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January 31, 2012

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Dear Sir,

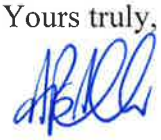
Interim Proposal concerning Revision of Companies Act

ACGA is pleased to have the opportunity to comment on the Interim Proposal concerning Revision of Companies Act published by the Ministry of Justice in December 2011.

Our response to your call for public comments is attached. We hope that the points and recommendations in our submission provide constructive input to the Ministry as it completes the review of the Companies Act.

Thank you again for the opportunity to comment on this important undertaking. If you have any questions regarding our comments and recommendations, please do not hesitate to contact me.

Yours truly,



Jamie Allen
Secretary General

ACGA Submission to the "Interim Proposal concerning Revision of Companies Act"

January 31, 2012

The Asian Corporate Governance Association (ACGA) is pleased to have the opportunity to respond to the "Interim Proposal concerning Revision of Companies Act", published by the Ministry of Justice in December 2011. ACGA is an independent, non-profit organisation that works with investors, companies and regulators to improve corporate governance across 11 markets in Asia. (For more background on ACGA, please see the end of this document.)

We would like first to commend the Ministry for its detailed consideration of ways to improve the legal framework for corporate governance (CG) in Japan. We believe that in recent years Japanese regulators have taken some important steps towards CG reform. We are broadly in agreement with the direction the Ministry is taking in the Interim Proposal—in particular its proposals to strengthen the independence of Outside Directors and obligate public and listed companies to appoint such Outside Directors. We believe, however, that these proposals still fall short of acceptable international norms of good governance; and we have serious doubts about the strategic value of proposing a third system of board governance in Japan, rather than addressing flaws in the existing two systems.

Due to time constraints, our submission is limited to these and other selected topics in the Interim Proposal. We would be pleased to discuss any of these issues further with the Ministry.

On the Independence of Outside Directors:

Although the consultation paper does not start with this topic, we have placed it first in our submission because we believe that the definitions of Outside Director and Outside Company Auditor must be robust; otherwise, several other key proposals will not have their full, intended effect.

Note: We follow below the wording of the section headings found in the Ministry's consultation paper. For the sake of brevity, we do not repeat the full wording of each proposal outlined in the consultation paper.

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Part 1 Corporate Governance
- I Supervisory Function of Board of Directors
- 3. Rules Concerning Outside Directors and Outside Company Auditors
- (1) Treatment of Related Persons, etc., of a Parent Company in the Requirements for Outside Directors, etc.

ACGA Response
We support Proposal A, which proposes to amend the Companies Act to ensure the independence of Outside Directors for the first time, but believe it should go further. While the proposal sensibly states that the definition of Outside Director should be extended to exclude anyone who is a director, officer or employee of a Parent Company and/or a relative of a director, officer or employee of the Company, it does not yet cover Affiliated Companies or key business partners. We believe it should.

Similar amendments are proposed in the paper for the definition of Outside Company Auditor—and we take the same view that they should go further.

As we noted in our "White Paper on Corporate Governance in Japan (2008)" and "Statement on Corporate Governance Reform in Japan (2009)", external directors and statutory auditors should be free of conflicts of interest, which might arise when they have relationships that are too close to the company. We believe such relationships include ties with all Affiliated Companies of the stock company as a director or executive officer, manager or other employee. We are therefore in agreement with Notes 1 & 2 to this Proposal to consider extending a similar requirement to other categories, such as related persons of a Subsidiary of the Parent Company and of an important business counterparty.

We would like to also take this opportunity to rebut the argument made by some organisations in Japan that the Outside Director system is unnecessary because, for example, it allegedly failed to prevent the accounting scandal engulfing Olympus Corp. In our view, the fraud at Olympus—and other recent cases such as Daio Paper—shows precisely why it is important to tighten the definition of Outside Directors and to appoint Outside Directors who are genuinely independent from management. If genuinely independent Outside Directors had made timely efforts to press inside directors and management of Olympus about its questionable acquisitions and extraordinary payments to deal advisers, the company may have avoided the trouble it is in now. As we wrote in our "Japan White Paper", the presence of genuinely independent directors is to provide "an important safeguard against the potential for managerial self-interest and weak execution of company strategy". To argue against mandatory independent Outside Directors is, in essence, to claim that management only needs to be accountable to itself. Such a philosophy can never produce a credible system of corporate governance.

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- (2) Limitation of the Applicable Period during which Requirements for Outside Directors, etc. Must Have Been Met

ACGA Response

The consultation paper proposes a 10-year "cooling-off period" before an executive director, executive officer, manager or other employee of a stock company (or one of its subsidiaries) can join the same company's board as an Outside Director or Outside Company Auditor. We fully agree that the current requirement that Outside Directors/Auditors must not have had any prior relationship with the stock company can lead to extreme and unproductive results, such as prohibiting a person who held a relatively minor position in the company at the start of his/her career from acting as an Outside Director decades later. On the other hand, setting artificial time limits can also have perverse results: would an executive who worked for a company for his/her entire life, or for a considerable period of time, lose their unquestioning loyalty to the company after 10 years? Probably not, especially in the close-knit community of a typical Japanese business corporation.

We believe that the way to strike the balance is to require that Outside Directors and Outside Company Auditors not have any "material" relationship with the company and its current management.[1] The focus is then more on the substance of the relationship rather than the form (ie, artificial time limits). Hence, a company that wanted to appoint an Outside Director who once held a relatively junior position at the firm could simply explain that the person had no material links to the company or current management; whereas it would be more difficult, for example, to make the same claim about a person who 10 years previously was a senior executive. Nevertheless, the ultimate arbiter should be the shareholder vote in the annual general meeting.

We do, however, support the Note item on the proposed changes to prevent a situation where a person who, after leaving the position of executive director of a stock company, assumes the position of Company Auditor of that stock company, and after 10 years or more, fulfils the requirements for Outside Director or Outside Company Auditor of the same company. Given the person's continuous involvement with the company, first as a senior executive and then as an inside statutory auditor (with clearly close links to current management), it would be stretching credibility to allow them to be "redesignated" as an Outside Director or Outside Company Auditor.

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[1] See page 9 of the "ACGA Statement on Corporate Governance Reform in Japan (2009)" for our more detailed definition of "independent outside director".

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On the Minimum Number of Outside Directors:

Part 1 Corporate Governance
- I Supervisory Function of Board of Directors
- 1. Obligation to Appoint Outside Directors

ACGA Response
We support Proposal B, which states that companies that are required to submit annual securities reports pursuant to the provisions of Article 24(1) of the Financial Instruments and Exchange Act are obligated to appoint one or more Outside Directors. We favour Proposal B to Proposal A for the reason that Proposal B will cover mostly listed companies, whereas Proposal A extends to several thousand unlisted firms as well. (For the sake of clarity, we are not suggesting that the governance of unlisted firms is unimportant. Rather that listed firms should be given priority at this stage.)

As with our comment regarding the definition of Outside Director, we believe that this Proposal needs to go much further. We question whether a single Outside Director would make any difference on a Japanese board, which can comprise half a dozen to more than a dozen directors. With larger boards, it is debatable how much influence even two Outside Directors could have over board decisions. As we noted in our "Japan White Paper" and "Japan Statement", having just one Outside Director would also be seen as tokenistic by many observers.

We believe at least three genuinely independent Outside Directors are needed to lay the foundations for board independence, to ensure that each individual Outside Director is not over-worked and that board discussions carry a sensible and workable balance between the views of all directors. In many other developed countries, three independent Outside Directors is the minimum regulatory requirement for listed companies, while larger companies often have more than three in practice.

We would also like to reiterate that the effectiveness of Outside Directors to exert real influence on the affairs of the company, as opposed to rubber-stamping management decisions, depends on appointing people who are appropriately qualified and genuinely independent. Therefore, it is crucial that the revised Companies Act incorporate a wider and more robust definition of Outside Director, as outlined above.

In addition, we strongly recommend that all board members—outside and inside directors—undergo training to ensure they understand their fiduciary duties and legal liabilities under law, the listing rules of the Tokyo Stock Exchange (TSE) and current best practices in corporate governance. Governance is an evolving, not static, process. We further recommend that the TSE amend its rules to require detailed disclosure in the

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Corporate Governance Reports of listed companies of the nature and extent of their director training policies and record. Most major financial centres around the world, and even many emerging markets, have developed soft-law guidelines on director training. Japan is an exception in not doing so yet.

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On the Proposed Third System of Board Governance:

Part 1 Corporate Governance
- I Supervisory Function of Board of Directors
- 2. Companies with Audit and Supervisory Committee
- (1) Establishment of an Audit and Supervisory Committee

ACGA Response
We wholeheartedly agree with the importance of improving the supervisory role of the board of directors over management. We believe, however, that the current proposal for an "Audit and Supervisory Committee" falls well short of this goal and will not meaningfully improve the governance practices of most Japanese listed companies.

One of our primary concerns is that adding a third system of board governance in Japan on top of the existing two ("Company with Board of Auditors" and "Company with Committees") is a strategic mistake from a regulatory point of view and will likely cause confusion among investors. It would be fair to say that most global investors do not fully understand the precise role of the *Kansayaku* system (Board of Auditors), since the same system does not exist in any other developed or emerging market. Even the role and composition of committees in the Company with Committees system is not fully understood. "Audit Committees" under the latter may sound the same as audit committees in other developed markets, but they are not (ie, their terms of reference are more limited in Japan and their composition is less independent). A third voluntary system would surely only add to the complexity. Why not seek to clarify and strengthen the existing two systems instead?

Furthermore, the design of the Audit and Supervisory Committee system is flawed in certain respects. We strongly disagree, for example, with the proposal (I.2.(1).iii) that "a Company with Audit and Supervisory Committee shall not have Company Auditors, a Nominating Committee, an Audit Committee, or a Compensation Committee". It makes no sense to limit companies to just one board committee. This is an excessively rigid stipulation that would prevent companies and their boards from evolving over time in line with their changing business situations and needs. Since different board committees fulfil different functions, any company should have the flexibility to create new committees when they need them.

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This proposal will almost certainly undermine investor confidence in the direction of Japan's corporate governance reform.

On the issue of design, we also have questions about the Committee's proposed composition: it must have at least three members, each of them must be a Director, and a majority must be Outside Directors (I.2.(2).i & ii) Yet, at the same time, Committee members "may not concurrently hold positions as executive directors, managers or other employees of the Company" (I.2.(2). iii). Since a minority of the Committee do not have to be Outside Directors, this proposal implies that at least one of its members could be someone who is closely connected to the company (eg, someone from an affiliated company or who until recently held a position as an Inside Director or a manager). This seems a counterproductive recommendation, given that the purported purpose of the Committee is to enhance supervision of Inside Directors and management. (Note: A similar and even looser rule applies for the composition of committees under the Company with Committees system, in which case just less than one-half of each committee can be populated with Inside Directors. This aspect is a major weakness in that governance model.)

A final area of concern with the Ministry's interim proposals is that they do not contain any mandatory requirement for improvement in the *structure* of the Board of Directors at companies which chose to retain their Statutory Auditor Boards or Three Committee System. In other words, listed companies could simply opt to keep their current governance structures as they are, with only a minor change in board *composition* through the addition of one mandatory Outside Director (assuming that proposal goes ahead). Such incremental steps fall well short of the robust reform that we believe Japan needs to instigate to turn around the loss of confidence in its corporate governance system.

We believe that a more productive approach would be to address weaknesses in the existing two systems. One starting point would be to create a legal basis for companies with a Board of Auditors *(Kansayaku)* to establish formal committees under their Board of Directors. Although many such companies already have board committees, these entities lack a proper legal basis and cannot be held responsible for their actions.

Once the above amendment is in place, the legal system should make it mandatory for all listed companies to establish—at a minimum— an Audit Committee with formal and regular oversight over financial reporting, internal controls/risk management, internal audit and external audit (ie, terms of reference that go beyond the existing role of the audit committee in a Company with Committees). In terms of composition, the Audit Committee would be chaired by and composed entirely of independent Outside Directors (at least three), although other directors could be invited to meet with the committee if necessary. Meanwhile, it is envisaged that the finance/risk-oversight role of such Audit Committees would complement the legal-oversight role of the Board of Auditors. At a later date,

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companies could have the option of disbanding their Board of Auditors if they found that it was effectively duplicating the work of the Audit Committee.

At the same time, the system should allow the overly rigid Company with Committees system to become more flexible. For example, firms would have to start by creating an Audit Committee, but could sequence the formation of the other two committees (Nomination and Compensation) to suit their needs and/or shareholder demands. They could even be permitted to set up a different mix of committees if they judged this to be more useful for their business (eg, risk management instead of remuneration); however an audit committee would remain mandatory. Meanwhile, the role of the Audit Committee in the Company with Committees system would also need to be reviewed and strengthened.

All of these reforms assume, as discussed earlier, that the definition of Outside Director is amended and the law or listing rules mandate at least three independent Outside Directors for listed companies.

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On Third-Party Allotments (Private Placements) in Conjunction with a Change of Control:

Part 1 Corporate Governance
- III Corporate Governance in Financing Activities
- 1. Issue etc. of Shares for Subscription through a Private Placement in conjunction with a Change in the Controlling Shareholder
- (1) Necessity of Resolution of a Shareholders Meeting

ACGA Response
We broadly support Proposal A, which would require an ordinary resolution of a shareholders' meeting when a Public Company undertakes a large private placement to a subscriber who in turn becomes a new controlling shareholder. One qualifier we would add is that any related parties and parent companies with an interest in the transaction should be barred from voting. We also sympathise with the Tokyo Stock Exchange's view that the threshold in law for a change of control should be lowered from a "majority of voting rights" to one-third of voting rights, since changes of control in listed companies often occur at levels well below 50%. (Whether one-third of shares is the right level, however, is something that the Ministry should study further. Changes of control in listed companies can occur at much lower levels, such as 20% or less.)

In such change-of-control situations, we also do not agree that companies should be able to amend their Articles of Incorporation to allow the board of directors to override the need for a shareholder meeting in 'urgent cases' (eg, where financing is urgently needed). Although the Proposal also provides that shareholders with 3% of the voting rights could

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object to such a board decision and insist on a shareholder vote going ahead, we believe that as a matter of principle shareholders should always be given the right to vote on a major transaction that results in a change of control. It is hard to believe that any listed or Public Company would not have time to organise a shareholder meeting in a situation where such significant transactions were at stake.

For smaller private placements, however, a more flexible mechanism can be imagined. In other developed markets listed companies may seek annual renewal of shareholder approval allowing directors to place new shares at any time within the following 12 months and within certain limits. In this way the board can react quickly to raise capital in order to seize new investment opportunities. The global best practices for shareholder resolutions on such "general mandates" are:

- A limit on the amount of new Shares that can be issued (as a percentage of existing share capital) to 5-10% or less in any 12-month period; and
- A 5-10% limit on the discount at which the new Shares can be issued.

End.

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Asian Corporate Governance Association

The Asian Corporate Governance Association (ACGA) is a Hong Kong-based independent membership organisation dedicated to promoting corporate governance in Asia. ACGA covers 11 markets in the region and facilitates improvements through research, advocacy and educational programmes. It is Asia's leading expert organisation on corporate governance.

ACGA's membership comprises major global pension funds and asset managers that manage US$10 trillion in assets, as well as highly regarded Asian listed companies, intermediaries and tertiary institutes.

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