# Asian Corporate Governance Association

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Dear Professor Iwahara,

As a result of a delegation that ACGA led to Japan earlier this month, we understand that the Legislative Advisory Council's Company Law Sub-Committee will be meeting on September 29, 2010 to consider some amendments to the Company Law concerning the general model of governance for corporations, the role and authority of statutory auditors (*kansayaku*), the proper role of directors, and the governance of dilutive capital issues, among other important issues. As the outcome of these deliberations could have a significant impact on the direction and substance of corporate governance in Japan for many years, we would like to take this opportunity to provide the Sub-Committee with our views on some of these matters.

The Asian Corporate Governance Association (ACGA) is an independent, not-for-profit membership association dedicated to helping facilitate improved corporate governance



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throughout Asia. We speak on behalf of more than 80 member firms based in Asia-Pacific, Europe and North America, many of which are long-term institutional investors in the Japanese market and which collectively manage more than US$10 trillion in assets globally.

ACGA and its members believe that the level of independent monitoring and strategic oversight provided by the board of directors of most listed companies in Japan is insufficient to protect shareholder interests (domestic as well as foreign). We believe that this undermines the confidence of public-equity investors and is a major factor underlying the continued slump in the Japanese stock market. If not corrected, we believe that the holdings of global investors in Japan will continue to plummet and the country's role in the global financial markets will become eclipsed by other Asian markets.

Our specific comments and suggestions are as follows:

**1. Independent Directors:** We believe that in order to strengthen the monitoring and oversight functions of Japanese boards, the Company Law or stock exchange listing rules should initially require public company boards to comprise at least three qualified and experienced independent outside directors with full voting rights. Given the urgent need to increase confidence in Japan's capital markets, we recommend that such a rule be incorporated in any proposals made by the Sub-Committee to amend the Company Law.

In order to allow companies time to adapt, such a rule could be gradually implemented over a period of, say, two to three years. This would allow companies to select their independent directors thoughtfully and ensure the individuals chosen have the requisite skills and business or financial experience to contribute productively to board discussions. We strongly believe that the quality of independent directors matters as much as the quantity.

Regarding the definition of "independence", we respectfully refer you to our "White Paper on Corporate Governance in Japan" (2008) and "Statement on Corporate Governance Reform in Japan" (2009). Experience in Asia shows that the definition of independence has a significant impact on whether the right people are nominated to boards. Definitions that are overly rigid and simplistic, for example, tend to produce 'form rather than substance' and, therefore, disappointing outcomes.



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**2. Board Committees:** In order to allow independent directors to play their expected role, listed companies should be legally permitted to establish formal board committees with clear terms of reference and responsibilities on any specific matters for which the board deems a committee to be necessary (and not to be limited to audit, nomination, and remuneration matters). Such committees should be chaired by an independent director and comprise a majority of independent directors (with the exception of the audit committee, which should be fully independent). Committees for nomination and remuneration may include non-independent "outside directors" (called "non-executive directors" in other markets), but should not include executive directors/managers, otherwise they would quickly face conflicts of interest.

Although many listed companies with the *kansayaku* system already establish board committees, such committees have no legal validity or force and their meetings are only informal (ie, no minutes are required to be taken, not all members are directors, committee decisions are not binding on the board, and committee members cannot be held accountable).

Independent directors, meanwhile, should be permitted and encouraged to meet only among themselves for discussion from time to time.

**3. Role of boards:** In order to enable Japanese boards to play more of a strategic oversight role, rather than focusing most of their time on managerial and operational matters, the present Company Law rules on matters that require board approval should be relaxed so that boards are not legally required to approve relatively small or insignificant decisions that can be delegated to senior management. (However, this suggestion is conditional on the implementation of rules introducing a greater element of independence to boards—see point 1 above.)

**4. Voting by Kansayaku:** One criticism of the *kansayaku* (statutory auditor) system is that such auditors do not have a vote in board decisions. Recently, we understand that there has been discussion in Japan about strengthening the *kansayaku* system further by allowing statutory auditors to vote on board decisions related to their auditing function.

To the extent that such a proposal enhances the supervision of management, and at the same time makes the *kansayaku* more accountable to the company (including shareholders) for their comments and decisions, as a general matter ACGA may support



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this idea, under the conditions set forth below. In our "White Paper" and "Statement" we support the strengthening of the *kansayaku* system, while also emphasizing the different (and complementary) role that can be played by independent directors.

It is important to differentiate between measures to address the shortcomings of the *kansayaku* system as presently structured and the high quality and diligence of many individual statutory auditors. Indeed, the current cadre of "independent outside statutory auditors", as defined by the new Tokyo Stock Exchange rules, could potentially provide a pool of independent directors in future (assuming they also have the requisite business experience and skills to be directors).

If the Sub-Committee is considering the possibility of allowing statutory auditors to vote at board meetings in any respect, we believe that such a proposal is worthy of consideration, but must be subject to both of the following conditions:

- If, and only if, it is part of an integrated plan to transition (over a set number of years) all listed companies into corporations which initially have a minimum number of independent directors (as outlined above) and a formal audit committee of the board that is entirely comprised of independent directors. This transition could involve transforming some independent statutory auditors into independent directors, or appointing to the board new independent directors who previously held the role of independent statutory auditor at unrelated companies.

- There will be no differentiation between different members of the board of directors with respect to the voting rights and terms of office. All voting members of the board (including any who were previously statutory auditors) will at all times have full rights as directors to vote on all matters coming before the board, and will have the same length of term of office as set forth in the company's Articles of Association. If they are directors that are to be considered "independent" for legal purposes, they must satisfy the same criteria. Further, no director may serve on any particular committee unless he or she selected by the full board in session to do so.

**5. Shareholder approval rights:** We understand that the Sub-Committee will be asked to consider the possibility of removing requirements for shareholder approval of certain M&A and reorganization transactions, and giving this decision-making power to the board



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instead. In our view, there should be a clearly defined set of decisions requiring board approval and a separate set of decisions requiring shareholder approval. As a matter of principle, we strongly oppose any weakening in the rights that shareholders in Japan currently enjoy. We urge the Sub-Committee to consider all such proposals with caution and not to recommend any amendments without full consultation of public shareholders (ie, independent minority shareholders, both foreign and Japanese).

Even in cases where decision-making by the board is deemed acceptable, the Sub-Committee should amend the law so that a board committee composed exclusively of independent directors must first approve transactions that are potentially dilutive or pose potential conflict-of-interest issues.

We further recommend that shareholder rights be strengthened in Japan in relation to dissenters' rights in tender offer and squeeze-out situations. At present, dissenting shareholders do not have meaningful rights unless they are willing to be locked up for a period of time and, ultimately, pay legal fees to go through an appraisal process in court. A significant lock-up period applies to dissenters and they cannot withdraw dissent without the company's approval. There is no requirement for good faith negotiation on the company's part and, faced with the prospect of having shares locked up until the last moment when the company could just re-offer the original takeover or squeeze-out price, shareholders have little incentive to dissent in the first place.

We also recommend that the Sub-Committee review the law governing follow-on offerings and private placements ("third-party allotments") in Japan. The current system often results in considerable dilution of existing minority shareholders and does not provide them with adequate opportunities to approve such offerings and placements in shareholder meetings. This is an issue that we intend to write to the Sub-Committee on in more detail in the near future.

**6. The "Joint Audit Committee Company" Proposal:** For the avoidance of doubt, and for the reasons stated above, we are strongly opposed to the new proposal put forward by the Ministry of Economy, Trade and Industry (METI) for a third form of corporate governance in Japan—the "Joint Audit Committee Company". This proposal envisages a governance system where a company need only have a "joint audit committee", mostly comprising statutory auditors who will serve in a dual capacity as directors, but need not meet any criteria for independence.



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Not only does this proposal exclude any requirement for the independence of these statutory auditors, it omits any mention of independence requirements for the other directors, and says nothing about the need to fortify the current *kansayaku* system by defining and requiring independence for outside statutory auditors of existing kansayaku-style companies. Instead of supporting the current trend towards board independence and more effective statutory auditors, it complicates matters by offering yet another alternative where none is needed. It would be far better to focus on improving existing structures. This proposal, if introduced, would confuse and dismay investors, and greatly damage the goodwill generated by Japan's recent corporate governance reforms. We believe that its impact would be negative for the country's capital markets.

We thank the Sub-Committee for your attention and would be pleased to answer any questions you may have on our letter.

Yours truly,

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