ACGA

Asian Corporate Governance Association

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Mr. Yuichi Ikeda
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Dear Ikeda-san,

Capital Raising in Japan

Over the past year, there has been considerable focus in the media and official announcements in Japan about the need for a fairer, more efficient and transparent system of raising capital in public securities markets. This has been an issue of concern for the Asian Corporate Governance Association (ACGA) and a significant topic of discussion within our global membership network. We would, accordingly, like to take this opportunity to make a number of suggestions regarding the evolving regulatory system for capital raising in Japan.

Firstly, however, we would like to express our appreciation for the initiatives that the Financial Services Agency (FSA) has taken in this area under its "Action Plan for the New Growth Strategy", published in December 2010, and the recent amendment to the Financial Instruments and Exchange Act on the revitalization of rights issues (promulgated on May 25, 2011). We welcome the Agency's determination to strengthen the disclosure and underwriting of rights issues and to address possible unfair trading prior to public offerings. We believe that these reforms will enhance the integrity and transparency of Japan's capital market.

The specific topics we would like to discuss in this letter overlap with those raised in the Action Plan, namely: rights issues, public offerings, and private placements (third-party allotments). We believe that existing mechanisms for issuing shares through public offerings and third-party allotments could be greatly improved in Japan, while a sound system for undertaking rights issues would greatly benefit both companies and investors.

Public offerings

There has been considerable controversy over the past year about the way in which public offerings have been conducted in Japan. Institutional investors believe the process is open to abuse and is detrimental to both themselves and issuers. Evidence suggests that some brokers are enabling a small number of favoured hedge-fund

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clients to profit unfairly on inside information during the public offering period (by selling short and then covering with discounted stock allocated to them). Weak enforcement against insider trading, and the lack of a proper process for rights issues, appears to compound these problems.

We believe that there are several ways in which the integrity and transparency of the public offering process could be improved in Japan over the short term:

- Allow companies to have some say in the allocation of new shares in a public offering or, at the very least, to see the broker's book. This is a market-based solution that would not require any regulatory amendment, only a change in the rules of the Japan Securities Dealers Association, a self-regulatory organisation.
- Require shareholder approval of any public offering above a certain percentage, such as 10-20% of total issued capital. (In other words, share issuances above 10-20% would have to be done by a public offering or a rights issue—and not by a private placement. See discussion below on private placements.)
- Shorten the public-offering period from the current 7-15 calendar days to no more than 5 working days. While originally put in place to allow retail investors to study and respond to an offering, the extended book build gives speculative funds more time to sell short before the deal closes.[1]
- Prohibit investors who are participating in the offering from covering short positions with deal stock. (We understand that the FSA will shortly introduce a new rule on this point.)

Institutional investors feel they are disadvantaged in public offerings because the allocations they receive from underwriters are usually not commensurate with their percentage level of ownership in the company doing the offering. Underwriters have full authority to issue new shares to whomever they please.

Listed companies also suffer because they have no way to suggest to the underwriter which shareholders should receive allocation. Underwriters appeal to a Japan Securities Dealers Association rule on client confidentiality that prohibits them from informing companies about the names of investors receiving allocations. While giving the appearance of impartiality, many market participants believe that this allows the underwriter to distort the system and give allocations to favoured fund managers.

[1] The Financial Instruments and Exchange Act (Article 8) gives 15 days as the standard public-offering (book-building) period, but also allows for a shorter period if the offering is "easily understandable to the public". Additional guidelines from the FSA allow for a 7-day period.

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There certain risks in allowing companies to approve allocations of new issuances, notably that some may direct shares to friendly shareholders. On balance, however, many investors believe that such a system would result in a fairer allocation to mainstream institutions and could help to improve corporate governance generally in Japan (by encouraging boards to exercise due diligence in the allocation process and to focus on building long-term, appropriately diversified and committed shareholder bases). Underwriters have no incentive to build healthy shareholder bases for companies; rather, they tend to allocate stock to their best customers. Alongside granting companies a right to review share allocations, there should be guidelines that instruct companies and directors on their fiduciary duties to shareholders and how to avoid the pitfalls described above.

Rights issues

While there are ways to improve the public offering process in Japan, ACGA and its members believe that pro-rata rights issues provide the fairest and most transparent system for raising equity capital. We broadly support the FSA's recent amendments to the Financial Instruments and Exchange Act allowing for more flexible disclosure rules for rights issues (such as allowing prospectuses to be posted online rather than sent to each shareholder by mail) and strengthening the underwriting process. We also agree that the time period for undertaking rights issues needs to be reviewed and shortened, so as to reduce market risk. This is in line with reforms in other developed markets, such as the UK.

We further recommend that:

- There should be a cap on the size of rights issues. For example, companies may undertake an issue (or issues) of up to 50-66% of total share capital in any 12-month period. If they wish to go beyond this, they would need shareholder approval in an EGM.

  (Note: In Hong Kong and Singapore, the annual threshold is 50%. It was previously 33% in the UK, but effectively rose to 66% after the global financial crisis.)

- Rights issues should be renounceable (ie, the rights can be sold in the market if not taken up by shareholders). This compensates shareholders who do not wish to participate in the new issue from dilution.

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Private placements (third-party allotments)
Issuing shares for cash to a select group of investors through a private placement is an efficient and cheap way to raise a moderate amount of equity capital, yet it is also potentially unfair to shareholders not invited to participate (depending on how market prices move, they can suffer dilution from both the new shares issued and the discount at which they are issued). For this reason, both regulations and best practices have evolved in developed markets that put tighter restrictions on such issuances. The regulatory framework typically includes:

- Annual shareholder approval of mandates that allow directors to place new shares at any time within the following 12 months (and before the next AGM).
- A limit on the amount of new shares that can be issued (as a percentage of existing share capital).
  - Note: Most jurisdictions do not draw a distinction between private placements for cash and non-cash (such as the issuance of new shares as payment for an asset acquisition). However, some markets allow a somewhat higher threshold for non-cash issuances. ACGA believes that the two thresholds should be the same, or as close as possible.
- A limit on the discount at which the new shares can be issued.
- A certain degree of flexibility is allowed for smaller growth companies that need to raise a higher proportion of capital (and more so for companies facing bankruptcy). However, the basic principle is that companies should explain their need for a higher amount to their shareholders and seek their approval.

While the Tokyo Stock Exchange (TSE) amended its listing rules governing private placements in 2009, we believe that the rules need to be further clarified and strengthened. For example:

- As in other developed markets, listed companies should be required to seek annual shareholder approval at their AGM for the right to issue new shares through private placements for the subsequent 12 months. Global investors value their right to vote on major transactions, including capital issuance. (Note: Current TSE rules on shareholder approval requirements are unclear and this proposal would go some way to clarifying them.)

- The maximum amount of shares that can be issued through private placement in any 12-month period should be limited to 10%. (Current TSE rules imply 25% as the upper level under normal circumstances.)

- If companies wish to exceed 10%, they should seek shareholder approval in an EGM. Or arrange a public offering, as outlined above.

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Note: The permitted discount in Japan for ordinary placements is 10%. Although higher than guidelines in the UK—where 5% is the maximum discount—it is in line with investor expectations in other Asian markets. While many global institutional investors would prefer smaller discounts of no more than 5%, most will accept 10% as the ceiling.

We hope that the points and recommendations in this letter provide constructive input to the FSA as it formulates detailed rules on capital raising in Japan.

We would be pleased to answer any questions that the Agency may have.

Yours truly,

Jamie Allen
Secretary General

cc:

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