Facilitating better corporate governance in Japan – how do the proposed amendments to the Companies Act change the Corporate Governance of Japanese companies?

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One of the unique aspects of Japanese corporate law is the corporate governance structures. Japan has, over a number of years, developed the “Auditors” (kansayaku) system as a means of auditing and supervising the conduct of executive directors, and corporate governance has always been one of the most crucial issues among scholars and practitioners.

The Companies Act of Japan (the “Companies Act”) was enacted in 2005 and it is now in the process of its first significant amendments. Appropriate corporate governance structures, including whether or not the Companies Act should mandate the appointment of Outside Directors, have been one of the most controversial issues in relation to the reform of the Companies Act. On September 7, 2012, the Justice Ministry’s Legislative Council approved an outline regarding amendments to the Companies Act (the “Outline”) introducing, among other things, a new corporate governance structure while leaving the appointment of Outside Directors to the discretion of each company. This article introduces major proposals in the Outline in relation to the corporate governance of Japanese companies as well as the background thereto and the possible effects of those proposals on the corporate governance of Japanese companies.

Current corporate governance

Under the Companies Act, a company may elect its corporate governance structure from a number of forms prescribed in the Companies Act. However, as far as large public companies are concerned, they may only elect either a Company with Audit and Supervisory Board (kansayakukai secchigaisha) or a Company with Committees (inkai secchigaisha).

Under the Companies Act, Companies with Audit and Supervisory Board are not required to appoint any Outside Director. On the other hand, they must appoint three or more Auditors (kansayaku) and half or more of them must be Outside Auditors. In Companies with Audit and Supervisory Board, the management function is vested in the board of directors while the audit and supervisory board is expected to supervise the conduct of the directors. Companies with Audit and Supervisory Board may not delegate their decision making functions to individual directors, including the representative director.

Companies with Committees are companies which have a nominating committee, an audit committee and a compensation committee. Companies with Committees were introduced in 2002 as a means of a new corporate governance structure. In a Company with Committees, directors may not execute the operations of the company and, instead, one or more executive officers appointed by the board who may or may not be a director of the company is or are in charge of the operation of the company. Each committee shall be composed of three or more members who is a director of the company. The majority of each committee members must be Outside Directors. Unlike Companies with Audit and Supervisory Board, Companies with Committees are based on the monitoring model in which the board of directors functions as a body to supervise the conduct of executive officers who have the management function of the company.

While Companies with Committee structure was introduced aiming at facilitating better corporate governance, it has so far not been popular and, according to a survey of the Japan Association of Directors, only 58 listed companies have a committee type governance structure as of August 1, 2013.

One can easily imagine the reluctance of the management of Japanese companies to adopt the committee type governance structure because, in a Company with Committees, the management must delegate its authority to determine the candidates of directors and their remuneration, the authority for which had long been vested in the board of directors (or in practice, the representative director), to the nominating committee and the compensation committee.

Audit and Supervisory Committee

As Companies with Audit and Supervisory Board are required to appoint at least two Outside Auditors, appointing Outside Directors could be redundant for such companies. On the other hand, as mentioned above, Companies with Committees have not become popular due to the reluctance of the management of Japanese companies to give up their authority to
As is the case with auditors of Companies with Audit and Supervisory Board, Audit and Supervisory Committee is expected to have the authority to audit and supervise the execution of operation by the executive directors and prepare audit reports. As part of the supervisory authority, certain designated members of the Audit and Supervisory Committee may express their opinion on the appointment or removal of directors other than the directors who are the members of the Audit and Supervisory Committee and the remuneration of such directors. To put it differently, the Audit and Supervisory Committee is, to a certain extent, expected to substitute the nominating committee and the remuneration committee of Companies with Committees through its involvement in the process of appointment and removal of other directors as well as their remuneration.

Unlike Companies with Audit and Supervisory Board, who are comprised of two folds (i.e., board of directors and board of auditors consisting of different members), the Audit and Supervisory Committee is to be set as part of the board of directors. Companies with Audit and Supervisory Committee can be said to rotate personnel. In light of such situation, the Outline proposes Companies with Audit and Supervisory Committee (kansa kantaku inka seichoaiha) as a new corporate governance structure to further utilise Outside Directors.

The Audit and Supervisory Committee must have at least three members who are directors of the company, half of which must be Outside Directors. In other words, there must be at least two Outside Directors. Appointment of the members of the Audit and Supervisory Committee shall be made by an ordinarily resolution of a shareholders’ meeting and the agenda must be separate from those appointing other directors. Submitting the agenda regarding the appointment of the members of the Audit and Supervisory Committee to the shareholders’ meeting requires prior consent of the Audit and Supervisory Committee. The Audit and Supervisory Committee has the authority to propose agenda appointing directors who are the members of the Audit and Supervisory Committee. The remuneration of the members of the Audit and Supervisory Committee shall be prescribed in the articles of association or approved by the shareholders’ meeting.
have an intermediate form of corporate governance structure compared to Companies with Audit and Supervisory Board and Companies with Committees. While there has been no strong voice against the introduction of Companies with Audit and Supervisory Committee, when management of Japanese companies were asked whether they would be willing to adopt the Audit and Supervisory Committee, most of them said they would like to wait and see what others will do. Thus, the practical effect of the introduction of Companies with Audit and Supervisory Board remains to be seen.

Regulations on Outside Directors and Auditors

Mandatory Appointment of Outside Directors – comply or explain

As mentioned above, whether or not the Companies Act should mandate the appointment of Outside Directors has been the centre of debate in the preparation of the Outline. Such debate has been intensified by some corporate scandals which occurred in 2011 when the Companies Act Subcommittee, a task force established within the Legislative Counsel, was preparing the draft proposal for the amendments.

In the interim proposal regarding amendment to the Companies Act (“Interim Proposal”) which was announced for public comments in December 2011, the Companies Act Subcommittee proposed three alternatives: (i) A large public company with a board of auditors must elect at least one Outside Director; (ii) a company which is required to submit an annual report pursuant to the Financial Instruments and Financial Exchange Act of Japan must elect at least one Outside Director; or (iii) no reform is to be made.

Those who support mandatory appointment of Outside Directors claim that the appointment of Outside Directors is inevitable to regain confidence in the Japanese stock markets from foreign investors. Opponents of mandatory appointment of Outside Directors counter argue that (i) there is no empirical study to show that the appointment of Outside Directors would reinforce the corporate governance, (ii) Companies with Audit and Supervisory Board are already required to appoint Outside Auditors and appointing Outside Directors would therefore be redundant, (iii) the best corporate governance structure for each company differs from one company to another depending on the size and business of the company and hence it should be left to the management of each company to determine the best corporate governance structure taking into consideration factors surrounding that company, and (iv) it would be excessively burdensome to secure competent candidates.

After extensive discussions considering opinions expressed by various interested parties, the Outline ultimately does not mandate the appointment of Outside Directors. Instead, it proposes to adopt a rule similar to the “comply or explain” rule in Europe. That is, large public companies with an audit and supervisory board and which are required to submit annual reports pursuant to the Financial Instruments and Exchange Act must explain in their business report (jigyo houkoku) why the appointment of Outside Director is inappropriate if they do not appoint at least one Outside Director.

Even without the appointment of Outside Directors being mandatory, lots of listed companies have already appointed Outside Directors amid strong voice from investors, especially foreign institutional investors. According to a survey of the Japan Association of Directors, in 2004, only 30.2% of the companies listed on the Tokyo Stock Exchange (“TSE”) 1st section appointed one or more Outside Directors. This number increased to 62.2% as of August 2013. Of those 62.2% companies, however, 31.8% have only one Outside Director and only 2.6% of the companies listed on the TSE 1st section have a board of directors, a majority of which are Outside Directors. With the “comply or explain” rule expected to come into force in the near future, lots of Japanese companies are now considering seriously whether they should appoint Outside Directors and the number of Outside Directors of Japanese companies is expected to continue to increase.

Requirements of Outside Directors

Under the current Companies Act, Outside Director means a director who is not, or was not in the past, an executive director, executive officer, manager or other employee of the company or any of its subsidiaries. The Companies Act disqualifies those people as they are, or were directly under the authority of the management and hence it would not be possible for them to supervise the conduct of the management. In other words, under the Companies Act, so long as he or she is independent from the management, he or she can be qualified as Outside Director even in cases where he or she has interests which conflict with those of other shareholders. For instance, it is not unusual that an executive director, officer or employee of a parent company becomes Outside Director of its subsidiary. Likewise, Outside Directors are often chosen from banks or other transaction parties with which the Company transacts substantial business.

As related persons of a parent company or subsidiaries of the parent company may have a conflict of interest between the company for which he or she...
is serving as Outside Director and the parent company or the subsidiary of the parent company, the Outline proposes to disqualify these persons from Outside Directors. It now proposes that (i) a person who is a director, executive officer, manager or other employee of a parent company of the company or any person who controls the management of the company or (ii) a person who is an executive director, executive officer, manager or other employee of any of the subsidiaries of a parent company of the company or any person who controls the management of the company may not be Outside Director or Outside Auditor of the company. It should be noted, however, that a person who transacts major business with the company is not disqualified from being an Outside Director partly due to the difficulty of defining “major business”.

In addition to affiliates of the parent company and subsidiaries of the parent company, the Outline also disqualifies the spouse and relatives within the second degree of kinship of a director, executive officer, manager or other important employee of the company or a controlling shareholder who is a natural person from being an Outside Director. Similarly, under the Outline, the spouse and relatives within the second degree of kinship of a director, executive officer, manager or other important employee of the company or a controlling shareholder who is a natural person are disqualified from being an Outside Auditor.

While tightening the requirement of Outside Directors and Outside Auditors, the Outline proposes to specify a period for which a certain person is disqualified as Outside Director or Outside Auditor. Under the current Companies Act, once a person engages in the execution of business of the company or its subsidiaries as executive director, executive officer, manager or other employee of the company, he or she will never be able to qualify as Outside Director or Outside Auditor. Under the Outline, after the passing of a 10 years period, even if a person once served as executive director, executive officer, manager or other employee of the company, he or she can still be Outside Director or Outside Auditor of the company.

**Stock Exchange regulations**

Even before the Outline or the Interim Proposals were announced, the TSE already had regulations on independent officers (dokuritsu yakuin). According to the listing regulations of the TSE, to protect the interest of minority shareholders, listed companies are required to appoint at least one independent officer. Independent officer means either an Outside Director or Outside Auditor whose interests are unlikely to conflict with those of other shareholders. Whether or not a candidate is someone whose interests are unlikely to conflict with those of other shareholders shall be determined by listed companies at their own discretion, however, the listing regulations of the TSE set out catalogues of persons who are not generally considered to be independent including executives of a parent company and subsidiaries of the parent company, a person who transacts major business with the company or its executives, consultants, accounting experts, and legal professionals who receive substantial compensation from the company.

In addition, while the Outline adopted the “comply or explain” rule, in the ancillary resolution to the Outline, it is stated that, in addition to the items prescribed in the Outline, it is necessary to stipulate in the regulations of stock exchanges that listed companies shall endeavor to appoint at least one independent officer who is a director of the company. In response to this ancillary resolution, the TSE and other stock exchanges are expected to amend their listing regulations.

**Facilitating better corporate governance**

The effect of the proposed amendments in the Outline remains to be seen. However, as the Outline is expected to come before the Diet in late 2013 and, if all goes as expected, the amendments will come into force in 2014, foreign investors should keep a close eye on the progress of the amendments.

**Notes:**

3. However, the independent officer should not necessarily be Outside Director. In fact, most of the companies have designated the Outside Auditor as the independent officer.