

September 9, 2020

Engagement Agenda “Policy Concerning Cross-Shareholdings”

Investors’ Common Views and Request for Engagement Meetings on Policy Concerning Cross-Shareholdings

The Institutional Investors Collective Engagement Forum (hereinafter referred to as “IICEF”) together with the seven companies participating in the Collective Engagement Program, namely The Dai-ichi Life Insurance Company, Limited, Meiji Yasuda Asset Management Company Ltd., Mitsubishi UFJ Trust and Banking Corporation, Pension Fund Association, Resona Asset Management Co., Ltd., Sumitomo Mitsui DS Asset Management Company, Limited, and Sumitomo Mitsui Trust Asset Management Co., Ltd. (in alphabetical order) has sent letters requesting collective engagement meetings with companies holding cross-shareholdings.

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1. Overview of the Agenda

In conjunction with the revision of Japan’s Corporate Governance Code in 2018 (hereinafter referred to as “CG Code”), companies, pursuant to Principle 1.4, are now required to disclose their policies on and approaches to the reduction of cross-shareholdings, to specifically examine each individual cross-shareholding, to assess whether or not each shareholding is appropriate, and to disclose the results of such assessment. Additionally, Supplementary Principle 1.4.1 articulates that when cross-shareholders indicate their intention to sell their shares, companies should not hinder the sale of cross-held shares by, for instance, implying a possible reduction of business transactions; and Supplementary Principle 1.4.2 articulates that companies should not engage in transactions which may harm the interests of the companies or the common interests of their shareholders by, for instance, continuing the transactions without carefully examining the underlying economic rationale. Furthermore, in 2019, the Cabinet Office Ordinance was revised to encourage the improvement of the disclosures of cross-shareholdings in the annual securities reports.

While many companies have declared compliance with Principle 1.4 (Cross-Shareholdings) in the “Corporate Governance Report” (hereinafter referred to as the “CG Report”), updated based on the revisions to Japan’s Corporate Governance Code, we have come across cases of

disclosures in which the purpose of holding remains general and abstract or no concrete reduction policy is provided in the description. Consequently, IICEF, from 2019, has been holding collective engagement meetings to understand actual situations of cross-shareholdings with several leading companies in Japan.

Based on the actual situations of these initiatives by the Japanese companies to improve the disclosures on cross-shareholdings and to reduce cross-shareholdings, we have once again decided to send letters requesting collective engagement meetings to the CEOs and outside directors of major companies that hold a substantial amount of cross-shareholdings as well as companies whose shares are held by a large number of companies in cross-shareholdings to discuss their views on cross-shareholdings.

2. Questions to be asked at the collective engagement meetings

As mentioned above, disclosure rules on cross-shareholdings have been strengthened through the revisions of the CG Code and the Cabinet Office Ordinance and most companies have declared their compliance with these rules.

However, despite their declaration of compliance, the disclosures pursuant to Principle 1.4 (Cross-Shareholdings) in the CG Reports of most companies are limited to statements of policies indicating their intention of cross-shareholding in order to maintain and strengthen business relationships and do not include specific policies on reducing them. Additionally, while not required by the disclosure rules of CG Reports, there are no mentions of policies relating to Supplementary Principles 1.4.1 and 1.4.2 Statements on the reason for cross-shareholdings in the annual securities reports are also limited to general descriptions and do not touch upon specific initiatives and their effects toward enhancing corporate value.

Therefore, we would like to ask top management and outside directors who are expected to appropriately reflect the opinions of the stakeholders commencing with minority shareholders at the Board from an independent standpoint, the following questions in order to hear their views on the type of discussions held at Board meetings in response to the CG Code and the type of policy upheld by the company regarding cross-shareholdings, among others.

- (i) Whether a concrete reduction policy is set up or not, and the scale of and the process for the reduction.
- (ii) How the company is reacting with the policy in the event that the counterparty in the cross-shareholding indicates its intention to sell the shares it holds. If the company is in

compliance with “companies should not hinder the sale of the cross-held shares” of Supplementary Principle 1.4.1 of the CG Code, then how it is enforced on the employees to ensure that sales are not hindered. What you think of IICEF’s opinion of stating the company policy in the CG Report and clearly indicating the stance to the cross-shareholders and business partners.

(iii) What the details of analyses of the individual cross-shareholdings are. Whether a simulation has been conducted on the impact on business activities and results in the event that cross-held shares are sold. If the disposal of shares is found to impact business activities, it indicates that the counterparty has practically decided not to comply with Supplementary Principle 1.4.1 of the CG Code. What your thoughts on the counterparty’s non-compliance are.

(iv) Thoughts on the various concerns held by investors regarding cross-shareholdings (described in “3. Investors’ approach to cross-shareholdings”).

(v) Why cross-shareholdings are thought to be linked to maintaining and strengthening business relationships.

(vi) Thoughts on building stable (loyal) shareholder-base through mutual holding of shares.

3. Investors’ thoughts on cross-shareholdings

Cross-shareholdings are a type of shareholding unique to Japan. The mutual holding of shares, in particular, began in post-war Japan as a way for companies to protect themselves from cornering or from the entry of foreign capital as a result of capital liberalization. Some view this practice played an integral part in the reinforcement of stable management from a long-term perspective by mutually becoming stable shareholders with amicable companies and business partners, by limiting shareholder interference in management from a short-term perspective. These circumstances have led to Japan’s unique two-fold relationship between cooperative business and capital relationships. This practice of increasing the volume of information with business partners, sharing risks, and reducing transaction costs, while at the same time acquiring cooperative shareholders who do not interfere in management is said to have promoted Japanese-style management carried out by internally-promoted corporate managers (the so-called Employee-Sovereignty principle).

Cooperative relationships that accompany capital contributions such as capital alliances and joint ventures also exist overseas. Investors are receptive to a certain extent to shareholdings that entail cooperation such as business transactions and joint developments, which have been demarcated by a detailed agreement. However, they are negative on thinking of utilizing management participation rights and the pressure of stock disposal to continue transactions other than to take control or as a capital alliance or joint venture. Most important of all, investors are

opposed to the concept of a company forcing another company to hold its shares to become a stable shareholder in exchange for business relationships. Investors believe that companies should get out of these concepts and systems of old-fashioned Japanese-style management.

Cross-shareholdings have given rise to various concerns and risks with the passage of time and the changes in the business environment, including the possibility that cross-shareholdings “could lead to a lack of management discipline” and “are de-sterilized risk assets on company balance sheets causing inefficiency in capital management,” as pointed out by the Council of Experts Concerning the Follow-up of Japan's Stewardship Code and Japan's Corporate Governance Code of the Financial Services Agency.

While many companies state the continuance and strengthening of business relationships as the reason for cross-shareholdings, we believe that the continuance and strengthening of business relationships and holding of shares should be recognized separately. In cooperative relationships such as business relationships and joint projects, the actions of both counterparties are contractually defined. Providing superior products and services at a reasonable price and continuing to engage in contractual transactions in good faith leads to good business relationships and a mutual relationship of trust, and the concept that the mutual holding of shares is a sign of such amicable relationships is untenable. In today's world of expanding global supply chains, the concept of cross-shareholdings can no longer be justified to overseas business partners. On the contrary, the Japanese market practice of making cross-shareholdings “a prerequisite of stable ongoing business relationships” appears to overseas parties as a sign of a closed market.

Maintaining and strengthening business relationships as a reason for cross-shareholdings also represent a skeptical legal argument. If business transactions were being conducted on the assumption of holding shares, it would raise concerns of “profit-giving to specific shareholders” and would, in turn, be a breach of the “Principle of Shareholder Equality” in the Companies Act of Japan. Moreover, if the holding of shares had been forced on the business partner, it raises concerns that the party forcing the shareholding is “Abuse of a Superior Bargaining Position” under the Antimonopoly Act. At the same time, the possibility of conflict between the benefits of the business partners and the benefits of the shareholders has been pointed out. Therefore, when examining “whether the benefits and risks from each holding cover the company's cost of capital,” in accordance with CG Code Principle 1.4, and when such benefits include monetary benefits such as revenue and income, the company could, in effect, be admitting to the profit-giving or the conflicts of interest described above.

Furthermore, the concept of “justifying cross-shareholdings because the returns from the shares exceed cost of capital” implies that the company is allocating capital to the non-core

business of equity investments rather than investments for growth of the company's core business or returns to shareholders, and from a capital efficiency perspective, it means that the company is not maximizing its business value. This could result in the discounting of the company's share price and the deterioration of its future financing capabilities. Another disadvantage of cross-shareholdings is that it ties up funds, which otherwise could have been effectively utilized as working capital. These are the concerns that have been raised from a financial perspective.

Furthermore, the concerns of companies whose shares are being held (or who have forced the holding of their shares) include concerns relating to business strategy. A business partner holding a company's shares in a cross-shareholding may be a vital business partner now but there is no guarantee that it will remain so into the future. In today's "discontinuous age" of drastic changes in the business environment, fundamental changes to the supply chain is always a possibility. In the event that an important business partner must be replaced, the existence of the cross-held shares may make the change difficult and may give rise to discrepancies in the execution of business strategies. In certain instances, the party concerned may become a powerful dissenting shareholder against current management.

Finally, cross-shareholding may raise concerns which the investors fear the most, i.e. concerns over governance and ethics. Investors fear that because of the "stable shareholder policy" which unconditionally supports management, management will no longer feel the constraints to honor the mandate given by the shareholders, resulting in lax business management. "Stability of management" is essentially made possible by ensuring accountability to shareholders and reinforcing the legitimacy of management, and not by excluding shareholders who do not align with management.

Furthermore, a stable shareholder policy may also give employees misrecognition of governance and may lead to inefficient business activities. The pursuit of a stable shareholder policy by management may result in employees deciding "to place orders with business partners who are stable shareholders, despite the poor quality because they are like family," or "to reduce transactions with business partners who have sold the company's shares" and promote inefficient business practices, as well as foster a misguided set of values where "there is nothing wrong with giving benefits to shareholders who make up the 'ruling party.'"

In light of the above, we ask that companies that consider cross-shareholdings a necessity to depart from the concept of "stability of management" based on cross-shareholdings and steer management toward "stability of management" based on strong support from the investors.

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*Japan's Corporate Governance Code (excerpt)

Principle 1.4 Cross-Shareholdings

When companies hold shares of other listed companies as cross-shareholdings, they should disclose their policy with respect to doing so, including their policies regarding the reduction of cross-shareholdings. In addition, the board should annually assess whether or not to hold each individual cross-shareholding, specifically examining whether the purpose is appropriate and whether the benefits and risks from each holding cover the company's cost of capital. The results of this assessment should be disclosed.

Companies should establish and disclose specific standards with respect to the voting rights as to their cross-shareholdings, and vote in accordance with the standards

Supplementary Principles

- 1.4.1 When cross-shareholders (i.e., shareholders who hold a company's shares for the purpose of cross-shareholding) indicate their intention to sell their shares, companies should not hinder the sale of the cross-held shares by, for instance, implying a possible reduction of business transactions.
- 1.4.2 Companies should not engage in transactions with cross-shareholders which may harm the interests of the companies or the common interests of their shareholders by, for instance, continuing the transactions without carefully examining the underlying economic rationale.