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Revisions to Corporate Governance Disclosures

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Summary

- On 31 March, Japan's government announced revisions to the Cabinet Office Ordinance on Disclosure of Corporate Affairs, etc. New requirements include enhanced disclosure on corporate governance.
- Among other points, listed companies will be required to disclose the outline of their corporate governance systems, reasons for employing those systems, whether they have statutory auditors with expert knowledge of finance and accounting, relations between outside directors/auditors and divisions in charge of internal controls, whether any outside directors/auditors are appointed and if not, internal systems that substitute for their functions.
- The new rules will apply to annual securities filings for the fiscal year ended 31 March 2010.

*This report updates our 4 March 2010 report on the proposed revisions to the Cabinet Ordinance (Japanese only).

1. New Disclosure Rules to Improve Corporate Governance

On 31 March, Japan's government announced revisions to the Cabinet Office Ordinance on Disclosure of Corporate Affairs, etc.¹ (Cabinet Office Ordinance No.12, or Kaiji Furei). Newly added requirements include (1) disclosure of shareholdings (including cross-shareholdings), (2) disclosure of executive compensation, (3) extraordinary reports of shareholder voting results, and (4) additional disclosure of corporate governance structure. These are all aimed at improving corporate governance.

These revisions are based on suggestions made in a report² ("Report by the Financial System Council's Study Group on the Internationalization of Japanese Financial and Capital Markets: Toward Stronger Corporate Governance of Publicly Listed Companies") published 17 June 2009 by a study group formed under the Financial System Council of the Financial Services Agency (FSA) to discuss

¹ Released on 31 March 2010 government gazette (extra edition No. 67). A comparison chart for previous and revised rules is available on the FSA's website <http://www.fsa.go.jp/news/21/sonota/20100331-8.html> (Japanese only).

² Available on the FSA's website (http://www.fsa.go.jp/singi/singi_kinyu/tosin/20090617-1.html) or English version <http://www.fsa.go.jp/en/news/2009/20090618-1.html>). Our 7 July 2009 report *Financial System Council Study Group Report-2* (Japanese only) also contains relevant information.

internationalization of Japan's financial and capital markets (these revisions follow an earlier round of changes made in 2009 based on the same report).

In this report, we focus on disclosure of corporate governance structure.

2. Enhanced Disclosure of Corporate Governance

Before the revisions, the *Kaiji Furei* required companies to disclose the information listed below under the corporate governance section in annual securities filings and reports submitted by firms offering new/existing shares (Rule 57 as to preparation of Form 2, etc. in previous *Kaiji Furei*).

- (i) General information on corporate governance
 - a) Organization, internal control systems, risk management systems, and remuneration for directors (breakdown by inside and outside director)
 - b) Outlines of liability limitation agreements*, if any, with outside directors, accounting advisors, outside auditors, and accounting auditors
 - c) Details of the special director system**, if the company has one
- (ii) Information related to auditing
 - a) Organization and members of the internal auditing department and board of statutory auditors, as well as auditing procedures they employ
 - b) Cooperation between the internal auditors, board of statutory auditors, and accounting auditors
- (iii) Information related to outside directors/auditors

Personal, investment, and economic relations between and other interests shared by outside directors/auditors and the company

* Based on the articles of incorporation, outside directors/auditors, etc. can have limited liability for negligence by contract. For example, if compensation is claimed in shareholders' litigation, such outside directors/auditors will have limited liability for compensation (higher of minimum liability [amount equivalent to two-year remuneration for outside directors/auditors] and amount pre-defined by company within range stated in articles of incorporation) if they acted in good faith and show no gross negligence (Article 427 and others, Companies Act).

** A system that enables three or more pre-selected directors (special directors) to decide on disposals and purchases of important assets, as well as on a large amount of borrowings, without approval at an ordinary board meeting (Article 373, Companies Act). Companies (excluding those with committees) with at least six directors (including at least one outside director) are allowed to adopt the system.

The major disclosure requirements added in the revised *Kaiji Furei* are as listed below (Rule 57, etc. as to preparation of Form 2 in *Kaiji Furei*):

- 1) Outline of the governance system and reasons for employing the system (under "General information on corporate governance")
- 2) Whether they have statutory auditors with expert knowledge of finance and accounting (under "Information on auditing")
- 3) Functions and roles of outside directors/auditors, relations between outside directors/auditors and divisions in charge of internal control, and, if no outside director/auditor is appointed, outline of the internal systems that substitute for their functions (all under "Information on outside directors/auditors")

We believe the new requirements reflect the following statement in the study group report mentioned previously:

"...there have been examples of listed companies in Japan that have adopted progressive approaches in terms of their governance systems by appointing one or more highly independent outside directors and having them cooperate closely with the board of auditors and officers in charge of internal audits and internal control. This type of governance system can compensate for the authoritative and

systemic deficiencies relating to auditors while effectively utilizing the functions of auditors, and it enables the supervisory function over management to be strengthened. It has the potential to serve as a preferred, realistic model that maintains consistency with Japan's legal system while also being acceptable by international standards.

“Naturally, the best form of corporate governance will differ depending on the organization, size, line of business and other aspects of each individual company; but in spite of the difficulties in applying the same rule to all companies, if the above line of thinking is adopted one can say that there is room for improvement, since there is a considerable gap between this and the reality that 55% of companies listed on the Tokyo Stock Exchange have not appointed any outside director.”

Source: “Report by the Financial System Council's Study Group on the Internationalization of Japanese Financial and Capital Markets; Toward Stronger Corporate Governance of Publicly Listed Companies” (17 Jun 2009).

Note: Underlining added.

The major changes from the draft revisions³ announced on 12 February are:

- ◇ Only listed companies will be subject to the disclosure requirements (see Section 3)
- ◇ The requirement that a company reports a management advisory commission and other systems set up of its own accord is clarified (Section 4)
- ◇ What should be disclosed is defined by whether a company has outside directors/auditors or not (Section 6).

3. Companies Required to Enhance Disclosure on Corporate Governance

Companies which issue the following securities are required to enhance their disclosure on corporate governance as stated in sections 4 to 6 of this report, under the corporate governance section of their securities reports (Rule 57-a regarding preparation of Form 2, *Kaiji Furei*; Financial Instruments and Exchange Law, Article 24.1, clauses 1, 2). These securities exclude “specified securities,” which are defined as securities for which disclosures in regular filings of securities reports are not required (investment trust beneficiary certificates, investment fund securities, etc.).

- (1) Securities listed on an exchange (excluding certain types of listed securities*)
- (2) OTC securities (excluding those with liquidity similar to certain types of listed securities*)

*Refers to securities trading only in a market for professional investors (Tokyo AIM), based on the Financial Instruments & Exchange Law, Article 2.33.

In other words, only listed companies need to disclose the newly required details on corporate governance. This probably reflects the fact that recommendations by the aforementioned Study Group were specifically for listed firms⁴.

³ Available on the FSA's website (<http://www.fsa.go.jp/news/21/sonota/20100212-2.html>) or English outline <http://www.fsa.go.jp/en/news/2010/20100219-2.html>).

⁴ For unlisted companies filing securities reports, the revised *Kaiji Furei* simply stipulates disclosure in a detailed and straightforward manner.

4. Disclosure of Corporate Governance Structure

The revised *Kaiji Furei* goes further than the previous disclosure requirement for general information on corporate governance (Section 2 (i)). Listed companies are now obligated to provide more detail on their corporate governance systems (including committees or other bodies set up at companies' own discretion to play a role in corporate governance), and to spell out their reasons for their chosen structure.

We believe this more thorough disclosure requirement is based on the following suggestion in the aforementioned Study Group report:

“The stock exchanges should present a model of corporate governance in line with the above thinking [see excerpt in Section 2 above], which is regarded as suitable for the majority of listed companies for securing the confidence of shareholders, investors and others. Based on this, stock exchanges should adopt measures that would require companies to sufficiently disclose the details of their respective governance systems and the reasons for selecting particular systems.”

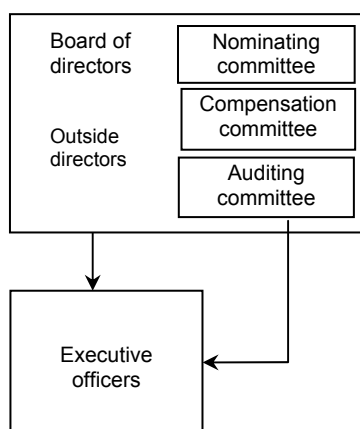
Source: “Report by the Financial System Council's Study Group on the Internationalization of Japanese Financial and Capital Markets; Toward Stronger Corporate Governance of Publicly Listed Companies” (17 Jun 2009).

Note: Underlining added.

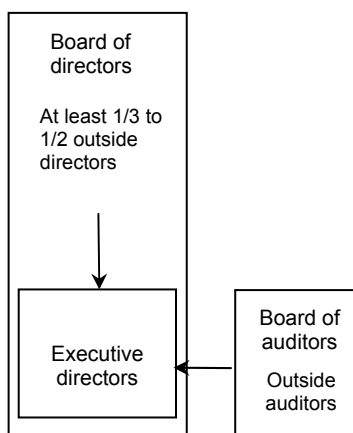
In response to the above suggestion, the Tokyo Stock Exchange (TSE) revised its rules as of 30 December 2009⁵, imposing disclosure requirements on listed companies as advocated in the revised *Kaiji Furei* (revised TSE Securities Listing Regulations, clauses 211.6, 226.6).

For reporting on the governance system and the reasons for employing it, TSE suggests in its guidelines (*Corporate Governance Houkokusho* Guideline II-2) to refer to the three types of governance systems proposed in the aforementioned Study Group report. The three models are (1) a “company with committees” structure, (2) a board of directors staffed mainly by outside directors, and (3) appointment of outside directors and collaboration between the boards of directors and auditors.

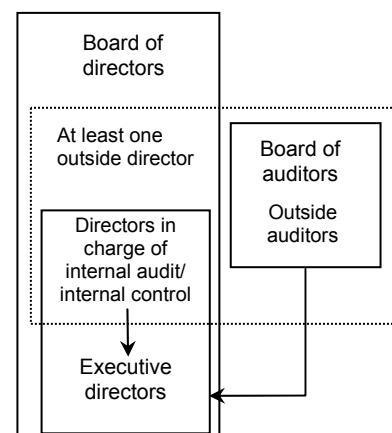
(1) “Company with committees”



(2) Board of directors consisting mainly of outside directors



(3) Appointment of outside directors and collaboration with auditors committee



Source: TSE, *Principles of Corporate Governance for Listed Companies* (revised 22 Dec 2009), and *Corporate Governance Houkokusho* Guideline II-2.

⁵ Reference to analyst's 5 Jan 2010 report on amendments to TSE regulations regarding independent directors.

We believe disclosures in securities reports under the revised *Kaiji Furei* will basically follow the same ethos.

Furthermore, under the revised *Kaiji Furei*, companies which choose to set up corporate governance-related bodies (such as management advisory commissions and managing committees) in addition to those stipulated by the Companies Act must also disclose details of such bodies (FSA's responses⁶ released on 31 Mar to public comments on the draft revisions, hereafter *Kinyucho no Kangaekata*, 43).

5. Disclosure of Auditing Systems

In addition to the information about auditing regimes already subject to disclosure as outlined in Section 2 (ii), the revised *Kaiji Furei* requires disclosure of the following:

- (i) If any of the statutory auditors boast in-depth knowledge of finance/accounting, the nature of this expertise
- (ii) The relations between internal auditors, statutory auditors, accounting auditors, and internal control divisions

We believe (i) is based on the following statement in the Study Group report:

“...it has been suggested that there are cases where the effectiveness of audits is inadequate, the independence of outside auditors is low, and their specialized finance and accounting knowledge is insufficient. Therefore, at present, auditors are not necessarily capable of meeting the expectations of shareholders and investors.”

Source: “Report by the Financial System Council's Study Group on the Internationalization of Japanese Financial and Capital Markets; Toward Stronger Corporate Governance of Publicly Listed Companies” (17 Jun 2009).

Note: Underlining added.

The revised rules only require the disclosure of auditors with in-depth knowledge of finance/accounting, and not the appointment of such auditors (*Kinyucho no Kangaekata*, 51). That said, by obligating disclosure, the rules likely aim to indirectly promote the enhancement of auditing functions at corporations⁷.

The FSA defines “in-depth knowledge” as follows (*Kinyucho no Kangaekata*, 48):

“In-depth finance and accounting knowledge” in the context of Rule 57-a (b) as to preparation of Form 2 (*Kaiji Furei*) is given the same definition as in the business report rules in the Companies Act (clause 121.8). It is not limited to legal qualifications, such as those for certified public accountants or tax accountants, and could entail knowledge accumulated through experience in an accounting department.

⁶ Available in Japanese only on the FSA's website (<http://www.fsa.go.jp/news/21/sonota/20100331-8.html>).

⁷ The TSE revised its corporate governance principles on 22 December 2009. The revised Principles of Corporate Governance for Listed Companies lists the appointment of auditors with an in-depth knowledge of finance/accounting as one of the “issues requiring attention” (5 (1) *3).

Regarding (ii), the revised rules go beyond the previous requirement to report cooperation between internal auditors, statutory auditors, and accounting auditors, further stipulating that relationships between auditors and a company's internal control divisions be disclosed.

We believe this obligation is also based on the suggestion in the Study Group report that companies “maintain adequate human resources and infrastructure to support the statutory auditors who carry out audits (cooperating with internal audit and internal control divisions for this purpose).”

The FSA gives an explanation of internal control divisions in *Kinyucho no Kangaekata*, 52:

Internal control divisions include the divisions responsible for compliance, risk management, and accounting, and finance, as well as those in charge of internal controls over financial reporting. The revised *Kaiji Furei* does not limit internal controls to those directly related to financial reporting, but more broadly includes functions for securing fair business practice at reporting companies.

6. Disclosure on Outside Directors/Auditors

In addition to the relations between outside directors/auditors and the reporting company mentioned in Section 2 (iii), the revised *Kaiji Furei* requires companies to disclose the following:

- (i) Number of outside directors/auditors
- (ii) If outside directors/auditors are appointed:
 - a) functions and roles of outside directors/auditors in the reporting company's corporate governance, including the reporting company's view on their independence;
 - b) the reporting company's view on the status of outside directors/auditors;
 - c) coordination among outside directors/auditors, internal auditors, statutory auditors, and accounting auditors, as well as relationship between outside directors/auditors and the internal control divisions
- (iii) If outside directors/auditors are not appointed:
 - a) governance structure substituting for their functions;
 - b) reasons for adopting that structure

Among these, (ii) b) and c) most likely reflect the suggestions below in “The Corporate Governance Study Group Report” (17 Jun 2009) compiled by the Corporate Governance Study Group of Ministry of Economy, Trade and Industry (METI):

“...the Corporate Governance Study Group has concluded to require listed companies to choose either of options (1) or (2) below:
 (1) To have an outside director as a minimum, and to disclose facts concerning the corporate governance system (disclose the role and function of the outside director, etc.);
 or
 (2) If option (1) is not chosen, to disclose facts concerning the corporate governance system using the company's own original method.”

Source: “The Corporate Governance Study Group Report”, METI's Corporate Governance Study Group (17 Jun 2009).

For both (1) and (2), the report had only assumed the appointment of outside directors. In comparison, the revised *Kaiji Furei* stipulates disclosure rules regarding outside auditors as well as outside directors. As such, companies that have not appointed outside directors among those required to set up a board of auditors⁸ must disclose the functions and roles of their outside auditors (ii), as well as the corporate structure that makes up for the absence of outside directors (iii).

(ii) a) requires the disclosure of the functions and roles of outside directors/auditors in terms of corporate governance. The rules allow any overlapping functions and roles to be reported collectively (*Kinyucho no Kangaekata*, 55).

Companies must also indicate their views on the independence of outside directors/auditors. The FSA explains the purpose of this as follows (*Kinyucho no Kangaekata*, 66):

The level of independence of outside directors from reporting companies varies by director. As outside directors are assumed to be given roles in corporate governance adequate for their level of independence, we believe it important that such information be disclosed. Accordingly, the revised *Kaiji Furei* requires reporting companies to disclose their relationship with every outside director, as well as their views on the independence of each, not limited to outside directors that have a certain level of independence.

In other words, the FSA requires companies to disclose their positions on the directors' independence, but does not necessarily require a specific level of independence.

TSE's aforementioned revised regulations require listed companies to appoint independent directors/auditors (TSE Securities Listing Regulations Rule 436-2), and also provide criteria regarding independence, or, to be precise, factors that would violate the independence of outside directors/auditors (Guidelines Concerning Listed Company Compliance, etc., III 5 (3) 2). As such, reporting companies may refer to TSE's criteria when indicating their views on independence.

That said, TSE explains that the criteria is only a minimum requirement for determining the independence of an outside director/auditor⁹. In other words, meeting the TSE criteria does not necessarily mean a director/auditor is independent rules. Neither does the bourse guarantee their independence.

Furthermore, TSE states that it is desirable for listed companies to select outside directors/auditors that not only meet its criteria, but also those about whom companies can confidently assert an absence of potential conflicts of interest with general shareholders¹⁰.

As such, we believe that while companies may fulfill the minimum disclosure requirement (i.e., not violate law) by indicating in annual securities reports that they meet TSE criteria, this may not sufficiently achieve accountability to shareholders and investors.

⁸ Market regulations require listed companies to either adopt the "company with committees" structure or set up a board of auditors (TSE Securities Listing Regulations Rule 437, etc.). Companies must appoint outside directors in the former case (Companies Act, Article 400-3), and outside auditors in the latter (Companies Act, Article 335-3).

⁹ Page 54 of TSE *Saishin Tosho no Joujou Seido Seibi no Kaisetsu*, Shoji Homu, 2010. (Also see p. 53 of *Business Homu* May 2010 issue, Motoya Sasaki "Kaisetsu Dokuritsu Yakuin; Dokuritsu Yakuin Kakuho no Tame no Tetsuzuki to Handan Kijun.")

¹⁰ Ibid.

The revised *Kaiji Furei* requires companies which have not appointed outside directors/auditors to disclose the governance system substituting for these functions, as well as the reasons for its selection (iii). In this case also, it seems that the requirement for disclosure does not stipulate adoption of a specific system.

TSE also requires companies to disclose reasons for adopting their current corporate governance structure (Guideline to Reporting on Corporate Governance II-1.).

Listed companies must provide details of corporate governance structures that substitute for the roles of outside directors, and how they function. For example, if a company appointed outside auditors to ensure external checks and balances, it might indicate the structure it has adopted to cover the functions expected from outside directors, in view of the difference between the legal roles of directors and auditors. Other points the disclosure might include are the specific structure adopted for enhancing monitoring of corporate management, and how effectively it is functioning, as well as the company's view of the objectivity and neutrality of such functions.

The content of annual securities reports should be consistent with the above. In our view, given the aim of corporate governance, and from the standpoint that a corporate governance structure should be determined through “a consensus-building process including dialogue with minority shareholders and investors involved in the company” (“The Corporate Governance Study Group Report”, METI), companies should fulfill their responsibilities for accountability to shareholders and investors.

7. Timing of Implementation

Excluding some rules, the amendments to the Cabinet Office Ordinance on Disclosure of Corporate Affairs took effect from 31 March 2010 (Revised Supplementary Provision 1).

Listed companies are required to disclose the additional information regarding corporate governance in their securities reports from the fiscal year ending on 31 March 2010 (FY09 for companies which close their books in Mar; Revised Supplementary Provision 2, 9).