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Introduction
Since April 2009, a number of business and government agencies in Japan have published papers and statements outlining their vision for the next stage of corporate governance reform in Japan. These included:

- **Nippon Keidanren:** "Towards Better Corporate Governance (Interim Discussion Paper on Key Issues)", April 14, 2009.
- **Advisory Group on Improvements to TSE Listing System**: "For Creating Better Market Environment Where Investors Feel Secure", April 23, 2009.
- **Corporate Governance Study Group, Ministry of Economy, Trade and Industry**: "The Corporate Governance Study Group Report", June 17, 2009
- **Financial System Council's Study Group on the Internationalization of Japanese Financial and Capital Markets:** "Toward Stronger Corporate Governance of Publicly Listed Companies", June 17, 2009

ACGA welcomes these papers and believes they represent a sincere effort to enhance the governance of listed companies in Japan and the quality of market regulation. We also note that the papers respond to many of the issues raised in our own "White Paper on Corporate Governance in Japan", published in May 2008, and to concerns raised by institutional investors in recent years.

ACGA would like to take this opportunity to comment on key points raised in the four documents above and to provide constructive suggestions on specific reforms. In the spirit of open dialogue, we would also like to clarify our position on certain corporate governance principles and recommendations in our earlier White Paper.

This statement is divided into five themes of particular concern to ACGA members:

- The role of independent directors vis-à-vis "statutory auditors" (*Kansayaku*)
- Shareholder meetings and proxy voting
- Private placements and other capital-raising issues
- Cross-shareholdings and other equity investments
- Company-investor dialogue

Under each theme, we first summarise our understanding of the respective positions in the four documents (to the extent that they address each issue), and then provide our combined response and recommendations.

We would like to emphasise that there are, as discussed in our White Paper, other aspects of corporate governance in Japan that are of interest and concern to ACGA and its members (eg, capital inefficiency and poison pills). We are limiting our discussion in this paper to just the five issue above for reasons of space, but look forward to engaging in continued dialogue with Japanese companies and regulators on these other topics as well.

Executive Summary

Our key points and recommendations are as follows:

1. We believe that the definition of "outside director" in Japan's Companies Act is weak and often confusing to foreign investors and others. Amending it is becoming increasingly necessary. This would also help to avoid confusion with new definitions of "independent director" that stock exchanges will be required to add to their listing rules, and would put the concept of the independent director on a firmer legal foundation. *(See page 8 for further discussion)*

2. Any definition of "independent director" in either the company law or stock exchange list rules should be largely principles-based and avoid artificial quantitative criteria. *(See box on page 9 for ACGA's definition of independent director)*

3. We recommend that listed companies introduce an independent element on their boards of directors and that they allow their boards to play more of a strategic oversight role (rather than only a managerial, operational role). In this regard, the quality of the individuals chosen as independent directors—their character, expertise, business experience and broader understanding of the interests of all stakeholders, including shareholders—is critical. For practical and organisational reasons, however, companies with medium to large boards (of 10 or more people) will generally need at least three independent directors if they are to gain tangible value from their participation. Companies with smaller boards (less than 10 people) may find that two independent directors are sufficient. However, the final number depends on many factors, including the complexity of the company's business, how many board committees they have, and so on. Companies should do their best to lend all necessary support to their independent directors so that they can play an effective role. *(See page 10)*

   Note: Our recommendations in this paper on independent directors complement those in our Japan White Paper of 2008. The numerical targets above should be read as a minimum standard, not the maximum level that institutional shareholders will find acceptable.

4. The publication of full and detailed voting results of shareholder meetings is increasingly becoming the norm in major capital markets. It also enhances corporate transparency and a listed firm's reputation for good governance. We commend companies in Japan that have started publishing the results of proxy votes received before shareholder meetings; however, we recommend that listed companies move towards full voting by poll as soon as possible. *(See pages 13-14)*

5. We support the FSA Study Group suggestion that Japan consider introducing legislation similar to the ERISA, which stipulates that private pension funds in the US have a fiduciary duty to exercise their voting rights. We agree that institutional investors and fund managers should be required to publish their internal voting guidelines and disclose how they have voted. We also believe, however, that the voting of shares should be carried out in an informed manner; it should not be "automatic" or an exercise in compliance. *(See pages 13-14)*

6. We recommend that companies be required to seek annual shareholder approval for third-party allotments (also known as "private placements"). That the threshold for the maximum amount of such shares that can be issued in a year be tightened to no more than 10% of total issued capital. And that they be required to provide an explanation to shareholders if they want to exceed these thresholds. *(See page 18)*

7. Moving Strike Convertible Bonds (MSCBs), also known as "toxic convertibles", can severely undermine the value of shares held by existing shareholders. They should be made subject to shareholder approval. Stricter rules should be introduced on voting thresholds for squeeze outs of minority shareholders. *(See page 19)*

8. Cross-shareholdings and other equity investments among Japanese listed companies are one of the country's most serious corporate governance issues. ACGA backs greater disclosure of cross-shareholdings and equity investments, and would welcome any measures to reduce them, with the ultimate aim of supporting higher corporate returns. Ideally, there should be a regulatory change requiring the disclosure of cross-shareholdings and major equity investments. At a minimum, and over the short term, we would strongly encourage listed companies to make full disclosure of cross-shareholdings, or at least their largest equity holdings in outside companies, in their annual reports. This should be accompanied by details on the strategic objectives of each position and, where appropriate, actual investment returns. (*See pages 20-21)*

9. Despite considerable effort and investment in investor relations in Japan in recent years—especially with regard to gathering votes for annual shareholder meetings—there remains much room for improvement in the quality of dialogue between companies and shareholders. We recommend that senior managers make themselves more available to meet with investors, especially long-term investors, to conduct open and constructive dialogue to better understand each other's perspectives. *(See page 22)*

10. We would strongly urge that Japan adopt a national code of corporate governance, which sets down best-practice principles that Japanese listed companies could follow. To draft it, we recommend that Japanese authorities appoint a committee of practitioners from the investment, business, accounting, legal and regulatory communities. Such a code would not constitute a mandatory regulation, but would contain aspirational goals that augment existing laws and regulations.
(*See page 23)*

1. The role of independent directors vis-à-vis "statutory auditors" (*Kansayaku*)

The definition of "outside director" in Japan's Companies Act is weak and confusing to foreign investors and others. The discussion on "independent" and "outside" directors in the four Japanese papers is also confusing.

Japan is the only major market in Asia that does not mandate some degree of board independence for listed companies. This is partly because the country has its own system of "statutory auditors"* (*Kansayaku*), but more so because boards at most Japanese companies function more like the top decision-making committee of management than as a strategic and supervisory body overseeing management (as in most other developed markets). It therefore becomes difficult to conceive how an "independent director" could contribute to a committee that meets, for example, every week or fortnight and discusses operational details. Against this backdrop, there is much debate within Japan about the merits of appointing more independent directors versus those of strengthening the role of *Kansayaku*.

The Keidanren position

The Nippon Keidanren—the federation of Japanese businesses which counts many large industrial firms, including Toyota, Canon and Nippon Steel, as members—takes a generally conservative stance on corporate governance reform. Its April 2009 paper argues that each company should have the right to choose its own governance system, and that foreign investors in particular do not fully appreciate the efforts that have been made to improve corporate governance in Japan in recent years.

The Keidanren opposes any mandatory requirement for independent directors or stricter rules on who can be considered an "independent" or even "outside" director. The group instead argues that it is up to shareholders to exercise that judgment when they vote on elections of directors. It maintains that Japan already has "a very high level of disclosure" on the attributes of outside directors.

The federation, however, does not completely oppose the concept of outside directors: it acknowledges that 44.1% of companies listed on the Tokyo Stock Exchange with *Kansayaku* have voluntarily appointed outside directors and are benefiting from their advice. Nevertheless, the paper says the most important consideration for the board of directors is not whether it has outside or independent directors, and how many of them it has, but each member's qualifications to oversee the business.

Meanwhile, the federation continues to affirm the value of the *Kansayaku* system, which requires at least half of the statutory auditors to be outside auditors. The paper claims that the *Kansayaku* are more independent from management than outside directors, because the statutory auditor board does not engage in business execution, unlike the board of directors. It notes that *Kansayaku* have unique power to demand cessation of business operations that violate the duty of care that directors owe, and that their lengthy term of office (four years) further enhances their independence.

In the Keidanren's opinion, if Japanese companies want to strengthen business supervision, the most preferable way to do so would be to promote closer cooperation between the board of directors and their existing *Kansayaku*.

*"Statutory auditors" in Japan should not be confused with accounting auditors.

METI Study Group position
The METI paper discusses in some detail whether Japan's Companies Act should be amended to include an "independence" requirement for outside directors and outside *Kansayaku*. In the end, however, it does not endorse any revision to the law, and instead looks to stock exchanges to establish such requirements in their listings rules.

"Independence", according to the METI Group, means "having an independent position from management, and sharing no mutual interests with management". This definition is somewhat confusing as it could be read to leave out independence from the controlling shareholder as well as management. Indeed, the subsequent discussion in the paper goes to some lengths to argue that persons from parent companies and business counterparties should not be automatically ruled out as potential directors because of this new emphasis on "independence".

Referring to an OECD report from February 2009—"The Corporate Governance Lessons from the Financial Crisis"—the METI paper notes that "a trade-off can be found" between the "two desirable values" of "ensuring 'effectiveness' of corporate governance and securing 'independence' [of directors]". In other words, the METI Group argues that board independence on its own does not produce good corporate governance.

To be sure, the METI Group concludes that listed companies, at a minimum, should have one independent director or one independent *Kansayaku* (according to METI's own definition of "independence" above) to protect minority shareholders. But at the same time, it questions if it is really in the best interests of companies to eliminate people from the board who are executives/employees of parent companies or business counterparties—since they are potential directors with superior knowledge about the company and who have a substantial stake in enhancing corporate value.

The paper concludes that the most appropriate overall governance structure should be left to individual companies to determine in consultation with shareholders. This means that, although companies with *Kansayaku* should ideally introduce outside or independent directors, it should be on a voluntary basis. The only requirement the group proposes is that, if any listed company chooses not to introduce an outside director at a minimum, it "disclose facts concerning the corporate governance system using the company's own original method".

FSA Study Group position
The FSA Group puts forward a blend of the *Kansayaku* system and "highly independent outside directors" as its recommended governance structure for Japanese listed companies. With only 2.3% of companies listed on the Tokyo Stock Exchange as of August 2008 having adopted the "company with committees" system—that is, an alternative to the *Kansayaku* system with a board that exercises "a high level of supervisory function"—the paper notes that the so-called US-style approach to the board of directors is unlikely to spread fast in Japan.

At the same time, it says Japanese companies with *Kansayaku* which have also appointed independent outside directors have shown that such a "hybrid" system can compensate for deficiencies of statutory auditors and lead to stronger supervision of management. The FSA group urges stock exchanges to adopt a model of corporate governance in line with this approach, enabling one or more independent outside directors to cooperate closely with *Kansayaku*. It believes the majority of listed Japanese

companies should be open to this system as a realistic, workable compromise. Concurrently, the paper also advises stock exchanges to beef up the *Kansayaku* system by stipulating new rules on appointing "independent outside auditors" and "auditors with an in-depth knowledge of finance/accounting".

In terms of who should be considered an independent outside director or outside *Kansayaku*, the FSA Group recognises that persons from the company's major corporate shareholder or business affiliate would "hardly" qualify as being independent. Yet it does not believe that automatically excluding them will necessarily help a supervisory body's effectiveness and specialisation. To balance these concerns, the paper calls on stock exchanges to require companies to disclose more specific details on the relationships that outside directors and outside *Kansayaku* have with management.

ACGA Response

We continue to believe that listed companies and capital markets in Japan would benefit greatly from a system of genuine independent directors, as opposed to mere outside directors or outside statutory auditors. Investor confidence would rise, company boards would play a more effective oversight role, and management accountability would improve. The global financial crisis has reaffirmed, in our view, the need for robust governance structures in companies.

We agree that outside *Kansayaku* can play a useful role in Japan, especially if they are truly independent. We also know that their contribution to corporate governance has expanded in recent years following reforms starting in 2001. But this does not alter the fact that their role is different from independent directors, and that their powers are circumscribed: *Kansayaku* do not have the right to vote in the board and their main task is to ensure that the company and board comply with laws and regulations. We agree with the FSA Group that independent directors can complement the work of *Kansayaku* in a "hybrid" board structure by providing management with a truly independent perspective on corporate strategy and governance. We see this trend among Japanese listed companies as a positive development and believe, over time, it will help to improve the country's corporate competitiveness.

To clarify our view: we see the role of independent directors and outside (or independent) *Kansayaku* as complementary, but different. A director is a full member of the board and has commensurate powers and responsibilities, including the right to vote. An auditor is not a member of the board, nor should he/she be. An auditor is there to audit the board, not to provide strategic business advice and guidance.

(See over for an outline of some of the ways in which independent directors can contribute value to company boards.)

The Value of Independent Directors
Independent directors can:

- Enhance investor confidence in companies (which should positively affect their liquidity and cost of capital over time).
- Improve management accountability.
- Help strengthen board decision-making by bringing a wider perspective to board deliberations.
- Ensure the board considers the interests of all stakeholders, including shareholders.
- Expand the range of relevant expertise on the board.
- Assist global strategy development and risk management, and bring independent judgment to strategic decision-making.
- Help ensure that the governance systems of companies are continuously improving—global governance standards are evolving, not static.

Specific issues raised in the three papers that we would like to respond to include:

- *'Each company should have the right to choose its own governance system. There should be no mandatory requirement for independent directors.' (Keidanren, METI)*

We believe that listed companies should be required to follow certain minimum standards of corporate governance and that this is beneficial to companies, investors and capital markets. Without a certain degree of common standards, investor confidence will remain weak and government policy will lack coherence and conviction. We also believe that regulators have a positive role to play in setting minimum standards, as most listed companies look to them for basic guidance and rules. Very few companies have the desire or expertise to create their own governance systems. Existing governance systems are, after all, based mostly on law and regulation, not the independent choice of companies. A mandatory requirement for independent directors would raise the bar of corporate governance in Japan over time and enhance the market's reputation.

- *'There should be no amendment to company law to more clearly define the concept of the "independent director" or the "independent statutory auditor". Stock exchanges should be charged with amending listing rules.' (Keidanren, METI, FSA)*

While in general we support changes to listing rules as an efficient way to enhance corporate governance, we have concerns about the unwillingness to amend the company law to define "independence". Companies may not take the concept as seriously with only a listing rule change (as it sends a weaker signal). There could also be a possible contradiction (and confusion) between the concept of the "independent director" in the listing rules and "outside director" in the company law. How does this help unlisted companies to improve their corporate governance prior to an IPO, for example? How does it help existing listed companies that want a clear definition of "independence"? Ideally, this change should be implemented through an amendment to Japan's Companies Act.

- *'Kansayaku are more independent from management than outside directors. Kansayaku have unique power to demand cessation of business operations that violate the duty of care that directors owe.' (Keidanren)*

If some *Kansayaku* are more independent than outside directors in Japan, this can only be because the definition of "outside director" in the Companies Act is weak. Outside *Kansayaku* would not be more independent than a genuine independent director. While *Kansayaku* may have the power to stop a transaction that violates a director's duty of care, an independent director has the opportunity to comment upon and potentially influence all major transactions undertaken by a company. Hence, the role of the auditor is essentially negative in this case; whereas the role of the independent director, if carried out well, is by definition more participatory and positive.

ACGA's Definition of Independent Director

An independent director should:

- Have an "independent mind" and be capable of bringing an independent perspective to major corporate decisions.
- Be able to read company accounts and ask sensible questions about them.
- Have the expertise and authority to discuss issues with executive directors as equals.
- Be capable of considering the interests of all shareholders and the company as a whole, including the broader environmental and social risks facing the company.

An independent director should not:

- Have close family or personal ties with any of the company's advisors, directors or senior employees.
- Be a former employee or manager of the company.
- Hold cross-directorships or have significant links with other executive or non-executive directors.
- Be a representative of a major shareholder connected to the controlling shareholder or management, or be representatives of any special interest group, or former employees of such groups.
- Have commercial involvement with the company as professional advisers, major suppliers or customers.
- Be entitled to performance-related pay, stock options, or pensions.
- Hold other directorships in competing companies in a closely related industry.

After an independent director has served for 8-10 consecutive years, the shareholders of the company should evaluate his/her continuing role on the board.

(Section 1 continued over.)

- *'Companies, at a minimum, should have one independent director or one independent Kansayaku to protect minority shareholders.' (METI)*

We welcome this positive recommendation, although we note that it is immediately diluted by offering a choice (why not one of each?). Having one independent director or *Kansayaku* will likely be seen outside the company as tokenistic. As argued in our White Paper, we recommend that companies make a commitment to appoint at least three independent directors. This is not a formalistic, but a practical, step. Many boards of large Japanese companies have at least 10 people, so three is a practical minimum to ensure that independent directors are not over-stretched and that board discussions benefit from a sensible and workable balance between views from insiders and outsiders.

For companies with smaller boards (less than 10 people), we recognise that a smaller number of independent directors, such as two, would probably be sufficient.

In other parts of Asia, the regulatory minimum is usually at least three independent directors or one-third of the board—and this is not considered high. Asian companies with large market capitalisations tend to have more than three, because they have larger boards and more board committees.

- *' "A trade-off can be found" between the "two desirable values" of "ensuring 'effectiveness' of corporate governance and securing 'independence' [of directors]".' (METI)*

We believe the METI Group has misinterpreted the OECD report, which referred to other reports that have raised the issue of independent directors and their qualifications. The OECD paper did <u>not</u> claim that there was an inherent trade-off between the effectiveness of corporate governance and the independence of board members, but suggested, quite tentatively, that: "the fact that a number of financial sector companies are now seeking to change the composition of their boards would support this hypothesis" that in the pursuit of independent directors, their competence may have been neglected. Hence, the OECD is <u>not</u> saying that the independence of directors somehow automatically makes them less competent—it is only saying that some Western banks which are in difficulty may have appointed independent directors who were under-qualified. In a more comprehensive report released in June 2009, titled, "Corporate Governance and the Financial Crisis: Key Findings and Main Messages", the OECD clearly stated that "board member competence is certainly important but there is no necessary trade-off between independence and competence". This accords with ACGA's view and widespread evidence from around the world that many independent directors are highly competent.

There is a view in Japan that the presence of too many "unqualified" independent directors at US financial institutions was largely responsible for the global credit crisis and the failure of those institutions. Yet this analysis overlooks deeper and more relevant factors that led to the crisis, and allowed it to spread to so many different markets, such as loose central bank monetary policy, inadequate regulatory oversight of banks, poor risk management and short-term incentive policies within banks, excessive borrowing on the part of households, and so on. If independent directors at some US financial institutions did not have the right experience, the best response would have been to replace them with independent directors who did know what they were doing.

- *'The most important consideration for the board of directors is not whether it has outside or independent directors and how many of them it has, but each member's qualifications to oversee the business.' (Keidanren, METI)*

We agree that all directors should have sufficient expertise and experience to fulfil their responsibilities. But the principle of board independence is of equal importance in our view. The broadly consensual style of management in most Japanese companies means that the decisions of an inner circle of senior directors will seldom be challenged, even if they may not be in the best interests of the company and its stakeholders. A more open and candid discussion between management and independent board members would improve risk management and help companies become more competitive in the long term.

- *'Is it really in companies' best interests to eliminate people who are executives/employees of parent companies or business counterparties—since they are potential directors with superior knowledge about the company and substantial stakes in enhancing corporate value?' (METI) 'Persons from the company's major corporate shareholder or business affiliate would "hardly" qualify as being independent. Yet automatically excluding them will not necessarily help a supervisory body's effectiveness and specialisation.' (FSA)*

We are not suggesting that such people should be excluded from boards, as they may indeed have a lot to contribute. However, they should be called "non-executive directors" rather than "outside directors". The latter label carries the connotation of "independence from management" and is confusing to non-Japanese investors. This is another reason why amending the Companies Act definition is important.

- *'If any listed company chooses not to introduce an outside director, it should "disclose facts concerning the corporate governance system using the company's own original method".' (METI)*

We find this recommendation quite vague and are concerned that it will lead to formalistic disclosure that is not of much use to investors.

2. Shareholder meetings and proxy voting

A fundamental right of shareholders is proper access to general meetings and the voting of shares. This carries an expectation that all votes, whether cast in person at the meeting or by proxy, will be counted in a fair and transparent manner. In Japan, however, the counting of votes cast at shareholder meetings remains largely opaque and disclosure of results is rare.

The Keidanren position

The Federation in principle commends the voluntary disclosure by companies of the voting results of general shareholder meetings. But, again, it opposes any mandatory requirement to do so, arguing that "at present, it is practically difficult for the companies to disclose figures that include the votes cast on the date of the shareholder meetings". The Keidanren also claims that disclosure of voting results to the public could magnify the "influence" of non-shareholders who have no legal right to know the outcome, and sow confusion should incomplete figures be released that do not include a full count of the votes cast at the shareholder meeting. In order to prevent such factors from distorting governance, the group says the decision to disclose voting results should be left to the judgment of individual companies.

TSE Advisory Group position

The TSE committee states that the environment for exercising voting rights in Japan—such as declustering of shareholder meetings, early notice of meetings and electronic voting—could be improved further, and recommends that the Tokyo Stock Exchange conduct a survey of listed companies to ascertain what they are doing in this regard. As for disclosure of voting results, the committee acknowledges that the TSE has no relevant rules, and that the minimum measures prescribed in the Companies Act allowing shareholders to inspect ballots kept by companies are cumbersome to apply. The TSE group therefore concludes that "it is desirable to set up the system enabling shareholders [to] easily get access to the voting results" in order to enhance transparency.

FSA Study Group position

The paper provides clear guidance on voting, noting that "it is important for the behaviour of listed companies to be subject to proper scrutiny of shareholders and investors exercising their voting rights". Moreover, this is a central fiduciary duty of institutional investors towards their policyholders and beneficiaries. The study group therefore suggests that Japan introduce legislation akin to the Employee Retirement Income Security Act (ERISA) in the US, which stipulates that private pension funds have a fiduciary duty to exercise their voting rights. It also says institutional investors should publish their internal voting guidelines and disclose how they have actually voted.

As for listed companies, they should be covered by a legal requirement or stock exchange rule to disclose the number of votes for and against individual resolutions. The paper stops short of calling for full voting by poll (ie, the counting of votes in shareholder meetings as well as any cast beforehand—see *box* on page 14), but argues that even publishing the results of proxy votes would be "disclosure of reasonable significance".

The FSA Group agrees with the TSE committee that more effort is required on improving the environment surrounding the exercise of voting rights, such as staggered meeting dates, the earlier dispatch of proxy materials, more English translations, and so on. The

FSA paper also urges stock exchanges to encourage some 90% of listed companies which do not use electronic voting platforms to do so to give investors more time to examine proposed resolutions.

ACGA Response

We welcome the in-principle support of the Keidanren on disclosure of voting results, and the comments of the TSE Group on this same issue. We agree in principle with all of the FSA Study Group's points above; however, we encourage full voting by poll and believe that the detailed results should be published promptly. These steps would improve the transparency of shareholder meetings.

Specific issues raised in the three papers on which we would like to respond include:

- *'Disclosure of voting results should remain voluntary. It is practically difficult for companies to disclose figures that include the votes cast on the date of the shareholder meeting.' (Keidanren)*

The underlying argument here seems unfounded. There is little evidence that the publication of voting results would have any negative consequences for Japanese companies. Voting by poll is becoming the norm around the world, and no self-respecting capital market should be without it. It is mandatory in Hong Kong, and most large-cap companies in the UK, the Netherlands, Canada, China and Thailand practice it (about three-quarters of FTSE 100 and AEX companies, for example, vote by poll). ACGA strongly urges Japanese listed companies to move in the same direction.

Nor is voting by poll especially difficult (see *box* on next page). The fear that counting votes in meetings poses insurmountable practical problems is greatly exaggerated.

- *'If voting results are disclosed to the public, it could magnify the influence of non-shareholders and sow confusion should incomplete figures be released.' (Keidanren)*

We believe that listed companies have disclosure obligations not only to their existing shareholders but also to potential investors and the market as a whole. If all votes were promptly counted at a shareholders meeting, and the results made clear, there should not be any confusion.

- *'It is desirable to set up the system enabling shareholders [to] easily get access to the voting results.' (TSE)*

We support this conclusion and recommend that the TSE study the different methods for organising poll voting around the world (ACGA has data on these methods and would be pleased to share with the TSE).

- *'Japan should introduce legislation akin to the ERISA in the US, which stipulates that private pension funds have a fiduciary duty to exercise their voting rights, and institutional investors should publish their internal voting guidelines and disclose how they have actually voted.' (FSA)*

We agree with these recommendations. The disclosure of institutional-investor voting policies is a well-established practice around the world, and we support the trend

towards more open disclosure of their voting records as well. We also believe, however, that the voting of shares should be carried out in an informed manner; it should not be an "automatic" process (ie, wholly delegated to an outsider provider) or merely an exercise in compliance.

- *'Even publishing the results of proxy votes would be "disclosure of reasonable significance".' (FSA)*

We would accept the publication of proxy-vote results only as a short-term measure, but we believe that listed companies should move towards full voting by poll and publication of detailed results as soon as possible.

If companies do publish only their proxy results, we recommend that they clearly lay out the total number of votes for and against, and any abstentions, on each resolution. We commend the voluntary disclosure of proxy votes by a number of Japanese companies in 2008 and 2009. However, we note that the format in which the data is presented is often confusing.

"Show of hands" vs "polls"

When a vote is taken on a show of hands, each person attending the meeting has one vote on each resolution. This undermines the "one share, one vote" principle—that is, an investor with 1,000 shares, for example, should have 1,000 votes. They should not have the same number of votes as someone with only 100 shares. Voting by poll ensures a full and fairer count of the votes.

How to vote by poll

For many companies, the term "voting by poll" conjures up the dreaded notion of "voting by ballot". A ballot refers to cases where companies have to organise an impromptu count of all votes on one resolution, because a few shareholders call for it. The count is usually done manually—a process that takes about half an hour to 45 minutes. The assumption, therefore, is that counting the votes for all resolutions will take most of the day (since 10-12 resolutions x 30-45 minutes = 5-9 hours).

However, this is not how modern polls are taken. One method involves collecting completed voting forms from shareholders at the end of the meeting, then closing the meeting, quickly counting the vote either manually or with computers and announcing it later the same day or the following day. Another method is more immediate—using electronic voting pads in the meeting. In both cases, the length of the AGM is not extended by taking a poll. It is an efficient process, and costs tend to be incremental.

3. Private placements and other capital-raising issues

Some Japanese companies have been using third-party share placements not to raise capital but to ward off unwelcome corporate bidders or to change their ownership structure. This practice dilutes the holdings of existing shareholders, which is unjust, and does not necessarily strengthen the company's business. Existing shareholders deserve more protection against such infringements of their rights.

The Keidanren position

The Keidanren agrees that there should be rules governing large-scale capital increases by third-party allotment (private placement) of shares which dilute the rights of existing shareholders and which may affect control of companies. It says issuing companies must be held accountable and that they must ensure the interests of existing shareholders are not infringed unreasonably. To this end, the Federation urges stock exchanges to improve the screening of allottees (investors) and to consider requiring adequate disclosure on whether they have enough funds to take up the allotted shares.

TSE Advisory Group position

The TSE Group states that private placements are a "top priority" issue for the Tokyo Stock Exchange to address as a market provider. It argues that improving the way in which private placements are carried out will create an investment environment where investors feel more secure. The paper adds that it is undesirable for companies to dilute the voting rights of shareholders easily or to take initiatives to select large shareholders unilaterally.

The TSE Group looked at 116 cases of private placements by TSE-listed companies during April 2007-March 2008. It found that there was insufficient explanation in general of the need for, and reasonableness of, choosing private placements. It found that there were many instances of private placements with "substantial" dilution of the total votes: in 57 cases, the dilution exceeded 20%; in 47 cases, it was more than 25%; in 22 cases, more than 50%; and in 9 cases, more than 100%.

Although it comes out against any uniform restriction of private placements by dilution ratio, the committee says the TSE should restrict cases where shareholders' interest is "unreasonably impaired". This means a threshold of 25% or more of the total votes (or total issued share capital)—the point at which the takeover defences of many companies are triggered. In such cases, and in instances where controlling shareholders change, companies should obtain "a higher level of shareholders' understanding". Such procedures could involve asking the opinion of a special committee set up to evaluate a proposed private placement, outside directors or others who maintain "certain independence from management" (eg, outside *Kansayaku*)—or directly seeking shareholder approval through a vote at an EGM or AGM. Exceptions to this, however, should be made in emergency cases where companies require immediate financing. Other companies which fail to undertake such procedures should be penalised according to listing regulations.

As for the discount level of private placements, the committee says that a legal opinion may be required from the *Kansayaku* when it exceeds 10%.

The Group also recommends much stronger enforcement action by the TSE when placements cause a dilution of more than 300%. It describes such placements as a “betrayal of the shareholders’ investment premise” and recommends delisting.

Furthermore, the TSE Group addresses cases when private placements are allocated to “inappropriate parties” or “anti-social forces” (eg, crime syndicates). It recommends that regulators set up preventive procedures similar to the initial listing examination to confirm the absence of such parties, and issue ex-post confirmation of the “soundness of transactions” to address offshore allotments for the purpose of hiding an increase in a large shareholder’s holdings. If any transactions are found to have failed in protecting the interest of existing shareholders, it says delisting measures should be applied.

The TSE should also require companies making private placements to confirm in advance the finances of the counter-parties and disclose the results. This is necessary to prevent non-payments leading to the cancellation of the transaction, which can hurt the credibility of the company and cause damage to existing shareholders, the paper says.

Since the release of the Advisory Group’s paper, the TSE has adopted a number of measures directed at private placements to third parties. The table on the next page from the TSE summarises these steps, which became effective on August 24, 2009. (ACGA’s clarifications on some of the measures upon consulting the TSE are highlighted in *italics*.)

TSE's Outline of Measures for Private Placements to Third Parties (Effective: August 24, 2009)

<table>
<tr><th>Item</th><th>Applicability</th><th>Outline of Response</th><th>Measures</th></tr>
<tr><td rowspan="2">Revision of Delisting Criteria</td><td>Over 300% Dilution</td><td>Conduct an examination into whether or not the likelihood of impaired shareholders' interest is deemed negligible.</td><td rowspan="2">Delisting</td></tr>
<tr><td>Change of Controlling Shareholder</td><td>Confirm the soundness of transactions with controlling shareholders.</td></tr>
<tr><td>Newly Established Code of Corporate Conduct</td><td>Equal to/Over 25% Dilution, or Change of Controlling Shareholder</td><td>In principle, require the procedures in either "a" or "b" below:

a) Receipt of the objective opinion of a person who has a specific degree of independence from the management (such as an outside director, outside Kansayaku or independent committee whose composition is similar to one for defensive measures against hostile takeovers).

b) Confirmation of the intent of shareholders such as resolutions of a general shareholders meeting (the TSE does not specify which shareholders, but assumes that all shareholders' intent should be confirmed).</td><td rowspan="3">Punitive Measures

- Public Announcement

- Listing Agreement Violation Fine

Improvement Measures

- Improvement Report

- "Securities on Alert"</td></tr>
<tr><td>Newly Established Rules regarding Timely Disclosure</td><td rowspan="2">Private Placements to Third Parties Overall</td><td>Require timely disclosure for the items below: ("Timely disclosure" means immediately after a board resolution to allot shares to a third party.)

a) Confirmation of funding of the recipient of such placement.

b) Calculation basis of issue price and a concrete explanation of such basis.</td></tr>
<tr><td>Submission of Written Confirmation</td><td>Require the submission of a written confirmation stating that the recipient of a private placement is not under anti-social influences.</td></tr>
</table>

* "Controlling shareholder" refers to a parent company as well as an entity which holds a majority of the voting rights either directly or indirectly.

Source: Tokyo Stock Exchange (TSE); with additional information, highlighted in italics, from follow-up questions to the TSE.

FSA Study Group position

The FSA Group says "there is an urgent need to improve market discipline when raising capital through third-party share issuance". Therefore, it says a company making a third-party share issuance should be required to disclose "various information concerning the issuing company, the third-party and the relationship between them", including details on how the new capital will be spent. The issuing company should also be required to confirm if the third-party has sufficient funds for the share subscription. In addition, stock exchanges should require an official, published opinion from the *Kansayaku* on the legality of a planned third-party share issuance if there is a risk of a favourable issuance. If major problems come to light with a third-party share issuance, such as significant dilution or transfer of company control, stock exchanges should launch an investigation and, if warranted, take countermeasures such as delisting.

The FSA Group also has concerns with other problematic capital-raising strategies of listed companies. One is the use of Moving Strike Conversion Bonds (MSCBs) and similar instruments that could not only undermine existing shareholders' rights but also exert downward pressure on the issuing company's share price when their holders convert them into shares. Thus, the paper says the statutory disclosure regime relating to such instruments should be enhanced.

Forced surrender of ownership by minority shareholders in exchange for cash ("squeeze outs") is another dubious practice the FSA Group believes should be better regulated. Because companies in Japan can usually squeeze out minority shareholders by passing a special resolution with just a two-thirds majority of votes at an AGM, it says stock exchanges should examine such practices more rigorously.

Lastly, the FSA paper highlights the potential conflicts of interest between a parent company and minority shareholders of its listed subsidiary, and advises stock exchanges to consider introducing rules, such as the appointment of outside directors and auditors, to ensure that the parent company does not abuse its power.

ACGA Response

We welcome the recognition given by all three papers to the potential damage to shareholders of private placements. However, we believe tighter regulation of the practice is needed. We recommend, firstly, that companies be required to seek annual shareholder approval in AGMs for private placements. Secondly, that the threshold for the maximum amount of such shares that can be issued in a year be tightened to no more than 10% of total issued capital. Thirdly, if companies wish to exceed this, they would need to make a cogent case to their shareholders and allow them to vote on it (eg, at their AGM).

Specific issues raised in the three papers on which we would like to respond include:

- *'A private placement "could be regarded as a betrayal of the shareholders' investment premise" when it causes dilution exceeding 300%.' (TSE)*

We find the logic hard to follow here. The rationale for the 300% figure is based on the Companies Act that says a company's "authorised capital" may not be more than four times its "issued capital" (ie, a 300% increase). Therefore, the committee concludes that investors buy stocks in firms on the implicit understanding that the total capital will not be increased more than four times, nor will they suffer more than a 300% dilution in a worst-

case scenario. Hence, anything greater than this would constitute a "betrayal of [their] investment premise".

However, it is unlikely that many investors think in these terms—most would be appalled if a company increased its issued capital by 300% through a private placement. Indeed, most global institutions object to placements that exceed 10% in any one year.

- *'A company making a third-party share issuance should be required to disclose details on how the new capital will be spent.' (FSA)*

We strongly support this recommendation, but would add that the TSE follows up with issuers to make sure the capital raised has been spent as disclosed and put to productive use. Otherwise, investors will question whether it needed to be raised.

- *'If major problems come to light with a third-party share issuance, such as significant dilution or transfer of company control, stock exchanges should launch an investigation and, if warranted, take countermeasures such as delisting.' (TSE, FSA)*

While the TSE has already moved ahead with a regulatory change on delisting, we continue to believe that delisting is a harsh sanction that hurts minority shareholders more than a dilutive private placement. It would be better to have adequate rules in place to guard against excessive dilution and a change of control.

- *'The statutory disclosure regime relating to Moving Strike Conversion Bonds (MSCBs) should be enhanced. "Squeeze outs" should be better regulated.' (FSA)*

We believe that the risks of MSCBs should be fully disclosed and that any decision by a listed company to issue such a bond be made subject to shareholder approval in a company meeting. As for squeeze outs, we believe that stricter rules should be introduced on voting thresholds (as one finds in Hong Kong, for example).

- *'Rules on the potential conflicts of interest between a parent company and minority shareholders of its listed subsidiary are needed to ensure that the parent company does not abuse its power.' (FSA)*

We support a stronger regime for governing these situations, and believe this again highlights the need for effective independent non-executive directors.

4. Cross-shareholdings and other equity investments

Japanese companies frequently form cross-shareholding pacts, in which they agree to vote to support each other's management (in, for example, a takeover situation). But this arrangement often leads to a sub-optimal use of corporate funds and can disenfranchise minority shareholders. While cross-shareholdings were declining in the earlier part of this decade, the evidence suggests they are making a comeback.

A related problem is the practice of banks and other financial institutions buying the shares of major customers. This can also represent a sub-optimal use of scarce funds and, as recent experience shows, can lead to large stock market losses in an economic downturn.

FSA Study Group position

The FSA paper acknowledges the demerits of this practice, including the fact that cross-shareholdings can foster a business relationship not bound by contracts and companies' ownership structures. It goes on to commend companies that are voluntarily disclosing their cross-holdings, but suggests that some sort of institutionalised disclosure requirement is needed. It also recommends more active use of the Banks' Shareholdings Purchase Corporation, which until March 31, 2012 is tasked with acquiring shares that banks hold in companies and other banks. The FSA group adds that promoting more investment by individuals would support such a shift in the ownership structure of Japanese companies and would strengthen their governance.

ACGA Response

Many foreign and Japanese institutional investors consider cross-shareholdings and other equity investments by Japanese listed companies as one of the country's most serious corporate governance issues. After decreasing significantly in the early part of this decade, cross-shareholdings began to increase again from 2006. According to the Nomura Securities Financial & Economic Research Center, cross-held shares as a percentage of the market capitalisation of all listed stocks rose in fiscal 2008 to 12.5% from 12.3% in fiscal 2007. Companies ostensibly are hoping to cement business relationships or establish a stable shareholder base. Earlier this year, however, falling prices of equities hurt Japanese banks, as their non-core investments in the shares of other companies dragged down their earnings, which were already battered by losses from bad loans, and undermined their capital adequacy ratios.

ACGA backs greater disclosure of cross-shareholdings and equity investments, and would welcome any measures to reduce them, with the ultimate aim of supporting higher corporate returns. Ideally, there should be a regulatory change requiring the disclosure of cross-shareholdings and major equity investments. We also believe cross-shareholdings should not be used as a means to defend the company against a possible takeover attempt. The best defence against hostile takeovers remains sound management reflected in a strong share price.

At a minimum, and over the short term, we would strongly encourage listed companies to make full disclosure of cross-shareholdings, or at least their largest equity holdings in outside companies, in their annual reports. This should be accompanied by details on the strategic objectives of each position and, where appropriate, actual investment returns.

At the same time, we recommend that regulatory authorities start to consider a mandatory disclosure requirement on these shareholdings, as alluded to in the FSA paper. The difficult question is how to structure a new regulation? One option is the "percentage threshold test": companies would need to disclose any major equity investment above a certain percentage, say 1% or 2% of issued share capital of the target company. The drawback with this approach is at least twofold. Firstly, in any large-cap stock, this would represent a significant investment in absolute terms and one that could have a material effect on the cash reserves of the investor firm (hence there will almost certainly be calls for a monetary threshold to be required as well—but deciding on the right yen value would not be simple). Secondly, companies could easily game the system by keeping their investments to a level just below the percentage threshold, say, 0.99% if the threshold was 1%.

A second option is the "top 10 test": companies would be required to disclose full details of their 10 largest equity investments in outside companies. This would avoid the artificiality of either a percentage or monetary threshold, and would get closer to the issue of which firms a listed company had close business relationships with. If a list of the top 10 holdings was not considered sufficient, then it could be increased to the top 15 or 20.

We note that the TSE has identified "establishing a system for the disclosure of the cross-shareholding situation" as a matter "to consider for actual implementation" in its action plan for listing system improvement, released on September 29, 2009. We would encourage the TSE to follow through on this as soon as possible.

5. Company-investor dialogue

In recent years, many Japanese companies have stepped up their communication with shareholders and investors, especially with regard to voting at annual meetings. It is, nonetheless, still common for many listed companies to view shareholders as a group whose views are of little consequence. We believe that this mindset is outdated and that listed companies can benefit in numerous ways—both tangible and intangible—from an open dialogue with their shareholders. Investors are not managers, but capital-market specialists. This knowledge can be useful to mangers, whose knowledge of capital markets is often limited.

The Keidanren position
The Keidanren recognises the importance of deepening mutual understanding between companies and investors, including domestic and foreign funds, to further enhance the credibility of Japan's capital markets. The group adds that it supports the effort to develop an environment that fosters reciprocal dialogue between companies and shareholders.

FSA Study Group position
The paper backs constructive discussions between shareholders/investors and management, and notes that one of the benefits of such regular dialogue would be the avoidance of "emotional responses" in case of company takeovers. Saying corporate governance in Japan would benefit from having "a base of investors who talk to management constructively", its authors expect "greater efforts" from the parties concerned.

ACGA Response
We would welcome more open and regular dialogue between institutional investors and listed companies on strategic and governance issues affecting companies. However, to be most effective, this should involve more than just meetings with IR departments. We understand that senior managers are extremely busy, but we recommend that they make themselves available to meet more often with investors and corporate governance officers of investment funds–especially long-term investors. Open and constructive dialogue should help both sides to better understand each other's perspectives.

Conclusion

ACGA recognises that awareness of the importance of corporate governance reform in Japan has been increasing in recent years. As the Keidanren paper notes, many TSE-listed companies with the traditional statutory auditor system have voluntarily appointed outside directors to provide them with an external perspective on crucial corporate matters. Many have also established board committees on nomination, compensation, risk management, and so on. We believe that such moves towards a "hybrid" board structure are a positive development and a sensible compromise between local and international standards. Moreover, some Japanese companies have decided that they need a more diverse and independent board to better address their different business needs (eg, expanding overseas into new markets, where the company managers may need some guidance).

Yet we remain concerned that much discussion of boards and directors in Japan appears to assume that these structures are mere formalities that have little impact on the real business of the company. This is certainly the case if a company sees them as no more than "compliance mechanisms", designed to please regulators and shareholders, and not intended to do anything substantive. However, if a company genuinely seeks value from its board committees and independent directors, and selects them carefully, we believe it will be rewarded over time. It is entirely up to the attitude and actions of the company management and controlling shareholders.

For these reasons, ACGA cannot agree with the view that sees the appointment of independent directors as a mere formality if a company already has well-qualified inside directors. The two roles are different. By bringing alternative views to board discussions, a knowledgeable and committed independent director can help to strengthen board decision-making and ensure that the board is considering the interests of all relevant stakeholders, including shareholders.

We would also like to address a perception that corporate governance advocates are demanding, in an overly simplistic manner, that Japanese companies introduce US or UK-style corporate governance. We are not. Corporate governance in neither country, nor indeed anywhere else, is perfect. What ACGA is advocating are basic principles of corporate governance that we believe have universal applicability. We are promoting practices that, if implemented well, can enhance corporate competitiveness and accountability. And we have chosen these practices carefully and deliberately, based on what works in other markets and what we believe could work in Japan. As we hope this paper shows, our goal is to contribute constructively to corporate governance in Japan, and to offer recommendations that complement and enhance existing governance institutions, not entirely replace them.

In this regard, we would strongly urge that Japan adopt a national code of corporate governance, which sets down best-practice principles that Japanese listed companies could follow. To draft it, we recommend that Japanese authorities appoint a committee of practitioners from the investment, business, accounting, legal and regulatory communities. Such a code would not constitute a mandatory regulation, but would contain aspirational goals that augment existing laws and regulations. It would be an educational document outlining the standard of behaviour that regulators and the market expect of listed companies. It would therefore support a flexible evolution of corporate governance reform at Japanese companies, allowing them to marry their traditional strengths with new global norms.

We understand that meaningful corporate governance reform cannot take place overnight. New proposals inevitably generate discussion and, when change takes place, it is often gradual. At the same time, however, we believe that no country has unlimited amounts of time to make corporate governance reforms. In a globalised economy with competitive capital markets, corporate governance is becoming a more important determinant of investor confidence, liquidity and the cost of capital. Japan's listed companies and its financial services sector can only benefit from better corporate governance.

End.

Notice

ACGA's recommendations in this Statement represent the consensus views of the Association and its members. These recommendations may differ, in certain respects, from the specific corporate governance and voting policies of individual ACGA members regarding the Japan market.

Appendix 1: About ACGA

The Asian Corporate Governance Association (ACGA) is an independent, non-profit membership association dedicated to promoting long-term improvements in corporate governance in Asia through research, advocacy, and education.

ACGA carries out independent research in 11 major Asian markets. It engages in a constructive and informed dialogue with regulators, issuers, institutional investors and other key interest groups. And it organises educational events, including an annual conference, to raise awareness and provide a forum for discussion of timely corporate governance issues.

ACGA is best known for its “White Paper on Corporate Governance in Japan” (May 2008) and its regular “CG Watch”* survey of corporate governance in Asia—first undertaken in 2003. It has also developed a website, **www.acga-asia.org**, providing a wide range of data and analysis on corporate governance conditions and regulations in major Asian markets.

(*Carried out in collaboration with CLSA Asia-Pacific Markets, a Founding Sponsor of ACGA)

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Appendix 2: About the Endorsers

Aberdeen Asset Management, Singapore
Aberdeen Asia is a wholly owned subsidiary and the Asian headquarters of Aberdeen Asset Management PLC, an independent asset management company listed on the London stock exchange with US$238 billion under management. (www.aberdeen-asia.com)

APG Asset Management, The Netherlands
APG Group offers products and services in the fields of pension management, communication, asset management and management support for the government, education and construction sectors and housing corporations. APG is one of the largest pension fund asset managers in the world and manages approximately €205 billion (June 2009) of pension capital. (www.apg.nl)

British Columbia Investment Management Corporation, Canada
British Columbia Investment Management Corporation (bcIMC) is one of Canada's largest investment managers. In its C$75 billion global portfolio, almost $23 billion is in international investments, ranging from public equity holdings in China, to private equity interests in the United Kingdom, to commercial real estate in Mexico. (www.bcimc.com)

California Public Employees' Retirement System, USA
The California Public Employees' Retirement System (CalPERS) is the largest public pension fund in the US whose mission is to advance the financial and health benefit security for approximately 1.6 million California public employees, retirees, and their families. CalPERS has more than US$187 billion in assets under management as of July 30, 2009, comprised of a global portfolio of investments, including real estate, private and public equities, fixed income, inflation linked assets and cash. (www.calpers.ca.gov)

California State Teachers' Retirement System, USA
The California State Teachers' Retirement System (CalSTRS) is the second largest public pension fund in the United States with approximately US$130 billion in assets under management. CalSTRS administers retirement, disability and survivor benefits for California's 833,000 public school educators and their families from the state's 1,400 school districts, county offices of education, and community college districts. (www.calstrs.com)

F&C Asset Management, UK
F&C Asset Management is a leading global diversified investment management group with a heritage spanning more than 140 years. Today the group operates from offices in 12 countries and manages €109 billion of assets for a diverse range of institutional, insurance and retail clients across all major asset classes – equities, bonds, cash, property and alternatives. (www.fandc.com)

Governance for Owners, UK
Governance for Owners (GO) was established in November 2004 by Peter Butler and Steve Brown and has operations in Europe, the USA, South East Asia and Japan. The group is an independent partnership between major institutional share owners, a long-term financial backer and its senior executives. GO is dedicated to adding long-term shareholder value for clients by exercising owners' rights. (www.g4owners.com)

PGGM Investments, The Netherlands
PGGM Investments is a Dutch pension administrator and asset manager acting on behalf of, amongst others, Pensioenfonds Zorg en Welzijn, the Dutch pension fund for the healthcare and welfare sector and one of the largest pension funds in Europe. PGGM Investments currently has about €79 billion under management. (www.pggm.nl)

Railway Pension Investments, UK
Railpen Investments is an investment management firm and Occupational Pension Scheme (OPS) member, whose sole client is the Railways Pension Trustee Company Ltd (RPTCL), a trustee of four pension schemes. RAILPEN's principal role is to act as a manager of managers, advising on the range of assets to be deployed, investment manager appointments and monitoring investment management performance. In total RPTCL owns approximately £18 billion of assets. (www.railpen.co.uk)

TIAA-CREF, USA
TIAA-CREF (www.tiaa-cref.org) is a US-based national financial services organization with more than US$402 billion in combined assets under management, as of September 30, 2009, and the leading provider of retirement services in the academic, research, medical and cultural fields.

Universities Superannuation Scheme, UK
Universities Superannuation Scheme (USS) is the second largest pension fund in the United Kingdom and the principal pension scheme for UK universities, acting for 378 universities and academic institutions. It has US$42 billion in assets as at August 2009, and approximately 250,000 members. (www.uss.co.uk)