



## Issue No.2, October 2002

### Corporate Governance and Reform of Japan's Commercial Code

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On May 22, 2002 a bill on reforms to Japan's Commercial Code was passed by the Diet. The revisions, scheduled to take effect from April 1, 2003, have two objectives: diversification of managerial means and streamlining of management. With respect to corporate governance, the amendments contain a number of points of importance, notably those having to do with systems by which corporate boards of directors operate.

New reforms of significance in terms of corporate governance fall into two categories: those relating to general shareholders meetings and those affecting boards of directors. In reference to general shareholders meetings, the reforms call for an earlier deadline for shareholders to exercise their rights to present proposals, and relaxation of the quorum requisite for special resolutions to be decided at those meetings. Concerning boards of directors, the reforms launch a one-tier system under which companies will establish three board committees and the like.

#### 1. General shareholders meetings

In the context of corporate governance, operations of general shareholders meetings have been amended in the following ways.

##### **Earlier deadline for shareholders to exercise their rights to submit proposals**

Under the current Commercial Code, any shareholder who has continuously held 1% or 300 units or more of the voting rights of all shareholders may, up to six weeks ahead of the appointed date of a general shareholders meeting, exercise his/her right to make proposals by submitting to the directors, in writing, a request to have a specific matter included on the meeting's scheduled agenda. Thereafter the company undertakes preparations for including the shareholders' proposals on its notices of invitation to the meeting so as to meet the legal deadline for dispatching such notices, which is two weeks prior to the meeting in question. The six-weeks-in-advance proposal deadline is considered

too short, however, to give companies wishing to dispatch such notices earlier -- in order to afford shareholders adequate opportunity to prepare for attendance and encourage them to exercise their voting rights -- sufficient time to make the necessary preparations. Accordingly the business community has been calling for a longer preparation period, i.e. an earlier deadline for shareholders to submit their proposals.

The legal reforms respond to this demand from the business community by moving forward the deadline for submission of shareholders' proposals to eight weeks ahead of a general shareholders meeting. From the perspective of corporate governance, however, the amendment creates a problem in that by compelling shareholders to carry out the necessary preparations for exercising their rights to submit proposals at an earlier time, the burden on the shareholder is increased.

##### **Relaxation of quorum requisite for special resolutions**

Special resolutions are a voting method requisite in conjunction with agenda proposals of a kind that would effect major changes in a company's underlying base: for example, changes to articles of incorporation, mergers, corporate split-ups, etc. Under the current law, passage of special resolutions requires the attendance (including votes cast by instruction card) at the general shareholders meeting by shareholders possessing a majority of the total voting rights of all shareholders -- the quorum -- and a vote in favor of such resolution by shareholders representing more than two-thirds of those voting rights. A company's articles of incorporation can impose a quorum of greater weight, but not of lighter weight. In the case of passage of ordinary resolutions, legal provisions in principle demand a quorum of shareholders holding a majority of the total voting rights of all shareholders and a positive vote by the majority of those voting rights; but in this instance the quorum may be removed if the articles of incorporation so delineate. Nearly all companies eliminate their quorum requirement and reach decisions through vote by a majority of the voting rights held by the shareholders in attendance at their general shareholders meetings.

In recent times, however, as the practice of cross-shareholding collapsed and holdings by individual and

foreign shareholders increased, it became difficult to secure the quorum demanded to convene a general shareholders meeting. That difficulty was often criticized as an impediment to the implementation of responsive business strategies at a time when reforms to the Commercial Code are heightening the need to change articles of incorporation and corporate reorganization is being carried forward through special resolutions on mergers, split-ups, and the like. The result is that under the latest legal reforms companies are to be permitted to lower the quorum required to pass special resolutions in compliance with their articles of incorporation to one-third of the number of voting rights held by all shareholders.

Because the Commercial Code reforms will enable a company to relax its quorum requirement by changing its articles of incorporation, the move should relieve the significant pressure companies have heretofore been under to secure a quorum. Companies will need to maintain communicative avenues open with their shareholders, however, to prevent the reforms from leading to light treatment of investor relations.

## 2. Boards of directors: launch of new system under which companies establish board committees, etc.

From the perspective of corporate governance, the most important change rendered in line with the latest reforms to the Commercial Code is that large companies, as well as companies of medium scale whose accounts are audited by independent auditors<sup>1</sup>, are to acquire the option of adopting a “one-tier” board structure of the kind in widespread use in the United States. Companies will be at liberty to decide whether to adopt the new American system or to maintain the Japanese-style system currently in use.

Under Japan’s current Commercial Code organizations operate under a unique system that differs from both of the major governance systems commonly in use: the one-tier system characteristic of the United States and United Kingdom, and the two-tier system adopted in Germany. The Japanese system is similar to other systems in the respect that the general shareholders meeting is positioned at the top of the corporate organization, but in Japan directors

(*torishimariyaku*) and corporate auditors (*kansayaku*) are elected at the general shareholders meetings. All directors serve on the board of directors, and the board of directors renders decisions relating to the execution of business activities and supervises other directors, especially representative directors. The representative director, corresponding to a CEO, is elected from among the members of the board of directors, and is in charge of actual day-to-day business activities. The corporate auditor is an office whose function is to monitor the business activities of the directors, and companies of large scale form boards of corporate auditors. The board of directors and (board of) corporate auditors are hierarchically on an equal plane below that of the general shareholders meeting, and in this respect the Japanese system differs substantially from both the one-tier system, in which the board of auditors is an internal body within the board of directors, and the two-tier system, in which the management board (*Vorstand*) is subordinate to the supervisory board (*Aufsichtsrat*).

Debate has been waged as to whether the current system, under which the board of directors has the dual functions of supervision and execution, indeed affords adequate supervision. Critics have charged that the Japanese system structurally does not provide independence of the directors or adequate separation of management and supervision. Also, the (board of) corporate auditors, who serve in a monitoring capacity, have actually not functioned fully despite the powerful authority and position legally vested in them through numerous revisions to the Commercial Code. It is also suggested that this inadequate operation of corporate functions and lack of corporate governance are the reason why Japan is unable to break out of recession. The latest revisions to the Code stem from the view that Japan’s corporate organizations should adopt a system of corporate governance patterned on the U.S. example. It might be noted that when debate on the issue began -- prior to the scandals surrounding Enron and the like -- American corporations were viewed as success stories.

Under the new system, Japanese corporations choosing this will now be obligated to establish three board committees: one overseeing nominations, one in charge of auditing, and one responsible for compensations. The new system does not permit directors to execute business activities; instead, companies are required to have executive officers in charge of executing such activities. Also, companies will no longer be allowed to maintain their own internal auditors. The majority of members of the three committees must be outside directors, and directors of companies having three committees must not serve in executive functions. Such companies are also required to maintain executive officers. Furthermore, because decisions rendered by these committees will be treated as decisions of the corporate

<sup>1</sup> (#1) Under Japan’s Commercial Code, the scale of a limited company (*kabushiki-kaisha*) is categorized as follows:

- Large scale: capital of ¥500 million or more, or total liabilities on the most recent balance sheets of ¥20 billion or more
- Medium scale: companies that qualify as entities of neither large nor small scale
- Small scale: capital of ¥100 million or less.

Most public companies targeted for investment by foreign investors are those of large scale.

organization, the committees will be fully autonomous and not entities merely subordinate to the board of directors.

### **Board of directors**

The board of directors renders decisions relating to corporate business activities and also has the authority to supervise directors and executive officers. The principal decisions left to the discretion of the board of directors are as follows:

- i. Basic management policies
- ii. Items set down by order of the Ministry of Justice as necessary to carrying out the duties of the auditing committee
- iii. Items relating to the delegation of duties of the executive officers, when there exists a plurality of such officers, and relationships among executive officers with respect to leadership commands, etc.
- iv. Selection of directors to form the various committees
- v. Selection and dismissal of executive officers
- vi. Authorization of financial statements

Among these, the first three are especially important as they relate to companies that establish committees, etc. Item i. refers to policies setting the directions for directing and exercising control over a company: the central functions of directors. The details of item ii. are decided by the Ministry of Justice, but with respect to content they are seen to call for the establishment of an internal control system and risk management system in order to ensure that the executive officers comply with laws and ordinances and carry out business activities efficiently. Item iii., aimed at ensuring the smooth execution of business activities by the executive officers, calls for the selection of a representative executive officer (corresponding to a CEO) from among the executive officers, and decisions on segments to be overseen by each executive officer.

With reference to item iv., it is only natural that the directors should decide the makeup of the nomination, auditing and compensation committees because these committees are organizations internal to the board of directors. With respect to item v., the board of directors has the authority to select and dismiss executive officers by virtue of its position as the supervisory authority overseeing the executive officers. In conjunction with item vi., if the outside auditors (accounting firm, CPA) state in their auditors report the opinion that the financial statements conform with the law, and if the auditors report of the board of auditors contains no opinion suggesting impropriety of the auditing results by the auditors, authorization of financial statements by the board of directors is deemed as approval by the general shareholders meeting. Until now, authorization of financial statements in Japan was a decision delegated to the general shareholders meeting; and decisions relating to profit appropriation in particular were by convention rendered by

shareholders because they relate to the benefits of the shareholders themselves. Under the legal reforms, instead of shareholders controlling affairs through decisions rendered at general shareholders meetings, including details specific to profit allocation (especially dividends), shareholders will now use general shareholders meetings to monitor management for improper management policies, including dividend policy, as is the case in the United States and elsewhere.

The board of directors may, at its discretion, delegate to executive officers the authority to render decisions relating to business activities, except for certain matters of great importance. As an example, decisions relating to significant debt, earlier rendered by the board of directors, can be delegated to the executive officers as matters having a decisive bearing on specific business activities. However, decisions on important matters -- such as those relating to supervisory duties as described in items i. to v. -- cannot be delegated to executive officers.

### **Nomination committee**

Final authority on decisions concerning the selection and dismissal of directors is vested in the general shareholders meeting, but traditionally agendas on the selection or dismissal of directors submitted to the general shareholders meeting were decided at meetings of the board of directors. At companies adopting the new system, agendas concerning such selections and dismissals will be decided by a nomination committee.

It is expected that by nominating directors at meetings of the nomination committee, in which outside directors constitute a majority, such selections will be more fair and appropriate than under the earlier system in which nominations were made by the board of directors, whose members were almost exclusively directors from within the company itself.

### **Audit committee**

As with the nomination and compensation committees, members of the audit committee are to consist of three or more directors, the majority of whom must be drawn from outside the company. Furthermore, it is forbidden for the outside directors on the audit committee to simultaneously be serving as executive officers or employees of the company or its subsidiaries or as directors conducting the business activities of a subsidiary. The reason for this ban is the greater autonomy demanded of outside directors on the audit committee than of counterparts on either the nomination or compensation committee, in order to boost the autonomy of the audit committee.

The authority vested in the audit committee generally consists of the following:

- i. Auditing of business executed by directors and executive officers
- ii. Decisions on agendas pertaining to selections and dismissals of auditors submitted to general shareholders meetings, and agendas relating to intent not to appoint auditors

The system of corporate auditors, which has been a feature unique to Japan, was generally viewed as a vehicle for monitoring the legal conformity of business conducted by directors. For that reason, in spite of numerous reforms targeted at strengthening the corporate auditors' functions, there have been limitations to the powers vested in auditors in the respect that monitoring by corporate auditors has not been able to extend to questions of propriety. Under the circumstances, the establishment of an audit committee (albeit at the discretion of the corporation) under the latest reforms should be viewed as a means to reinforce the quality of audits, and not as a committee merely serving as an organization to substitute for corporate auditors.

Accordingly, the audit committee should be thought of as a body having the power to audit not only the legal conformity, but also the propriety, of business carried out by corporate directors.

Agendas concerning the selection of outside auditors (accounting firm, CPA) call for approval by the general shareholders meeting, and resolutions for such purposes can now be decided by the audit committee. Because the audit committee is independent of and supervises management, preparation of resolutions relating to the selection of outside auditors leads to heightened autonomy of the auditors. Also, because the audit committee bears responsibility for internal control, it also becomes necessary for the committee to have a close relationship with outside auditors.

The audit committee is also obligated to prepare audit reports. The audit reports are required to record all instances in which the committee determines inappropriate a decision rendered by the board of directors relevant to matters set by regulations of the Ministry of Justice as necessary to the execution of the duties of the audit committee, together with the committee's reasons why it considers the decision inappropriate. "Matters set by regulations of the Ministry of Justice" are slated largely to consist of matters pertaining to internal control and risk management systems, with the purpose of recording such data in the audit reports being the evaluation of internal control systems. An important mission of the audit committee is to ensure that an internal control system is set in place.

### **Compensation committee**

Until now, directors' remuneration had to be determined at the general shareholders meeting when it is not written within the articles of incorporation. It was understood that

what needed to be determined was either the maximum or total amount of compensation. Only rarely have disclosures been made not only of the specific compensation amounts granted to each director, but even of the total amount, and the practice has drawn widespread criticism from overseas investors. A number of companies made disclosures at their general shareholders meetings this year of the total amount of compensation granted to their directors and the number of recipients, but none revealed specific amounts granted to specific individuals.

At companies adopting the new system, a compensation committee will decide remuneration sums to be granted to each director and executive officer. In such cases, the general shareholders meeting will lose the authority to decide on compensations. The committee will be required to lay down a policy relating to the content of the compensations to be received by each director and executive officer, and such content must conform with that policy. The policy is to be recorded in the company's business report. The compensation committee will decide three items pertinent to individual compensations: i. amounts to be granted to each individual, in cases when the compensation amount is fixed; ii. a specific method for calculating individual compensations, in cases when remuneration amounts are not fixed; iii. the specific content of individual compensations when such compensations are in other than monetary form.

Until now, officers' bonuses have been included in agendas on allocation of profits. At companies adopting the new system, such resolutions can now be decided at board of directors meetings, and for that reason it is forbidden to undertake monetary allocations to directors or executive officers by way of profit distribution. Accordingly, compensation previously treated as bonuses will henceforth be treated as remuneration linked to business results.

In the United States, as a result of the Sarbanes-Oxley Act of 2002 and reforms of SEC rules, it has become a natural trend that a majority of members of a board of directors must be "independent" directors, and all members of an audit committee must be independent auditors. While the Japanese system is still behind, the latest reforms to the Commercial Code may be viewed as progress.