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To: Fair Acquisition Study Group
To: Study Group Secretariat

Asset Value Investors Limited
Joe Bauernfreund, Chief Executive Officer

Our Opinions on Key Issues Discussed by "Fair Acquisition Study Group"

Thank you very much for the opportunity to provide our opinions on the key issues being discussed by the Fair Acquisition Study Group (the "Study Group").

We strongly agree with the aim of the Study Group, which is to demonstrate best practices for parties related to acquisitions in order to make it more likely for acquisitions that enhance corporate value to occur. Therefore, we have decided to submit this document to contribute to this effort by sharing our thoughts as an institutional investor with the Study Group.

The uncertainties left behind by the recent judicial decisions on takeover defences have had a significant chilling effect on hostile acquisitions and unsolicited takeover bids, and the economic significance such efforts should have has been undermined. Against this backdrop, we are encouraged by the Study Group's timely approach to this issue and its emphasis on the positive significance of these acquisitions. We do not deny that there may be situations where countermeasures are necessary to deal with abusive takeovers. However, there are real concerns that defence measures may be abused by the management to protect their own interests and that defence measures may loosen the discipline on company management. As we believe that these concerns are more serious, viewed as a whole, we have taken a cautious attitude toward investing in companies that have adopted takeover defence measures. If takeover defence measures continue to be used in Japan in the future, we hope that they will become clear and reasonable, without any need to worry about arbitrary use. With this in mind, we have put together our opinions on the key issues being discussed by the Study Group as follows. We would like to add that we basically agree with many of the proposals for which we have not explicitly expressed an opinion in this document.

We would be pleased if this document assists the Study Group in its discussion.

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2. General Principles for Takeovers (Principle of Enhancing Corporate Value)

While we understand the significance in economic and industrial policy of the principle that "[t]he desirability of an acquisition should be judged on the basis of whether it enhances the corporate value of the target firm," we believe that the side effects of using this as the primary standard need to be carefully considered again in designing the rules. Even though the definition of corporate value itself is unambiguous, actually discussing it can easily be arbitrary, as has been repeatedly warned in the past guidelines.[1] Therefore, at a minimum, quantitative studies should be conducted as much as possible, and the results should be disclosed. Still, it is extremely difficult to accurately estimate post-acquisition cash flows or to accurately calculate the discount rate to calculate the present value. Therefore, it is difficult to prevent arbitrariness. In fact, there are some cases where there are concerns that subjective judgments may have been made that are biased toward the incumbent management team in judging corporate value. In addition, if the corporate value standard is the primary principle, the target company could easily defend itself against unsolicited takeover bids by denying bidders the opportunity to consider specific corporate value enhancement measures, for example, by denying them the opportunity to conduct due diligence. In addition, in a partial acquisition, the increase or decrease in corporate value after the acquisition is linked to the presence or absence of coercion, so a hostile partial acquisition will almost automatically be attacked by the incumbent management as a coercive takeover. However, since judging corporate value can be arbitrary, judging coercion can be equally arbitrary. Therefore, we believe that the opinion is worth listening to that the principle of securing general shareholder interests should be primary for the code of conduct of directors and the management in situations of structural conflicts of interest. Nevertheless, if the corporate value standard continues to be used, it is essential to address the adverse effects described above. Specifically, we believe that there is no effective solution other than to increase objectivity and transparency as much as possible in the review process by the management and the board of directors, who otherwise may make an arbitrary decision, and to ultimately leave the decision on whether or not an acquisition is desirable to shareholders.

In the proposal that "[w]hen the management of a target company . . . reviews a takeover proposal for the

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[1] "Fair M&A Guidelines," p. 38, note 70; "Takeover Defence Measures in Light of Recent Environmental Changes," p. 1, note 1, etc.

company, it should consider the outcome of the takeover from the viewpoint of whether it will contribute to enhancing corporate value of the company" (2(1)), the perspective of whether it would contribute to the interests of general shareholders is missing. In addition, page 9 of the secretariat's explanatory document for the fifth meeting proposes a code of conduct that the principle of enhancing corporate value is primary before the crucial stage of negotiation, and even after that, the same principle is still primary, with the principle of securing general shareholder interests being given only "attention." However, there is a question as to the appropriateness of using totally different codes of conduct based on the vague concept of whether or not negotiations are in a full-fledged stage. The principle of enhancing corporate value and the principle of securing general shareholder interests should at least be two wheels of a cart (except in very exceptional cases where there is a sharp conflict between the requirements of the two principles and no effort can resolve the conflict). In light of the above-mentioned problems associated with the corporate value standard, we believe that it is not appropriate to present a code of conduct as if the principle of securing general shareholder interests were subordinate to the other.

3. General Principles for Takeovers (Principle of Confirming Shareholders' Intent), Ways of Thinking That Do Not Frustrate Takeovers That Enhance Corporate Value

We agree with adopting the principle that "[u]pon determining whether an acquisition contributes to the enhancement of the corporate value of the target firm, the decision of the target firm's shareholders should be respected." As stated in 2 above, we believe that the only effective way currently available is to confirm the intent of shareholders in order to eliminate the risk, which always exists in hostile acquisitions, that the management's self-protection distorts the judgement on whether or not an acquisition would increase corporate value. We are concerned that the risk of management (consciously or not) preferring the option that protects its own position in a hostile takeover is greater in Japanese companies, which are characterised by lifetime employment and community management,[2] than in the United States. In addition, the substantive independence of the board of directors of many Japanese listed companies is still lower than in the US.[3] In light of the above, we believe that if the board of directors or the special committee is the final decision-making body, the risk of arbitrary use of defence measures cannot be eliminated. Therefore, we believe that the above principle should be adopted and confirmation of the intent of shareholders should be required to trigger countermeasures.

However, we believe that it is not appropriate to unconditionally allow to trigger countermeasures by merely confirming the shareholders' intent without questioning the substance of the confirmation. It should be noted that, although cross-shareholdings have decreased to a certain extent on average among listed companies in Japan, there are still many companies, particularly those with small market capitalisations, that have a high ratio of stable shareholders. In such a group of companies, management is so strongly entrenched that engagement by institutional investors does not work, or in many cases, these companies

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[2] Strategy&, "2018 CEO Succession Survey," p. 9.
[3] Boston Consulting Group, "'2021 Industrial Economics Research Commission, Domestic and Foreign Substance Survey on Corporate Governance Reform' Final Report," p. 35.

are not even considered for investment in the first place in anticipation that the desired engagement will not work. As a result, they are a group of companies for which it is difficult to expect the improvement of corporate value through constructive dialogue between the company and investors as envisioned by the Double Codes, and are inherently a group of companies for which improvement of management efficiency through the market for corporate control is particularly expected. However, stable shareholders are expected to exercise their voting rights in accordance with the wishes of the incumbent management regardless of whether or not an acquisition will enhance corporate value. Therefore, the higher the ratio of stable shareholders, the more likely it is that the confirmation of shareholders' intent will be distorted to the detriment of the acquirer, thereby discouraging hostile acquisitions that would enhance corporate value.

It is also proposed that the company should "[r]efrain from engaging in activities that distort the reasonable decision-making of shareholders or undermine their interests, such as appealing to the shareholders who are business partners by taking advantage of their business relationships" (4), which in itself is an appropriate proposal. However, it is assumed that stable shareholders will act in line with the wishes of the incumbent management even without such an approach. Therefore, it is not enough to focus on the words and actions of the management during the actual takeover phase, but also the shareholding structure itself needs to be examined.

This issue requires careful consideration from the policy perspective of the *ex-ante* impact on the behaviour of listed companies. Unconditionally endorsing the results of confirming shareholders' intent would provide a strong incentive for the management of many inefficient companies that are potential targets of hostile acquisitions to resist the dissolution of, or even to expand, strategic cross-shareholdings.

The Study Group has discussed the prior acquisition of shares by an acquirer ("toehold"). However, toehold can be seen as an attempt to equalise the acquirer's position in a situation where the management team is strongly entrenched by stable shareholders and there are high hurdles to making a hostile acquisition. We believe that it is important to consider whether or not a balance as a whole would be well-maintained if the Study Group was concerned only with the shareholdings of the acquirer and not with the shareholdings of stable shareholders.

To address this issue, a rule design that uniformly excludes stable shareholders in confirming shareholders' intent would be very effective. In addition to that, we can adopt another type of rule which, for example, encourages courts to review during *ex-post* judicial examinations facts like the existence or non-existence of stable shareholders, the background and the purpose of their shareholdings, the details of voting rights exercised, and the reasons for decisions and the decision-making process. Under this rule, if voting rights exercised by stable shareholders are found to have unjustifiably distorted the confirmation of shareholders' intent, excessive reliance should not be placed on the results of the confirmation. Alternatively, the rule could be designed to advise courts to review whether or not a majority of shareholders would have approved the resolution even after excluding the shareholdings of stable shareholders. By leaving a possibility of this *ex-post* examination, it would be expected to eliminate some of the adverse effects on prior corporate actions.

4. Treatment of Takeover Proposals

We agree with the proposal that "[w]hen there is a concrete takeover proposal being put forward, . . . the board of directors . . . should determine whether the proposal can be considered as a serious one." As there is a risk of arbitrariness in the determination of seriousness, we believe that this determination should not be made solely by the management.

However, care should be taken not to leave room for the management to hold on to a proposal for an unnecessarily long period of time under the guise of conducting an initial evaluation without putting it to the board of directors. Not only is such conduct problematic in that it may result in the acquisition being given up (and such concern having a chilling effect on unsolicited takeover bids as a whole), but even if the acquisition is eventually completed, from the perspective of time value, it would also be detrimental to the interests that general shareholders should have received if the proposal had been considered without delay. Since individual members of the management often disfavour their company being acquired, after which the company may become de-listed, a subsidiary, or smaller in size, or their position may be lost, unstable, or less important, we believe that the above-mentioned concern that management may hold on to a proposal for a long period of time or have it being given up is a reality for unsolicited takeover bids in general.

In order to prevent such problems, we believe that upon receipt of a takeover proposal, a first report should be promptly made to the board of directors prior to any initial evaluation of its seriousness, etc. This would potentially extend the board's oversight of the management's initial evaluation to this initial stage and enhance the transparency of the process. Given that it is not necessarily essential for the board of directors to hold a physical meeting at the time of the first report and that it is sufficient for the board of directors to wait until the management's initial evaluation is made before beginning its review (as long as the management properly conduct its evaluation), we believe that adopting the above rule would not impose an undue burden on the board of directors, and the disadvantages would be minor.

In the case of unsolicited takeover bids, it should be clarified that the terms and conditions of the acquisition and the securing of funds for the acquisition are not required to be overly specific from the outset, as these will be fleshed out and progressed through the process of discussion, negotiation and information exchange with the target company.

5. Consideration and Negotiation of Takeover Proposals

In relation to "management policies after the acquisition, and the buyer's management capabilities [and] attributes," we would like the Study Group to discuss the stance on hostile acquisitions by financial buyers.

In recent years, several cases have emerged in which financial buyers have attempted to purchase noncontrolling interests through hostile tender offers. In these cases, the acquirers stated that they did not intend to be directly involved in the management of the company, which would remain managed by the incumbent management team, while using their enhanced voice as a shareholder to exercise discipline against the incumbent management team in order to enhance corporate value. In general, such an approach can be regarded as having a positive significance in listed companies, where collective action problems (Rational Apathy) due to the dispersed shares make it difficult to exercise discipline on management, in that the concentration of voting rights under a particular shareholder (or the possibility of such concentration existing in advance) enables to effectively exercise discipline on management.

However, given that management would normally not like to be placed under strong shareholder discipline, and that it would be unrealistic to expect them to acknowledge the potential that their own management efficiency will be enhanced as a result of greater discipline, the incentive for the management to oppose such acquisitions is strong. Although it is not our intention to discuss the individual cases, in such cases, the target companies, in fact, expressed their opposition to the acquisition on the grounds that the corporate value would be damaged due to the acquirer's insufficient understanding of the business and that there is a "potential risk" that the management would be adversely affected if such an acquirer owned certain voting rights.

However, it is a fundamental premise of the principle of separation of ownership and management in publicly listed companies that the management team as an expert has a deeper understanding of the business than shareholders, and this should be the case regardless of whether the shares are widely dispersed or concentrated under a certain shareholder. This is why shareholders seek to eliminate agency costs by exercising discipline on the management team through corporate governance while leaving the day-to-day management of the company up to the management team that is familiar with the business. It may even be said that acquisitions such as the above, which are conducted in order to restore the discipline on management, are exactly what the market for corporate control anticipates and even expects.

Nevertheless, if the management is allowed to easily judge that an acquisition by a financial buyer would damage corporate value mainly on the basis of circumstances that inevitably accompany such an acquisition as mentioned above, or if it is easily permitted to request the triggering of countermeasures, we are concerned that hostile acquisitions by financial buyers would be effectively banned in Japan. In light of this, we would like the Study Group to discuss what content and extent should be required for financial buyers in terms of post-acquisition management policies and the management capabilities of the acquirer in hostile acquisitions.

6. Information Disclosure by the Target Company

We believe it is important for the target company to "[make] information disclosure at the appropriate time, so that shareholders can evaluate how the board of directors and outside directors responded to a concrete and serious takeover proposal." In particular, in cases where a takeover proposal was rejected, it is necessary to objectively disclose the detailed reasons why it was judged that the proposed acquisition would not enhance corporate value and why it was judged that the continuation of the incumbent management team would provide shareholders with a value greater than the proposed acquisition.

7. Information Disclosed by the Acquirer

We agree with the proposal that a certain level of information and disclosure by acquirers is required “[f]rom the viewpoint of ensuring that information necessary to evaluate the acquisition offer is provided for the target company and its shareholders.” On the other hand, it should be prevented to effectively discourage hostile acquisitions or unreasonably delay or deprive shareholders of the opportunity to make decisions by endlessly asking the acquirer to provide information, or requesting information that is difficult to provide or overly detailed and immaterial. We believe that it should be made clear that such behaviour will not be tolerated. In particular, as pointed out on page 11 of “Takeover Defence Measures in Light of Recent Environmental Changes,” if opportunities for due diligence are not guaranteed to unsolicited bidders, we believe that it would not be fair unless providing and disclosing detailed management plans should not be required (nor should opposition to a takeover be permitted on the grounds that such information is not provided or disclosed).

However, we believe that the most effective way to eliminate the risk of arbitrary use is to limit the evaluation period by the target company to a fixed period and to allow all requests for information, negotiations, searches for white knights, etc., only within this period. Even if the information that the board of directors considers necessary and has requested cannot be obtained within that period, it should be sufficient for the target company to form an opinion based on that fact and for the shareholders to decide whether the takeover is desirable or not based on that opinion. Given that in an MBO, a passive market check of 30 working days is generally considered sufficient for counteroffers to emerge, and that it should be much easier for the incumbent management to present an alternative proposal or secure a white knight than for a third party to submit an unsolicited counteroffer, we believe the evaluation period of 30 working days would be sufficient. If a longer period is required, we would like the Study Group to also discuss whether 30 working days is sufficient for passive market checks and ensure consistency.

In cases where the target company’s management and the board of directors are not willing to seriously consider an acquisition proposal, announcing in advance the plan to make a tender offer would encourage serious consideration by them and therefore contribute to general shareholder interests, by moving the discussions and negotiations from under the radar to public view and thereby using discipline by shareholders, the capital markets, etc. (or by giving bidders such an option in order for the discipline to function from the backstage discussion/negotiation stage). While we believe that some effort should be made to prevent abusive use, we do not believe that it is appropriate to uniformly require withdrawal within a certain period of time, including good faith use, as this would give the target company an incentive to prolong the response.

8. "Target-Specific" Takeover Defence Measures

We agree with the proposal that "[i]n the case of 'target-specific' takeover defence measures, . . . it seems reasonable to offer shareholder vote regarding the implementation of the defensive measures at least after the implementation."

However, we do not agree with creating "exceptions in cases that have a high degree of urgency or in cases where it is clear that corporate value will be damaged." In principle, shareholders' intent should be confirmed prior to the implementation of countermeasures, and only in cases of urgency should it be permitted to confirm after the fact. Provided that it is possible to confirm shareholders' intent after the fact, we do not believe that there would be any urgency which makes the confirmation of shareholders' intent itself unnecessary. On page 16 of the secretariat's explanatory document for the fifth meeting of the Study Group, Article 206-2, paragraph (4) of the Companies Act is referred to as the basis for allowing the exception of urgency. However, the resolution of the general meeting of shareholders under the article cannot be implemented after the fact and is different in nature from the confirmation of shareholders' intent here, so this cannot be the basis for allowing the exception of urgency.

Since allowing exceptions to the confirmation of shareholders' intent could allow room for arbitrary use for self-protection purposes, we believe that the confirmation of shareholders' intent should always be followed. The cost of confirming shareholders' intent is so small compared to the benefits that general shareholders enjoy that they are willing to bear it. Since it is possible to confirm shareholders' intent after the fact, it seems unlikely that there would be any disadvantages in doing so, other than the risk that the management would not be able to protect their own interests.

Provided that it is a transitional measure until the tender offer regulations are amended to cope with abusive takeovers, we believe that there is room to support allowing the MOM resolutions only for "rapid purchases within the market" on the condition that appropriate measures are taken with respect to the treatment of stable shareholders as mentioned in 3 above, and that an appropriate balance is maintained between the acquirer and the management in terms of correcting the distortion in the confirmation of shareholders' intent. However, currently, the possibility of the MOM resolution being used has a strong chilling effect on hostile acquisitions. In light of this situation, the Study Group should clarify matters, such as the definition of "rapid purchases," the clear threshold that the MOM resolution can be used, the treatment of voting rights already held prior to the commencement of the acquisition, and whether cases where a competing offeror purchases shares within the market during the tender offer period launched by another party are included in the scope. We believe that it is necessary to ensure that the scope of the MOM resolutions is unambiguously clear through achieving these.

While the proposal that institutional investors and proxy advisors should make a substantive decision on the merits of takeover defence measures is in itself reasonable, we believe that the same request should also be made to companies with cross-shareholdings in the target company. Such stable shareholders are not only problematic from the point of view of the target company being held, as mentioned in 3 above, as they may prevent desirable acquisitions, but also from the point of view of the company holding the shares (especially for the case of listed companies), as unreasonably giving up the opportunity to sell shares at a premium is a highly problematic act from the perspective of capital efficiency. In this respect, it can be said that this is the situation in which the problems with strategic cross-shareholdings become particularly apparent.

9. "Advance-Warning" Takeover Defence Measures

Currently, companies that have adopted advance-warning takeover defences are valued at a discount in the stock market, reflecting the risk of abuse and undermining of management discipline, and are therefore excluded from the investment targets of some active institutional investors. While the need for advance-warning defence measures in the event of an overall stock market turbulence has been pointed out, it must also be recognised that introducing defence measures at such times of share price declining across the market has the disadvantage of discouraging governance-oriented value investors from investing in companies and thereby increasing existing shareholders' losses even further as a result of losing the support for the share price these investors would have offered. The necessity of keep allowing the advance-warning defence measures should be minor after reasonable guidelines have been developed for the target-specific takeover defence measures. If the Study Group declares that Japan will graduate from the advance-warning takeover defence measures and allow only rationalised target-specific takeover defence measures in the future, that is expected to have a significant announcement effect on the Japanese stock market since both the improvement and the new rule are easy to understand from a global perspective, including foreign investors.

Nevertheless, if the advance-warning takeover defence measures are to be retained, we believe that, at a minimum, the following two conditions must be followed in addition to the adoption being approved by the general shareholders' meeting: "(1) an "advance-warning" defence measure has a mechanism to confirm shareholders' intent at a shareholders meeting at the time of implementation" and "(2) . . . there is a lack of discretion, such as . . . the structure [being] designed for the sole purpose of obtaining time to negotiate."