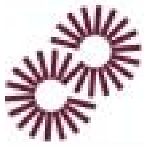

J-IRIS Research Newsletter

Japan Investor Relations and Investor Support, Inc.

1-5-1 Otemachi, Chiyoda-ku, Tokyo 100-0004, Japan
TEL: +81-3-5208-5460
http://www.j-iris.com

Introduction

We are pleased to introduce this inaugural issue of the J-IRIS RESEARCH NEWSLETTER, a publication focused on issues relating to the Japanese investment environment, especially corporate governance. The launch of the NEWSLETTER coincides with the establishment of Japan Investor Relations and Investor Support, Inc. (J-IRIS), a new company devoted to fostering solid relationships between corporations and investors and to promoting good corporate governance practices in Japan.

The increasing internationalization of Japan's investment environment in recent years has heightened interest in the nation's corporate governance practices. At the same time, practices and regulations affecting corporate governance in Japan have come under increasing critical review, and the fiduciary obligations of institutional investors have been strengthened.

This NEWSLETTER is intended to help the reader outside Japan to understand the latest developments and issues pertaining to corporate governance in Japan. We hope you will find its contents both interesting and informative.

Japanese Corporate Governance and Revisions to the Commercial Code

Methods for understanding the characteristic features of corporate governance vary from country to country. In the United States, institutional investors, pension funds in particular, and active shareholders tend to play the proactive role, while in the United Kingdom serial reports on corporate governance typically lead such initiatives. In Germany, the topic frequently focuses on the relationships among management, employee representation and major shareholders (banks), in line with co-determination laws.

In Japan also, a number of characteristics are unique to local corporate governance practices. These include the relationships between banks and business corporations, management's strong focus on employees, and dominant power wielded by management rather than by shareholders. However, in Japan the most important factor directly fostering advances in corporate governance is perhaps review of the existing Commercial Code undertaken in conjunction with input from governmental, academic and industrial circles. Most recently, members of the Diet have often played the leading role in submitting proposals on revisions. In contrast with other countries, in Japan institutional investors are less active, probably owing to the fact that best practices do not carry sufficient weight within the general business climate.

The Company Law of Japan is part of the Commercial Code enacted more than 100 years ago. At the time, Japanese capitalism was still in its early stages, ownership was often synonymous with management, and general shareholders meetings were imbued with enormous controlling powers. In effect, all major decisions were rendered by shareholders, who tended to be members of one family.

In 1950 the Commercial Code was radically revised so as to promote separation between ownership and management. The revisions, heavily influenced by the US, had three defining traits all targeted at strengthening the executive powers of company directors. 1) Ownership and management systems were separated by introducing the Board of Directors system and scaling back the authoritative powers of general shareholders meetings. 2) The authorized shares system was launched to enable flexible fund acquisition. 3) The Board of Directors was granted supervisory authority, thereby limiting the authority of auditors to accounting affairs.

Subsequent to the 1950 revisions, the Commercial Code was modified every several years, resulting in the introduction of new regulations governing financial statements, handling of stock certificates, internal auditing, etc. In 1974 the authority of corporate auditors was enhanced by recognizing their power to oversee executive functions. In 1981 the Code underwent a major overhaul designed to revitalize general shareholders meetings, for example by prohibiting payments to "sokaiya," professional corporate extortionists.

The pace of revisions to the Commercial Code accelerated during the 1990s in tandem with rapid internationalization

of Japan's capital markets. Today revisions are carried out on a nearly annual basis, and in some years on two or more occasions. The major revisions enacted during the past decade include the following:

• **1993**: The supervisory authority of shareholders was strengthened by reducing the fee required to file a lawsuit on behalf of all shareholders to a flat 8,200 yen in all cases. Also, the statutory auditor's tenure was extended to three years and new systems were introduced relating to outside auditors and Boards of Auditors at companies of large scale (capitalized in excess of ¥500 million or more than ¥20 billion in debt). These revisions have substantially advanced the debate on corporate governance in Japan.

• **1994**: Rules were relaxed regarding corporate acquisitions of their own stock.

• **1997**: Merger procedures were simplified, new rules were introduced for stock option schemes, and new legislation was drawn up in reference to stock retirement. To further strengthen regulations targeted against sokaiya, penalties against the provision of illegal payments were made more severe and such extortion was incorporated into criminally punishable offenses.

• **1999**: In conjunction with revisions to the Antimonopoly Law enacted in 1997, which removed the ban against pure holding companies, a new system was created for share swapping and stock transfers, to facilitate relations between wholly owned subsidiaries and their parent firms.

• **2000**: As part of new legal codification relating to corporate groups, the 1999 revisions were enhanced by the introduction of new rules governing corporate demerger procedures.

In order to render these revisions to the Commercial Code more effective, Japan's Securities and Exchange Law was also modified in line with the systems newly incorporated into the Code. The various revisions relating to stock repurchases, holding companies, and simplified mergers and demergers have not only brought the legal framework more in tune with the demands of Japan's internationalized capital markets, but also made management at Japanese corporations more conscious of corporate value.

Revisions to the Commercial Code are by no means finished, however. Further changes taken under consideration in 2001 or targeted for future consideration encompass a long list of matters critical to setting the directions of corporate governance in Japan going forward. They include:

1. Launch of a treasury stock system
2. Introduction of a new trading unit system
3. Review of the system governing derivative lawsuits
4. Strengthening the functions of statutory auditors
5. Greater elasticity in classes of shares
6. Improvement of stock option schemes
7. Review of regulations governing general shareholders meetings
8. Launch of a management committee system
9. Obligation to appoint outside directors
10. Introduction of Board subcommittees, executive officers
11. Launch of online processing

Items 1 and 2 passed through the Diet in June 2001 and were enacted in October. Proposals relating to items 3 and 4 were submitted to the Diet in June and were passed by that body during its extraordinary session in late November.

An unusual approach was adopted in relation to items 5 through 11, which contain many areas crucial to deciding the future of corporate governance in Japan. The Ministry of Justice, which compiled these proposals, took steps to put them up for public hearing (on April 18, 2001). A bill relating to items 5 and 11 was submitted to the Diet on October 5, targeted at facilitating corporate fund-raising procedures and responding to the economic shift toward information technology and reliance on the Internet. The bill passed through the Diet in early December and is expected to take effect from April 1, 2002.

1. Launch of a treasury stock system

Until recently, Japanese companies were prohibited from repurchasing their own stocks except for very limited purposes. Now that policy has been reversed, and companies are free to buy back their stocks at any time, at their own discretion. Also, the repurchased stock may be retained as treasury stock for an unlimited period of time, or it may be written off from existing capital. Under the revised policy, treasury stock can now be used in a spectrum of applications from improvement of capital efficiency to implementation of effective stock option plans; but most importantly, the new policy is expected to make management more conscious of shareholder value. In line with the principle of maintaining capital adequacy, however, the rule imposing a maximum limit on repurchases and on funds used for such purposes was retained. Before a company can buy back its own stock, it must receive the approval of its shareholders by special resolution at a regularly scheduled meeting, garnering two-thirds approval with a quorum of one-half. The resolution defines the total acquisition price as well as the type and number of shares

that may be purchased prior to the subsequent regular shareholders meeting.

The newly liberalized treasury stock system was approved in light of rising demands to pursue efficient restructuring and reorganization, to achieve a more favorable balance between share demand and supply, and to prevent hostile takeovers. In all respects, the issue of treasury stock is a topic of grave importance to corporate governance. Going forward, it will be interesting to monitor whether or not companies actually determine to repurchase their stocks, and if they do, to monitor any limits they might impose as well as whether or not they actually conduct such repurchasing initiatives.

Repurchasing of a company's own stock is fraught with a variety of potential problems, for example: 1) it runs counter to the principle of maintaining an appropriate level of capital (because payouts of company assets to shareholders runs counter to the principle of protecting creditors); 2) it runs counter to the principle of equal treatment of all shareholders (because purchasing company stock from specified shareholders would generate inequality among shareholders); 3) it creates inequality within existing management (because a decline in the number of voting rights leads to self-protection of management); 4) it can impair fairness in trading (because it easily invites insider trading). Although these problematic points will be resolved through revisions to the Commercial Code and the Securities and Exchange Law, it will still be necessary to monitor repurchasing practices as they are carried out.

2. Introduction of a new trading unit system

A unique feature of Japan's corporate stock structure has been the trading unit system. Under the system, an investor was required to purchase a minimum number of shares in order to exercise voting rights, and the minimum par value of the unit was set at 50,000 yen. As the shares of the majority of listed companies in Japan have par value of 50 yen, it has been customary for the minimum trading unit to be 1,000 shares. (In cases where a company's net worth per trading unit exceeded 50,000 yen, the number of shares could be less than 1,000.) The system was introduced in tandem with revisions to the Commercial Code effected in 1981 which mandated that the shares of companies established after that date had to have a minimum value of 50,000 yen. The new ruling, introduced in order to reduce shareholder maintenance costs, resulted in minimum investment sums that were often too high for prospective individual investors, and in recent years it came to be viewed as a deterrent to recovery of the stock market. It was therefore replaced by a new trading unit system under which the 50,000 yen minimum was abandoned and companies acquired free rein to fix their trading units however they may deem appropriate.

In conjunction with the launch of the new system, it was also decided to abolish the par-value stock system. One reason for the prevalence of par-value stocks in Japan has been the Commercial Code's preferential lean toward creditors. However, as in many other parts of the world, today par value has become meaningless because shares are traded independent of their face amount. In this respect, the abolition of the par-value stock system is another indication that the Japanese Commercial Code is moving towards shareholder primacy.

3. Review of the system governing derivative lawsuits

Although the system enabling derivative lawsuits by shareholders was launched in Japan as early as 1950, investors began to actively take advantage of it only in the wake of the 1993 revision which substantially reduced the fee required to file a suit. As a result, from only a handful of lawsuits per year prior to 1993, the number of cases has leaped to upwards of 200 each year in recent times. Some of those cases have led to directors losing in court or settling out-of-court and having to render significant compensatory payments to shareholders. The recently implemented review of the system focused on the following point.

• Alleviation of responsibility: The scope of a corporate director's liability should be limited to no more than six years of income in the case of a representative director, four years for an internal director, and two years for an outside director, subject to the condition that the director is free from wrongful intent or gross negligence.

Before this rule could be applied, approval would first need to be obtained from the shareholders or from the Board of Directors, incumbent upon amendment to the company's articles of association.

The proposal was formulated in response to demands from economic associations and other sources. However, the revision would not likely effect major changes of real substance; this is because it would apply only to cases where a director is free from wrongful intent or gross negligence, and the record indicates that in cases of this kind to date the director is rarely if ever found guilty. Nonetheless, by imposing such upper limits, companies would be required to disclose the compensatory salaries, etc. of their directors, and this added transparency would make a positive contribution to the advancement of good practices in corporate governance.

4. Strengthening the functions of statutory auditors

The Commercial Code demands that all corporate entities maintain statutory auditors who, like directors, are elected by vote of the shareholders. There are two types of auditing: business auditing, which monitors the activities of directors pertinent to the execution of their business duties for the company; and account auditing, which monitors the conditions of a company's assets, i.e. the results of the activities undertaken by its directors. With the exception of companies of minor scale (capitalization below 100 million yen), in Japan the duties of statutory auditors encompass both business and account auditing. However, the business auditing by a statutory auditor is limited to legal auditing; valid auditing is performed by the Board of Directors. Companies of large scale (capitalization above 500 million yen or total liabilities exceeding 20 billion yen) are required to maintain at least three statutory auditors (at least one of which must be external) and to form a Board of Auditors composed of all statutory auditors; they must also appoint a professional account auditor.

The Code revisions now proposed in connection with auditors have two main points: 1) henceforth external auditors must form the majority, and 2) the tenure of all auditors may not exceed four years. Taken together, these revisions may be said to enhance the progress of corporate governance in Japan. For although systems mandating external auditors and Boards of Auditors were introduced in tandem with the Code revisions of 1993, until now the requisite condition enabling the appointment of an external auditor has been that the auditor was not in the company's employ during the most recent five years. In order to achieve greater independence, under the newly proposed revisions the regulation would be modified to open external auditor positions only to individuals who had never, at any time, served as a director, manager or employee of either the company in question or one of its subsidiaries.

5. Greater elasticity in classes of shares

Earlier, Japanese corporations were authorized to issue participating preferred stock only in the case of shares bearing no voting rights. The legal framework has now been amended to admit all issues of stock without voting rights regardless of whether or not they are eligible for preferred dividends. The revisions also clarified the position of "tracking stock," in which dividends closely reflect the actual performance of specific company segments or subsidiaries.

The proposals submitted on October 5 aimed to allow companies the authority to issue non-voting shares up to one-half the total volume of their outstanding shares. They also lifted the ban against tracking stock issuance, on the condition that the upper limits of dividend payments and other calculation standards are indicated in the articles of association. Companies issuing shares of multiple classes will now be able to hold shareholders meetings by class of stock.

6. Improvement of stock option schemes

The stock option system was introduced into Japan only several years ago, and the legal framework, largely prepared in haste, has been inadequate. Proposals are now seeking to make the necessary improvements so as to streamline regulations governing stock options and other management incentive plans.

Specifically, the proposals aim to abolish the upper limit now set on allocations of stock options (10% of outstanding shares under current law), eliminate restrictions limiting parties eligible to receive such options (currently, only directors and employees of the company in question), and simplify methods for allocating stock options (presently, the names, etc. of all recipients have been disclosed at shareholders meetings). Also, in line with the launch of a treasury stock system, the existing system of stock options using repurchased shares is to be abolished.

7. Review of regulations governing general shareholders meetings

In Japan, decisions fundamental to the operation of joint-stock companies are made at shareholders meetings. Items typically on the agenda include important organizational changes (changes to the articles of association, mergers, demergers, etc.), approval of financial statements and profit disposition proposals, appointments of directors and statutory auditors, etc. Among these agenda items, approvals of financial statements, appointments of officers and the like require approval, by vote, by the majority of the shareholders in attendance. Under law, attendance is required by shareholders holding a majority portion of the company's total outstanding shares; but this quorum requirement can be removed in the articles of association. In the case of items having particularly significant impact on the interests of shareholders (major organizational changes, etc.), decisions must be rendered by special resolutions voted on at the shareholders meeting. In these cases, shareholders holding a majority portion of the company's total outstanding shares must be in attendance and a two-thirds majority approval must be voted -- and it is not possible to eliminate these quorums in the articles of association.

Stock ownership is widely dispersed in Japan, however, and most corporations of large scale have shareholders

numbering upwards of 100,000. Moreover, because many individual investors acquire stock for speculative rather than investment purposes, many fail to exercise their voting rights. As a result, achieving the quorum necessary to approve a special resolution on the agenda can at times be quite difficult.

The new proposal suggests relaxing the quorum requirements attendant to such special resolutions. Instead of shareholders representing the majority proportion of all outstanding shares needing to be in attendance, the requirement would be lowered to one-third through changes effected to the articles of association; the regulation itself would remain in place.

In addition, concerning the approval of proposals for disposing of profits, items which under current law must be voted upon at a shareholders meeting, it has been proposed that approval at the shareholders meeting should not be needed in cases when account auditors and statutory auditors offer the view to that effect. Going forward, in tandem with a decline in the number of agenda items presented at shareholders meetings, regular corporate governance monitoring by shareholders should thereby become all the more important.

8. Launch of a management committee system

Historically, a large number of business corporations in Japan have maintained 20, 30 or even more managing directors simultaneously, a situation that has made it difficult for decisions on business matters to be rendered at Board of Directors meetings. Instead, company policies have effectively been decided upon at meetings of discretionary bodies comprised of senior managing directors only or of directors of the highest echelons, and the role of the Board of Directors has been merely to authorize decisions made by those groups. However, because such "management committees" have not been mandated under law, the scope of their responsibilities and relationship to the Board of Directors have been opaque.

To rectify this situation, it has now been proposed that corporate enterprises should have the liberty, either stated in their articles of association or by vote of the Board of Directors, to establish a management committee entrusted by the Board of Directors to render decisions on business matters relating to legal affairs, articles of association, or specified items. The members of such management committees are to be a representative assembly of the company's directors as elected by vote of the Board of Directors.

9. Obligation to appoint outside directors

Today a number of Japanese business corporations maintain outside directors, even though they are currently under no legal obligation to do so. In the United States and Europe, however, external or independent directors commonly play a significant role in corporate governance as monitors of management affairs. Under proposed revisions to Japan's Commercial Code, companies of large scale would become legally obligated to appoint at least one independent director outside the company, in order to strengthen supervision of the Board of Directors. Outside directors would be limited to individuals who prior to their appointment had never served as directors, administrators, or employees of the company in question or any of its subsidiaries.

In addition, because the current legislative framework makes no distinction between internal and outside directors, today internal and outside directors bear identical responsibilities as corporate directors. But because outside directors, who are inherently less knowledgeable in the internal business and other information of the company, are required to shoulder equal responsibility as those directors who actually execute the corporation's business, the demands placed on them are excessively severe, for which reason companies have difficulty acquiring outside directors.

The proposed revisions to the Commercial Code aim to lighten the responsibilities of outside directors. Specifically, under the proposal outside directors would become exempt from responsibility for actions taken by vote of the Board of Directors that became cause for damage indemnities. Under current law, such actions are made the responsibility of all directors who voted to approve them as well as all directors who are not described in the Board of Director meeting minutes as having opposed the action in question.

10. Introduction of Board subcommittees, executive officers

Under current law, corporate Boards of Directors are legally in charge of executing company business as well as responsible for supervising their own actions -- a combination that has drawn frequent criticism. Moreover, because in many instances members of the Board of Directors simultaneously serve as employees of the company, their joint position constitutes an impediment to dynamic business execution and effective supervision.

It has been proposed that the Commercial Code should be revised, with the aim of separating executive and supervisory functions and securing the autonomy of the Board of Directors, so as to permit companies of large scale to establish, by their articles of association, a system of

executive officers as well as various subcommittees whose members should center on outside directors. Adoption of such a dual structure would not be forcefully imposed, however; rather, each company would be able to choose between this new option and the traditional system maintaining a Board of Directors and Board of Auditors in parallel.

The proposed subcommittees would include an Audit Committee, a Nominating Committee and a Remuneration Committee. Each committee would be required to have a minimum of three members, to be determined at meetings of the Board of Directors, with the majority membership consisting of outside directors. The Audit Committee would monitor the duties executed by executive officers. The Nominating Committee would decide the content of resolutions pertaining to the appointment of directors. The Remuneration Committee would determine policy relating to compensation rendered to directors and executive officers, and also decide the amount and content of such compensation to each individual in question. To achieve full separation between executive and supervisory functions, no outside director or internal director serving as a member of the Audit Committee would be permitted to simultaneously serve as an executive officer.

Executive officers would render decisions on executing company business as entrusted to them by the Board of Directors, who would maintain the authority over the appointment and dismissal of the executive officers. Any company adopting the system of executive officers would be required to appoint a representative chief executive officer (CEO). (The representative director would not be appointed.) Also, in keeping with the nature of the system, a director in charge of executing business would not be permitted to simultaneously serve as an executive officer. Furthermore, because executive officers, unlike conventional directors, would not have the authority to supervise the execution of business matters, it is proposed that the executive officer's responsibility should be lighter than that of directors.

11. Launch of online processing

The rapid development and adoption of Internet functions in recent years have had a tremendous impact on every aspect of our lives. In countries around the world, schemes to achieve online processing of governmental functions extend to a broad range of civil services that until now have been possible only via written documentation. These include a variety of application processes.

Proposed revisions to the Commercial Code call for online processing of company documents, including financial statements, serving of public notices, communication between companies and their shareholders, etc. A proposal of importance particularly with respect to corporate governance is the suggestion to recognize online procedures in conjunction with the operation of annual general shareholders meetings, including processing of invitations and the exercise of voting rights. Under current law, Japanese corporations are required to dispatch invitations to general shareholders meetings two weeks in advance, a practice that fails to provide foreign shareholders with adequate time to consider resolutions on the agenda. Moreover, it has been suggested that because these meetings tend to be conducted under management's direction, they have become mere form without any real substance. If, as proposed, procedures affecting general shareholders meetings are rendered online, this would allow more shareholders to participate and to exercise their voting rights effectively. Revitalization of general shareholders meetings will inevitably enhance the efficacy of corporate governance.

The proposals submitted to the Diet on October 5 therefore include calls for invitations to general shareholders meetings to be rendered over the Internet, and for voting rights to be exercisable online. These proposals are in line with current global trends, and they should be welcomed in these times when the fiduciary duties of institutional investors are a subject much in debate.

Conclusion

The current revisions to the Commercial Code being considered by the government have the potential to change the parameters of corporate governance in Japan drastically. While it may be argued that an excess of regulation is not necessarily the preferred means of enhancing corporate governance, the system currently operating in Japan suggests that enhanced regulatory policy can indeed prove useful if it clears the way to long-awaited improvements in the nation's corporate governance practices.