Date: **March 15, 2023**

From: **Nicholas Benes**

To: **METI Fair Acquisition Study Group**

Respectfully, I would like to submit the following comments to the members of METI's Fair Acquisition Study Group.

Background

1. The goal of increasing "corporate value" was ingrained in the very name of the「企業価値研究会」which enabled takeover defenses in 2004. However, since then, no credible evidence has emerged to suggest that takeover defenses have succeeded in raising market capitalization or profitability at Japanese companies. Rather, there is ample evidence that, if anything, they have had the opposite effect. Increasingly over time, mainly it is low-performing companies that deploy takeover defenses, for the obvious purpose of successfully entrenching management.

   For instance, during the three-year period of fiscal years 2019 through 2021, the average ROA of TSE1 companies without takeover defenses was 3.3%, as compared with 2.5% for companies with defenses, indicating a significant difference of 0.8%, nearly one percent. Separately, an analysis in 2021/2022 showed that: "of the 421 companies found to have proposed anti-takeover measures at shareholder meetings since 2014, those companies that have not adopted anti-takeover measures now have superior performance in terms of ROE, ROA, and P/B, as well as in terms of the percentage of independent directors and the percentage of female directors."[1] The same trend was shown for Tobin's Q.

2. Furthermore, to my knowledge there are either no, or extremely few[2], examples where the existence of a takeover defense was used effectively by a Japanese board to raise the price of a TOB, increase the % ceiling of a TOB, find a "white knight" at a higher price, or gain time so that in subsequent years a significant restructuring or strategic redirection could be executed, and led to a higher stock price.

3. As a result, institutional and individual investors alike have come to generally oppose the use of takeover defenses in Japan. They have communicated their opposition to executives. Accordingly, whereas fully 23.4% of TSE1 companies had takeover defenses in place in 2011, that percentage has now dwindled to a mere 8.6% as of the end of 2022.

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[1] "Takeover Defenses: Stock Price Performance (Metrical Analysis Using BDTI Data)", by Aki Matsumoto, Dec. 2021 and Jan.2022, two posts in the discussion forum of The Board Director Training Institute of Japan (https://blog.bdti.or.jp/en/2021/12/23/metrical-takover-defense/ , and https://blog.bdti.or.jp/en/2022/01/04/takeover-defensesstockprice/)

[2] Are there any at all? The study group should look at hard data and examples from real life.

4. In 2004, in his well-written paper entitled "The Poison Pill in Japan: The Missing Infrastructure"[3], Professor Ronald J. Gilson of Columbia Law School (now at Stanford Law School) pointed out that Japan's legal and governance landscape lacked several crucial features that were essential for there to be a chance that poison pills in Japan might function so as to actually raise corporate value by facilitating "an equilibrating process that reallocates ownership of assets…to the entity that then values them most highly". The two most important missing features were: (a) the presence of large numbers of independent directors "of the character that has proven so important in the operation of the poison pill in the U.S." and (b) a court system that (in the absence of legislative guidance) was likely to be able to take up the "mantle that the Delaware courts took up more than fifteen years ago, and which they have yet to fully discharge", i.e., "to write, through the accretion of judicial decisions, a poison pill 'code' that will give transaction planners for both bidders and targets guidance concerning the operational rules of a Japanese market for corporate control."

   As Professor Gilson perceptively wrote in 2004, "the pill has 'worked' in the United States--that is, it has been largely but not exclusively used to support seeking a better deal for the shareholders rather than simply to block a bid --because independent directors, courts, and active institutional investors have all combined to police the uses to which the pill actually is put."

5. Now, almost 20 years later, it is clear that Professor Gilson's skepticism was well-founded, and that because of the continued absence of the necessary "infrastructure" that he described, "the pill" has not "worked" in the case of Japan.

6. Against this challenging background, I commend the efforts of the study group members to tackle what are extremely difficult issues in any country. However, reading the comments by study group members, I am struck by the apparent cacophony of views about the practices that would lead to optimal outcomes,－and indeed, even about what constitutes "optimal outcomes" and how they should be measured. Most of all, I am struck by the immense time that is being spent trying to force the "square peg" of US-style takeover defense rules into the "round hole" of Japan's existing corporate law infrastructure and corporate governance realities. The study group appears to be engaged in contortions to come up with a logical grounding based largely on US legal principles that can justify the guidelines it comes up with, notwithstanding the facts that (a) unlike the law in Delaware, those guidelines cannot have legally binding effect, and (b) Japan's corporate governance landscape is very different from that of the US.

   With respect, this is not surprising when one considers the composition of the study group. I would note that: (a) five of the 18 members of the study group are practicing lawyers, and four others are academics; (b) apparently, none of the members of the study group appear to have experience actually sitting as independent directors on listed company boards in Japan, much less under contentious circumstances; and (c) only one member hails from a foreign investment organization that has extensive experience related to hostile M&A transactions. While the name of the study group

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[3] Ronald J. Gilson, "The Poison Pill in Japan: The Missing Infrastructure", Columbia Law School, 2004.

contains the word “fairness”, its composition seems non-optimal if the goal is to achieve “fairness” based on a balanced understanding of practical realities.

Current Realities

7. Those realities are as follows: (a) at the end of FY2021, only about 8% of TSE1 companies had a majority of “independent directors” (by each companies’ own definition) on their boards; (b) only about two-thirds of such company-reported “independent directors”, on average, fully satisfied the TSE’s own “independence criteria”; (c) because the vast majority of companies (92% or more) do not have a majority of fully independent directors per the TSE’s own criteria, at most of those companies the composition of the nominations committee (if it exists) each year tends to be influenced by the CEO, who usually also sits on the committee and often chairs it; and (d) reflecting the same tendency towards insufficient utilization of independence and objectivity in, as of FYE2021, only 39% of the chairs of the nominations committees that existed were chaired by outside directors.

   In the nearly 20 years since 2004, Japan has made slow progress towards developing the large body of truly independent-minded directors which, borrowing Professor Gilson’s words, has “the character that has proven so important in the operation of the poison pill in the U.S.”. The plain and simple fact is that boards that are not controlled by truly independent directors, often do not appoint truly independent directors to the nominations committees that select the next slate of nominee directors. And so on and so forth, with respect to next year’s slate in the proxy statement.

   Moreover, about 24% of PRIME companies still do not even have nominations committees. With the TSE’s “reorganization” that only required PRIME companies to have boards with one-third (self-reported) independent directors, Japan is now stuck in a vicious circle in this regard.

8. Other practical realities include: (a) the fact that there are still many “listed subsidiaries” on Japan stock exchanges, for which the chance of having truly independent directors on the board in sufficient numbers to credibly police takeover defenses is far less than for the ordinary firm; (b) the fact that there have been few relatively few hostile takeover transactions or attempts in Japan, especially those transactions where boards acted responsibly, such as might set an example of “best practice” and increase corporate and judicial understanding of important practical issues; (c) the fact from the very start, the term “corporate value” has been interpreted (some might say “hijacked”) by many to suggest not merely the market capitalization of the company now or at any given time in the future, but rather to include subjective value in the eye of a beholder, based on assigning non-measurable *possible or assumed* societal or other value to aspects like the employee community of interests and their loyalty, or the continuation of employment, etc. Not all of these subjective aspects are ever set forth in full, and to the extent they are referred to, most of them are things which target Japanese firms themselves cannot promise to ensure forever.

9. Yet another area of lack of progress and rules confusion in Japan’s “infrastructure” is the field of judicial precedents and principles. This of course is the most important

area, because it creates binding law and not just "guidelines" that can be easily ignored. Recent court cases have left experts shaking their heads, instead of filling them with clarity.[4] It might be said that executives and boards now have even less clear judicial guidance than they did several years ago. While I understand that this is the very reason that the study group has been convened, it is unlikely that "guidelines" can solve this problem. Only the courts and legislature can do that with finality, and in a country that does not adhere to the principle of stare decisis and where litigation is infrequent, it is not at all clear that the courts will be able to bear that burden, even with guidance. And in the meantime, by their very nature, "guidelines" are things that the worst actors, those for whom they most necessary, can simply ignore or distort.

10. Next, Japan's securities law allows "partial" takeover bids, whereby the bidder can offer to acquire just enough shares (e.g. 45%) to effectively control the company without consolidating it, whereupon if many shareholders tender their shares, all of them will be cut back on a pro-rata basis, and will be left holding shares for which they may well never receive the full control premium that they deserve.

11. Last, the FSA's rules regarding "collective engagement" are burdensome for large institutional investors that wish to make "important suggestions" – which is to say, suggestions about the most meaningful issues that relate to corporate value and sustainability: dividend policy, composition of the board including diversity, business portfolio and capital allocation, and ESG-related actions, to name just a few. These are matters that signatories to the Stewardship Code have a duty to engage about, but as a practical matter the rules currently prevent those same signatories from doing so by the most efficient method, which would often be collective engagement.

    Although it is difficult to measure, this is probably one of the biggest reasons why seven years after the CGC was adopted, there are still so many listed Japanese firms trading at a PBR of less than one. This makes such companies clear targets for takeovers, which makes them want to adopt takeover defenses, thereby increasing the probability that their stock price may trend to an even lower level. This is another vicious circle.

Recommendations

12. For the reasons set forth above, I believe it may be neither practical nor productive to further attempt to transplant US-style takeover defenses and rules to Japanese soil, particularly if those "rules" take the form of non-binding "guidelines".

    At the present time, in almost all cases, takeover defenses simply do not function in Japan (and cannot function) in a manner that increases "corporate value" and sustainability by any ordinary definition held by investors. Moreover, there is no reason to think that this state of affairs will change anytime soon. Rather, as used to be said by Japanese lawyers in the years after 2005, devising "bouei-saku" (takeover

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[4] "Mitsuboshi Case Leaves Poison Pill Doctrine Unresolved", by Stephen Givens, August 2022, a post in the discussion forum of The Board Director Training Institute of Japan. (https://blog.bdti.or.jp/en/2022/08/10/mbpil/).

defenses) quickly became the “bouei-sangyou” (“defense industry moneymaker”) for lawyers, and that situation has continued to this day, with no reason to believe that corporate value has been enhanced in the process.

13. Instead, I believe that the study group should seriously consider proposing that Japan adopt the UK model for takeovers and similar transfers of control or substantial influence, and the UK’s rules for collective engagement. These rules fit much better with Japan’s systemic and corporate governance realities.

    Were this to be done, the following policies should be implemented:

    (a) per the FIEA, if a bidder is interested in shares carrying 30% or more of the target's voting share rights, the bidder would be required to make a mandatory offer in cash at no less than the highest price it paid during the preceding 12 months, in any transaction; and

    (b) per the exchange listing rules, takeover defenses for all companies listed on public stock exchanges would not be permitted for exchange-traded companies (such rule to be phased in over a period of two years);

    (c) bidders and other de-facto acquirers would be required to include in their offer documents (or other relevant public documents) post-offer “intention statements”, and post offer “undertaking statements”, which would be policed by the FSA and which would (inter alia) refer to intentions related to employment, redeployment of assets, and strategic plans, etc.;

    (d) to ensure oversight and compliance, the FSA would set up its own version of a “Takeover Panel”; and

    (e) the FSA would amend its rules regarding collective engagement so that burdensome filings separate from the ordinary system for large holder reports are no longer necessary (as long as the group has a clear “opt-out” policy), except in the case where the collective group plans to make a joint takeover or take its aggregate holdings percentage over 30%, whereupon the TOB rules would take effect.

I would appreciate it greatly if the study group could consider these comments and suggestions in its deliberations.

Regards,
Nicholas Benes

(writing his own personal opinion and not that of any organization)