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*Because of the generality of this update, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations.*

## **Impact of Paperless Stock on Exercise of Minority Shareholder Rights**

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As a result of the January 5, 2009 implementation of the law mandating abolishment of stock certificates,<sup>1</sup> shares of all listed companies have been migrated to a paperless, book-entry transfer system (the “Paperless System”). The Paperless System differs from the previous custody and book-entry transfer system (the “Depository & Transfer (*hofuri*) System”) as follows:

- Depository & Transfer System: Shareholders were able to choose, at their discretion, to participate in the system, and all stock certificates of participating shareholders were deposited with Japan Securities Depository Center, Inc. (“JASDEC”).
- Paperless System: Physical stock certificates have been completely eliminated. In order to eliminate the need to deliver physical stock certificates among shareholders participating in the system, shareholder participation is mandatory.

The Paperless System will require changes to share handling practices, including procedures with respect to the exercise of certain shareholder rights that are referred to as “minority shareholder rights” under Japanese law.

### **I. Procedures with Respect to Exercise of “Minority Shareholder Rights”**

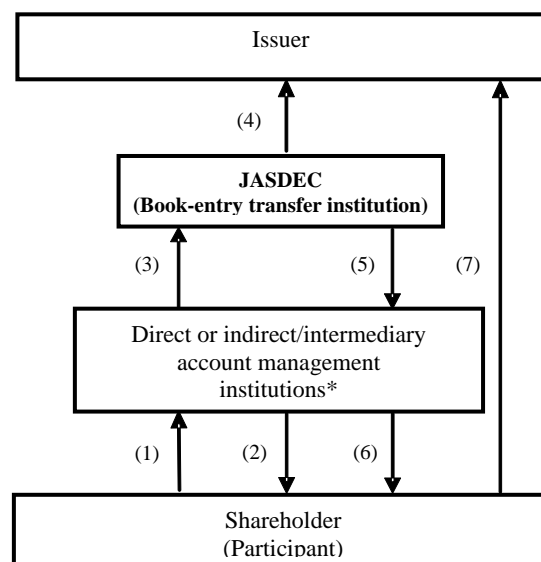
It is important to note that “minority shareholder rights” as used in this newsletter are rights defined in Article 147(4) of the Act Concerning Book-Entry Transfer of Corporate Bonds, Stocks, etc. (*shasai, kabushiki-tou-no-furikae-ni-kansuru-horitsu*) (the “Transfer Act”). Under that article, “minority shareholder rights” refers to rights other than those set forth in Article 124(1) of the Companies Act (*kaisha-ho*), which in turn are rights with respect to which an issuer has the authority to determine the shareholders who may exercise them based on its shareholder register as of a set record date. Minority shareholder rights, therefore, do not depend on

<sup>1</sup> This change has also been referred to as “stock dematerialization”.

holding shares as of an issuer-designated record date, and include such rights as appraisal rights<sup>2</sup> and rights to demand convocation of a general meeting of shareholders,<sup>3</sup> while excluding such rights as voting rights. Thus, “minority shareholder rights” as used in this newsletter may not necessarily be consistent with the common usage of such term outside Japan.

Under the Depository & Transfer System, a listed company was required to maintain both a beneficial shareholder register and an ordinary shareholder register. All stock certificates in JASDEC’s custody under the Depository & Transfer System were registered in the name of JASDEC in the ordinary shareholder register, and a shareholder within the Depository & Transfer System had to be listed on the beneficial shareholder register to exercise its minority shareholder rights. Because the beneficial shareholder register was updated only on set record dates,<sup>4</sup> if a shareholder acquired shares in between two record dates and was not already listed on the beneficial shareholder register, the shareholder was forced to go outside the Depository & Transfer System to exercise its minority shareholder rights that had already vested. Specifically, the shareholder had to receive delivery of the stock certificates and have the transfer recorded in the ordinary shareholder register, a burdensome process for shareholders to exercise their minority shareholder rights.

Under the Paperless System, the same procedures do not apply since there are no physical stock certificates. Rather than relying on the shareholder register, the Paperless System uses a new notification process involving Individual Shareholder Notifications (*kobetsu-kabunushi-tsuchi*)<sup>5</sup> for the exercise of minority shareholder rights. The Individual Shareholder Notification process is outlined below:



(\*Note: Account management institutions operate in a multi-tiered structure, under which two or more account management institutions may exist between the shareholder and JASDEC. A direct account management institution refers to the institution that has an account at

<sup>2</sup> Companies Act, Article 116, etc.

<sup>3</sup> Companies Act, Article 297(1).

<sup>4</sup> Regular record dates of Japanese companies are typically March 31 and September 30. In addition to these regular record dates, companies may set additional record dates for appropriate purposes.

JASDEC, and indirect account management institutions are intermediary account management institutions that exist between the shareholder and the direct account management institution. A shareholder may have an account at a direct account management institution or at one of the indirect account management institutions.)

- (1) The shareholder requests an account management institution (which may be a securities company or another institution) where it has an account (the “Requesting Institution”) to send an Individual Shareholder Notification.
- (2) The Requesting Institution delivers a document confirming receipt of the request (*uketsukehyo*) (a “Receipt”)<sup>6</sup> to the shareholder.
- (3) The Requesting Institution forwards (via any intermediary institution(s) and the direct account management institution if the Requesting Institution does not hold an account directly with JASDEC) the shareholder’s request to JASDEC.
- (4) JASDEC notifies the shareholder name, etc.<sup>7</sup> to the issuer (the Individual Shareholder Notification is considered delivered at this point).<sup>8</sup>
- (5) JASDEC notifies the Requesting Institution (via the direct account management institution and any intermediary institution(s) if the Requesting Institution does not hold an account directly with JASDEC) of the fact that it has delivered the Individual Shareholder Notification.
- (6) The Requesting Institution notifies the shareholder of the details of the notification delivered in step (5).
- (7) The shareholder exercises its minority shareholder rights within two weeks<sup>9</sup> after delivery of the Individual Shareholder Notification.

## II. Key Points

### A. Shareholders with Multiple Accounts

If a shareholder has only one account with an account management institution, the shareholder would request delivery of an Individual Shareholder Notification through that one institution, and JASDEC would require information from the book-entry transfer account ledger of that institution only. If, however, a shareholder has multiple accounts at other institutions, JASDEC also would require, prior to step (4), information regarding the shareholder from other account management institutions where the shareholder has accounts.<sup>10</sup> JASDEC would collect information

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<sup>5</sup> Transfer Act, Article 154.

<sup>6</sup> The Receipt lists, among other things, the shareholder’s name and address, name of the book-entry transfer organization, date of receipt of request, receipt number, and issuer (Business Regulations Relating to Book-Entry Transfer of Stocks, etc. (*kabushiki-tou-no-furikae-ni-kansuru-gyomu-kitei*) (the “Business Regulations”), Article 154(4)).

<sup>7</sup> The Individual Shareholder Notification includes the name and address of the shareholder making the request, as well as the initial and updated numbers of shares (including the date of the change) recorded in the book-entry transfer account ledger (*furikae-kouzabo*) (Transfer Act, Article 154(3) and Article 129(3)(vi)).

<sup>8</sup> According to the Manuals on Operational Processing related to the Book-Entry Transfer System for Stocks, etc. (*kabushiki-tou-furikaeseido-ni-kakaru-gyomushori-yoryo*), the Individual Shareholder Notification will be delivered to the issuer by JASDEC, at the earliest, on the fourth business day after the request for notification is received. Additional days may be needed if the Requesting Institution is an indirect account management institution or the shareholder has additional account(s) at account management institution(s).

<sup>9</sup> Transfer Act, Article 154(2); Enforcement Order for Act Concerning Transfer of Corporate Bonds, Stocks, etc. (*shasai, kabushiki-tou-no-furikae-ni-kansuru-horitsu-sekourei*) (“Transfer Act Enforcement Order”), Article 40. The two-week requirement is counted from the day immediately following the Individual Shareholder Notification (step (4)) reaches the issuer.

<sup>10</sup> A shareholder with multiple accounts may choose to have JASDEC not collect information from account management institutions other than the Requesting Institution by so requesting in step (1).

from all such institutions to generate the Individual Shareholder Notification.<sup>11</sup> Consequently, a shareholder who holds accounts at several institutions only needs to file one request.

#### B. Shareholder Register System Inapplicable

As described above, the Depository & Transfer System relied on entries in the beneficial shareholder register and the ordinary shareholder register (for shareholders outside the system). Because the beneficial shareholder register was updated only periodically on set record dates under this system, unless a shareholder went through the burdensome process of receiving delivery of the stock and recording the transfer in the ordinary shareholder register, a shareholder who acquired shares could not exercise its minority shareholder rights until the beneficial shareholder registry was updated on the record date following share acquisition.

Moreover, reliance on beneficial shareholder registers had the effect of extending the waiting period imposed on a shareholder before it could exercise its rights subject to statutory continuous holding requirements.<sup>12</sup> This result was due to the technical problem that the clock for the statutory continuous holding period could not start until the first record date after the shareholder acquired the relevant shares, because the beneficial shareholder register was first updated on that record date to reflect the shareholder's new status as a shareholder. Thus, if the statutory continuous holding period were six months, the following periods would need to have passed before the shareholder could exercise its rights subject to the statutory continuous holding requirements: (i) period between the share acquisition date and the first subsequent record date, plus (ii) period of six months, representing the statutory holding period. In this case, the total waiting period would be longer than the statutory minimum of six months, and could be nearly a year long. In order to avoid a waiting period longer than the statutory minimum, it was necessary for the shareholder to go outside the Depository & Transfer System and transfer the share certificates from under JASDEC's name to under the shareholder's name, and to have the transfer be reflected on the ordinary shareholder register. This allowed the shareholder to exercise its minority shareholder rights immediately after the lapse of the statutory continuous holding period, counting from the date when the transfer was recorded.

In contrast, the Paperless System is exempted (by Article 154(1) of the Transfer Act) from the application of Article 130(1) of the Companies Act, which requires registration of a share transfer in the shareholder register as a condition for perfection of the transfer. The implication is that any shareholder, whether or not listed on the shareholder register, may exercise

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Upon receiving such a request, JASDEC will prepare an Individual Shareholder Notification based on information solely from the Requesting Institution (Business Regulations, Article 154(8); Enforcement Rules of Business Regulations Related to Book-Entry Transfer of Stocks, etc. (*kabushiki-tou-no-furikae-ni-kansuru-gyomukitei-sekoukisoku*) ("Enforcement Rules of Business Regulations") Articles 203(1) and 200(2)).

<sup>11</sup> Business Regulations, Article 154.

<sup>12</sup> Minority shareholder rights subject to continuous holding requirements include the right to demand convocation of a general meeting of shareholders (six months, unless shortened by the articles of incorporation).

its minority shareholder rights only through an Individual Shareholder Notification. Moreover, where a statutory continuous holding requirement applies as a condition to exercising minority shareholder rights, the calculation of the holding period starts on the day following the date that a change in the number of shares is recorded in the book-entry transfer account ledger that is included in the Individual Shareholder Notification.<sup>13</sup> In this way the Paperless System allows shareholders who acquire shares between record dates to exercise their minority shareholder rights without being subject to the company's record dating practices. Instead, the Paperless System allows shareholders to meet the relevant statutory continuous holding requirements based on their actual holding periods.

#### C. Attachment of Receipt When Exercising Minority Shareholder Rights

In August 2008, *Zenkoku Kabukon Rengōkai*<sup>14</sup> published Model Rules for Handling Shares (*kabushiki-toriatsukai-kitei-moderu*) (the "Model Rules") to address the new procedural requirements under the Paperless System. While implementation of the Model Rules is not mandatory, we expect a large number of listed companies to study the Model Rules closely and make amendments to their share handling rules accordingly.

Under Article 11 of the Model Rules, when a shareholder exercises its minority shareholder rights, the exercise must be evidenced by a signed or sealed written document accompanied by the Receipt (step (2)). Where multiple shareholders seek to jointly exercise minority shareholder rights, each shareholder is expected to request an Individual Shareholder Notification from its own account management institution. The representative shareholder would then collect all the Receipts and submit them together to the issuer.<sup>15</sup>

#### D. Erroneous Entry – Excess Number of Shares

If the book-entry transfer institution or any account management institution erroneously records in the book-entry transfer account ledger an excess

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<sup>13</sup> An Individual Shareholder Notification includes the historical record of the number of shares held and the changes in that number for a period of 6 months and 14 days up to the day immediately preceding the day the request is received (Business Regulations, Article 154(19), (8)(i); Enforcement Rules of Business Regulations, Article 204). Consequently, the issuer is able to use an Individual Shareholder Notification to confirm whether applicable continuous shareholding requirements have been fulfilled by a shareholder before the shareholder exercises its minority shareholder rights. Further, the issuer may demand confirmation from any shareholder that it is still a shareholder as of the time of exercising its minority shareholder rights (Transfer Act, the latter part of Article 277; Transfer Act Enforcement Order, Article 84; Cabinet Order Concerning Transfer of Corporate Bonds, Stocks, etc. (*shasai, kabushiki-tou-no-furikae-ni-kansuru-meirei*), Article 61(2)). See also "Guidelines on Interpreting Reasonable Grounds for Requests for General Shareholder Notifications / Information Provision Requests" released by the Reform Promotion Center for Securities Clearing and Settlement System).

<sup>14</sup> *Zenkoku Kabukon Rengōkai* is an influential private organization that consists of twelve regional groups that are comprised of practitioners in companies (e.g., staff at the department in charge of share handling practices) that study share handling practices.

<sup>15</sup> See *Stock Dematerializations: Practice and Migration (Kabuken Denshika, Sono Jitsumu to Ikou no Subete)* (Hideki Kanda, 2008), page 151. Personal identification documents, power of attorney, etc. are also required to be submitted when a shareholder exercises its minority shareholder right by proxy. (Article 10 of the Model Rules). Multiple shareholders attempting to jointly exercise minority shareholder rights should indicate the fact that they are doing so (Manuals on Operational Processing related to the Book-Entry Transfer System for Stocks, etc., Chapter 2, Section 10).

number of shares (e.g., 1,000 shares instead of 100), and a shareholder makes a bona fide purchase<sup>16</sup> of the excess shares, the total number of transferred shares would exceed the total number of outstanding shares. In such circumstances, the institution in error would be required to acquire the excess shares (i.e., 900 in the above example) and to declare to the issuer that it waives all its rights with respect to those transferred shares.<sup>17</sup>

Furthermore, until such institution has remedied the situation by acquiring the excess shares, shareholders who are accountholders at such institution or any of the lower-tier account management institutions are not able to perfect against the issuer their interests in the excess shares corresponding to their respective shareholding ratio,<sup>18</sup> and are not able to exercise rights corresponding to the excess shares. All shareholders should therefore be aware that the number of shares they hold may be reduced unexpectedly, and as a result, they may fail to meet the minimum share number during a statutory continuous holding period required to exercise their minority shareholder rights.

For instance, even if a shareholder owns 3% of a company's outstanding shares for six months – a typical statutory minimum before being entitled to the right to convene a general meeting of shareholders – its interest in part of the holding may not be perfected against the issuer while an erroneous entry of excess shares exists in the book-entry transfer account ledgers at the account management institution where that shareholder holds its account (or any other upper-tier institution(s)) and such an error remains unremedied. During the period of error, the shareholder would be deemed to have owned less than 3% during the statutory minimum holding period, and thus would not be able to exercise its right to convene a general meeting of shareholders. Once the institution in error has remedied the situation by acquiring the excess shares, excess shares would be deemed to have never existed, and minority shareholder rights subject to the continuous holding requirements would be fully restored (i.e., the shareholder would be deemed to have owned 3% since the share acquisition date without interruption).<sup>19</sup>

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<sup>16</sup> Transfer Act, Article 144.

<sup>17</sup> Transfer Act, Articles 145 and 146. This measure would ensure that the total number of transferred shares will equal the total number of outstanding shares.

<sup>18</sup> The number of shares that cannot be perfected is calculated by multiplying the overall excess number by a fraction the numerator of which is the number of shares held by each shareholder and the denominator of which is the aggregate number of shares held by the organization (JASDEC or account management institution) in error or any account management institution subordinated thereto.

<sup>19</sup> Transfer Act, Article 147(4) and Article 148(4).