ARQIS FOREIGN LAW OFFICE

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Corporate Law: New Rules on Corporate Governance

Following the enactment of the Japanese Companies Act ("JCA") in 2005, the legislative council submitted a proposal for amendment in 2010, which was finally adopted during the 186th legislative session in 2014. This amendment will come into force on 1 May 2015 and includes two important changes also relevant for foreign investors, namely (I.) the introduction of a new corporate governance structure, and (II.) new rules on outside directors and auditors, as further described in this newsletter.

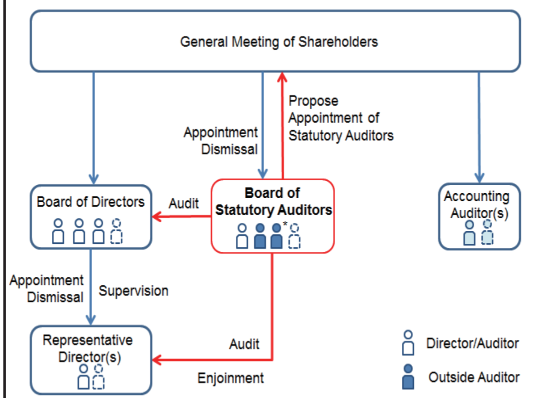
I. New Corporate Governance Structure

One of the most anticipated changes introduced by the amendment of the JCA is the newly created option to choose a third corporate governance structure for Japanese joint-stock corporations (kabushiki kaisha (KK)): the so-called audit and supervisory committee (kansa to iin-kai).

This amendment will be particularly relevant for public “large” companies (i.e. companies with a paid-in share capital of JPY 500 million or more, or liabilities of JPY 20 billion or more), as these are obliged to implement a corporate governance structure prescribed by the law. However, if a private large company voluntarily adopts a corporate governance structure prescribed under the JCA (e.g. by establishing a board of statutory auditors) the new provisions of the JCA will be applicable as well. Under the current JCA, a company could choose between two alternatives: (1.) the establishment of a board of statutory auditors, and (2.) the committee-type system.

1. Company with a Board of Statutory Auditors (Kansayakukai Secchi Gaisha)

Currently, the most prevalent corporate governance structure is the board of statutory auditors.



*Only large publicly-held companies require a board of statutory auditors in addition to an accounting auditor

a. Overview

A public large company is obliged to establish a board of statutory auditors (unless it chooses a committee-type structure as described under 2. below) and appoint three or more statutory auditors, the majority of whom being outside auditors and at least one being a full-time statutory auditor. Statutory auditors are appointed for a four-year term and have various duties such as the audit of financial affairs, the execution of business by the management, as well as the preparation of audit reports thereof etc. Statutory auditors are also entitled to express their opinion at the board of directors' meeting and demand a report from the management on the company's operations etc.

(While for private and small companies the scope of audit may be limited to financial audit (thus excluding business affairs), such limitation must be registered in the commercial registry upon (re-) appointment of the statutory auditor after 1 May 2015.)

b. Issue

The statutory auditor's primary responsibility is to ensure the execution of duties by directors being in compliance with applicable laws and regulations as well as the company’s statutes. However, it is debatable whether statutory auditors have the necessary tools to effectively supervise the management’s business activities, in particular, as they do not have voting rights on the board of directors. This lack of direct influence limits the supervision of representative director(s), because only the members of the board of directors are entitled to appoint and dismiss representative director(s). Therefore, it is often demanded that statutory auditors should be provided with broader rights for a more efficient control of management activities.

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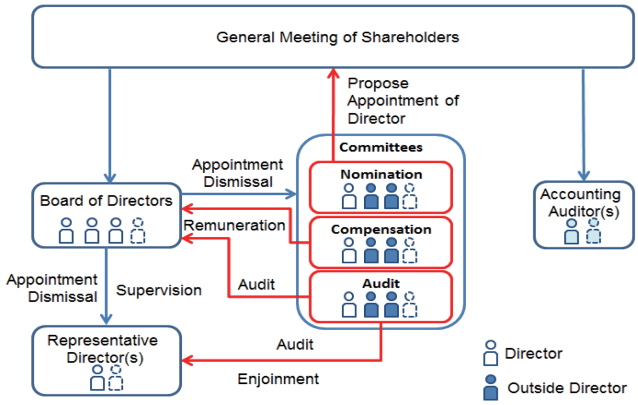
2. Committee-type Company (Shimei-Iinkai to Secchi Gaisha)

The current alternative to a board of statutory auditors is to establish a committee-type system, which is, however, only adopted by few companies in Japan (most of them in the electronics industry).



a. Outline

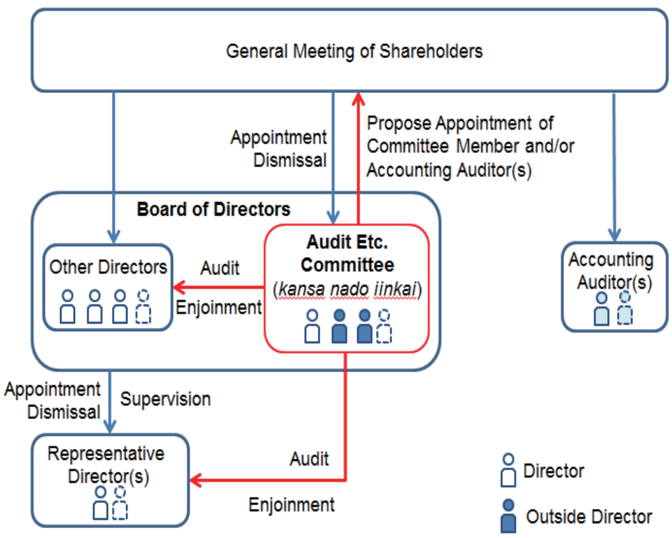
Committee members are appointed by the shareholders' meeting for a term of one year. Each of the three committees (for audit, compensation and nomination) comprises at least three members, the majority of whom must be outside directors.
Each committee has its own rights and duties: (i) the nomination committee determines the details of any proposals concerning the election and dismissal of directors, (ii) the audit committee controls the directors and representative director(s) execution of their duties and determines the details of proposals concerning the election, dismissal, and (non-) reappointment of the accounting auditor(s), while (iii) the compensation committee decides the remuneration of each director.

b. Issue

The broad authority of the committees together with the requirement for a majority of committee members to be outside directors has made this system rather unappealing for most Japanese companies, especially as the committees determine the nomination and remuneration of the management. To this end, for many traditional Japanese companies it remains questionable whether or not outside directors are actually able to effectively act in the company's best interest due to their rather distant relationship to the company.

3. Company with Audit and Supervisory Committee (Kansa to IInkai Secchi Gaisha)

In view of these deficits, a new corporate governance structure was approved by the Japanese diet: the audit and supervisory committee ("Committee"). The centerpiece of this new governance structure is the Committee, which acts as the company's main audit organ. As the Committee only cursorily covers decisions on management compensation and nomination, Japanese entrepreneurs do not need to be concerned about decisions by an organ of which the majority comprises outside directors. Furthermore, as members of the Committee are simultaneously members of the board of directors, the new corporate governance structure also resolves one of the main issues surrounding the board of statutory auditors: the lack of influence on the board of directors.



a. Outline

The Committee has at least three directors as its members ("Committee Members"), the majority of whom must be outside directors. Committee Members are not allowed to concurrently act as executive directors or employees of the company or its subsidiary, or as accounting advisors or executive officers of a subsidiary. These requirements aim to ensure sufficient impartiality, which is regarded as essential to guarantee effective supervision of the business operations. In order to fulfill their roles as auditors and supervisors, Committee Members have been provided with various rights and duties as explained under (c.) below.

b. Operation of the Committee

Each Committee Member is legally entitled to convene a meeting and to submit and vote on resolutions, which require a majority of the votes of the Committee Members present. The Committee may also demand the members of the board of directors and accounting advisors to attend the meeting and provide explanations on matters requested.

c. Rights and Duties of the Committee Members
Committee Members are first and foremost obliged to oversee the execution of duties by directors and accounting advisors, and prepare audit reports of the results thereof. To this end, Committee Members have the same privileges and responsibilities as members of the audit committee in a committee-type company. Additionally, since Committee Members are members of the board of directors, the rights and duties of members of the board of directors are applicable to Committee Members as well. Thus, Committee Members have a broad authority and may file proposals to the shareholders' meeting, e.g. for the election of accounting auditors, and vote at the board of directors when the management policy is being determined. The remuneration of Committee Members is determined either (i) by a provision in the company's articles of incorporation, or (ii) by a resolution of the general meeting of shareholders. To this end, it is important to note that the remuneration of Committee Members, when determined by the shareholders' meeting, must be determined separately from the remuneration of other directors and not in the same resolution.

d. Implementing the new Corporate Governance Structure
The following steps are required to implement the new corporate governance structure:

1. **Amendment of the Articles of Incorporation ("AOI"):** The AOI must be amended to the effect that, in addition to the shareholders' meeting, (i) a board of directors, (ii) accounting auditor(s), and (iii) a Committee are installed.

2. **Appointment of Committee Members:** At least three directors must be appointed by the shareholders' meeting as Committee Members, the majority of whom must be outside directors. The term of office must continue until the conclusion of the annual shareholders meeting for the last business year, which ends within two years from the time of their election. This period cannot be shortened, even if the term of other members of the board of directors is shortened to one year.
To this end, it must be noted that Committee Members are to be appointed separately from other directors and the shareholders' meeting may not appoint Committee Members and other directors in the same resolution.
Additionally, the appointment (as well as the dismissal) of Committee Members requires a special majority of two thirds or more of the voting rights of the shareholders present, who must represent a majority of the voting rights of all shareholders.

3. **Registration with the Commercial Register:** The new corporate governance structure has to be registered with the commercial register.

e. Overview of the Corporate Governance Structures after the Amendment

Type of Stock Corporation * (kabushiki kaisha)			Board of Directors	Number of Directors	Director's Term of	Corporate Governance	Number of Auditors/	Auditor's/ Member's	Outside Directors	Accounting Auditor
Public Corporation[1] (no limitation on transfer of at least one class of shares[2])	Small		Mandatory	3 or more	Up to 2 years	Optional	1 or more	4 years	None	Optional
	Large[3]	Board of Statutory	Mandatory	3 or more	Up to 2 years	Mandatory	3 or more	4 years	"Comply or explain" rule	Mandatory
		Committee System[4]	Mandatory	3 or more	Up to 1 year	Mandatory	3 or more per committee	2 years	Majority of each committee	Mandatory
		Audit and Supervisory	Mandatory	3 or more	Up to 1 year	Mandatory	3 or more	2 years	Majority of the Committee	Mandatory

1 None of the corporate governance structures is mandatory for private corporations, i.e. corporations with limitation on the transfer of all classes of shares.
2 "Limitation" = the transfer of shares is subject to the approval of the shareholders' meeting or the board of directors.
3 "Large Corporations" = stock corporations with at least JPY 500 million in paid-in capital or JPY 20 billion in liabilities as of the most recent balance sheet.
4 Companies must install one of the three corporate governance structures.
5 Companies with a board of statutory auditors must appoint statutory auditors whereas companies with a committee system, or an audit and supervisory committee must appoint directors as committee members.

II. New Rules on Outside Directors and Statutory Auditors

The second significant change under the JCA amendment concerns the definition of outside directors and statutory auditors. Under the current law, persons belonging to the parent company as well as relatives or the spouse of a director of the company in question are eligible to be appointed as outside director or outside statutory auditor. This definition of outside officers is considered to be too lax in order to ensure sufficient impartiality, and, as a consequence, the scope of persons eligible to be appointed as outside officers will be narrowed considerably as described in detail below. However, due to strong objections in the business world, the law falls short of making the appointment of outside directors strictly mandatory. Thus, instead of facing legal obligations or sanctions, companies with a board of statutory auditors not having appointed at least one outside director, will have to state the reasons thereof in their annual securities report (according to Sec. 24 No. 1 of the Japanese Financial Instruments and Exchange Act). The amendment thus establishes a "comply or explain" rule, as it is known in other jurisdictions such as the German Corporate Governance Code. Please note that for outside members of the board of statutory auditors the below described legal requirements are mandatory and the "comply or explain" rule does not apply.

1. New Requirements for Outside Directors and Statutory Auditors

Under the current law, an outside director is a director of a stock corporation who is neither an executive director nor an executive officer, nor an employee, including a manager, of such company or any of its subsidiaries, and who has neither served in the past as an executive director or an executive officer, nor as an employee, including a manager, of such company or any of its subsidiaries is eligible to become an outside director. Under the amendment, the new definition of outside directors will also exclude:

・Directors or executive directors or executive officers, or employees, including managers, of the company's parent company (i.e. any company which controls the financial and business policies of the stock company),

・Executive directors, executive officers or employees, including managers, of a subsidiary of the company's parent company (not including the company and its subsidiaries),

・2nd degree relatives or the spouse of any director, executive officer or an important employee, including a manager, of such KK, or of any natural person who controls the financial and business policies of the company.

As for outside company statutory auditors, the current JCA defines an outside statutory auditor as an auditor of any company who has neither served in the past as a director, accounting advisor (or, in cases where the accounting advisor is a juridical person, any member thereof who was in charge of its advisory affairs) or as an executive officer, nor as an employee, including a manager, of such company or any of its subsidiaries. After the amendment comes into force, the definition of an outside company auditor will further exclude:

・Directors or statutory auditors, executive officers or employees, including managers of the company's parent company (including any company which controls the KK),

・Executive directors or executive officers, or employees, including managers, of a subsidiary of the company's parent company (not including the company and its subsidiaries),

・2nd degree relatives or the spouse of a director or an important employee, including a manager, of such company, or of any natural person who controls the financial and business policies of such company.

2. Cooling Off Period

To further ensure sufficient impartiality, the amendment prescribes a "cooling off" period of 10 years for outside directors before the assumption of office at a company respectively it's subsidiary. In particular, this means that:

・Outside directors (i) may not have worked at any time within 10 years before the assumption of office as executive director or executive officer or employee, including a manager, of such company or its subsidiary, or (ii), where the director has already worked as director (not including executive directors, executive officers or employees, such as a managers), financial advisor or statutory auditor of such company or its subsidiary, may not have worked at any time 10 years before his assumption of office as such director, financial advisor or statutory auditor as executive director or executive officer or employee, including a manager of such company or its subsidiary.

・Outside company statutory auditors (i) may not have worked at any time within 10 years before the assumption of office as director, financial advisor or executive officer or employee, including a manager, of such company or its subsidiary, or (ii), where the statutory auditor has already worked as statutory auditor of such company or its subsidiary before, may not have worked at any time 10 years before his assumption of office as such statutory auditor as director, financial advisor or executive officer or employee, including a manager, of such company or its subsidiary.

The new definitions need to be observed also with respect to appointed outside directors or statutory auditors.

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