. Even if the system does need to be revised, the revisions should be thought through fully, based on an international comparison.

I. Rising criticism over the rules for disclosing large shareholdings

1. A series of large-scale stock acquisitions

With Livedoor's acquisition of a large block of Nippon Broadcasting stock in February 2005 and the defensive strategies employed in response still fresh in our memories, the Murakami Fund, a fund managed by Yoshiaki Murakami, a former METI bureaucrat and now a well-known shareholder activist, acquired approximately 40% of the shares of Hanshin Electric Railway Murakami then promptly floated the idea of listing shares in the Hanshin Tigers, a popular baseball team that is a subsidiary to Hanshin Electric Railway.

Meanwhile, Rakuten, an operator of online shopping malls, acquired roughly 15.5% of the shares in TBS, a leading private-sector broadcaster, and proposed a business merger through the establishment of a joint holding company.

It appears that in every case, the acquisition targets were not given any notification prior to the stock purchases. None of the management teams who were suddenly subjected to demands related to the operation of their core businesses by these new major shareholders made any effort to hide their surprise and displeasure.

Some observers have watched this latest string of events and concluded that market rules may be insufficient. One component of the regulations that has come under criticism is the exception granted to investment funds and other institutional investors regarding the time frame within which large shareholdings must be disclosed.

2. The large shareholdings report and its significance

1) The large shareholdings report

The large shareholdings report is a document that must be filed that is based on the so-called 5% rule in the Securities and Exchange Law (SEL). Under Article 27-3 of the SEL, large shareholders, defined as shareholders with more than 5% of the outstanding shares of a listed company, must file a large shareholdings report (disclosing the percentage of shares owned, the amount of funds used in the acquisition, and the purpose of ownership) within five business days of becoming a large shareholder.

Furthermore, they must file a change report for any trades following the filing of the initial report that result in a ±1% or greater change in the percentage of shares owned (SEL Article 27-25).

The owner in the large shareholdings report is a substantive concept that goes beyond just the titular owner of the shares to include individuals with the authority to exercise voting rights as well individuals with the authority to direct how those voting rights are exercised. Recently, it has become increasingly common for institutional

investors to own shares through a custodian bank, and listed companies often voice their dissatisfaction over this, since it makes it difficult for them to know who the real shareholder is. In this regards, it is probably safe to view the filer of the large shareholdings report as the "real shareholder." When shares are held jointly such as through a group company, disclosure is required when overall ownership exceeds 5%.

2) Exceptions to large shareholdings reporting

The exception to large shareholdings reporting requirements that has recently come under fire is the rule in SEL 27-26, which only applies to securities companies, banks, and other persons stipulated by the Cabinet Office directive that own shares without the objective of controlling the business activities of the company issuing the shares.

In this case, the shareholder does not need to file a report within five business days, but can file once a quarter by the 15th day of the month following a designated reference date. Furthermore, the change report is normally required anytime there is a ±1% or greater change, but under the exception the report must be filed (1) by the 15th of the month following the quarterly reference date if there is a ±1% or greater change as of that date and (2) by the 15th of the month following any month in which there is a ±2.5% or greater change, even if not in the month of the quarterly reference date (Article 17 of the Cabinet Office directive on large shareholdings). This exception does not apply, however, if share ownership exceeds 10% (Article 17 of the Cabinet Office directive on large shareholdings).

This exception was included because of the excessive administrative costs of complying with the 5% rule that would be incurred by securities companies and other institutional investors that regularly trade in large quantities of stocks as part of their normal business activities.

Figure 1: Standards for reporting by large shareholders

	Normal reporting		Exceptional reporting	
	Ownership share	Reporting deadline	Ownership share	Reporting deadline
Large shareholdings report	When over 5%	Within 5 days of going over 5%	When over 5% as of the reference date	On the 15th of the month following the month of the reference date
Large shareholder's change report	When there is a change of at least ±1%	Within 5 days of the change in ownership percentage	When there is a change of at least ±1% as of the reference date	Same as above
	When there is a decline of a majority and over 5% within the past 60 days		When there is a change of over 2.5% as of the end of the month in a month without the reference date	On the 15th of the month following the month of change

Source: Nikkei Kin'yu Shimbun dated October 20, 2005, page 28 *Sukuranburu* (Scramble)

3) Comparison of large shareholdings reporting requirements among Japan, the US, and Europe

Since Japan's large shareholdings reporting requirements were modeled on the US system, it is only natural that there would be many common elements between the two systems. There are important differences between the two, however, as outlined below.

First, the reporting requirement for institutional investors in the US, at only once a year, is considerably more lax than that of Japan, which requires quarterly disclosure. Second, the US has a much looser reporting deadline, within ten days under normal circumstances (versus five business days in Japan) and within 45 days under the exception (versus within 15 days in Japan). Third, in the US the exception applies across the board until ownership exceeds 10%, and when ownership is between 10% and 20% the reporting requirements are still less rigorous than the normal case. Contrast this with Japan, where institutional investors must follow the normal reporting deadline of within five business days as soon as they exceed 10% ownership.

The current reporting requirements in Europe are also less strict than in Japan, with reporting only required when ownership exceeds 10% and with a change in ownership only required when there is a change of greater than 20%. Although the new reporting requirements going into effect as a result of transparency directives are stricter, the frequency of the reports is not that great. Change reports are also not as strict as in Japan.

Furthermore, the items that must be reported are, in principle, only the date the shares were acquired and the percentage of ownership attained, with no need to disclose information on past trading activity as is normally required in the US and Japan. Under Europe's new rules the reporting deadline under normal circumstances will be within four business days, which is even shorter than in Japan, but the deadline for releasing the information to the public is within seven business days, which makes Japan's system better from the perspective of the users of that information.

In summary, it seems fairly clear that Japan's current reporting requirements for institutional investors are considerably more strict than they are in the US and Europe (Figure 2).

Figure 2 Differences in large shareholdings reporting requirements among Japan, US, and Europe

	Japan	US	Europe (current rules)	Europe from Jan. 2007 (new rules)
Shareholders required to submit report	Persons with over a 5% stake	Persons with over a 5% stake	Persons with over a 10% stake	Persons with over a 5% stake
Report deadline	Within 5 business days	Within 10 days	Notify company within 7 days, company must report within 9 days	Notify company within 4 business days, company must report within 3 business days
Change report	When there is a change of at least ±1%	When an important change occurs	When ownership rises above or falls below 10%, 20%, 33.3%, 50%, or 66.6%	When ownership rises above or falls below 5%,10%, 15%, 20%, 25%, 30%, 50%, or 75%
Main report contents	Number of shares held, ownership share, book value, source of funds used for acquisition, purpose of acquisition, trading related to said shares within the past 60 days	Number of shares held, ownership share, book value, source of funds used for acquisition, purpose of acquisition, trading related to said shares within the past 60 days	Ownership share	Ownership share
Shareholders subject to exceptional rules	Banks, securities companies, investment advisory companies and other shareholders with 5-10% ownership not for the purpose of controlling the business	Banks, securities companies, investment advisory companies and other shareholders who acquire 5-10% ownership as part of normal operations and without seeking to exert an influence on control of the business	Professional securities traders who take ownership without any relation to the subject company	Temporary holdings in the process of clearance or settlement, holdings through a custodian, and holdings through a market maker with no impact on the business
Exceptional report deadlines	On the 15th day on the month following the reference date	Within 45 days of the end of the calendar year	Those subject to the exception are exempt from reporting	Those subject to the exception are exempt from reporting
Exceptional report contents	Number of shares held and ownership share	Number of shares held and ownership share	Those subject to the exception are exempt from reporting	Those subject to the exception are exempt from reporting

Note: For Europe, "current rules" refers to the Major Shareholdings Directive of 1988 and "new rules" refers to the Transparency Directive, which must become domestic law by January 2007.

Source: Compiled by author

3. Rising chorus to revise the exceptions

Management at listed companies have cast doubt on Japan's current reporting requirements, noting that it is not right that large blocks of company shares can be acquired before they are aware of it. As a consequence of this dissatisfaction in the corporate sector, a number of joint conferences have called for revision of the reporting exceptions without delay, including a Liberal Democratic Party committee on corporate governance that met on October 13.[1]

This exception was also cited as a problem during the battle between Livedoor and Nippon Broadcasting. At the time, the focus was on actions by the Murakami Fund, which owned 18.5% of Nippon Broadcasting's shares at the time, but it was completely unknown to what extent the fund would retain its holdings, and by the time it finally reported it had reduced its stake to approximately 3.4%. Some observers argued that this distorted the investment decision-making process of regular investors.

[1] On page 3 of the Mainichi Shimbun's Osaka morning edition dated October 14, 2005, and on page 2 of the Nikkei Kin'yu Shimbun dated October 17, 2005, *Kasumigaseki Fusokukei* (Kasumigaseki Wind Meter).

Within the context of such criticism, the Liberal Democratic Party committee on corporate governance issued a proposal for fair rules governing M&A in July. The proposal argued that there was an urgent need to consider revisions to the questionable reporting exception, from the perspective of ensuring the timely and fair disclosure of information to shareholders and corporations such that no harm is done to the real intent of disclosure rules. In response, a working group within the Financial System Council on the system of tender offers (chaired by Shinasaku Iwahara, a professor researching law and politics at Tokyo University) has begun looking into revising the system.[2]

II. Is it realistic to revise the exceptions?

1. Revision expected to have a seriously negative impact

As noted above, Japan's rules for disclosing large shareholdings demand a fairly high level of transparency relative to other regimes as they are currently written, and whether or not this will be acknowledged in the process of debate, it seems fairly certain that there will be calls for the revision (or maybe repeal) of these "nontransparent" exceptions. That said, we do not think it would be realistic to completely abolish the current exceptions and require all shareholders with over a 5% stake in a company to meet the regular reporting standards now in force.

The author of this report has recently had the opportunity to exchange opinions with those working on the front lines at multiple different asset management companies and securities firms. Nearly everyone at the working level seemed to agree that it would be virtually impossible to comply with the requirements if the exceptions were repealed.

It would be particularly difficult to comply with the requirement to add together the individual stakes in the case of joint ownership. To do so would require foreign-capitalized asset management companies to collect paperwork from group companies located in the US, Europe, and elsewhere and compile their numbers. Furthermore, because Japan's regulations are more strict that those in the US and Europe, it will make it that much more difficult to convince those working outside of Japan of the need to submit the paperwork.

Even if those companies eligible for the exception (like the securities companies) that have already automated the process of collecting data from group companies to a substantial degree were able to somehow get information on number of shares held and percentage of ownership, it would probably be close to impossible for them to accurately put together within five business days data on trading and prices from the past 60 days. There is also a need to understand the reality that a substantial increase

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[2] Although the author is a member of this working group, the opinions expressed in this report are solely those of the author and in no way related to the internal discussions or opinions of the working group.

in the number of issues that must meet the standard would make it that much harder to follow procedures as prescribed by law.

For example, since going over 10% ownership would trigger application of the standard reporting requirements and make it impossible to keep up in practical terms, there are probably companies that instruct their asset managers to invest so as to keep from exceeding 10% and/or devise early warning mechanisms that kick in for stocks in which ownership is already over 5%. Although this is an investment approach geared toward avoiding reporting violations, from the perspective of pursuing investment objectives it would seem to be putting the cart before the horse to not purchase stocks that you otherwise want to purchase out of excessive fear of regulatory violations.

Nevertheless, the more such measures become necessary, the more difficult it becomes to adhere to reporting requirements. In addition, the penalty for failing to submit a large shareholdings or change report, or for filing false information on a critical item, is up to three years imprisonment and a fine of up to JPY3 million (Article 198-5 and 198-6). Being fined for securities violations is a serious offense, and grounds for being deregistered as an investment advisor or for derailing the approval process for making discretionary investments. Another obvious consequence would be that institutional investors would become highly sensitive to compliance risk.

2. Would this really improve transparency?

One reason that exceptions to reporting rules for institutional investors have been criticized is the perception that the existence of these exceptions has made the movement of shares affecting management control less transparent. The question, however, is whether that perception is correct.

Looking only at one of the cases that has brought attention to this debate, the Murakami Fund's acquisition of Hanshin Electric Railway, the fact that there was a reporting exception did not have that much of an impact, in our opinion.

That said, the market first became aware of the Murakami Fund's acquisition of Hanshin Electric Railway when the Fund submitted its report on September 26 noting a stake of approximately 26.7%. The exception granting an extension of time to report did not apply at that point, pursuant to the Cabinet Office directive noted above. The Fund exceeded a 10% stake on September 15 and submitted a report on September 26, which was five business days later in accordance with the normal rules.[3]

Although it is true that the Murakami Fund had already acquired a 9% stake in Hanshin Electric Railway by early July, it did not immediately disclose this, in accordance with the exception rules. Furthermore, as already noted, there has also

[3] On page 8 of the Mainichi Shimbun's Osaka morning edition dated October 14, 2005. Because this fell between two 3-day holidays, even though the calendar deadline is the 11th, it may not have immediately become a violation at that point.

been a tendency to criticize the fact that because of the exception, the Murakami Fund disclosed its large-scale acquisition of TBS stock after Rakuten did despite acquiring the stock earlier. There are doubts, however, over how much the situation changed purely on the disclosure of that information.[4]

Although market transparency is clearly important, there is a need to tread very carefully when addressing the question of how much burden should be placed on the regulated entity in order to achieve the regulatory objective of transparency. Rather than making sweeping changes in the exceptions to the rules on reporting large shareholdings in a way that would saddle a large number of securities companies and other institutional investors with unnecessary administrative costs, we think it would be preferable to expect market participants to conduct themselves professionally and adhere to a high ethical standard.

III. Conclusion

The purpose of the large shareholdings report is to ensure market transparency. Although the primary users of the disclosed information are general investors, another purpose of the report is to enable listed companies to ascertain that an entity intent on having an influence on the control of the business does not suddenly acquire a large quantity of shares. This seems to be clear based on the fact that in Japan as well as in Europe and the US, the large shareholdings report is sent not only to the authorities but also to the issuer of the shares.

It is important to remember, however, that this reporting system is not predicated on a negative assessment of corporate acquisitions nor aimed solely at making it easier for corporations to mount a takeover defense.[5]

From October 2005, the Financial Services Agency began making the large shareholdings reports and change reports available on the Internet through its EDINET service, and anyone can view these reports starting on the day they are filed. This should be a welcome change, given the boost it will provide to market transparency.

We expect to see a wide-ranging debate over such issues as the nature of the reporting exceptions, the specific data to be published, and the normal reporting deadlines. The Japanese market tends to be considered less transparent than markets in Europe and the US, and there needs to be a more reasoned debate over the reporting of large shareholdings while also taking account of the considerably different conditions that prevail.

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4 It would be possible to argue that if this was disclosed in July, Hanshin Electric Railways would probably have been able to mount a takeover defense. If the exception did not exist, the Murakami Fund would probably have acted differently.

5 See Akio Kondo, Kasushi Yoshihara, and Etsuro Kuronuma, *Shoken Torihiki Hou Nyuumon* (Introduction to the Securities and Exchange Law), Second revised edition, page 215.