February 24, 2005
Financial Law Board

Note on Public Interest Corporations in Financial Transactions
-- Focusing on Derivatives Transactions --

* Note to the English version

After the publication of the original Japanese version of this article (February 24, 2005), there has been a reform of the legal system regarding corporations in public interest including the revision of the Japanese Civil Code as well as the enactment of the Act on General Incorporated Associations and General Incorporated Foundations (Act No. 48 of 2006) and the Act on Authorization of Public Interest Incorporated Associations and Public Interest Incorporated Foundation (Act No. 49 of 2006). This English version contains up-to-date information after the said reform (as of end December 2009).

I. Issues

Article 34 of the Civil Code of Japan provides that the legal capacity vested with corporations (judicial persons) only lies within the scope of the "purposes" (corporate purposes) determined in their articles of incorporation. The Supreme Court has ruled that this provision should apply analogously to joint stock companies (*kabushiki-kaisha*), and that as such, no action of a corporation is valid unless such action is prescribed in the "purposes section" of its articles of incorporation, regardless of whether the other party to the transaction is acting in good faith or not (the Great Court of Judicature (*Daishin'in*) Judgment of 29 January, 1903, 9 Minroku at 102). However, given that the Supreme Court has determined that "affairs inferable or deducible from the provisions of articles of incorporation" and "affairs necessary to achieve the purposes of the company" are included in the scope of purposes (the Great Court of Judicature Judgment of 25 December, 1912, 18 Minroku at 1078), and further, that the issue of whether or not a particular act is necessary to achieve the purposes of the company should be determined objectively from the appearance of the act (the Great Court of Judicature Judgment of 7 February, 1938, 17 Minshu at 50; Supreme Court Judgment of 15 February, 1952, 6 Minshu No. 2 at 77), there is virtually no possibility that the courts will admit the "*ultra vires*" defense. Generally accepted theories also support the view that the legal capacity of a company should not be interpreted as being limited to the purposes set forth in its articles of incorporation (which means Article 34 of the Civil Code does not apply to profit corporations) for the sake of consistency (See for example, Kenjiro Egashira, *Kabushiki Kaisha-ho* [Stock Company Act], third edition, 2009 at 30 and subsequent pages, Hideki Kanda, *Kaisha-ho* [Company Act], eleventh edition, 2009 at page 5; Misao Tatsuta, *Kaisha-ho* [Company Act], tenth edition, 2005 at page 48). In practice, a company usually enumerates its main purposes and adds a catch-all clause, such as "any and all business related or incidental to the foregoing," at the end of the "purposes section" of its articles of incorporation, thereby avoiding the occurrence of the *ultra vires* issue in most cases.

On the other hand, according to the generally accepted view, public interest corporations (*koueki-houjin*) are always subjected to Article 34 of the Civil Code, and their purposes should be interpreted more strictly than those of profit corporations. Several opinions have been expressed on the issue of how to apply the above view to particular cases. If the application of the above view is taken to require "strict interpretation of purposes mentioned in the articles of incorporation or acts of endowment in view of giving priority to the public interest (i.e. to protect the interest of the public interest corporation) over the stability of its transactions concerned, as opposed to the case of a profit corporation" (that is, transactions outside the scope of its purposes are absolutely invalid), we cannot approve such straight application in financial practices. Though these public interest corporations are specifically licensed as corporations (judicial persons) because of their purposes to pursue social and public interests, in order to ensure proper management to carry out these purposes they need to maintain their endowments by actively engaging in commercial transactions such as investing in financial products, as do profit corporations; failure to do so inevitably renders their directors liable for breach of duty of due care. The investment targets are generally listed in internal rules, such as the articles of incorporation, from a standpoint to which no one can object (i.e. a "safe and advantageous investment"), but the financial products actually traded by the corporations often deviate from these criteria. In recent economic circumstances, where interest rates are low, even public interest corporations and nonprofit corporations have to pay more attention to improving the performance of their portfolios. As a result, they become more and more inclined to trade in high-risk and high-return products, especially hybrid financial products which integrate derivatives and futures transactions for investment purposes rather than for hedging purposes. Public interest corporations which invest in these highly volatile products leave themselves open to the criticism that they are acting against their legislative purposes. In light of the need to support the activities of public interest corporations to serve the public interest, especially in a low-interest-rate environment at this present moment, any comprehensive prohibition of investing in high-risk products may raise questions regarding the director's responsibility to perform his/her duty of due care.

Progress in financial technology has made it much easier to integrate various hybrid derivatives in investments which have generally been accepted as "safe and advantageous" for public interest corporations, such as "bonds" and "deposits". In addition, derivative transactions are now ordinarily included in general financial products to which ordinary consumers become parties (e.g. housing loans), and "trust" schemes which have started to be widely used. As the hedging of overall risk takes on growing importance in portfolio management, a financial product which is highly volatile in itself may not always contribute to the high volatility of the portfolio when combined with other financial assets within that portfolio. Furthermore, the emergence and prevalence of credit derivatives in recent years has brought about dramatic changes in the risks borne by investors.[1] Under these circumstances, an absence of appropriate control makes it possible to overlook the existence of a portfolio consisting substantially of volatile investments, which is legally disguised as "bonds" or "funds" thereby allowing a public interest corporation to deviate from its purposes of protecting the public interest.

Considering these circumstances, we must keep in mind that if we carelessly deny the validity of financial transactions, based on a naïve interpretation and application of Article 34 of the Civil Code concerning the purposes of public interest corporations, we will be very likely to complicate financial transactions and to cause difficulties in the management of public interest corporations.

This report is composed of three sections. Firstly, it presents an overview of judgments awarded by the Supreme Court and the lower courts concerning the legal capacity of public interest corporations.[2] Secondly, it introduces several efforts in legal interpretation to reconcile the conflicting needs described above especially by reporting the activities of educational corporations (*gakko-houjin*) who have sought diversified investment opportunities to cope with the recent recession. Lastly, it reports on relevant situations overseas.

---

[1] For example, we can conceive of bonds integrating single-name credit derivatives in which the investor is the seller of protection. Though an issuer of the bond is a special purpose company (SPC) provided with bankruptcy remote, the bond will be redeemed valueless without any balance left for the principal and interest if the reference entity of the bond goes bankrupt. Therefore, we may conclude that the risk of losing the principal of the bond depends on the credit of the reference entity rather than on that of the SPC.

[2] In this report, the term "public interest corporation" is used to encompass a broad range of corporations in public interests, including, but not limited to the public interest corporations defined in Article 2 (iii) of the Act on Authorization of Public Interest Incorporated Associations and Public Interest Incorporated Foundation (hereinafter referred to as "Authorization Act").

II. Current Practices and Issues Incidental Thereto

a. Precedents of the Supreme Court and lower courts

The following are representative precedents and rulings concerning public interest corporations and the scope of purposes prescribed in their articles of incorporation (*Italics and underscores added by the Board*).

1. Public interest corporations under the Civil Code[3]

1-1 Supreme Court Judgment of 23 April, 1976, 30 Supreme Court Civil Law Reports No. 3 at 306.

In this case, the plaintiff, an incorporated foundation (*zaidan-houjin*) operating a hospital for the purposes of providing predicament recuperation to the diseased and injured based on charitable intention, sold its real estate to the defendant to acquire funds for the launch of a new business. After the sale, the plaintiff alleged that the sale agreement of the said estate was invalid and filed a claim against the defendant demanding the return of the estate or payment of damages in lieu of the return, on the grounds that the plaintiff's new business lay outside the scope of the purposes set forth in its act of endowment (the plaintiff had changed its act of endowment, but it failed to obtain necessary approval from the competent authority until after the sale). The court ruled that the foundation's sale of the land and whole building, equipment and machinery of the hospital for launching *a new business that was not determined in its act of endowment*, as disputed in this case, was invalid on the grounds that the foundation disposed its only endowment and frustrated its original business purposes. However, the court also added a statement to the effect that <u>if the plaintiff had changed its act of endowment to include the new business in its purposes, such sale would have been within its scope of purposes</u>. (As a conclusion, however, the court dismissed the plaintiff's claim for invalidation of the sale, adjudging the claim to be against the principle of good faith, since the claim was submitted more than seven years and ten months after the sale of the estate.)

[3] The reform of the legal system regarding corporations in public interests has been effective since 1 December 2008. Under the new system, nonprofit corporations in general, including public interest corporations, are governed by the Act on General Incorporated Associations and General Incorporated Foundations. The public interest corporations which used to be defined in Article 34 of the Civil Code before the said reform are eligible to be authorised, subject to certain conditions, as public interest corporations defined in Article 2 (iii) of the Authorization Act under the new system.

1-2 Hiroshima High Court, Okayama Branch Judgment of 16 September, 1955, 8 High Court Civil Law Reports No. 6 at 406.

In this case, the plaintiff, an incorporated foundation whose purposes were to engage in the scholarship business, filed a claim against the defendant demanding the repayment of money loaned by the plaintiff (at a high interest rate) for moneymaking purposes. The defendant argued that, "since the money lending fell outside the scope of purposes determined in the plaintiff's act of endowment, it was invalid." In this case, the court granted that an attempt to increase funds in order to conduct a scholarship business, i.e. the purposes of the plaintiff, was an act necessary to achieve its purposes. At the same time, however, it ruled that moneymaking should be conducted in a safe and sound manner, and that while lending money at a high interest rate could be extremely profitable, it also entailed the risk of losing the principal and thus could not be considered as an act necessary to achieve the purposes.

1-3 Tokyo High Court Judgment of 20 November, 1956, Hanrei Times 66 at 62.

In this case, the plaintiff, an incorporated foundation whose purposes were to engage in the scholarship business, filed a claim demanding that the defendant vacate a building acquired by the plaintiff from the defendant under a sale agreement. The defendant, in turn, argued that "the sale agreement was invalid because it fell outside the scope of purposes determined in the plaintiff's act of endowment." In this case, the court ruled that it was within the scope of purposes to acquire real estate and lease it to obtain income for use as scholarship funds.

1-4 Tokyo High Court Judgment of 20 April, 1964, Hanrei Times 163 at 181.

In this case, the plaintiff claimed that the defendant, an incorporated foundation whose purpose was to provide medical services, must repay money loaned by the plaintiff under a loan agreement. The defendant, in turn, argued that "the lending was invalid because it fell outside the scope of purposes determined in the defendant's act of endowment." In this case, the court ruled that borrowing money for expanding wards and purchasing medical equipment was within the scope of purposes because such an act had been done to maintain and develop the hospital.

1-5 Kyoto District Court Judgment of 29 June, 1994, Hanrei Jiho No. 1531 at 103.

In this case, the plaintiff, an incorporated foundation whose purpose was to resolve housing problems in Tokyo, claimed that the defendant, a religious corporation (*shukyo-houjin*), must undertake procedures to register transfer of title to land, alleging that the plaintiff had acquired the title under the sale agreement of the land. The defendant argued that "the sale agreement was invalid because it fell outside the scope of purposes determined in the act of endowment." In this case, the court ruled that the acquisition of land in Kyoto as a substitute for acquiring land in Tokyo could be recognised as an act indirectly required to achieve the above purposes, hence the act was objectively considered to fall under "any other business necessary to achieve the purposes" referred to in the act of endowment.

2. Educational corporation[4]

2-1 Tokyo District Court Judgment of 22 September, 1987, Hanrei Times 667 at 134.

In this case, the plaintiff, an educational corporation, filed a claim demanding the restitution of money granted to the defendant on the grounds of a loan agreement or unjust enrichment, alleging that "the grant of money which is the basis of the claim of unjust enrichment (re-defense in this case) fell outside the scope of purposes determined in the act of endowment and thus invalid." The court determined that <u>an act which could bring reasonable value and effect in the effective development of an educational corporation should not be prevented from being recognised as an act necessary to achieve its purposes, and as such, that the bestowal of the property of an educational corporation as a gift could not be reasonably considered as an act beyond the scope of purposes of the corporation, merely on the grounds that such gift was not specifically mentioned in the act of endowment, insofar as the act was required for an educational corporation as a social existence and beneficial to ensure the effective development of the educational corporation, and remained within the reasonable limits of social conventions</u>. Then the court ruled that <u>a gift would be invalidated as an act beyond the purposes if it went beyond the limits deemed reasonable on the basis of various factors, such as the size of the</u>

[4] Educational corporations, social welfare corporations (*shakaifukushi-houjin*), and religious corporations are permitted to engage in profit-making business by the provisions of applicable acts (Article 26 of Private School Act, Article 26, paragraph 1 of Social Welfare Act, and Article 6, paragraph 2 of Religious Corporation Act, respectively). However, these business purposes must be set forth in their articles of incorporation, etc. (Article 30, paragraph 1, item (ix) of Private School Act, Article 31, paragraph 1, item (xi) of Social Welfare Act, and Article 12, paragraph 1, item (vii) of Religious Corporation Act), and failure to do so may create a similar problem.

educational corporation, the status of the corporation in the school education business, and the economic base of the corporation, as well as the donee, purposes, contents and other conditions of the gift. (In this case, the court judged that the gift was invalid because it greatly exceeded the reasonable range, stating that a gift amounting to ¥600,000,000 might have adversely affected the economic base of the corporation.)

b. Analysis

1. Relationship with "act of investment"

1-1 The precedent referred to in a.1-2 above is a suggestive case in relation to financial transactions as acts of investment. There the court ruled that "an attempt to increase funds in order to conduct scholarship business, i.e. the purposes of the plaintiff, was an act necessary to achieve its purposes." In this regard, investment can be considered practically as an act to attempt to increase funds, and abstractly as an act necessary to achieve the purposes of the corporation.

In addition, considering that a public interest corporation basically maintains its existence and activities based on the management of its endowments, we may naturally conclude that investment in general is an act within the scope of the legal capacity of a corporation.

1-2 However, it would be difficult to conclude that all acts of investment fall within the scope of the legal capacity of a public interest corporation solely because they are acts of investment.

For example, in cases involving a cooperative association (an entity similar to a public interest corporation as a nonprofit corporation) the court ruled that loans extended by the association to outsiders were invalid as a rule because loans to persons other than its members were outside the scope of its purposes.[5] If this is the rule, all investments, including new investing trends involving derivatives transactions, may not be unconditionally claimed as transactions falling within the scope of the legal capacity of a public interest corporation.

1-3 In the following section we look into other precedents to see if a standard has been

[5] See the Supreme Court Judgment of 26 April, 1966, 20 Minshu No. 4 at 849; and the Supreme Court Judgment of 4 July, 1969, 23 Minshu No. 8 at 1347. Both cases involved loans provided by cooperative associations to persons other than their members. Though there may be arguments as to the manner of evaluation of these cases, it seemed possible to evaluate loans to outsiders as a kind of investment. However, the Supreme Court ruled that the loans in question were invalid as they fell outside the purposes of these associations.

established for evaluating whether or not certain transactions of a public interest corporation fall within the scope of its legal capacity. The Supreme Court has not given any definite standard in this regard. The best possible precedents available are the precedents referred to in a.1-2 and a.2-1 above, where certain standards were suggested.

The precedent in a.1-2 above sets the general standard that moneymaking can only be recognised as a permissible investment if it is "conducted in a safe and sound manner" and adjudged that "while lending money at a high interest rate could be extremely profitable, it also entailed the risk of losing the principal." This precedent seems to point out that, insofar as lending activities are concerned, the collectability of loans depends on the credit risk of the borrower, and hence the act of lending to a person with a high default risk cannot be considered as lending "in a safe and sound manner." Though derivatives transactions were not contemplated in this precedent, the standard established in this case can lead to the conclusion that highly volatile financial products are not suitable for investment "in a safe and sound manner."

The precedent in a.2-1 above provides more specific and flexible standard, that is, "a gift would be invalidated as an act beyond the purposes if it went beyond the limits deemed reasonable on the basis of various factors, such as the size of the educational corporation, the status of the corporation in the school education business, and the economic base of the corporation, as well as the donee, purposes, contents and other conditions of the gift." Though this standard merits evaluation, it only suggests an abstract standard that "… can be determined to fall within the scope of the [corporation's] legal capacity, so long as we can deem it to fall within a reasonable range in consideration of individual and specific circumstances involved." As such, we cannot evaluate this standard as one presenting foreseeable and stable standards for investment in general.

2. Scope of "purposes"

According to the precedent mentioned in a.1-1 above, the court seemed to contemplate that "if the plaintiff had changed its act of endowment to include the new business in its purposes," then transactions which had not been specified in the purposes, for example, dispositions of land, "would have been within its scope of purposes." Similarly, in other precedents concerning public interest corporations, it seems that the courts have clearly had no intention to limit the legal capacity of a corporation to within the scope of their express purposes. Therefore, it will be safe to say that public interest corporations and nonprofit corporations are allowed to perform the acts required to achieve their purposes, without being restricted by a literal interpretation of their scope of purposes.

3. Guidelines for analysis

As seen above, our analysis of precedents or rulings has not provided us with a standard by which to evaluate whether a transaction falls within the scope of the legal capacity of public interest corporations.

Considering that a public interest corporation depends on the acts of its representatives, such as its directors, we may determine the scope of investments (financial transactions) that can be deemed to fall within the scope of the legal capacity of a corporation by determining the range of its directors' duty of due care. In other words, irrespective of theoretical controversies regarding the identity of corporation, i.e. whether a corporation is a real entity or a constructive one, the scope of transactions which are regarded to have been carried out in the exercise of due care by its representative should logically be embraced by the outer sphere of transactions generally accepted as acts within the corporation's legal capacity. This is a practical approach intended to provide secure stability for such transactions, based on the principle that no transaction will be refuted as invalid so long as it is conducted with due care. In this report we look into the requirements of investment (financial transaction) which must be fulfilled to ensure recognition of an investment as a transaction within a director's duty of due care.

4. Scope of duty of due care of directors etc.

4-1 The Supreme Court has not given any precedent clarifying the scope of duty of due care required of directors or other representatives (hereinafter referred to as "directors etc.") in connection with the "act of investment." We find a few rulings given by lower courts, but none of them are sufficiently suggestive on this point.
Lacking any Supreme Court's precedent indicative of useful standards, we must determine the range of directors etc.' duty of due care by interpretations. For this purpose, we refer to the recent discussions on duty of due care required of a fund manager managing pension assets. A director etc. in a public interest corporation is in a position comparable to a pension fund manager with respect to asset management, in that the director is responsible for managing a certain property on the basis of fiduciary relationships with others.

4-2 Approach to limit investment targets (Legal list approach)

A simple solution may be to predetermine the financial transactions (financial products) permissible for investment by specifying them in the articles of incorporation or by-laws, thereby defining the extent of duty of due care expected of a director etc. According to this method, the investment targets determined in the articles of incorporation or by-laws should be interpreted strictly. As this approach clearly designates the investment targets, the directors etc. would not be liable for any breach of duty of due care as long as they act in accordance with the list of eligible investments, and this would effectively avoid the occurrence of the *ultra vires* issue. A similar approach was employed in traditional pension fund management.[6]

The above approach can be inflexible in including newly developed financial products, however, and this limitation may lead to rigid asset management and impede efforts to take appropriate action by limiting choices when value of investment targets plunge.[7] Any limitation in investment targets makes it necessary to check investment target one by one, which is from economic point of view inconsistent with the scientific investment theory, the so-called modern portfolio theory.

Conversely, as mentioned above, today's highly advanced financial technology can produce risky scenarios where investors invest all of their assets in financial products which are permissible as a legal form (i.e. products listed in a legal list) but nonetheless highly speculative in substance.

4-3 Approach to maintain safety of whole assets (Prudent investor rule approach)

To address the problem mentioned above, the issue of directors etc.' duty of due care regarding investment targets should be considered from the standpoint of overall portfolio safety instead of limiting the products in which to invest. Under this approach, it is desirable to adopt a method to estimate the risk of damage to the overall portfolio while imposing no restriction on financial transactions (financial

---

[6] In the past, pension fund management was regulated by limiting investment targets and also the allocation of the assets to be invested under the so-called "5:3:3:2 Rule," the legislation requiring that 50 percent or more of the assets be invested in safe investment assets (government bonds, local bonds, etc.), 30 percent or less be invested in equity, 30 percent or less be invested in foreign currency securities (foreign stocks, foreign bonds), and 20 percent or less be invested in real estate.

[7] A similar problem was pointed out in the US legal list approach. The great depression of 1929 triggered a plunge of bonds which had been regarded as safe assets under the legal list approach, eventually raising questions about the effectiveness of the approach. As a result, the prudent man rule (and later the prudent investor rule) replaced the legal list approach in each US state by around 1940.

products) in which to invest.[8] This method conforms to modern portfolio theory and is also economically reasonable. Given that public interest corporations maintain activities by managing their endowments, it would clearly be preposterous to charge that this economically reasonable behavior is in breach of duty of due care. In fact, as early as January 1998, the "legal list approach" described in 4-2 above was repealed and replaced by the "prudent investor rule approach" in pension asset management.[9]

-- Excerpt from "On Guidelines Concerning the Roles and Responsibilities of Employee's Pension Fund Managers" (2 April, 1997) (Nenhatsu No. 2548) (Notice to the prefectural governors from the Director General of the Pension Bureau of the Ministry of Health and Welfare (*Underscore added by the Board*.) --[10]

In the management of fund assets, the selection of individual asset classes (stocks, bonds, etc.) and products (hereinafter collectively referred to as "assets etc." in this guidelines) (meaning the selection of individual issues in the case of internal investment management) shall be based on considerations of the risk (volatility of the earning rate) and return (earning rate) of the assets of the whole fund collectively. <u>Investment in high-risk assets etc. is allowable by the discretion of the fund, if it is deemed reasonable in view of the risk-versus-return relationship of the whole assets of the fund, unless such investment would constitute a violation of applicable acts</u> (See Article 136-3 of the Act).[11]

---

[8] This approach is in some respects common to the risk management capacity test used by the Financial Services Agency for supervising financial institutions.

[9] The deregulation process was implemented gradually from fiscal 1996 and completed in January 1998.

[10] Also see the following:
-Basic Policy Concerning the Management of Reserves for Pension Benefits etc. of Employee's Pension Funds (1 April, 1996) (Nenhatsu No. 2115) (Notice to the prefectural governors from the Director General of the Pension Bureau of the Ministry of Health and Welfare).
-Internal Investment Management of Reserves for Pension Benefits etc. of Employee's Pension Funds (31 May, 2000) (Nenhatsu No. 381) (Notice to the chief of local social insurance offices from the Director General of the Pension Bureau of the Ministry of Health and Welfare).

[11] If the asset management is delegated to a trust bank or other institution, no restriction will be imposed on the products that can be invested in by such a trust bank. In internal investment management, on the other hand, the products for investment will be regulated. In addition, in internal investment management, derivatives transactions are only permitted for risk hedge purposes and are prohibited for speculative purposes (See Article 41-3 of Employee's Pension Fund Regulations).

Accordingly, the “prudent investor rule approach” would be an appropriate option for addressing the issue of the scope of duty of due care in investment.

In our view, even if a public interest corporation has a list limiting its investment targets in its articles of incorporation or by-laws, such limitations would not prevent the corporation from adopting the “prudent investor rule approach.” This type of list only enumerates the main financial products to be included in the corporation’s investment portfolio, hence the investments would be deemed to fall within the scope of duty of due care as long as the objective, i.e. the “safety of the assets as a whole,” is maintained. Furthermore, the investment in any product excluded from the list in this case would not be deemed to constitute a breach of duty of due care, hence the “*ultra vires*” problem would not arise solely due to the exclusion.

4-4 In relation with the cabinet decision of 20 September, 1996

We find two cabinet decisions concerning the standard for the permission for the establishment of public interest corporations: the “Standard for Permission for the Establishment of Public Interest Corporations and for Directing and Supervising them” and the “Standard for Delegating the Function of Inspection etc. of Public Interest Corporations” (established on 20 September, 1996, and amended on 16 December, 1997).

There are some statements in these decisions regarding investment by public interest corporations (See the statement in Section 5 of the excerpt below) and they do not seem to contradict the prudent investor rule approach mentioned above.

Considering the reference to portfolio management in Section 6 of the decision, the decision seems to be based on the modern portfolio theory. If so, the statement in the decision asserting that assets must be managed by “<u>a method that offers a strong possibility of recovering the principal and ensuring the highest return possible</u>” does not seem to explicitly apply to individual assets, but rather to an asset portfolio as a whole.

-- Excerpt from “Standard for Permission for the Establishment of Public Interest Corporations and Directing and Supervising them” (*Underscore added by the Board*.) --

5. Finance and accounting

(5) Administration and management of invested assets shall be carried out by <u>a method that offers a strong possibility of recovering the principal and ensuring the highest return possible,</u> except for the administration and management of assets necessary for the sound

management of the corporation (cash, buildings, etc.).

6. Holding of shares

(1) As a rule, a public interest corporation shall not hold shares in commercial firms except for the cases listed below:

(i) Administration and management of assets under the provision of Clause 5-(5) above, provided that <u>such holding is clearly done in the context of portfolio management, such as through transactions in open market</u>, and

(ii) Administration and management of assets donated as endowments in the case of an incorporated foundation.

(2) In the case of shareholding under the provision of Item (1) above, a public interest corporation may not hold shares in excess of one half of the total outstanding shares of the relevant commercial firm.

(3) A public interest corporation holding shares under Item (1) above (limited to cases in which it holds 20% or more of the total outstanding shares in an entity) shall state the outline of the relevant commercial firm in the business report each business year.

5. Notes on particular transactions

As mentioned above, it would be appropriate to adopt the "prudent investor rule approach" concerning the scope of duty of due care in relation to the "act of investment". For this purpose, we need to analyse crucial factors of individual financial transactions (financial products) in which to invest, including the maximum loss, volatility and risk of loss inherent to the products.

Considering the existence of the standards established by the cabinet decision mentioned in 4-4 above, the safety of the overall assets should be stressed in addition to simple diversified investment.

In the following, we enumerate several examples to clarify the conditions an investment must fulfill in order to become eligible as a transaction within the duty of due care of directors etc.

5-1 Interest rate swap

An interest rate swap from a floating rate to a fixed rate on any borrowing made by a public interest corporation to carry out business related to its purposes set forth in the articles of incorporation will usually be deemed as a transaction within the scope of duty of due care because it fixes the amount payable by the corporation and stabilises the value of assets overall.

On the other hand, a swap from a fixed interest rate to a floating rate may be considered a transaction beyond duty of due care due to the perilously high increases in floating interest. In theory, floating interest can increase without limit, making it impossible to measure the maximum loss and endangering the financial base of the corporation. Under the present circumstances in Japan with limited levels of volatility of the interest rate, however, we cannot utterly deny the validity of this type of swap. In terms of volatility, a long-term swap is more likely to be determined as a transaction within the scope of duty of due care, while a short-term swap needs more prudent examination.

5-2 Equity derivatives transaction

As specified in Section 6 of the cabinet decision quoted in 4-4 above, public interest corporations are permitted to hold shares to a certain level. In this case, an equity derivatives transaction in which the share price is fixed to the current price is likely to be deemed as a transaction within the scope of duty of due care since it fixes the current asset value of the corporation and stabilises the value of the total assets.

5-3 Credit derivatives transaction

If a public interest corporation holds bonds, stocks, etc. issued by a third party and the corporation becomes a buyer of protection using that third party as its reference entity, the credit derivatives transaction is likely to be deemed as a transaction within the scope of duty of due care on the grounds that the transaction will facilitate collection of the relevant bonds etc.

Even if the public interest corporation does not hold bonds etc., the purchase of protection will probably be considered as a transaction within the scope of duty of due care unless the premium is large enough to materially affect the overall assets, as the maximum loss is limited to the amount of the premium (which normally is much smaller than the amount payable upon occurrence of a credit event).

On the other hand, the sale of protection by a public interest corporation is likely to be deemed as a breach of duty of due care depending on the credit risk of the reference entity and the amount of maximum loss involved in the derivatives (the amount payable upon occurrence of a credit event is normally large).

5-4 Others

(1) Loan to a firm facing a high risk of bankruptcy and credit derivatives using such firm as a reference entity

If a public interest corporation purchases the bonds whose issuer faces a high credit risk, such an acquisition alone may be deemed invalid as an act highly likely to impair the principal if the purchase price is high enough to so merit. However, if the corporation has acquired credit derivatives using the issuer as the reference entity prior to or simultaneously with the purchase of the bonds and the corporation can receive an amount equivalent to that of the principal upon bankruptcy of the issuer, this transaction, as seen in the whole picture, may not be regarded as an act likely to cause a loss of principal, irrespective of the amount of bonds purchased, provided that the credit risk of the other party to the credit derivatives transaction has to be carefully examined.

(2) Being a seller of protection while remaining a buyer of another credit derivative having the same conditions

Even when a public interest corporation becomes a seller of protection where the maximum loss (i.e. amount of payment) would endanger the financial base of the corporation upon occurrence of a credit event, if the corporation has also become a buyer of protection in another credit derivative having the same conditions as the former derivative prior to or simultaneously with the time of being the seller of protection, the two derivatives transactions, if viewed as a set of transactions, need not be considered highly perilous to the financial base of the corporation. It is, of course, necessary to carefully examine the credit risk of the other party in the credit derivatives transaction in which the corporation is the buyer.