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Japan’s proposed strengthening of strategic shareholding disclosures gets mixed reception

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- More info on business ties allows minorities to better assess risk, says analyst
- Proposal does little to resolve problem of cross-shareholdings, argues activist
- Opposition towards top management up sharply after new ISS voting guidelines

The **Financial Services Agency**’s (FSA) recent proposal to make disclosures of strategic shareholdings a requirement has been viewed as a step forward by some analysts, but a Tokyo-based activist investor says it will do little to resolve the very existence of cross-shareholdings.

Tsuyoshi Maruki, CEO of **Strategic Capital**, argues that the proposed amendment may be interpreted as saying that a company can continue to hold on to its strategic shareholdings as long as it discloses its business relationship with companies with which it has cross-shareholdings.

“Why is a cross-shareholding necessary to begin with for a company to have a business relationship and partnership with another company? There are zillions of companies entering into business relationships with other companies without them holding each other’s shares,” Maruki asked.

“My position is clear. A company should not have any cross-shareholdings at all. The question is not a matter of disclosures,” he told this news service.

Maruki’s comments come after the FSA on 7 November announced a proposal to amend the Cabinet directive to make it a requirement for Japanese companies to disclose in their annual securities reports (“yuho”) business transaction relationships with companies that they have cross-shareholdings with, and to describe these partnerships in more detail.

The FSA’s Disclosure Working Group (DWG) on 13 June published a report with a set of recommendations to that effect, noting that there is still a huge gap between the current level of disclosure and what equity market investors consider to be a good or appropriate standard of disclosure, as previously reported (https://www.dealreporter.com/intelligence/view/intelcms-xtf2vh).

The FSA's proposal is open for public comments until 7 December, after which a final decision will be made. The amendment will become effective with the publication of the annual securities reports for the fiscal year starting April 2024, according to an FSA official.

Under the 2018 revised Corporate Governance Code, companies are recommended to disclose the rationale behind their holding of cross-shareholdings, as well as plans to reduce them, but the code does not urge companies to disclose details of individual cross-shareholdings as that might reveal corporate secrets. According to the FSA's latest proposed amendment to the Cabinet directive, however, companies would be required to disclose individual business relationships and the outline of these partnerships.

"Under the new amendment, companies will be required to provide broader disclosures than those called for under the 2018 revised Corporate Governance Code," said Yutaka Suzuki, senior researcher at Daiwa Institute of Research, who is in favor of the proposed amendment.

By looking at the condition of strategic shareholders' business relationships, minority shareholders can assess the extent to which a company's profits might be at risk, while strategic shareholders can try to restrain behaviors that may induce such concerns among minority shareholders, Suzuki said.

However, a senior researcher with the Japan Investor Relations and Investor Support group echoed the view of Maruki at Strategic Capital. Through Japan's corporate governance codes and cabinet directives, "we have already sorted out that a company should not have any strategic shareholdings, the researcher said. "If the company has any cross-shareholdings, they can hold them only on an exceptional basis. It does not mean they are permitted to hold on to them if they make disclosures."

Maruki and the researcher's comments are also in line with the stance taken by leading proxy advisor **Institutional Shareholder Services** (ISS), which sent shockwaves through Japanese boards in December 2021 when it updated its voting guidelines.

Arguing that the issue of cross-shareholdings is of utmost concern for Japanese corporate governance, the proxy advisor has since February 2022 been recommending investors to vote against directors at companies that allocate 20% or more of their net assets to cross shareholdings. (Rival proxy advisor **Glass Lewis** is even more stringent, calling for investors to vote against directors at companies that allocate 10% or more of their net assets to cross-shareholdings.)

As a result of the new ISS guidelines, there was a marked decline in votes in favor of top management at companies deemed to have cross-shareholdings above the 20% threshold during the 2022 AGM season, according to a 17 November report by Goldman Sachs.

At 342 companies with cross-shareholdings above the 20% threshold, the opposition rate by foreign institutional investors increased to 39.5% from 15.9% in 2021, while the opposition rate among domestic institutional investors climbed to 11.3% from 4.0%, the report said.

However, increased disclosure requirements around tie-ups with cross-shareholders and the establishment of voting guidelines for cross-held shares, is facing strong opposition from influential Japanese business lobby group **Keidanren** (Japan Business Federation). In a statement late last year, the lobby group said such disclosures could infringe on confidentiality and corporate secrets, as reported.

Cross-shareholdings or strategic stockholdings between two corporate entities are common in Japan, with companies arguing that they strengthen business relationships with key suppliers or third parties. But they have been criticized for serving to protect management interests and prevent major corporate actions that would be in minority shareholder interests.

FSA aims to further strengthen monitoring strategic shareholdings

In its June report, the DWG also flagged a need to further strengthen the monitoring of strategic shareholdings held for passive investments and of how companies differentiate between shares held for passive investment and crossholdings, among other things.

This followed a discussion at the DWG meeting in December last year, where a few of the group members called for companies to disclose shares held for passive investment. The reason why this is needed, they said, is because many companies end up diverting internal reserves for such investments, while shareholders want internal reserves to be used to invest into the companies' own businesses and to improve corporate value.

Disclosure of information related to stocks held for passive investment is necessary in order to assess the appropriateness of capital allocation, they added. The FSA has yet to convert these recommendations into an actual proposal.

At the same December 2021 meeting, Jyoji Iguchi, chief corporate governance officer of **Nissei Asset Management**, noted that companies should be encouraged to disclose annual securities reports (equivalent to an Annual Report) prior to their AGMs. A **similar push (https://www.dealreporter.com/intelligence/view/intelcms-xbp3w3)** for this has been made by overseas investors, as previously reported by this news service.

Because the annual securities reports for the most recent fiscal year are typically not available prior to the AGM in Japan, investors and proxy advisers, such as ISS, currently have no choice but to use annual securities reports published an entire year earlier to assess the incumbent management's performance before exercising their voting rights in the current year.

Iguchi argued that even if a company makes a desperate effort to reduce its cross-shareholdings over the past 12 months, its incumbent top management and external directors from a company of cross-shareholding might be voted out by shareholders at the AGM based on the previous year's performance disclosures.

"Because many global passive investors follow ISS's recommendations, the Japanese capital market will turn into a considerably unhealthy situation if this practice continues," said Iguchi. "Therefore, information related to cross-shareholdings, which will be disclosed in annual securities reports, should also be made available in AGM convocation materials."

As for additional disclosure around individual stocks held as passive investments, the Keidanren said in its statement late last year that it will not be possible for companies to do so because of the secrecy of specific investment strategies. The FSA should not force them to make broader disclosures than they already do through notes attached to the financial statements in their annual securities reports.

“Japanese companies have already been making efforts on the assumption that these cross-shareholdings will be unwound. The importance of requiring blanket disclosures [of cross-shareholdings] is relatively low compared with other issues, such as climate-related disclosures,” Yoshiharu Obata, head of Keidanren’s Business Infrastructure Bureau, said in the same statement.

And the unwinding of cross-shareholdings is making progress.

According to a report published on 4 August by Daiwa Securities, the ratio of strategically held shares declined to 38.4% of a company’s shareholder register in the year ended March 2022, from a peak of 63.3% in the year ended March 1996.

Also, of the 53 companies with a market capitalization of at least JPY 500bn (USD 3.56bn) and strategic shareholdings exceeding 10% of net assets as of 15 November 2022, 36 companies (or close to 68%) had reduced the number of listed stocks held as strategic shareholdings from the previous year, the recent Goldman Sachs report showed.

by Norie Hata in Tokyo

Grade: Confirmed

OTHERS

Keidanren

Strategic Capital Inc

Institutional Shareholder Services Inc.

Glass, Lewis & Co., LLC

Japan

Government

Topics: Antitrust/Regulatory , Shareholder Activism

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