

The International Comparative Legal Guide to:

Corporate Governance 2008

A practical insight to cross-border corporate governance



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1 Setting the Scene - Sources and Overview

1.1 What are the main corporate entities to be discussed?

The companies covered in the answers below are the joint stock companies (*kabushiki kaisha*) whose securities are admitted to be listed and traded on the Tokyo Stock Exchange (“TSE”). The TSE has three sections. The First Section of the TSE lists the securities of major companies which, for example, have an aggregate market value in excess of JPY 50 billion at the time of listing. Over 1,700 companies are listed in the First Section of the TSE. The Second Section lists the securities of mid-sized companies (over 450 companies are listed), and the Mothers Section lists the securities of young, high-growth companies (nearly 200 companies are listed).

1.2 What are the main legislative, regulatory and other corporate governance sources?

Until recently, major legislation concerning companies was included in the Commercial Law, which was the primary legislation regulating all commercial transactions (including those such as transport trade or maritime commerce). In May 2006, the Companies Act came into effect, materially amending and modernising the regulations concerning companies under the Commercial Law and other related laws and regulations. The Companies Act, together with its subordinate rules, sets out the basic principles which a company must adhere to, whether listed or not, including incorporation, share issuance, corporate governance, operations, disclosure of information, mergers and acquisitions, and liquidation. The Companies Act requires companies to adopt articles of incorporation. Companies may choose to override certain standard provisions contained in the Companies Act by so providing in their articles of incorporation, which generally include the provisions concerning organisational structure, distribution of managerial power, the total number of shares which may be issued, etc.

A company conducting business which the government has the authority to supervise must also adhere to the laws which specifically regulate its business (e.g., banking business (Banking Law), trust business (Trust Business Law), insurance business (Insurance Business Law) or pharmaceutical affairs (Pharmaceutical Affairs Law) etc.).

The companies listed on the TSE must also adhere to the Financial Instruments and Exchange Law (“FIEL”) and the TSE’s Securities Listing Regulations, which regulate, among other things, disclosure of information by listed companies. Generally speaking, the FIEL and the TSE’s regulations focus on protecting investors to a greater degree than the Companies Act.

1.3 What are the current topical issues and trends in corporate governance?

Recently, the shareholders of Japanese companies have gained awareness of their rights. It has become popular for them to require the company to include their proposals in the agenda of the shareholders meeting pursuant to the Companies Act or to initiate a proxy fight pursuant to the FIEL and its subordinate rules.

2 Shareholders

2.1 What rights and powers do shareholders have in the operation and management of the corporate entity/entities?

The shareholders are ultimately the owners of the companies, but they have, in principle, delegated the power to operate and manage the company to the directors (or, for a company with committees, executive officers). (For the remainder of these answers, the term “directors” shall, as the context requires, include executive officers as further described in the answer to question 3.1 below.) Therefore, unless the articles of incorporation of a company require a shareholders’ resolution for certain issues relating to the operations and management of the company, the directors are the ones who should handle the daily operations and management. However, the Companies Act reserves certain rights and powers to the shareholders by requiring a shareholders resolution for certain issues.

The rights and powers to which the shareholders are entitled under the Companies Act include, among other things, the following: (a) decisions which materially effect the company’s business (such as amendment of the articles of incorporation, mergers, corporate splits, capital reductions and dissolution of the company); (b) appointment and dismissal of directors, corporate auditors and accounting auditors (see question 3.2 below for further detail); (c) approval of financial documents; (d) decisions which materially affect the interest of the shareholders (such as payment of dividends and issuance of shares or stock options at specially favourable prices); and (e) decisions which should not be left to the discretion of directors (such as determination of directors’ remuneration (see question 3.3 below for further detail) and the discharging directors’ liabilities (see question 3.9 below for further detail)).

As described above, the shareholders should, in general, exercise their rights and powers by submitting their votes at the shareholders meeting. However, in extreme circumstances, the shareholders are allowed to directly influence the operations and management of the company before the company takes certain actions. These powers include, among others, the following: (i) shareholders who are

likely to suffer damages due to certain issuance of new shares may demand the company to cease issuing such shares; (ii) shareholders who are likely to suffer damages due to mergers by summary method, etc. may demand the company to stop such mergers; and (iii) shareholders may demand the directors to stop engaging in certain acts, if such acts are in violation of the laws and regulations or the articles of incorporation, and they are likely to cause substantial detriment to the company. Please note, however, that some of these rights require the shareholders to hold a certain amount of shares or the shareholder to hold shares for certain period of time.

2.2 Do indirect shareholders (e.g. beneficial shareholders who hold through nominees), have direct rights in relation to the corporate entity/entities?

Generally speaking, indirect shareholders do not have direct rights in relation to the company. However, due to the fact that the Companies Act allows electronic communication to or by shareholders (see question 2.6 below for further detail), the TSE has implemented the Electronic Voting Platform (<http://www.tse.or.jp/english/listing/meeting/index.html>), allowing indirect shareholders of the companies which chose to join this Platform to directly obtain the company's information and to submit votes at the shareholders' meeting.

2.3 Are there any limitations on, and disclosures required, in relation to interests in securities by shareholders?

Under the Foreign Exchange and Foreign Trade Act, a report must be made to the finance minister, etc. if the holdings of foreign investors increase to more than 10% of the shares of a listed company. Further, if foreign investors wish to increase their stake to more than 10% of a company in certain industries which may have an impact on Japanese security or those producing products which could be used to manufacture weapons (such as the airline industry, nuclear business, utility business, titanium alloy industry and carbon fibre industry), then a report must be made to the finance minister, etc. prior to such purchase. In case the finance minister deems it necessary to restrict such increase in the stake, then the finance minister may recommend or even order the amendment of the terms of the purchase or stop the purchase altogether.

There also are *de-facto* limitations on the number of securities that foreign investors can hold in companies of certain industries, such as the broadcasting industry (in case more than 20% of the shareholding ratio of the company is held by foreign investors, such company will lose its license to broadcast) and the air transportation industry (in case more than one third of the shareholding ratio of the company is held by foreign investors, such company will not be permitted to conduct the air transportation business).

Regarding disclosure, a shareholder in a listed company must file a report with the authorities concerning its shareholding ratio if the percentage of ownership reaches 5%. Thereafter, a report must be made if the shareholding ratio increases or decreases by 1% or more. The report must be made by the shareholder itself and not the company.

In addition to the above, though beyond the scope of this publication, there are also insider trading rules and takeover rules which limit the timing and speed for which shareholders can sell or purchase certain shares.

2.4 What shareholders meetings are commonly held?

There are two types of shareholders' meetings. One is the ordinary

general meeting of shareholders, which is held annually for purposes such as approving the financial documents, to pay dividends, and to elect the directors and auditors. The other is the extraordinary general meeting of shareholders, which is held whenever material issues arise which need to be resolved by the shareholders.

All shareholders are entitled to receive a notice of convening a meeting, but in order to attend and vote at a shareholders meeting, a shareholder must have its name registered in the company's shareholders register as of the record date for each meeting. If a shareholder only purchases the shares of the company and does not have its name registered, the company will be deemed to have acted properly by sending notice only to the former shareholder who was still registered as a shareholder.

The vast majority of shareholder resolutions require a vote from a simple majority of the voting rights present at the meeting, but some resolutions which concern major issues of the company require separate formula, such as (i) a vote from more than two thirds of the voting rights present at the meeting, (ii) a vote from a simple majority of the entire shareholders which should total more than two thirds of the voting rights present at the meeting, or (iii) vote from all of the shareholders.

2.5 Can shareholders call shareholders meetings or put resolutions?

Although the default position is for the board to decide and the representative director to call the shareholders' meetings, a shareholder may, by meeting certain requirements (such as the amount of shares it holds or the period of time for which it has been a shareholder), require that directors of the company convene a shareholders meeting. If such request is not met within a specific amount of time, the requesting shareholder may convene a meeting on its own after obtaining court approval. A shareholder who meets certain criteria may also require the company to include its proposals in the agenda of the shareholders meeting. Further, in case a resolution is made at a shareholders meeting in substantial nonconformity with the laws and regulations or the articles of incorporation regarding its convocation, management, or resolution, a shareholder may initiate a lawsuit to cancel the resolution made at such shareholders meeting.

2.6 Is electronic communication to or by shareholders possible?

The Companies Act allows electronic communication to be used. The main cases are the following: (i) the company may send a notice of convening a shareholders meeting to the shareholders who gave consent to receiving notice by such means; (ii) the company may, if allowed under the articles of incorporation, disclose certain documents on its web site, which, as a general rule, must be sent together with the notice; and (iii) the shareholder may submit its vote at the shareholders meeting by electronic means when allowed by the company.

2.7 Can shareholders be liable for acts or omissions of the corporate entity/entities?

The shareholders are only liable for the amount of their capital contribution in the company. Although it is theoretically possible for the shareholders to be liable for the company's conduct due to the doctrine of "piercing the corporate veil," it is very unlikely that such doctrine would be applied in the context of listed companies.

2.8 Can shareholders be disenfranchised?

In ordinary circumstances, a company may not disenfranchise shareholders unless the company's articles of incorporation specifically provide that certain classes of shares may be compulsorily purchased by the company. However, it is possible for the shareholders of certain companies to be "squeezed out" in the case of corporate restructuring.

2.9 Can shareholders seek enforcement action against members of the management body?

In cases where a company suffers damages due to one of its directors' misconduct, the company, in the first instance, should pursue such director's responsibility. However, since the company is actually managed by the directors, it may choose not to pursue such director. Therefore, a shareholder who has held the company's shares for a certain period may demand the company to initiate a lawsuit against the director. If such demand is not met, then such shareholder may initiate a lawsuit against the director on behalf of the company.

In case a shareholder suffers damages concerning the operation or the management of the company due to the wilful misconduct or gross negligence by the members of the management body (including the directors, the corporate auditors, etc.), the shareholder may pursue such directors directly.

3 Management Body and Management

3.1 Who manages the corporate entity/entities and how?

The management body of a company can be classified into two types, according to the structure which the company has adopted. One is the "Company with Auditors" and the other is the "Company with Committee."

Company with Auditors

This is the most common type of corporate structure for Japanese companies. Both the directors and corporate auditors are elected by the shareholders. The directors form a board of directors and the board of directors elects, among these directors, a representative director, who has the power to represent the company. The daily management of the company is conducted by the representative director (the term "president" or "chairman" is not provided by the law, though such terms are commonly used). In addition, common directors may be authorized by the board to represent certain aspects of the business. Some major decisions of the company prescribed by law or the articles of incorporation are required to be made by resolution at the board meeting or the shareholders meeting. In the case of a "Large Company" (a company with a stated capital equal to or exceeding ¥500 million or with total debts equal to or exceeding ¥20 billion or more), the corporate auditors, whose duty is to audit the directors' conduct, form a board of corporate auditors.

Company with Committee

This is a new type of the corporate structure which was introduced by amendment of the law in 2002. Only the directors are elected by the shareholders. The directors will form a board of directors and elect the members for three committees among these directors. The three committees are (i) the audit committee, which conducts, among other things, the audit of the directors and executive officers, (ii) the nomination committee, which decides on proposals regarding the election and dismissal of the directors to be submitted

at the shareholders meeting and (iii) the compensation committee, which sets compensation for the directors and executive officers. The board of directors also appoints executive officers to manage the company by delegating certain aspects of the company's business to such executive officers. However, unlike in the case of the Company with Auditors, the executive officers are not required to be elected from among the directors who are appointed by the shareholders. If several executive officers are to be appointed, the board of directors must elect at least one executive officer who has the power to represent the company (the term "chief executive officer" is not provided by the law, though it is commonly used).

Term of the directors

In a Company with Auditors, the length of directors' service shall be two years or less, whereas it shall be one year in a Company with Committee. Even if a longer term is agreed upon in the service contract, such provision will not limit a resolution at the shareholders meeting to replace the directors upon expiry of the two-year period.

3.2 How are members of the management body appointed and removed?

Company with Auditors

The directors are appointed and removed by shareholders resolution. The representative director is appointed and removed by the board resolution. However, if a proposal to remove a director is rejected despite that director's misconduct, certain shareholders may request the court to remove such director.

Company with Committee

The appointment and removal of the directors which constitute the board and the committee is the same as a Company with Auditors. On the other hand, the executive officers, including the representative executive officers, are appointed and removed by board resolution.

3.3 What are the main legislative, regulatory and other sources impacting on directors' contracts and remuneration?

The Companies Act provides that, for a Company with Auditors, the remuneration of directors must be approved at a shareholders meeting. Most companies approve the maximum aggregate amount of remuneration which should be paid to all directors in total and give the board the power to decide how it should be allocated among the directors. The board may delegate such power to the representative director. With respect to a Company with Committee, the remuneration of each director and executive officer is decided by the compensation committee.

Further, the directors must disclose and obtain board approval in case they are to engage in businesses that compete with the company's business, carry out transactions with the company, etc.

3.4 What are the limitations on, and what disclosure is required in relation to, interests in securities held by members of the management body?

The limitations or disclosures required for the members of the management body to hold the securities of a company are basically the same with those described in question 2.3 above, though there are certain restrictions under the FIEL which the members of the management body must adhere to in order to ensure that they do not violate insider trading regulations.

3.5 What is the process for meetings of members of the management body?

The board meeting could be called by any of the directors whenever required by giving notice to all directors (and corporate auditors in case of a Company with Auditors) pursuant to the requirements stipulated in the laws and regulations or the articles of incorporation. Each director has one voting right and the resolution is made, in general, with a simple majority of the voting rights present at the meeting. A director who has a special interest in the resolution in question cannot vote for such resolution. If allowed by the articles of incorporation, the vote could be made in writing or by electronic means by obtaining the consent of all the directors and corporate auditors.

The Companies Act requires the representative directors and the executive officers to report to the board at least once every three months on how the business has been carried out. This requirement, in turn, means that a company must hold a board meeting at least once every three months.

3.6 What are the principal general legal duties and liabilities of members of the management body?

The principal duties that the directors owe to the company include, among others, the following:

- Duty of Loyalty (the directors must perform their duties in a loyal manner in compliance with the laws and regulation, articles of incorporation and resolutions of the shareholders meetings).
- Duty to Report (the directors must report either to the shareholders or the corporate auditors any facts which are likely to cause substantial detriment to the company).
- Duty of Care (the directors must assume the duty to administer the mandated business with the care of a good manager).
- Restrictions on Competition and Conflicting Interest Transactions (the directors must disclose and obtain board approval in case they are to engage in businesses that compete with the company's business, carry out transactions with the company, etc.).

3.7 What are the main specific corporate governance responsibilities/functions of members of the management body?

The Companies Act requires a Large Company and a Company with Committee to have the board develop systems necessary to ensure that the execution of duties by directors and executive officers comply with the laws and regulations, the articles of incorporation, etc. The systems which must be developed include, among others:

- (i) a system to store and administer information concerning the operation of the directors and executive officers;
- (ii) a system concerning risk management in case of incurring loss;
- (iii) a system to ensure that the execution of duties by directors and executive officers is efficient;
- (iv) a system to ensure that the execution of duties by the employees complies with the laws and regulations and the articles of incorporation; and
- (v) a system to ensure that the audit to be conducted by the corporate auditors is effective.

3.8 What public disclosures concerning management body practices are required?

The names of the directors and executive officers and the address of the representative director and the representative executive officer are registered in the corporate register, which is disclosed to the public. Listed companies must file an annual securities report with the local financial bureau, which is made available to the public. Since the items such as the directors' position, name, birth date, background, term, and shares held are described therein, such information is also disclosed to the public.

3.9 Are indemnities, or insurance, permitted in relation to members of the management body and others?

If the articles of incorporation of a company so provide, certain of the directors' liabilities to the company may be discharged to a limited extent by board resolution. Further, even if the articles of incorporation do not contain such provision, certain of the directors' liabilities may be discharged by shareholders resolution, though approval of all shareholders is required to discharge the directors' liability in full. Further, a company may, if allowed by the articles of incorporation, also enter into contracts with its outside directors, limiting their liabilities to the company to a certain extent.

Directors' and officers' insurance is not restricted and is therefore permitted. Although the company can pay the insurance premiums, the payment of such premiums is construed to be a part of salary paid to the relevant directors.

4 Corporate Social Responsibility

4.1 What, if any, is the law, regulation and practice concerning corporate social responsibility?

Currently, there are no laws and regulations regulating corporate social responsibility ("CSR"). However, many of the major companies have been aware of the importance of CSR and have been acting accordingly by disclosing CSR reports on a voluntary basis.

4.2 What, if any, is the role of employees in corporate governance?

The employees of a company do not have any specific role in corporate governance.

5 Transparency

5.1 Who is responsible for disclosure and transparency?

Generally speaking, the representative director or the representative executive officer has the ultimate power concerning the daily management of the company unless such power has been specifically delegated to other directors or executive officers. Therefore, the representative director or the representative executive officer has primary responsibility for disclosure and transparency. However, other executives such as the directors, corporate auditors, accounting auditors, etc. also bear collective responsibility to a certain extent.

5.2 What corporate governance related disclosures are required?

Among other documents, the contents of the corporate register, the balance sheet of the company, and the annual securities report (and the semi-annual and quarterly securities reports) are required to be disclosed to the public. The annual securities report contains a wide variety of issues concerning the company such as the company's approach to corporate governance, along with its business performance, amount of sales and turnovers, material agreements that were entered into, developments and investments, distribution of profits, consolidated and non-consolidated financial statements, etc.

5.3 What is the role of audit and auditors in such disclosures?

There are two types of auditors in a company, depending on the company's structure which the company has adopted (Company with Auditors and Company with Committee). One is the accounting auditor, who shall be a licensed accountant or accounting firm and whose main purpose is to audit the financial statements of the company. The other is the corporate auditor, who audits the entire business of the company in case such company has

adopted the structure of the Company with Auditors (in case of a Company with Committee, the directors forming the audit committee assume such role). The roles which such "auditors" play relative to disclosure are those described in question 5.1, where the representative director or the representative executive officer has primary responsibility for disclosure and transparency, but the accounting auditor and corporate auditors also bear collective responsibility.

5.4 What corporate governance information should be published on websites?

There are no requirements for a company to publish corporate governance information on its web site. However, since the Financial Services Agency implemented the Electronic Disclosure for Investors' Network ("EDINET") in May 2000, the annual, semi-annual, and quarterly securities reports of listed companies are disclosed by the Ministry of Finance through the EDINET. Further, disclosure of certain information by listed companies, due to the requirements of the TSE's Securities Listing Regulations as described in question 1.2 above, is available through the Timely Disclosure Network ("TDnet"), which is managed by the TSE.



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