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Corporate Governance Reform (1)

—Investigative Agencies—

Investigations into corporate governance

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Summary

- Japan's Ministry of Economy, Trade and Industry (METI), Financial Services Agency (FSA), and the Tokyo Stock Exchange (TSE) have set up investigative committees to examine the corporate governance of listed companies.
- Common topics under discussion include private placements and independence of outside directors.
- This report outlines the three investigative committees.

Establishment of Three Investigative Committees

Corporate finance problems

There have been cases where listed companies' financing policies and takeover safeguards have apparently been costly to shareholders, creditors, and other investors. For example, existing shareholders have seen their stakes dwindle due to large-scale issuances of new shares and new share warrants, and anti-takeover measures have prevented tender offers that could have been lucrative for shareholders.

Meanwhile, individuals affiliated with major shareholders of given companies have assumed directors' positions in those companies. This means a person whose interest is in maximizing investment returns becomes involved in managerial decision-making. Auditors have filed injunctions to prohibit such individuals from being directors, resurrecting the following questions—what are the functions of a director and what attributes are desirable?

Even under the former commercial code there were many lawsuits regarding private placements, and shareholders had the authority to elect the board of directors. Auditors have always had a lot of clout, and the recently invoked power to file injunctions is not something new that came in with the Corporation Law. The Japanese legal system has long posed potential problems regarding corporate governance, but these problems have started to surface more frequently in recent years. The corporate system essentially remains unchanged, but a transformation in the behavior of investors and corporate managers is developing into a completely different form of corporate management.

Shareholder composition changing

The shareholder composition of listed companies has significantly changed compared to 10-20 years ago—non-Japanese investors and pension funds have

emerged as major stakeholders. It has become essential for corporate managers to meet the demands of these new shareholders who behave differently from the cross-shareholders that had been the norm.

Further, while domestic and overseas takeovers have become easier on the back of tumbling global share prices, they have also fueled the need for safeguards against takeovers that could damage corporate value. On the other hand, as noted earlier, problems with takeover protection measures have been identified.

Investigative committees to consider corporate governance

Under these conditions, various investigative committees have been established to contemplate how corporate governance should be handled and what reforms are necessary. This includes legal reform, though three years have not yet passed since the Corporation Law took effect. Corporate governance is an issue that not only affects company managers, but a wide range of stakeholders, including investors (shareholders, creditors).

In December 2008, METI set up a corporate governance research team to consider what the overall rules should be for enhancing corporate governance.

In January 2007, the FSA established the Study Group on the Internationalization of Japanese Financial and Capital Markets under the Sectional Committee on Financial System of the Financial System Council. The study group reconvened in October 2008 for the first time in nearly a year, this time to analyze listed companies' corporate governance issues from a broad perspective.

The TSE set up an informal committee in September 2006 to discuss improvements for the listing system. Seven months after submitting an interim report in March 2007, the committee started examining measures for further improvement.

While these investigative bodies have been set up by different institutions and have varied backgrounds, they have all started to discuss reforming institutional infrastructures that would lead to significant changes in listed companies' finances and corporate governance.

Members of Investigative Committees

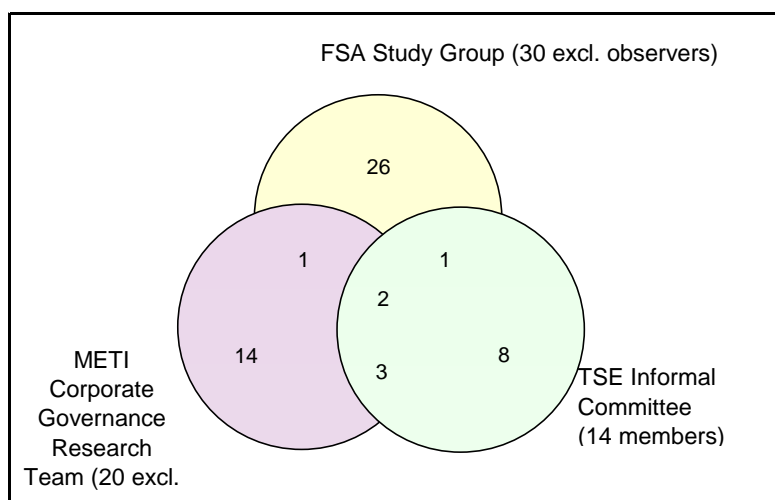
Academics, business professionals, and stakeholders usually form the membership of investigative committees.

Most of the academics on these boards are professors of law, business administration, or economics—those from other fields are rarely selected. Some groups include researchers in law & economics—a flourishing discipline that applies an economic approach to legal analysis. Business professionals generally consist of employees and directors of financial intermediaries and listed companies, both securities market participants, but are occasionally elected from institutional investors, who actually make investment decisions. These include banks and securities houses, stock exchanges, listed companies, investment advisories, and investment trust companies. Members of financial/securities think tanks are also frequently selected. Lawyers participate to provide a legal viewpoint. Members are also drawn from various public institutions, such as the Japan Securities Dealers Association, the Japan Federation of Economic Organizations (*Keidanren*), and the Japan Corporate Auditors Association.

Setting up several committees involves commissioning many members. It is important for committees to have a decent number of members in order to represent a full range of opinions, though an excessive number could hinder

committee operations. Moreover, sufficiently well-informed individuals are few and far between. Thus, some members concurrently serve on more than one of the above-mentioned boards (Chart 1).

Concurrent Service on Three Investigative Committees **Chart 1**



Source: Committee rosters; compiled by DIR.
 Note: Ministry officials acting as board observers and secretaries not included.

Professors Hideki Kanda (Tokyo University) and Kazuto Ikee (Keio University) serve on all three committees. Prof. Kanda chairs METI’s corporate governance research team and the TSE’s informal committee, while Prof. Ikee chairs the Study Group on the Internationalization of Japanese and Financial and Capital Markets.

Summary of Issues Under Investigation

Chart 2 lists the objectives and main concerns of the three committees.

Issues Under Investigation by Three Committees (¥ mil)		Chart 2
METI Corporate Governance Research Team	FSA Study Group on the Internationalization of Japanese and Financial and Capital Markets	TSE Informal Committee
1. Current state of and problems surrounding Japan’s corporate governance system. 2. Issues that must be resolved: a. Appropriateness of Japanese companies, particularly listed ones, adopting outside directors b. Independence of outside directors at listed companies of which parent or subsidiary is also publicly traded c. Other problems related to corporate governance 3. Issues that must be resolved going forward 4. Whether to choose soft law or hard law system	1. Initiatives to enhance corporate governance 2. Issues on corporate governance 3. Issues on equity financing: a Issuance of new shares b Issuance of MSCBs c Cash outs 4. Issues on corporate groups: a Corporate governance for business groups b Listing of both parent and subsidiaries 5. Other issues: a Cross-shareholdings b Takeover safeguards	Numerous items recorded in meeting minutes. For example: <ul style="list-style-type: none"> • Large-scale issuance of new shares after reverse stock splits • Large-scale issuance of new shares for private placement • Policy against antisocial forces • Private placement • Avoiding appointment of parent company alumni as outside directors • Disclosure of voting results • Adoption of takeover safeguards and outside directors • Independence requirements for outside directors • Cross-shareholdings • Management buyouts

Source: Charters and minutes of each committee; compiled by DIR.

Diverse concerns

The issues are wide-ranging—some old, some new. While some need to be resolved from a legislative perspective, some require changing mindsets in the financial sector. We look forward to seeing what proposals the three committees eventually set forth.