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Companies Act Reform: Supervisory Function of the Board of Directors (Company with Audit/Supervisory Committee, Outside Directors)

An amendment to the Companies Act was enacted on 20 June 2014 ("Amendment"). This is the first major amendment since the enactment of the Companies Act in 2006 and addresses many of the practical issues that have arisen since its enactment. The Amendment is expected to come into effect on 1 April 2015.

This Briefing explains (i) the introduction of a new corporate governance structure for large public companies in Japan by way of an audit/supervisory committee, and (ii) new rules on outside directors, which had been a point of protracted debate. The new audit/supervisory committee governance structure will be introduced to facilitate appointments of outside directors and provides a corporate governance system that is more familiar to foreign investors. It is expected to be an important alternative to the existing corporate governance structures. With respect to the new rules on outside directors, although companies are currently not obliged to appoint outside directors, the directors of listed companies that do not have outside directors will, following the Amendment, be required to explain why outside directors have not been appointed.

Company with Audit/Supervisory Committee

Background

Under the current Companies Act, there are only two corporate governance structures available to large public companies, (i) a company with a board of statutory auditors and (ii) a company with committees (nominating committee, compensation committee and audit committee).

With respect to the former, more than half of the statutory auditors appointed by a company with a board of statutory auditors must be outside statutory auditors. The combination of this, together with the additional requirement that such a company also appoint outside directors, is often cited as an overly burdensome obligation. In addition, foreign investors have indicated that the outside statutory auditors within a company with a board of statutory auditors are unable to function effectively as supervisors of the representative directors due to a lack of voting rights at meetings of the board of directors. With respect to the latter, only a small number of Japanese companies have chosen to adopt the committees governance structure, as the majority of the directors of each committee must be outside directors and Japanese companies are reluctant to entrust outsiders with the role of determining the nomination and remuneration of management personnel.

Overview of a Company with Audit/Supervisory Committee

The Amendment will introduce a new governance structure – a company with an audit/supervisory committee. Under the audit/supervisory committee governance structure, there is no requirement for statutory auditors, instead directors appointed as audit/supervisory committee members will audit the management of such a company. An audit/supervisory committee will consist of three or more directors, the majority of which must be outside directors. Directors who become members of the audit/supervisory committee are to be appointed at shareholders' meetings separately from the other directors, and the terms of office of such directors is two years, while that of the other directors is one year. As a result, it is expected that members of the audit/supervisory committee will be in a better position to audit and supervise effectively.

As audit/supervisory committee members are also directors, they can exercise their voting rights at meetings of the board of directors. In addition, audit/supervisory committee members may at any time request reports on the business from the directors, and investigate the operations and financial matters of the company. If a director acts in violation of the law or the company's Articles of Incorporation, and such act is likely to cause substantial damage to the company, the audit/supervisory committee members have the right to demand that such director cease such act.

Practical Implications

Japanese companies should find it worth adopting the audit/supervisory committee structure, because it resolves the issues surrounding companies with a board of statutory auditors and companies with committees, and at the same time provide more effective auditing and supervision.

Rules on outside directors

Explanation of the reasons why the appointment of outside directors is inappropriate

There was much discussion over whether the current Companies Act should be amended to require the mandatory appointment of outside directors for the purpose of enhancing the supervisory role of the board of directors.

While the amended Companies Act does not oblige companies to appoint outside directors, directors of listed companies that have not appointed outside directors will be required to explain at their annual shareholders' meeting why outside directors have not been appointed. Underpinning this "comply or explain" rule is the principle that outside directors should be appointed at listed companies unless there are good reasons otherwise.

Furthermore, a subsidiary provision of the Amendment prescribes that the Japanese Diet, two years after the enactment of the Amendment and upon consideration of the number of companies which appoint outside directors as well as other economic circumstances, may if necessary, take such measures that include the mandatory appointment of outside directors.

Amendments to the Definition of Outside Officer

Exclusion of Persons From a Parent Company and Family Members

Under the current Companies Act, a person from a parent company or a family member of the director of a company can become an outside director or an outside statutory auditor (collectively, "Outside Officers"). However, this position has been subject to criticism that a person connected to a parent company can hardly be expected to act purely in the interests of the subsidiary company in the event of a conflict of interests between the parent company and the subsidiary. Also, it would be difficult for a family member of the director to conduct an effective audit due to a lack of independence from the management. For these reasons, under the amended Companies Act, directors of a parent company, executive directors of affiliate companies, and certain close family members of a director of the company may no longer be appointed as Outside Officers.

Ten-year cooling period

Under the current Companies Act, a former director of a company or its subsidiaries may not subsequently become an Outside Officer of such a company. Under the amended Companies Act, a person who has not been a director of a company or its subsidiaries in the last 10 years may become an Outside Officer of such company, because such person is no longer deemed to be controlled by current management.

Practical Implications

The Tokyo Stock Exchange amended its listing rules in February 2014. Under the amended rules, listed companies must make efforts to appoint one or more independent officers[1]. This amendment to the listing rules, together with the "comply or explain" rule to be introduced under the Amendment, is expected to accelerate the appointment of outside directors by listed companies in Japan. In fact, 76% of the companies listed in the first section of the Tokyo Stock Exchange had appointed outside director(s) as of March 2014, while it was 62.3% as of August 2013.

The amendment of the definition of Outside Officer will apply as of the first annual shareholders meeting after the enactment of the amended Companies Act. Companies are advised to check whether candidates fall into the new definition of Outside Officer.

[1] An "independent officer" defined in the Tokyo Stock Exchange rules is different from an "outside director" under the Companies Act; for instance, persons related to major trade partners cannot be independent officers.

Where Japanese legal concepts have been expressed in the English language, the concepts concerned may not be identical to the concepts described by the equivalent English terminology as they may be interpreted under the laws of other jurisdictions.

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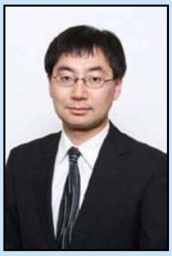

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