

5 April 2012 (No. of pages: 5)

TSE Proposal to Strengthen Independent Auditor/director System

Japanese report: 28 Mar 12

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Summary

- On 28 February, the Tokyo Stock Exchange released a set of proposed rule changes to improve corporate governance among listed firms.
- The specific reforms include greater disclosure when independent director or auditor (in this report, collectively referred to as “independent officers”) (1) is an officer, board member, or employee of the listed company’s client (incl. banks and other transaction parties), (2) is part of a cross-directorship arrangement, or (3) is the recipient of the listed company’s charitable donations. The TSE will also require listed firms to actually set up and operate internal control systems, a step up from the current requirement only to “decide on” them.
- Also, the exchange called for a “best-effort” rule to name outside directors as independent officers and not just outside auditors.
- The new rules are set to come into effect from around May 2012.

Introduction

On 28 February, the Tokyo Stock Exchange released a report outlining planned revisions to corporate governance rules for listed firms, for the purpose of restoring confidence in the securities market.

The move comes in reaction to recent corporate scandals and is intended to overhaul the TSE’s existing regulations, particularly the independent officer system.

The specific proposals are as follows:

- (1) Expanded disclosure of information on independent directors and auditors
- (2) Expanded disclosure of information on outside directors and auditors not meeting the standards for independence
- (3) Composition of independent officers
- (4) Creating an environment so that independent officers can do their jobs
- (5) Building and operating the systems necessary to ensure proper operations

The rest of this report is an overview of TSE's proposed changes.

1. Expanded disclosure of information on independent directors/auditors

(1) Entries in independent officer notification form

"Independent auditors and directors" are defined as outside directors or outside auditors that are not at risk of having conflicts of interests with general shareholders.

TSE makes the following requirements of listed companies regarding independent officers:

- (1) There must be at least one
- (2) They must notify TSE and publicize information on independent officers via a notification form
- (3) They must disclose the status of independent directors/auditors in their reports on corporate governance

The proposed changes will require the following disclosures in the notification form:

- a. Whether the outside officer is a client or a current or former officer, board member, or employee of said client, along with a description of the nature of said relationship.
- b. Whether the outside officer is a current or former officer of a party in a cross-directorship arrangement with the listed company, along with a description of the arrangement.
- c. Whether the officer is or is employed by the recipient of charitable donations made by the listed company, along with a description thereof.

In our view, if an independent officer is a related party or employee of a client of the listed company, such information would be material to shareholders or other investors as it raises doubts over the officer's independence.

Already, companies with independent directors/auditors that are current or former officers/employees of "major" clients (such as the firm's main bank) are required to disclose the reasoning why the firm believes such officers are appropriate for the position and are not at risk of a conflict of interest. In practice, many companies report the nature and scale of business done with the client in question.

The revisions remove the term "major," suggesting that TSE will require disclosure of relationships with a wider spectrum of clients. This should result in more extensive disclosure, in our opinion.

As things stand, listed firms inconsistently disclose the specifics on independent directors/auditors tied to "major clients." In many cases, firms give vague descriptions of the client relationship ("not very prominent," "not especially reliant," "similar to relationships we have with other clients," for example) or almost none at all (for instance, only mentioning other aspects of independence such as years since resigning from the client and subsequent career history).

Even after these changes, the TSE plans to allow firms not to describe the client relationship as long as they give a reason for the omission. Therefore, it is difficult to predict what practical impact the measures will have on the extent of disclosure.

As for disclosure of cross-directorship arrangements and charitable contributions, the exchange had not previously offered specific guidelines on what to disclose. To investors, cross-directorships can be cause for concern over possible collusion if supposedly independent directors are in fact part of a deal with another company. And appointing the recipient of the firm's charitable donations as an independent officer can raise questions as to that person's willingness to express unvarnished opinions.

In that sense, this new information could provide investors with critical information that they can use to determine whether supposedly independent directors/auditors are truly un beholden.

(2) Entries in general shareholder meeting notices

The system of independent directors/auditors is based solely on the TSE's own regulations. For that reason, related disclosures are made within the framework of the exchange's rules, including notifications of independent directors/auditors (submitted to TSE but also subject to public disclosure) and reports on corporate governance.

The proposed rule changes would add a requirement for firms to make their best effort to provide shareholders with information on independent directors/auditors in a manner that aids in the exercise of voting rights at the general shareholders' meeting.

Companies have the option of presenting the information in one of two ways:

- (1) As items regarding independent directors/auditors in the business report and reference materials for the agenda item on their appointment
 In the reference materials, a statement that the person will be named an independent officer, and items regarding the person's independence
 In the business report, a clear indication of which company officers are independent directors/auditors
- (2) By creating separate documents with the same information as (1) and sending them to shareholders along with the general shareholders' meeting notice (as well as reference materials).

The reference materials are legally mandated documents under the Company Act, and as such their content is determined by law.

This is likely why the TSE is only proposing a best-effort rule. It is also probably why companies will have a choice between including information on independent directors/auditors as a voluntary entry in the reference materials or creating a separate attachment.

2. Improved disclosure of information on outside directors/auditors

(1) Entries in the notification on independent directors/auditors

The current independent officer notification form only requires information for independent auditors/directors, including their names, affiliations, and reasons for selecting them as independent. This information is submitted to the TSE and available to the public. However, there is currently no such requirement for non-independent outside directors.

The proposed revisions will change that. Now companies will have to disclose the same information even for outside directors not designated as independent.

At present, listed companies are permitted to choose whether to grant all who meet the criteria the designation of independent officer, or just one to meet the requirement. Therefore, even if an outside officer does not have the "independent" label, that does not mean the company has determined that he or she has failed to meet the criteria for independence.

Firms are already required to include the company's views on each director's independence, as well as his or her roles and functions, in their reports on corporate governance. This should make it possible to ascertain the company's thoughts on the independence of outside directors/auditors that are not deemed independent.

However, some companies only include basic information for these items. Therefore, companies may not be providing investors with enough information on non-independent outside auditors/directors.

If these proposals are implemented as written, it may become easier to compare independent and non-independent officers by looking at what impact their backgrounds and relationships might have on their decisions.

(2) Entries in general shareholder meeting notices

As with the earlier-mentioned disclosure requirements for independent directors, companies will also be required to make their best effort to provide shareholders with information on non-independent outside officers in a manner that aids in the exercise of voting rights at the general shareholders' meeting. The methods of disclosure are identical to those given for independent officers.

3. Composition of independent officers

TSE proposes a rule requiring listed companies to make their best effort to include at least one "person holding voting rights in the board of directors" among independent officers.

A "person holding voting rights in the board of directors" matches the definition of a Director under the Company Act. As such, this rule will effectively require that a firm's independent officers include at least one Director. In other words, TSE plans to require firms to appoint at least one outside director as an independent officer and not just an outside auditor.

The language used in the proposal is vague, and the exchange is only requiring that firms make an effort. Therefore, it appears that there will not be any immediate enforcement mechanism for companies that do not comply.

To be sure, TSE regulations such as these are considered a form of "soft law" without legal enforceability. However, on this front the exchange appears to be taking an even lighter approach than usual.

Much criticism of Japanese corporate governance casts doubt on the effectiveness of soft law regulations. Indeed, even if these changes are put into effect as proposed, it will be necessary to keep a close eye on the situation as to how effective they can be.

At present, a Ministry of Justice advisory commission is considering reforms to the Company Act that would require companies that meet certain criteria to appoint outside directors. In our view, a combination of hard law and soft law approaches could be more effective.

4. Creating an environment so that independent officers can do their jobs

The TSE's proposal includes a best-effort rule for listed companies to create an environment in which independent officers can perform their expected roles.

Specifically, this refers to creating systems to ensure timely and appropriate communication of information to independent directors, coordination with relevant internal departments, and securing support personnel.

To enable independent officers to do their jobs properly, listed companies (or at least their managers) need to create an environment suitable for them to gather the necessary information. The proposed change seems to be based on this view.

This is another "best-effort" rule like some others mentioned above. As such, we must wait until implementation to judge its effectiveness.

5. Building and operating the systems necessary to ensure proper operations

Finally, the TSE plans to require listed companies to construct and operate internal control systems.

The Company Act mandates that large companies and Companies with Committees "decide on" the creation of internal control systems pursuant to a resolution of the board of directors. TSE rules also require listed companies to "decide on" the creation of internal controls in its Code of Corporate Conduct.

However, in reaction to the recent spate of corporate scandals, the exchange has apparently determined that “deciding” on such systems is not enough. It now plans to require companies to construct and operate internal control systems.

6. Implementation schedule

TSE plans to implement the proposed rule revisions around May 2012.