The Corporate Governance Study Group Report

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Corporate Governance Study Group

Ministry of Economy, Trade and Industry

The Corporate Governance Study Group was established in December 2008 as a study group under the Director-General of the Economic and Industrial Policy Bureau of the Ministry of Economy, Trade and Industry (METI). The further globalization has progressed in recent years, the more important the issue of corporate governance has become. For the purpose of ensuring the steady growth and sustainable prosperity of the Japanese economy, detailed discussion on socially and economically desirable corporate governance systems is needed. In particular, discussion about the introduction of independent board members for the purpose of protecting the interests of minority shareholders is required, and from the viewpoints mentioned above, we decided to deliberate on the desirable rules for improving corporate governance (these purposes mentioned above are described in a document entitled “Establishment of Corporate Governance Study Group” written by the Corporate System Division of METI). Considering the above purposes of its establishment, the study group consists of vice presidents of operating companies, institutional investors, and scholars and researchers in related fields. In addition, a representative of the Tokyo Stock Exchange (TSE) joined as a member, and representatives of the Financial Services Agency and the Ministry of Justice joined as observers (The chairman of the study group is Professor Hideki Kanda, Graduate Schools for Law and Politics, The University of Tokyo.). The study group engaged in intense and thorough debate on each key issue, without minutes being disclosed. Although furious exchanges ensued at each meeting, the study group was able to overcome differences in backgrounds and opinions and reach a consensus with respect to the range of issues set forth below in this final report. As a reference for general readers, we decided to make public all statements of each member without disclosing names (these statements can be found on “The Opinions of Members in the Study Group” [Japanese only] page.) We believe that the trend of discussions which led to the final report can be understood from these opinions.

As part of our deliberations, we held several interviews. We extend our thanks to those who helped and supported us in this respect: Mr. Jamie Allen, Secretary General, the Asian Corporate Governance Association (ACGA); Mr. Thomas W. Whitson, President of the American Chamber of Commerce in Japan (ACCJ); and Mr. Atsushi Saito, President and CEO of Tokyo Stock Exchange Group, Inc.

1. Fundamental Approach to Corporate Governance

The study group discussed specific areas and arguments based on the following fundamental ideas which were raised at the meetings.

Since general meetings of shareholders are usually held only once a year, minority shareholders cannot carry out daily monitoring aimed at enhancing corporate value. In addition, monitoring itself is quite difficult for minority shareholders, who are not usually professional corporate managers. Therefore, minority shareholders including institutional investors have a strong expectation that outside directors and outside kansayaku (company auditors) will perform monitoring functions on their behalf to enhance corporate value from a position closer to management.

Therefore, it was determined that the subject of the deliberations should be limited to listed companies.

Formalistic requirements of the system are important factors in corporate governance structures, but what is more important is ensuring substance, i.e., how to operate the system in practice. For that purpose, it is important to establish a framework that maintains communication between investors and operating companies and achieves a sense of satisfaction.

In an increasingly globalized world, it is important to consider establishing a system which is more understandable and more convincing to investors around the world. Many Japanese companies are operating in global markets, and the ratio of foreign holders of their stock is increasing. In these circumstances, some international recommendations on Japanese corporate governance rules have been submitted which include requirements of "independence" of outside directors and outside kansayaku and promoting introduction of outside directors, etc. It is not necessary to blindly follow the format of Europe or the United States, but stock markets are borderless, and therefore it is important to have a system that has the potential to foster international understanding.

2. "Independence" of Outside Board Members (Directors and Kansayaku)

The Japanese Companies Act requires outside directors and outside kansayaku to have "outsider" status in the sense that they have never been executive directors, executive officers, or employees of the company concerned or any of its subsidiaries, but it does not require them to be "independent" in the sense of sharing no interests with management. Because of this, there is some discussion as to whether the existing "outsider" requirements for directors and kansayaku should be replaced by "independence" requirements. The Corporate Governance Study Group deliberated this issue.

Specifically, the study group discussed the following matters:

The concept that such "independence" requirements should exclude not only CEOs and others of the company concerned and any of its subsidiaries but also the following persons:

(i) CEOs and others of parent companies;

(ii) CEOs and others of the company's important business counterparties or partners; and

(iii) family members of CEOs and others of the company.

On the other hand, some suggestion that if a director or kansayaku has not violated the requirement mentioned above for a given period of time in the recent past (for example, three or five years), the director or kansayaku should be considered to have "independent" status.

With regard to these issues, the Corporate Governance Study Group concluded as follows:

"Independence" means having an independent position from management, and sharing no mutual interests with management. From this standpoint, it is necessary to consider two cases in which it cannot be said that "independence" is present: (i) cases in which directors/kansayaku could be significantly controlled by management; and (ii) cases in which directors/kansayaku could have considerable control over management.

Possible examples of persons who cannot be independent (i) include executive officers or employees of the company concerned, subsidiaries, and business counterparties or partners of the company such as subcontractors, consultants obtaining remuneration from the company, family members, and similar others; and (ii) include executive officers or employees of parent companies, and business counterparties or partners of the company such as main banks, family members and similar others.

Both of the requirements above relate to objectivity and distance from management. Under the circumstance of (i), there is a risk that the judgment of directors or kansayaku could be biased by pressure from management, and it is highly probable that problems concerning governance would arise. On the contrary, further consideration is necessary regarding the pros and cons of governance stemming from the circumstance of (ii).

What is really important is the relationship between ensuring "effectiveness" of corporate governance and securing "independence" that does not conflict with the interests of minority shareholders trading shares in the markets. Recent studies show that a trade-off can be found between these two desirable values.[1] In other words, from the perspective of ensuring the effectiveness of monitoring, it is considered that those having actual substantial interests (stakes) in the enhancement of corporate value of the company concerned (present banks or parent companies, for instance) should have better knowledge about the company, and will make greater effort to monitor it. Therefore, in such a case it is easier to ensure the "effectiveness" of corporate governance from the perspective of enhancing corporate value, and at least in this context, it would benefit the interests of minority shareholders. If the existing "outsider" requirements are replaced by "independence" requirements, and persons are uniformly eliminated from outside director/kansayaku simply because they are executive officers or employees of the parent companies or business counterparties or partners of the company concerned, then there would be a risk that persons who are capable of greatly contributing to enhancing the company's corporate value and who have knowledge and experience regarding the company (for instance, persons of its business counterparties or partners and others) might be eliminated. In that event, the contrary concern arises that the company's directors/kansayaku would be unable to be sufficiently effective in the governance context.

On the other hand, from the standpoint of avoiding conflicts of interest with minority shareholders, especially under circumstances in which conflicts of interest easily occur, the very fact that such parties have substantial interests with respect to the company

[1] For example, OECD Report, (Grant Kirkpatrick, "The Corporate Governance Lessons from the Financial Crisis" (OECD, 2009)); and Arnoud W.A. Boot and Jonathan R. Macey, "Monitoring Corporate Performance: The Role of Objectivity, Proximity, and Adaptability in Corporate Governance" (Cornell Law Review, Vol. 89, pp. 356-393, 2004); etc.

concerned could in itself be a reason for the company not to win the confidence of minority shareholders. In fact, there are a number of opinions that explain the importance of “independence,” including the OECD Principles of Corporate Governance and rules established by the Pension Fund Association, etc. Also, many investors have submitted comments to the Tokyo Stock Exchange calling for the strengthening of “independence.” This issue should not be overlooked in the light of recent circumstances, in which many issues have raised contentious arguments regarding conflicts of interest, such as MBOs and the adoption of anti-takeover measures.

To enhance corporate governance based on recognition of demands for the dual requirements of securing independence and ensuring the effectiveness of governance as discussed above, it is necessary to try to find the appropriate combination of these two factors, and to determine the most appropriate governance structure. However, based on the aforementioned discussion, the most appropriate governance structure, and which of the two values should be emphasized and to what extent, would vary according to each company’s character, the environment and situation of the company, and other factors.

In that case, assuming that listed companies have the minimum framework necessary to protect minority shareholders and investors, such framework is considered to be suitable as the governance structure that is most appropriate for each company should be determined ultimately by individual company in a consensus-building process including dialogue with minority shareholders and investors involved in the company, based on proposals and thinking about such structure disclosed by the company with full accountability to explain them.

Consequently, the Corporate Governance Study Group has concluded that:

(1) The framework must necessarily assume that, as a minimum, there will be an “independent” director/kansayaku who is not at risk of having conflicts of interest with minority shareholders and who is supposed to protect minority shareholders. Moreover, the legal regulations that listed companies must fulfill should accept diversity in “outsider” status, and will not replace the existing “outsider” requirements with “independence” requirements.

(2) As to actions to be taken by individual listed companies, each listed company will be required to improve disclosure of its views in the framework, so that consensus regarding the most appropriate corporate governance structure for each company can be fostered through dialogue with shareholders, taking into account the dual requirements of securing independence while ensuring the effectiveness of governance.

3. Introduction of Outside Directors

The Corporate Governance Study Group has discussed the argument that boards should have a certain number or percentage of outside directors.

Specifically, the question was how to adjust the argument of setting rules requiring companies with a board of kansayaku to have a certain number of outside directors.

In this regard, the Corporate Governance Study Group concluded as follows:

In discussions in the Corporate Governance Study Group, there was an opinion presented from the operating company side that if the checking function is expected to be performed by outside or independent directors/kansayaku, there should be no critical difference in a practical sense whether that function is provided by directors or kansayaku. Meanwhile, from the investor side there was a strong opinion that the monitoring and supervision functions are insufficient if the system relies solely upon the existing kansayaku system, even though in practice kansayaku can express their opinions from the perspective of corporate value and shareholder value.

Considering this situation, it is thought to be important for individual companies with a board of kansayaku to introduce outside or independent directors on a voluntary basis. The significance here derives from the expectation of a role of advising how to enhance corporate value, based on the insight of outside or independent directors approaching things from an outsider's standpoint, as well as a role of supervision of the execution by directors. In fact, more than 40 percent of TSE-listed companies with a board of kansayaku have outside directors, and this trend is increasing.

However, it is necessary to carefully consider the governance pros and cons if all companies with a board of kansayaku were required to have outside directors, without any exceptions. It is better to promote effective measures by focusing on not only formality but also substance to enhance corporate governance. In fact, some companies are substantively working to improve governance by means of their own unique measures, beyond the regulatory requirements. For instance, some companies are making their own efforts by having advisory boards consisting of outside experts, and reflecting their advice in management decision-making. Other companies have executive directors who are from outside the company concerned and have never worked for it as an employee, though they are not regarded as "outside directors" under the Companies Act, because the definition of outside director under the act excludes a person who is currently or has ever been an executive director of the company concerned. To impose formalistic rules mandating even such companies to have outside directors in a uniform manner would have the contrary effect of hampering the formation of the most appropriate governance structure, even from the viewpoint of minority shareholders and investors.

Consequently, 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.

4. Selection of Measures

The Corporate Governance Study Group examined the selection of measures to establish the framework that Japanese listed companies must fulfill and, as mentioned above, reached the conclusion that the content of the framework needs to correspond to the actual circumstances of companies within a certain scope. So on this occasion the Corporate Governance Study Group decided to adopt measures that do not require any revision to the law, and concluded that it is realistic to require this to be established by financial instruments exchanges. Therefore, the study group does not draw a conclusion regarding the requirements for “outsider” status and whether such requirements could be ignored for those persons who have not violated the “outsider” requirements for a given period of time (for example, three or five years) in the recent past (review of “the requirements regarding past status”), as this is also linked to revision of the law.

The reasoning for requiring measures to be established by financial instruments exchanges is that one of the functions of exchanges as market operators is to maintain certain quality standards for companies so that any investor can make investments. Therefore, it seems that they play a role in establishing some sort of framework for corporate governance as one of their quality control functions.

In this regard, some have suggested a need to carefully consider whether or not the same framework should be uniformly adopted by all exchanges. However, it should also be noted that, while taking into account the actual situation of each market operated by exchanges, it is necessary for each exchange to take sufficient measures to ensure transparency, fairness and other aspects of transactions.

Roster of the Corporate Governance Study Group

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