

Japan

Corporate Governance Institutions, Practices and Developments

1. Key Institutional Features of Corporate Governance and Company Profile in Japan

1.1 Background

Companies law

The Companies Law allows a company to adopt a variety of organization structures, including a board structure, in accordance with the size of the company and other factors. However, listed companies can adopt only one of two legal forms: the “Company with Statutory Auditors” model⁸² and the “Company with Committees” model.

“Company with Statutory Auditors” model

In the “Company with Statutory Auditors” model, functional power rests with the board of directors, who execute and manage the business of the company as well as supervising and monitoring themselves and other executives and employees. Where this model is adopted, there are statutory auditors (Kansayaku) who form a separate organ of the company. The Kansayaku supervise the management by directors and owe the same fiduciary duties that directors do. The role of the Kansayaku is to ensure the legal validity of the actions taken by the board of directors. When they believe that the board of the directors has acted illegally, they can take legal action on behalf of the company.

Since related legislation went into effect in 1993, a “large company”, defined as one with at least 500 million yen in paid-in capital or 20 billion yen in debt, is required to have at least three Kansayaku, including one from “outside” the company. For this purpose, “outside” means not a current or former executive or employee of the company or a subsidiary within five years before becoming a Kansayaku.

In 2001, Japan introduced a requirement for at least half of a large company’s Kansayaku to be from “outside” the company. The definition of “outside” was also amended by this legislation. Under this legislation, which came into effect in 2005, “outside” is defined to mean not a current or former executive or employee of the company or an employee or executive officer of a subsidiary. This requirement has been retained in the new Companies Law established in 2005 (implemented in 2006).

⁸² This model includes “the ‘Company with a Board of Statutory Auditors’ model for the purpose of this memorandum”. Most listed companies adopting “Company with Statutory Auditors” model adopt the “Company with a Board of Statutory Auditors” version thereof.

“Company with Committees” model

The second form is called the “Company with Committees”, allowed under the 2002 legislation. Where this form is adopted, the company must establish three committees (compensation, audit and nominating committees), with each committee composed of three or more committee members appointed from among the directors. The majority of each committee’s members are required to be outside directors.

Securities law

The Financial System Council’s (FSC) Study Group on the Internationalization of Japanese Financial and Capital Markets published a report on 17 June 2009. On the basis of this report, a Cabinet Office regulation incorporated the following measures:

- Make registration of Corporate Governance structure, disclosure of executive compensation of 100 million yen or more, etc. on the security registration statement mandatory
- Make the submission of extraordinary reports regarding items discussed at the shareholders’ meeting mandatory

Stock exchange listing requirements, voluntary codes

The report mentioned above included various proposals for stronger corporate governance of listed companies. Also, the Tokyo Stock Exchange (TSE) has an Advisory Group on Improvements to TSE Listing System, which meets when appropriate and discusses corporate governance-related problems. The TSE implemented necessary revisions to its regulations in response to the report and the following discussion at the Advisory Group, such as its Securities Listing Regulations and Related Rules. TSE revised its rules as follows:

- Revised regulations on third-party share issues and combined reverse stock-splits (implemented on 24 August 2009)
- Revised regulations governing the structure of boards, strengthening of the function of statutory auditors and selection of independent directors or statutory auditors, etc. (implemented on 30 December 2009)
- Required disclosure of ballot results at shareholder meetings (implemented on 30 December 2009)

1.2 Trends

TSE listed companies and market capitalization (as of the end of year) are indicated below.

	2005	2006	2007	2008	2009
Number of companies	2,351	2,416	2,414	2,389	2,334
Market capitalization (JPY 100 billion)	540	550	484	283	308

As can be seen from the above statistics, the number of listed companies was largely unchanged over the last five years. TSE Market capitalization fell following the financial and economic crisis in 2008. The stock market has been on an increasing trend with the recovery of the world economy, but it has not returned to its pre-crisis levels.

1.3 Key Corporate Governance Rules and Practices

See Key Corporate Governance Rules and Practices in Japan, p. 118.

2. Development, Enforcement and Assessment of Implementation of Corporate Governance Rules

2.1 Development of Corporate Governance Rules

The Ministry of Justice (MOJ) is in charge of planning legislation regarding the Companies Law and related MOJ administrative regulations.

The Financial Services Agency (FSA), the FSC and Financial Products Exchange contribute to the development of corporate governance rules. First, the FSC's Study Group on the Internationalization of Japanese Financial and Capital Markets has published various proposals to strengthen corporate governance in listed companies. Also, the TSE convenes the Advisory Group on Improvements to the TSE Listing System when appropriate and discusses corporate governance-related problems. It also set up the Code of corporate conduct for listed companies, such as the Securities Listing Regulations and Related Rules, to protect shareholders and investors as well as to promote sound market management. Revising TSE regulations requires permission or notification from the FSA.

Ministry of Economy, Trade and Industry (METI) contributes to the development of Corporate Governance.

The METI Corporate Governance Study Group compiled a report in June 2009 and concluded in the report that, as a minimum, a listed company should have one "independent" director or Kansayaku who is not at risk of having conflicts of interest with ordinary shareholders in order to protect minority shareholders' interests. On the basis of this recommendation, the TSE revised its listing rules in December 2009.

2.2 Enforcement of Corporate Governance Rules

Corporate governance rules may be enforced by the FSA, shareholder lawsuits, or TSE in various ways typical in developed economies. Statistics on these enforcement actions and lawsuits are not available at this time.

2.3 Assessment of Corporate Governance Practices

Japan has not undertaken a formal self-assessment or conducted a Report on the Observance of Standards and Codes (ROSC) regarding the OECD Principles of Corporate Governance.

3. Awareness and Advocacy for Good Corporate Governance

3.1 Company Directors

There may be one or more private associations of company directors. However, the MOJ does not have any relationship with any such organizations.

The TSE does not provide any educational programs for company directors. However, the TSE holds open seminars on corporate governance when appropriate.

3.2 Media

Japan's financial press regularly covers related developments and does not evidence a need for special education to do so responsibly.

3.3 Educational System

The importance of corporate governance is widely acknowledged, and an increasing number of education institutions offer programs on corporate governance.

Also, the Legal Training and Research Institute of Japan, taking charge of training for judges, invites experts and provides lectures and joint studies regarding corporate governance. They cover broad themes, such as companies, employment, finance, and economics. Besides these programs, the Institute has curricula on leadership theory and management theory, where corporate governance is included.

3.4 Stock Exchange

The TSE does not provide any educational programs limited to company directors only. However, the TSE does hold open seminars regarding corporate governance when appropriate.

4. Corporate Governance of State-Owned and Family-Controlled Enterprises

4.1 State-Owned Enterprises

The FSC's Study Group on the Internationalization of Japanese Financial and Capital Markets has made various proposals in a report to strengthen corporate governance in listed companies (June 2009). The report made proposals about the development of market rules as follows:

- Issues concerning capital management
- Structural aspects of corporate governance
- Issues surrounding shareholders' voting rights

4.2 Family-Controlled Enterprises

In Japan, competitive capital markets and product markets ensure that any listed family-controlled corporations will make management decisions subject to the same pressures as other companies.

Family-owned enterprises do not all consider corporate governance requirements a disincentive to becoming listed companies.

5. The Role of Professional Service Providers in Corporate Governance

Under the Companies Law, certified public accountants or accounting firms can be appointed as an accounting auditor of the company. An accounting auditor conducts an accounting audit of the company and provides an accounting audit report to the company. The accounting audit report is provided to the shareholders with their invitation to participate in the annual shareholders' meeting. Also, shareholders and creditors of the company can inspect and request copies of the accounting audit report at the head office of the company where the accounting audit report is kept.

The Financial Instruments and Exchange Act stipulates that financial statements have to be accompanied by an audit contract from a certified public accountant or accounting firm with no specific relations with the company.

Considering the international trend toward the introduction and strengthening of rating agency regulations, it is important that necessary regulation and supervision is secured to ensure ratings by those agencies do not mislead investors. On the other hand, it is also important that rating agencies can perform their necessary function in capital markets.

6. Recent Developments in Corporate Governance

6.1 Corporate Governance Developments

The FSA revised its regulations regarding disclosure, the TSE revised its listing rules, and the association of institutional investors established voluntary rules regarding the following measures:

- Strengthening TSE examinations disclosure regarding third-party share issuances, squeeze-outs, governance of group companies and cross-shareholdings
- The structure of boards of directors (proposal for three models for boards of directors and disclosure of the governance structure and reasons for adopting it), strengthening the function of statutory auditors (Kansayaku) (maintenance of adequate human resources, appointment of highly independent outside directors or Kansayaku, appointment of Kansayaku with an in-depth knowledge of finance and accounting, disclosure of companies' actions), selection of one or more independent directors or Kansayaku, enhancement of the disclosure of Kansayaku compensation
- Strengthening disclosure of the results of shareholder votes by institutional investors and the disclosure by listed companies of ballot results at shareholder meetings

Also, Cabinet Office regulations provide for the following measures:

- Require disclosure of Corporate Governance structure and executive compensation exceeding 100 million yen per annum, etc., on security registration statements
- Require submission of extraordinary reports regarding items discussed at shareholders meetings

6.2 Enforcement of Corporate Governance Rules

One significant recent case of enforcement of corporate governance rules is a shareholders derivative lawsuit: Shareholders vs. directors and statutory auditors (Kansayaku) of Daiwa Bank Co., Ltd (Judgment, Osaka District Court, 20 September 2002). The matters at issue are:

- Whether directors and statutory auditors (Kansayaku) in question were liable for damages and losses invoked by the breach of duty to build up internal control system of the company?
- Whether directors in question were liable for damages and losses invoked by the breach of duty of compliance, including duty to have foreign branches to comply with foreign law?

The court held that, considering the facts in this case, certain directors of the particular business in question were liable for the damages and losses invoked by the breach of duty to build up proper internal control system and duty of compliance, while it held that the other directors and statutory auditors were not liable. The amounts of damages and losses held by the court that each director was liable for varied from US\$70 million to US\$775 million depending on the role and position of each director.

There are several cases which affirmed directors' liability for damages and losses invoked by the breach of duty of due care of prudent managers.

The derivative lawsuit of Duskin Co., Ltd (Judgment, Osaka High Court, 9 June 2006) is the case which affirmed the liability of statutory auditors (Kansayaku). In this case, the court ordered the statutory auditor (Kansayaku) to pay 211 million yen to Duskin Co., Ltd

6.3 Current Issues and Challenges for Corporate Governance

6.3.1 Challenges

Japanese companies have, on the whole, excellent corporate governance and do not face any of the challenges listed above to an extent more significant than other economies. Japan's past reforms have made their shareholders very active in corporate governance, applied competitive pressures to motivate boards to work harder, promoted domestic and international competition among companies, and enacted a legal principle of equality among all shareholders.

6.3.2 Priorities for Reform

Japan's system for corporate governance is of very high quality; however, we remain open to any future reform efforts backed up by solid research showing their potential for positive impact.

6.3.3 Financial Crisis

Japan's companies were comparatively better managed in terms of exposure to the junk bonds at the root of the crisis than the rest of the developed world during the years preceding the financial crisis, so except for secondary effects resulting from the drop in demand from other economies, they were able to emerge comparatively unscathed. In that context, reform measures would not be appropriate in Japan.

Key Corporate Governance Rules and Practices in Japan

Element	Yes	No	Source(s) of Rule	Comments
RIGHTS OF SHAREHOLDERS				
1. Do shareholders add items to the agenda for shareholders' meetings?	X		CL	Shareholders have the right to add items to the agenda for shareholders' meetings under the Companies Law.
2. Do shareholders ask questions of directors at shareholders' meetings and do they receive answers?	X		CL	The directors of the company, in principle, have a duty to explain in response to shareholders questions asked at shareholders' meetings.
3. Must company transactions with its insiders be on a non-preferential basis?	X		CL	Although there are no regulations that state specifically that the transaction between a company and its insiders to be made on a non-preferential basis, the following provisions under the Companies Law have equivalent legal effect: If a director of a company wants to make a conflict-of-interest transaction with the company, they are required to get approval from the board of directors. Any director who engages in such transactions and all directors who vote to approve such transactions shall be, in principle, liable for any damages resulting from such transactions. In addition, transactions made between a company and its insiders on a preferential basis shall be disclosed in the financial statements of the company.
4. Is a super majority vote	X		CL	A super majority is required at shareholders' meetings

Element	Yes	No	Source(s) of Rule	Comments
required for major company acts affecting shareholder rights?				approving major company acts affecting shareholders' rights such as merger under the Companies Law.
Composition and Role of Boards of Directors and company auditors (Kansayaku) ⁸³				
5. Must boards have independent directors? What percentage?	X		CL	<p>If a listed company adopts the model of the Company with Committees, each committee shall draw at least a majority of its members from "outside" directors.</p> <p>On the other hand, "outside" directors are not required for the board of directors of a Company with Statutory Auditors. However, in the large companies which adopt the model of the Company with Statutory Auditors, half or more "outside" Kansayaku are required within their Kansayaku. As Kansayaku have right to attend board meetings and address the board when necessary under the Companies Law, it can also be said that the outside "board" members are required at the Companies with Statutory Auditors.</p>
6. Do independent directors have significant influence over (a) internal and external audit and (b) executive compensation?	X		CL	<p>(i) Internal audits are conducted by the management of the company. Actions taken by the management are subject to audit by the Kansayaku (in the Company with Statutory Auditor) or audit committee (in the Company with Committees). As mentioned above, both Kansayaku and audit committees have "outside" Kansayaku or "outside" directors among their members. Through this, independent directors or Kansayaku have significant influence over internal audits.</p> <p>(ii) External audits are made solely by the accounting auditor of the company. Kansayaku and the audit committee shall review the audit methods taken by the accounting auditor.</p> <p>(iii) In a Company with Statutory Auditor, a resolution at a shareholders' meeting is required to determine the amount of executive compensation, and this resolution is legally binding. Kansayaku must review the agenda of the shareholders' meeting. In this way, Kansayaku (including "outside" Kansayaku) oversee executive compensation.</p> <p>In the Company with Committees, executive compensation is determined by the compensation committee. Therefore, outside directors within the committee oversee executive compensation.</p>
7. Do independent directors decide what information the board receives from management?	X			Directors and statutory auditors have the right to conduct investigations and request injunctions of illegal acts, as touched upon above.
8. Are the chairman of the board and chief executive officer different persons in the majority of listed companies?	X			Given the variety of organizational structures available to Japanese corporations, the narrow terminology of this question renders it impossible to answer with certainty. However, as all of these corporate forms provide for a large number of individuals with significant authority over actions in listed companies, this is more true than not.
9. Are all board members elected annually?		X	CL	Directors' terms in public companies continues until the end of the annual shareholders' meeting for the last business year which ends within two years from their election in principle. The term can be shortened by the articles of incorporation but cannot be extended in public companies.
10. Does the board oversee enforcement of a	X			Japanese companies may have various codes of conduct/guiding principles, and depending on the particular

⁸³ We add "and company auditors (Kansayaku)" to better reflect the situation in Japan.

Element	Yes	No	Source(s) of Rule	Comments
company code of conduct?				corporate governance structure adopted, the board or some other governance organ may oversee enforcement of company rules, etc., to the extent this enforcement falls outside the responsibility of management.
Transparency and Disclosure of Information				
11. Do financial statements comply with International Financial Reporting Standards (IFRS)?	X		FIEA	In the “Opinion on the Application of International Financial Reporting Standards (IFRS) in Japan” (Interim Report), IFRS was optional in financial statements since year ending in March 2010, and compliance is projected to be mandatory around 2012.
12. Are the identities of the five largest shareholders disclosed?	X		CL FIEA	Under the Companies Law and Ministry of Justice regulations, public companies are required to disclose their 10 largest shareholders in their annual report.
13. Is compensation of company executive officers disclosed?	X		CL FIEA	Under the Companies Law and MOJ regulations, public companies are required to disclose (1) the total amount of remuneration for all directors and the number of directors, (2) the total amount of remuneration for all officers and the number of officers, and (3) the policy on compensation decisions if the applicable committee has already decided it. In addition, the company must disclose these items on outside directors independently.
14. Are extraordinary corporate events disclosed?	X		CL FIEA	Under the Companies Law and MOJ regulations, public companies are required to disclose important corporate actions taken in the applicable fiscal year in their annual report, such as with regard to (i) financing, (ii) capital investment, and (iii) M&A.
15. Are risk factors disclosed in securities offering materials?	X		FIEA	Risk factors are disclosed in securities offering materials.
16. Are transactions of a company with its insiders disclosed?	X		CL FIEA	As mentioned above, transactions with insiders are required to be voted on, subject all parties and directors who voted in favor to liability, and are disclosed.

Note: CL – company law; SL – securities law; CGC – corporate governance code; SLR – stock exchange listing requirement, GP – general practice but not obligatory