Companies Act Reform 2014: Can the new amendment to the Companies Act of Japan strengthen the corporate governance systems of Japanese listed companies?

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Overview

On June 20, 2014, the Diet enacted a partial amendment to the Companies Act ("Reform Act"). The Reform Act was formally published on June 27, 2014, and will be effective within one and a half years from the date of publication. The prevailing view is that the Reform Act is expected to come into effect in April or May 2015.

This is the first substantial amendment to the Companies Act of Japan (Law No. 86, 2005) since the enactment of the current Companies Act in 2006, and it will likely have a substantial impact on corporate law practice in Japan.

After a string of corporate scandals in 2011, including that of Olympus Corporation, foreign investors began to levy significant criticism against the corporate governance of Japanese listed companies under the Companies Act. Accordingly, one of the primary objectives underlying this Reform Act is to introduce an alternative to, and concomitantly improve, the current corporate governance systems.

We will separately discuss each of those amendments arising under the Reform Act focused on corporate governance issues for listed companies: (i) the facilitation of appointments of outside directors; (ii) new requirements on outside directors or outside statutory auditors; and (iii) the introduction of an entirely new corporate governance system.

Appointment of outside directors

Prior to the Reform Act, the Diet and commentators extensively deliberated whether listed companies should be obliged to appoint outside directors. The Tokyo Stock Exchange ("TSE") amended its listing rules in February 2014, whereby listed companies must make efforts to appoint at least one independent officer as a director. An "independent officer" under the TSE rules is different from an "outside director" under the Companies Act. An "independent officer" must be either an outside director or an outside statutory auditor who is unlikely to have a conflict of interest with general shareholders. The view persists, however, that the requirement of the "make effort" basis is insufficient because it could be interpreted as a mere formality. On the other hand, objections, especially from the business community, have been raised against the requirement of mandatory appointments of outside directors. As a compromise, and to facilitate the appointment of outside directors, two measures have been adopted under the Reform Act:

(i) Under the Reform Act, if any listed company having a statutory auditors' committee ("kansayaku-kai") does not have an outside director at the end of the latest fiscal year, such company shall be required to explain at its annual shareholders' meeting why it is not appropriate to appoint an outside director (the "comply or explain" rule).

(ii) A supplementary provision in the Reform Act provides that, two years following its enactment and upon consideration of the then-existing corporate governance systems (as well as other circumstances), the government shall, as it considers necessary, take certain specific measures, including the mandatory appointment of outside directors.

A company may find it very difficult to explain the reason why it believes that the appointment of an outside director is not appropriate. The absence of an appropriate person to serve as an outside director, for example, would not be a valid reason under the Reform Act. According to an officer of the Ministry of Justice who is responsible for enactment of the Reform Act, the presence of two outside statutory auditors in a company, for example, would also not be a valid reason under the Reform Act. According to this officer, a company will be required to show that the appointment of an outside director will have a negative impact on the company. As this is a high hurdle to leap, the "comply or explain" rule set to be implemented under the Reform Act, together with the TSE's listing rules, will oblige listed companies to appoint outsider directors as a matter of practice.

Companies are advised to commence the search for prospective candidates to serve as outside directors, unless the company has good reasons otherwise, as the Reform Act will become effective in April or May 2015 and will apply to those listed companies holding their first annual shareholders' meeting following the date of enforcement.

New requirements on outside directors or outside statutory auditors

Under the Companies Act, the term "outside director" is defined as a director of a company who is not and never was an executive or managing director (gyomu-shikkou-torishimariyaku), executive officer (sikkou-yaku), manager (shihainin) or an employee of such company or its subsidiary (collectively, "Management Officers", or gyomu-shikkou-torishimariyaku-tou) under the Reform Act. The term "outside statutory auditor" is defined as a statutory auditor of a company who has never been a director, accounting advisor (kaikei-sanyo), executive officer (shikkou-yaku), manager (shihainin) or an employee of such company or its subsidiary.

The definitions of outside directors and outside statutory auditors (collectively, "Outside Officers"), have been criticized by global and inbound investors because directors, statutory auditors or other persons in managerial positions of a parent company, executive directors of affiliate companies, and certain close family members or relatives of a director of a company are eligible for appointment as Outside Officers. In the latter instance, for example, a family member of a director would find it difficult to remain objective stemming from a lack of independence from the management. Likewise, a director or other person from a parent company would likely not be expected to act solely in the interests of the subsidiary company in the event that there is a conflict of interest between the

parent company and its subsidiary.

For these reasons, the Reform Act will tighten the requirements of Outside Officers and will no longer permit, among others, directors or employees of a parent company, Management Officers of affiliate companies, and certain close family members or relatives of a director of a company to serve as Outside Officers. However, the Reform Act will allow a person who has not served in the capacity of a Management Officer in the last ten years to serve as an outside director of such company because it is expected that this person would no longer be influenced by the then management of such company. The Reform Act is expected to promote the independence of Outside Officers, thereby enhancing the supervisory function of the Board of Directors and statutory auditors' committees. Companies are advised to double-check whether prospective candidates satisfy the new requirements of Outside Officers.

New corporate governance system

There are two systems of board governance for listed companies under the Companies Act: (i) the statutory auditors' committee system where a company must have a board of statutory auditors consisting of at least three statutory auditors and at least half of them should be outside statutory auditors; and (ii) the three committee system – the nominating committee, compensation committee and audit committee - where a majority of the members of each committee must be outside directors.

The statutory auditors' committee system is the primary form of governance in Japan, but in discussions on the enactment of the Reform Act concerns have been raised that this system could become overly burdensome. In particular, the prevailing view is that this type of system, coupled with the additional requirement under the Reform Act that a company appoint at least one outside director, in addition to two outside statutory auditors previously appointed before the enforcement of the Reform Act, would become an overly burdensome obligation. In contrast, only a limited number of listed companies have adopted the three committee system because it is often cited that listed companies are reluctant to entrust outside directors with the power and responsibility to nominate and to determine the remuneration of management personnel.

A third corporate governance system, which is neither a statutory auditors' committee system nor a three committee system, has been introduced for listed companies under the Reform Act. Under this new corporate governance structure, called the "Audit Etc. Committee Establishment Company System (kansa-tou-iinkai-secchi-gaisha-seido)" ("New Governance System"), a listed company may have a supervisory committee, which will consist of three or more directors of which at least a majority must be outside directors. If a listed company chooses to adopt this New Governance System, neither a statutory auditors' committee nor a statutory auditor is required.

To strengthen the independence of supervisory committee members, directors nominated to serve on the supervisory committee will be appointed at shareholders' meetings separately from other directors and will serve a term of two years, which is longer than the one year term of other directors. In addition, the removal of a member of the supervisor committee will require a super majority vote at a shareholders' meeting.

The supervisory committee shall be responsible for the following three matters: (i) auditing the performance of directors and preparing audit reports; (ii) determining the agenda for the appointment/removal/non-reappointment of the accounting auditor to be submitted at a shareholders' meeting; and (iii) determining the opinion to be expressed by its members at a shareholders' meeting in relation to (a) the appointment/removal/resignation of directors (other than members of the supervisory committee); and (b) the remuneration of directors (other than members of the supervisory committee). On the other hand, the supervisor committee will not have any power in determining the selection and remuneration of management personnel.

The New Governance System also empowers members of the supervisory committee to, among other things, (i) request directors or employees to report on matters related to execution of their duties; (ii) investigate the status of the company's business or assets; and (iii) submit a report directly at a shareholders' meeting if the agenda or other documents to be submitted at the shareholders' meeting includes, among other things, illegal or materially inappropriate matters. With these powers, the supervisory committee will be in a better position to effectively audit and supervise.

Since the New Governance System is not mandatory, it remains unclear whether listed companies will adopt it, and there is some skepticism that the New Governance System may not strengthen existing corporate governance systems since supervisor committee members are also directors of a company. At a minimum, however, listed companies will have an important alternative upon the introduction of this system, which, at the same time, is expected to provide more effective auditing and supervision.

Conclusion

The Reform Act will promote substantial changes to the Companies Act, and its aim is to address the weaknesses in the corporate governance systems that have arisen since the enactment of the Companies Act in 2006. Despite the enactment of the Reform Act, especially the New Governance System, uncertainty remains as to whether the Act will directly strengthen the current corporate governance systems observed within Japanese listed companies. To placate the concerns of foreign investors, however, Japanese listed companies might adopt the New Governance System, as it resolves the weaknesses of the existing corporate governance systems and will provide more effective auditing and supervision.

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