

**Towards Better Corporate Governance
(Interim Discussion Paper on Key Issues)**

<Tentative Translation>

April 14, 2009

Nippon Keidanren

Proposal: "Towards Better Corporate Governance"
(Interim Discussion Paper on Key Issues)

April 14, 2009
Nippon Keidanren

1. Introduction

(1) Basic philosophy of corporate governance

Nippon Keidanren published a proposal in 2006 entitled "A Suitable Corporate Governance System for Japan." This policy proposal set out the philosophy that corporate governance should adopt, in an integrated manner, both perspectives of preventing unfair practices by companies and of enhancing competitiveness and profitability, while addressing the question of how to build a corporate management structure oriented towards the long-term growth of corporate value. With regard to the improvement of corporate governance, while respecting the diverse and voluntary efforts taken by individual companies based on the views of their domestic and overseas stakeholders, it advocated the necessity for a highly pliant framework that permits the flexible implementation of measures that lead to the enhancement of corporate governance, and also the need to take initiatives that are truly effective, oriented towards substance rather than formality. This philosophy of the business community with regard to corporate governance remains fundamentally unchanged.

(2) Background of the discussion

In recent years, there have been demands by the U.S. and European governments and institutional investors for the Japanese corporate governance system to be revised. Within Japan, corporate governance has also been a subject of discussion at such forums as "the Study Group on the Internationalization of Japanese Financial and Capital Markets (*Waga-kuni Kin'yu Shihon Shijo no Kokusai-ka ni kansuru Working Group*)" of the Financial Services Agency's Financial System Council, "the Corporate Governance Study Group (*Kigyo-touchi Kenkyukai*)" at the Ministry of Economy, Trade and Industry, and "the Advisory Group on Improvements to the Listing System (*Joujou-seido Seibi Kondan-kai*)" of the Tokyo Stock Exchange (TSE).

Given these circumstances, we wish to take steps to further enhance the credibility of Japanese companies and capital markets. We will do so by describing the current situation in which Japanese companies are making sincere efforts to improve and strengthen corporate governance, and elucidating anew the thinking of the Japanese business community with

regard to the philosophy on corporate governance, so as to gain the understanding of people and institutions overseas.

(3) Voluntary actions by companies to enhance corporate governance

A prerequisite for increasing corporate value over the long term is the sound functioning of corporate governance as a mechanism for assuring fairness and efficiency in corporate management. In addition, efforts to perfect corporate governance should not be rigid or unchanged, but should be improved constantly as part of management taking into consideration the changes in the environment of every individual company, and the voices of their diverse stakeholders both within Japan and overseas, including shareholders, employees, suppliers, business partners, and customers. In fact, companies are making a variety of voluntary efforts, including the improvement of communication with investors.

For example, companies are devoting greater effort to dialogue with shareholders, and as a result, investor-relations (IR) activity is greatly improved from what it has been previously. The general meetings of shareholders, the most important forums for dialogue with shareholders, were formerly held on particular dates resulting in concentrated voting season, but they are progressively being spread over a wider number of dates¹. Also, with regard to letters to shareholders giving notice of shareholders meetings, a growing proportion of companies are sending them out earlier than the two weeks prior to the meeting dates that is the legally prescribed minimum notice period. Of particular note is that a robust increase has been seen in the number of companies sending out the notices three weeks or more before the convocation dates.² Companies are also promoting the use of IT (information technologies) in sending out the notice of general meetings of shareholders and in voting procedures. More and more companies prepare notices in English and put them on their official website.³

¹ Research by the TSE shows that the degree of concentration of the assembly dates of general meetings of shareholders (of companies with March year-ends) declined from 96.2 percent in 1995 to 48.1 percent in 2008.

Source: TSE Website (<http://www.tse.or.jp/listing/sokai/shuchu/graph.pdf>).

² The proportion of companies sending out notices of convocation of general meetings of shareholders earlier than the legally prescribed minimum notice period (two weeks prior to the meeting date) increased from 38.4 percent in 1999, to 75.2 percent in 2008. There has also been a substantial increase in the proportion of companies sending the notices three weeks or more before the meeting date: from 1.3 percent in 1999, to 13.9 percent in 2008.

Source: *Shiryoban Shojihomu* No. 294 (September 2008).

³ Among companies with stock capitalization exceeding 100 billion yen, 65% (21.1% in 2003) companies use IT technologies in sending out invitations to shareholders meetings and in voting procedures, and in 2008, 71.0% companies use ICJ Electronic Voting Platform for Foreign and Institutional Investors established by TSE and Japan Securities Dealers Association and started operation from companies with 2005 December year-end. In the same statistics, number of companies who send notice of

As an indicator showing very clearly how IR activity is becoming more vigorous, average annual spending on IR activities by listed companies rose by more than 70 percent from 2004 and 2008.⁴ What is more, one-on-one meetings with overseas and domestic institutional investors are being held an average of 40 to 50 times per year, respectively.⁵ These facts indicate, especially in the case of listed companies, that vigorous IR activity is being undertaken.⁶ In addition, for the enhancement of IR directed at shareholders who are private individuals, numerous companies hold explanatory meetings for individual investors, participate in events and fairs for individual investors, have improved IR material, and take other steps such as actively displaying IR material over the Internet.⁷

Moreover, an increasing number of companies are making their dividend policies public. For example, they set target values for the return of profit to shareholders and they state specific numerical criteria for their targets for the return of profit to shareholders in their annual securities reports and in earnings digests.⁸ Actual dividend payment to shareholders also shown a steady increase in recent years⁹.

shareholders meetings in English has increased from 38.1% (in 2001) to 44.0% (in 2008) and companies who put English notice on their website from 25.0% (2001) to 54.0% (2008).

Source: Shoji-Homu, *White Paper on General Meetings of Shareholders* (Editions FY2001, FY2003, and FY2008)

⁴ According to the IR Activities Survey conducted by the Japan Investor Relations Association, among listed companies, the average IR spending per company rose substantially from 12.9 million yen (2004) to 22.1 million yen (2008).

Source: Japan Investor Relations Association, 11th IR Activities Survey (June 2004), 15th survey (June 2008).

⁵ Source: Japan Investor Relations Association, 13th IR Activities Survey (June 2006), 14th survey (June 2007), 15th survey (June 2008).

⁶ The Japan Investor Relations Association released a guideline on IR best practices (*IR Kodo Kensho*) in December 2008.

Source: JIRA website https://www.jira.or.jp/jira/jsp/usr/outline/pdf/IR_gensoku.pdf (available only in Japanese)

⁷ The numbers of listed companies holding briefings for individual investors, briefings for analysts and institutional investors, or briefings for overseas investors are trending upwards overall. Of note is the fact that the proportion of briefings hosted by the top management of these companies themselves has been increasing, demonstrating that there is a growing trend towards attaching importance to dialogue with shareholders. In addition, the proportion of companies displaying IR information on their own company websites is high, at 87.5 percent of all companies listed on the TSE.

Source: TSE, *TSE-Listed Companies: White Paper of Corporate Governance 2009* (January 2009)

⁸ According to a survey by The Life Insurance Association of Japan's leading 1,200 companies as measured by gross market capitalization, the number of companies announcing in their financial reports and in earnings digests specific numerical criteria for their targets for the return of profit to shareholders increased sharply from 96 at the time of the 2004 survey, to 387 at the time of the 2008 survey.

Source: The Life Insurance Association of Japan, *Fiscal 2008 Survey on companies' efforts to increase share value* (2008)

⁹ The ratio of dividends to net assets of TSE-listed companies (including 1st, 2nd & Mothers Sections) has increased from 1.68%(2003) to 3.33%(2008), and the amount of dividends paid has also increased from 2.2 billion yen (2003) to 5.6 billion yen (2008).

In regard to the terms of office of Directors, in many U.S. states they are permitted to a maximum of three years. In Japan, however, in companies with *kansayaku-kai* (board of company auditors or corporate auditors) the term is a maximum of two years according to the Companies Act, but there is a trend towards the voluntary exercise of discretion to shorten such terms, at present, the most common practice among listed companies is to make the terms one year.¹⁰ Also, whereas in the U.S. there must be a legitimate reason for the dismissal of Directors, such requirement has never been imposed in Japan.

As to corporate governance structures, it is essential that the governance structures have “genuine substance” which means that it is guaranteed to function as a governance system with the confidence of shareholders, in a way that promotes fair and efficient management of the corporation, rather than merely satisfying formality of the structure. It is indisputable on this point, since it is clear from the fact that even though the governance structures of the giant financial institutions that were the cause of the financial institution collapse in the U.S. satisfied the formality required by state companies laws and the rules of the New York Stock Exchange (NYSE), however, in terms of substance they do not seem to have exercised sufficient governance functions.

The lessons learned from this teach us that the desirable form of corporate governance should be discussed not from the perspective of the formality of governance structures, but rather how its mechanism actually functions. The evaluation of specific actions or measures taken by companies should be entrusted to the judgment of the market.¹¹

In view of this, as a premise for the debate, it is not appropriate to judge Japanese companies’ corporate governance applying the rules on corporate governance in other countries and markets without due modification. Instead, from the standpoint that the market discipline is more important, and particularly given the fact that the proportion of overseas investors is rapidly growing in the Japanese capital market, it is becoming more vital than ever for companies to gain the understanding of all market players and their own diverse stakeholders, including shareholders, by indicating the philosophy

Source: TSE, *Summary of Earnings Digest (April-March Business-Term Listed Companies) FY ending March 2008 (Non-Consolidated) Historical Data* (2008)

¹⁰ Among the companies included in the Nikkei JAPAN 1000, 62.1 percent have terms of office of Directors of one year, and 37.9 percent have terms of two years, demonstrating that one year is becoming the norm.

Source: JAPAN PROXY Governance, Inc. *Giketsuken koshi*, 2009 edition.

¹¹ In OECD Principles of Corporate Governance, it is clearly stated that “(T)here is no single model of good corporate governance”.

Source: OECD, *OECD Principles of Corporate Governance* (2004)

underlying their corporate governance mechanism and their methods of implementation.

From the basic stance outlined above, this proposal sets out, and serves as an interim discussion paper on the current key issues of corporate governance showing the thinking of Nippon Keidanren concerning the subject.

With this interim discussion paper as a starting point for discussion, Nippon Keidanren hopes to engage in more extensive dialogue with institutional investors both domestic and overseas and all other interested parties. Nippon Keidanren also wishes to deepen discussion within Japanese business community on what should be done to achieve good corporate governance in order to enhance corporate value on a continuous basis.

2. Corporate Governance Structure

(1) Appointment of Outside Directors at companies with *Kansayaku-kai*

The Companies Act provides for two institutional formats for large companies, classifying them as either companies with committees or companies with *Kansayaku-kai* (board of company/corporate auditors). Neither is regarded as superior or inferior to the other, and from the perspective of the separation of oversight/monitoring and execution their configuration is of equal merit institutionally.

In companies with committees, it is required that the majority of members of each of the three committees to be outside Directors.¹² On the other hand, companies with *Kansayaku-kai*,¹³ a category to which the majority of listed companies in Japan belong, are subject to the requirement that at least half of their *Kansayaku* (company/corporate auditors) be Outside *Kansayaku*,¹⁴ though they are not obliged to appoint Outside Directors and it is left to the judgment of individual companies whether they should appoint Outside Directors.

To take TSE-listed companies as an example, 44.1 percent of companies with *Kansayaku-kai* have exercised their own independent judgment and voluntarily elected Outside Directors, and that proportion is trending

¹² Companies Act Article 400 (3) The majority of the committee members of each Committee shall be Outside Directors.

¹³ Of the 1,717 companies listed on the TSE First Section, 1,670 companies, or 97.3 percent of the total number, are companies with a *Kansayaku-kai*.

Source: *TSE-Listed Companies: White Paper of Corporate Governance 2009* (January 2009).

¹⁴ Companies Act Article 335 (3)

A Company with Board of Company auditors shall have three or more company auditors, and the half or more of them shall be Outside Company Auditors.

upward.¹⁵ With regard to the significance of voluntarily appointment of Outside Directors, many companies have stated the benefit of appointing them as the insights of the Outside Directors through the advice on management from an external perspective so as to enhance corporate value on continuous basis, in addition to the supervision of the execution of operations. Among companies that have not appointed Outside Directors, there are also cases in which they establish advisory boards or similar bodies composed of external experts and are receiving advice on management policy and business strategy that is reflected in their management decision-making. There are also cases in which executive directors have been elected from outside a company with no previous experience of working for that company as an employee or an officer but are not classed as Outside Directors under the Companies Act's definition, since it prescribes an Outside Director as being someone who is not serving currently nor has ever served in the past as an executive director of the relevant company.¹⁶

In addition, in the company's annual securities reports (in the "State of corporate governance" section) and in the corporate governance reports inaugurated by the TSE in March 2006, individual companies disclose the reason why the company adopted their governance structure, and the philosophy underlying such decisions.

In companies with *Kansayaku-kai*, which account for the majority of listed companies in Japan, the execution of company business is conducted by Directors,¹⁷ and the duties of the Board of Directors are stipulated by Companies Act as being (1) deciding the execution of the operations of the company with Boards of Directors (decisions on the execution of important operations may not be delegated to Directors), (2) supervising the execution of the duties by Directors, and (3) appointing and removing Representative

¹⁵ According to *TSE-Listed Companies: White Paper of Corporate Governance 2009*, 44.1 percent of companies listed on the TSE (companies with a *Kansayaku-kai*) have elected outside Directors, representing an increase of 3.3 percentage points since the previous survey in 2006, and indicating the growing trend towards electing outside Directors voluntarily.

¹⁶ Companies Act Article 2 (xv)

"Outside Director" means a director of any Stock Company who is neither an Executive Director (hereinafter referring to a director of a Stock Company listed in any item of Article 363(1), and any other director who has executed operation of such Stock Company) nor an executive officer, nor an employee, including a manager, of such Stock Company or any of its Subsidiaries, and who has neither ever served in the past as an executive director nor executive officer, nor as an employee, including a manager, of such Stock Company or any of its Subsidiaries;

¹⁷ Companies Act Article 363 (1)

The following directors shall execute the operations of a Company with Board of Directors:

- (i) A Representative Director; or
- (ii) A director other than a Representative Director, who is appointed by resolution of the board of directors as the director who is to execute the operations of a Company with Board of Directors.

Directors.¹⁸ It is clear from above that the Boards of Directors of Japanese companies conduct both the execution of business operations and the supervision of that execution of business operations.

The Japanese Companies Act provides that the determination of dividends must be made by the resolution of general meetings of shareholders, and it also provides that shareholders may propose amendments to a company's articles of incorporation. In the U.S., in contrast, dividends are not subject to resolutions at general meetings of shareholders, and shareholders are not able to propose amendments to a company's articles of incorporation.¹⁹ In addition, in Japan the matters for resolution by the Board of Directors are prescribed in detail by the Companies Act.

Adding to the supervisory functions of the Board of Directors, Japan's Companies Act contains provisions for supervision of Directors' business execution by *Kansayaku* and *Kansayaku-kai*, at least half of *Kansayaku-kai* member must be Outside *Kansayaku*, thus creating dual monitoring functions with regard to business execution. The fact that *Kansayaku* are company officers who do not engage in business execution gives them even greater independence from management than that of Outside Directors, constituting a mechanism never inferior to the functions for monitoring in companies in the U.S. and European countries. The Japanese mechanism could be said to be superior insofar as there coexist two monitoring structures: the *Kansayaku-kai*, a group of company officers who do not engage in business execution (non-executive company officers), and the Board

¹⁸ Companies Act Article 362 (2) Board of directors shall perform the following duties:
(i) Deciding the execution of the operations of the Company with Board of Directors;
(ii) Supervising the execution of the duties by directors; and
(iii) Appointing and removing Representative Directors.

Companies Act Article 362 (4)
Board of directors may not delegate the decision on the execution of important operations such as the following matters to directors:
(i) The disposal of and acceptance of assignment of important assets;
(ii) Borrowing in a significant amount;
(iii) The election and dismissal of a important employee including managers;
(iv) The establishment, changes or abolition of important structures including branch offices;
(v) Matters prescribed by the applicable Ordinance of the Ministry of Justice as important matters regarding the solicitation of persons who subscribe for Bonds such as the matters listed in item (i) of Article 676;
(vi) The development of systems necessary to ensure that the execution of duties by directors complies with laws and regulations and the articles of incorporation, and other systems prescribed by the applicable Ordinance of the Ministry of Justice as systems necessary to ensure the properness of operations of a Stock Company; or
(vii) Exemption from liability under Article 423(1) pursuant to provisions of the articles of incorporation under the provisions of Article 426(1).

¹⁹ In the U.S. the relationship between general meetings of shareholders and the board of Directors differs from that prescribed in the Companies Act in Japan. For example, the board of Directors has exclusive authority to determine legal standards for corporate management, the right to make proposals relating to corporate reorganization and dissolution, and dividend rights.

Source: Akira Morita, "*Kokai kigyo no torishimariyakukai kengen no yuetsusei*" [*Supremacy of board of Directors' authority in public companies*], *Shojihomu* 1785 (December 2006).

of Directors, composed primarily of Directors responsible for business execution.

The question of whether or not the Board of Directors can conduct appropriate supervision of business execution depends more than simply on whether or not there are Outside Directors who are non-executive or a number of Outside Directors. It depends more on the qualification of Directors whether they have management knowledge and experience, whether they have a good knowledge of the business of the relevant company and the relevant industry, and whether, based on that knowledge and experience, they have capability to put forward timely and appropriate proposals. With regard to the substance of governance, we believe that the present framework is appropriate: the voluntary decision by individual companies is recognized, and on the questions of whether Directors are equipped with the aptitude and ability to do this, shareholders make judgments by means of exercising of voting right on proposal of the election of Directors based on disclosed information.

If investors call for the institution of Outside Directors, companies should lend an attentive ear and should explain as conscientiously as possible and communicate how they will respond to those calls by means of IR activity, including direct dialogue with investors.

(2) Review of conditions for externality (Strengthening independence)

Among the U.S. government's requests for regulatory reform in the 2008 fiscal year is the request for the revision of the conditions in the present Companies Act--"[person] who is neither an executive director nor an executive officer, nor an employee, including a manager, of such stock company or any of its subsidiaries, and who has never served in the past as an executive director or executive officer or as an employee, including a manager, of such stock company or any of its subsidiaries"--for being classed as Outside Directors and Outside *Kansayaku* ("[person] who has never served in the past as a director, accounting advisor, or executive officer or as an employee, including a manager, of such stock company or any of its subsidiaries"), and for the addition of "independence" conditions that exclude persons who have held such positions as an employee or officer of a supplier or related business entity or parent company.

The governance of entire corporate group is important, and external officers should not be thought of as representing the interests of particular investors (but, rather, as representing the public interest on behalf of all stakeholders). However, if people were to be excluded from the category of "Outside" officers purely by virtue of the fact that they are officers or employees of a parent

company or a supplier or related business entity, that would risk excluding related people (suppliers or related business entities, etc.) who are strongly connected with enhancing the corporate value of the company concerned, and have knowledge and experience of the inner workings of that company, and on the contrary could prevent the company from functioning adequately.

When discussing externality, we should examine independence from the management (whether or not the relationship is one in which judgment is influenced by the management, that is the persons who execute company business, by pressure or other means). The existence of the ability to influence the management would be desirable from a governance perspective.

Behind the assertion that persons who are officers or employees of parent companies should not become Outside Directors is the doubt that they might attach importance to the intentions of those companies, which are major shareholders, to the detriment of the interests of other shareholders. However, to give priority to the interests of a third party (in the form of a parent company) and thereby give rise to a conflict of interests should never be permitted and such conduct means the violation of the duty of loyalty as a Director, and the Companies Act does not tolerate acts of that kind.

In any event, with regard to the nature of external officers formal conditions should not be made stricter, but the present framework should be maintained. That is, it would be desirable to entrust to the exercise of voting right by shareholders on the proposal for the election of Directors at general meetings of shareholders, to judge whether an external officer would be able to function effectively as a check on the management by means of disclosure.

In Japan, matters relating to external officers are already subject to a very high level of disclosure. This includes, pursuant to the Companies Act, in reference documents for general meetings of shareholders and in business reports, and in the TSE's corporate governance reporting system there are provisions for detailed disclosure of the attributes of Outside Directors. With this situation as the foundation, it is essential for companies to continue their individual efforts to enhance their voluntary disclosure.

(3) Role and authority of *Kansayaku* as non-executive company officers

Since 1974, developments such as repeated revisions of the Companies Act have seen the strengthening of the supervisory functions of Japan's auditor system with regard to business execution, specifically through the enhancement of the powers and independence of *Kansayaku*. Recently, as a result of the 2001 revision of the Companies Act, the term of office of *Kansayaku* has been extended to four years in order to enhance their

independence, and for companies with a *Kansayaku-kai* it has become obligatory for at least half of all *Kansayaku* to be Outside *Kansayaku*. Further, in addition to the right to give its consent for proposals for election of accounting auditors, the new Companies Act that came into force in 2006 grants the *Kansayaku-kai* the right to give its consent for their remuneration.

As a result of these steps to strengthen the powers of *Kansayaku*, for the supervision of companies' executive structures of the kind that investors expect, there are numerous matters for which *Kansayaku*, as non-executive company officers, have the authority and responsibility to act appropriately. With regard to fair and appropriate business execution, not only persons engaging in business execution but also non-executive company officers participate in the supervision and fulfilling the responsibility on accountability to shareholders. This increases shareholders' satisfaction with regard to what they themselves see to be the propriety of business execution, which, in the end, contributes to the stability of business execution.

In contrast to a Director who participates in decision making on management-related matters in their capacity as a member of a Board of Directors, a *Kansayaku* has sole discretion having powers such as the authority to demand the cessation of business execution that violates Directors' duty of care. Also, by such means as stating his/her opinions in writing in audit reports, a *Kansayaku* can disclose its opinions directly to shareholders. In addition, accounting auditors provide information to *Kansayaku* on matters such as illegal acts perpetrated in the execution of business. *Kansayaku* are also obliged to attend meetings of Boards of Directors and to state their opinions, and if necessary they may make statements at meetings of Boards of Directors; there are no particular restrictions on the scope of the opinions they utter. With regard to the Outside *Kansayaku* who make up at least half of each *Kansayaku-kai*, in many cases companies appoint independent specialist or professionals, such as academics, lawyers, and certified public accountants.²⁰

If it is necessary to enhance or strengthen supervisory functions directed at business execution, we suggest that instead of revising existing laws it may be preferable to take steps to enable the functions already vested in *Kansayaku* to be used to the full. That would necessitate greater efforts by companies, including cooperative efforts by Boards of Directors and *Kansayaku-kai*, both bodies that have supervisory functions, to develop such structures and strengthen in-house collaboration on supervision.

²⁰ Among the TSE-listed companies with *Kansayaku-kai*, the outside *Kansayaku* include lawyers (18.5 percent), CPAs (9.8 percent), tax accountants (5.8 percent), and academics (2.4 percent).
Source: *TSE-Listed Companies: White Paper of Corporate Governance 2009*.

For example, as a stratagem for companies to enhance business practice, they could further develop their structure for information transfer and structure for addressing matters in-house, including by improving secretariat structures that support the activities of *Kansayaku* and by developing the structure of collaboration with internal-control units. We believe also that it would be effective to ensure that *Kansayaku-kai* are composed of persons with the character, career background, knowledge, and other characteristics that enable them to state opinions frankly to the top executives and other senior business executives, and to have those opinions received with sincerity by the persons responsible for business execution.

(4) So-called “Distortion of incentives (*incentive no nejire*)”

Some observers have claimed that since audit contracts are arranged between accounting auditors (persons conducting accounting audits of annual securities reports and other [consolidated] financial statements) under the Financial Instruments and Exchange Act and the management of companies subject to accounting audit, and the structure is such that the audited companies pay the auditors compensation for the audits, the auditors consequently conduct audits that pander to the managers, a fact that can easily lead to accounting scandals. Recognizing that this situation gives rise to “distortion of incentives”, such observers claim that it is preferable to grant *Kansayaku-kai* not merely the right to give its consent but the right to decide on proposals for the election of accounting auditor and to decide on audit remuneration. The present Financial Instruments and Exchange Act contains no provisions for the election or remuneration of auditors, but the Companies Act provides that *Kansayaku* have the right of consent for proposals for the election of accounting auditors (persons conducting accounting audits of accounting documents pursuant to the Companies Act) and their remuneration. Therefore, there are calls in certain quarters for the Companies Act to be amended so as to strengthen the right of *Kansayaku*.²¹

However, behind this attention given to the issue of “the distortion of incentives” may be the fact that the existing powers of *Kansayaku-kai* concerning decisions on the election, dismissal, and remuneration of accounting auditors have not been exercised fully.

²¹ This point does not appear to be based on the differences between auditing pursuant to the Financial Instruments and Exchange Act and auditing pursuant to the Companies Act.

"Auditing by *Kansayaku* and *Kansayaku-kai* pursuant to the Companies Act is conducted for the sake of the shareholders and company creditors, while auditing by CPAs or accounting auditors pursuant to the Financial Instruments and Exchange Act is for investor protection. ...Auditing under the Financial Instruments and Exchange Act is post-auditing conducted on confirmed financial statements approved by general meetings of shareholders, whereas...auditing by accounting auditors is pre-auditing conducted on accounting documents submitted to general meetings of shareholders."
Source: Hideki Kanda, *Kaishaho (Dai11 han)* [The Companies Act (11th ed.)] (March 2009).

In the present configuration of the Companies Act, companies with *Kansayaku-kai* and companies with committees are deemed to be of equal merit, and they are also of equal merit as mechanisms for monitoring company managements. They act as supervising body on CEO from an external perspective, the position of *Kansayaku* (or *Kansayaku-kai*) not forming part of the executive pyramid, while the position of Outside Directors within the committee system being members of Boards of Directors within the corporate pyramid.

If *Kansayaku* are to be given an authority to decide on proposals for the election and remuneration of accounting auditors, it means *Kansayaku* are granted business execution authority, and that would run counter to the spirit of the system of *Kansayaku* under the Companies Act, whose great merit is that the *Kansayaku* do not engage in business execution and therefore exist independently of the management. If *Kansayaku* came to undertake part of the execution of company business in this way, that might create a duplication of decision-making for business execution.

Kansayaku have the right to consent to proposals for the election of accounting auditors, and if they were to decide that accounting auditors that the Board of Directors wished to have elected were unsuitable, the opinion of the *Kansayaku* can be reflected by means of withholding their consent, and this would act as a restraint on the Board of Directors. Additionally, *Kansayaku-kai* have the right to request submission of proposals, and are thus in the position of taking the initiative in the election of accounting auditors. Similarly, *Kansayaku-kai* has the right of consent with regard to the remuneration of accounting auditors.

Accounting scandals arise because of the lack of ethical standards on the part of certain unprincipled management and certain like-minded accounting auditors rather than because the right to decide proposals for election and remuneration lie on the side of executive management. It is important for accounting auditors to be thoroughly imbued with professional ethics, and for *Kansayaku* to support that through the exercise of their authority.

(5) Disclosure of the results of the exercise of voting rights at general meetings of shareholders

According to the results of an opinion survey of investors conducted in 2008 by the TSE in relation to the corporate governance of listed companies ("TSE investor survey"), both domestic and overseas investors stated a desire for the disclosure of the results of voting at general meetings of shareholders.

The Companies Act provides that proxy and votes in writing be provided for inspection by shareholders for a period of three months after a general meeting of shareholders, and in addition to that there are some companies that, after general meetings, voluntarily display the results of voting at general meetings on their Websites and other media. At present, not all companies are in the position where they can disclose the results of voting, and hence the disclosure should not be made mandatory by law or under rules of stock exchanges. Nevertheless, from the perspective of enhancing communication with shareholders, companies taking such voluntary actions are commendable.

At the advance voting stage, agenda items satisfy the conditions for adoption in many cases, and therefore companies omit detailed counting of the affirmative or negative votes cast by the shareholders present at general meetings of shareholders, and at present it is practically difficult for the companies to disclose figures that include the votes cast on the date of the shareholders meetings. In addition, even for listed companies, it is a legal principle that general meetings of shareholders are meetings composed solely of shareholders with voting rights, and in practice companies act in accordance with that principle. However, by disclosing the results of voting public, not limited to shareholders, influence from non-shareholders may be magnified, or disclosing figures that do not include the votes cast on the days of meetings may create figures that take on a life of their own and give rise to misunderstanding. Owing to factors such as this, there is concern that in some cases governance may be distorted. In light of this, the way to address disclosure of such results should be to entrust each case to individual companies' own judgment adapted to the specific circumstances.

3. The Form of Corporate Behavior in Markets (Large-Scale Capital Increases by Third-Party Allotment)

Under the current system, it is possible, subject to resolution by the Board of Directors, for a company to issue new shares to specific third parties, provided they are within the authorized number of shares prescribed by the company's articles of incorporation and are not classed as being issued on favorable conditions.

However, as indicated by the TSE investor survey, both domestic and overseas investors are of the view that large-scale capital increases by allotment to third parties dilute the rights of existing shareholders and may give rise to changes in the control of companies, and also regard it as problematic that there is inadequate disclosure of information concerning allottees (investors). There have been some cases in which it has been suggested that companies in financial trouble are being taken advantage of

by antisocial forces. These must not be overlooked considering the fairness of the market and soundness of corporate management.

It is essential to enhance the accountability of the issuing companies and to attend to ensure that the interests of existing shareholders are not infringed unreasonably. In addition, while taking great care to avoid detrimental to flexible fundraising by companies, a balance between market fairness and ensuring the protection of existing shareholders must be found. To this end, the screening of allottees at stock exchanges should be improved, and study should be conducted into further enhancing the credibility of the market by such means as the disclosure of the state of allottees' funds.

4. Towards Better Corporate Governance

Whatever the country, companies do not achieve perfect corporate governance simply by satisfying the formal conditions prescribed by laws, regulations and rules of stock-exchanges. It is essential to continue to seek what the appropriate corporate governance for individual companies should be judged from the types of business they engage, and the state of the social and economic environment and markets in which companies engage in business activity.

It is necessary for Japanese government and businesses to reach out actively to gain greater understanding among both domestic and overseas investors regarding Japan's corporate legal system and practices. It is also important for companies to deepen mutual understanding with investors and be fully accountable by means of sustained and vigorous IR and other activities.

Although voluntary efforts by companies to strengthen corporate governance are ongoing, considerable disparities among companies remain. Nippon Keidanren itself will continue to engage in vigorous activity designed to foster companies' individual efforts to enhance corporate governance further. In addition, to encourage companies to communicate with their shareholders and other stakeholders of various kinds, it is vital to develop an environment that fosters reciprocal dialogue between companies and shareholders, including through the introduction of mechanisms to facilitate the acquisition by companies of information regarding the actual shareholders who are to make decisions regarding fund management and the exercise of voting rights.²² In addition, to enable companies to devise ways of improving their

²² In the United Kingdom, Section 793 of the Companies Act 2006 provides that with regard to a public company, if there are registered shareholders in the register of shareholders' holding shares with voting rights or others parties, and there is reasonable cause to believe that those other parties have had an interest in the company's shares during the past three years (regarded as a beneficial shareholder), the said shareholders of record and beneficial shareholders may be requested to confirm whether they have holdings. In this way, a system to enable the company to grasp information

governance structures, one possible option is to approve, as a system, diverse composite systems that combine the good aspects of both the *Kansayaku* system and the committee system.

From the perspective of further enhancing the credibility of Japan's financial and capital markets, Nippon Keidanren hopes to use this interim discussion paper as a starting point for stepped-up dialogue with domestic and overseas governments and institutional investors. Also, by strengthening liaison with all people and entities involved in the markets, we will continue our efforts to enhance the substance of corporate governance in a way that permits companies to improve corporate value on continuous basis.

#

concerning beneficial shareholders has been provided for (Former Section 212 of the Companies Act 1985).

COMPANIES ACT 2006 Section 793 Notice by company requiring information about interests in its shares

- (1) A public company may give notice under this section to any person whom the company knows or has reasonable cause to believe—
 - (a) to be interested in the company's shares, or
 - (b) to have been so interested at any time during the three years immediately preceding the date on which the notice is issued.
- (2) The notice may require the person—
 - (a) to confirm that fact or (as the case may be) to state whether or not it is the case, and
 - (b) if he holds, or has during that time held, any such interest, to give such further information as may be required in accordance with the following provisions of this section. (omitted the rest)