Provisional and unofficial translation

Report by the Financial System Council 's Study Group on the Internationalization of Japanese Financial and Capital Markets

～ Toward Stronger Corporate Governance of Publicly Listed Companies ～

June 17, 2009

I. Introduction

Since the financial system reforms of the late 1990s, Japan has been undergoing a transition from a financial system over-dependent on the risk-taking of banks, to a more market-based financial system.

Viewed from the perspective of corporate governance, this transition within the financial system can be taken to mean that the conventional governance structure centered on the main banks is giving way to market-based discipline. On the one hand, companies are required to achieve high quality management under the pressure of monitoring by the market, and on the other, investors are required to actively monitor the management of companies, through such actions as the exercising of their voting rights.

Based on the awareness of these issues, improvements to the legal system and to stock exchange rules amongst others have been made in recent years, with the aim of strengthening the corporate governance of listed companies in Japan,[1] as well as various initiatives aimed to improve corporate governance at the individual company level.

Nevertheless, even now, there appears to be no end to the misconducts involving listed companies, and to the implementation of capital policies that severely undermine the interests of minority shareholders. It has also been suggested that listed companies are controlled according to the internal logic of those managing the company, and that external accountability remains insufficient; or that companies tend to remain slow to react when faced with a demand for change in management. Amid these circumstances, deep concerns have been expressed by domestic and foreign investors alike about the corporate governance of listed companies in Japan, and there have been suggestions that this has been a major factor in driving down the overall market valuation of Japanese stocks. Given concerns of relative decline of Japanese markets within the international setting, it is necessary to remember that there is only a finite amount of time in which to address this issue.

Of course, a number of companies have achieved excellent corporate governance, and such excellence is not achieved by merely imitating the systems prevalent in Europe and America. In particular, careful attention should be paid to the fact that, during the outbreak of the current financial crisis, the European and American systems did not necessarily function effectively. However, this does not negate the importance of corporate governance – even in these countries, efforts designed to strengthen their corporate governance have already begun.[2] The corporate governance of listed

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[1] In this report, the term "listed companies" is used as a general term which, in addition to listed companies, could also include companies with disclosure requirements under the Financial Instruments and Exchange Act (FIEA).

[2] For example, in May this year in the US, SEC rule amendments were proposed to allow minority shareholders to nominate their candidate which will be included in the proxy materials sent out by the company.

companies in Japan needs, first and foremost, to be able to demonstrate its effectiveness. At the same time, however, given the increasingly global nature of the capital markets, it is necessary for corporate governance to be sufficiently accepted by domestic and foreign investors alike, and to maintain confidence at the international level. Should the confidence of market participants toward the Japanese market be undermined, it could have an extremely significant adverse effect on Japan's overall economic growth and on national wealth.

The study group convened eight times since October last year and conducted extensive discussions concerning the corporate governance of listed companies. This report summarizes the results of the discussions of the study group. Based on the content of this report, it is hoped that serious efforts should be promoted, aimed at improving corporate governance.

Also it has been pointed out that despite the initiatives undertaken in recent years to strengthen corporate governance standards in Japan, there has been a lack of information provided to investors in this regard. Therefore measures need to be undertaken to actively communicate improvements made on governance framework in Japan as well as initiatives undertaken by individual companies.

II. Issues concerning capital policies

While there are a range of issues expressed by domestic and foreign investors alike with regard to the corporate governance of listed companies in Japan, one of the key issues is the fact that there seems to be no end to instances where the interests of minority shareholders are severely undermined when companies raise additional capital from the market. The strengthening of governance in connection with capital policies of listed companies has become a pressing issue.

Relating to this, suggestions have been made in connection with the emerging market companies, where share prices have plummeted subsequent to the IPO, thereby undermining the confidence of investors. Discussions to reform the emerging markets are being made by various participants. It should be pointed out that ensuring fairness and transparency in connection with raising new capital from the market will also be an important issue in terms of restoring confidence in emerging markets.

1. On raising capital by issuing new shares

In recent years, often there have been instances of large scale capital increases through third-party share issuance, culminating in considerable dilution of control for existing shareholders, or a transfer of control, as well as instances of third-party share issuance where the identity of such parties remains uncertain.

Under the Companies Act (CA), where the capital increase involves favorable terms being offered to the parties concerned, a special resolution at a shareholders' meeting is required; and if the issuance terms offered are extremely unfair to existing shareholders, the issuance becomes subject to an injunction. However, if third-party share issuance does not fall under either of these cases, it can be executed with only a resolution by the board of directors, without any direct involvement by shareholders, regardless of the degree by which their control would be diluted.[3] Nevertheless, from the perspective of the corporate governance of listed companies, the rights of shareholders being significantly diluted at the discretion of the company, and the management of a company being able to arbitrarily choose where the control of the company lies, carry serious problems that cannot be ignored. From the perspective of aiming to increase the proportion of individual investors, and institutional investors with individuals as their ultimate beneficiaries, within the capital markets, suggestions have also been made that as a matter of general principle capital increases should be made through public offering.

Furthermore, there have also been suggestions that questionable financing methods that are being utilized in the primary markets quite often induce problems in securing fairness and transparency within the secondary markets, such as stock price manipulation, insider trading and accounting manipulations.

Amid these circumstances, there is an urgent need to improve market discipline when raising capital through third-party share issuance in order to secure fairness, market transparency, and the confidence of investors.

(1) Responding to the third-party share issuance in general

In order to respond appropriately to various problems concerning capital increases through third-party share issuance, it is important to improve accountability of the management of listed companies to its existing shareholders when undertaking third-party share issuance.

Therefore when a listed company is raising capital through third-party share issuance, various information concerning the issuing company, the third-party and the relationship between them is required to be disclosed such as the details of the plan for utilizing the new capital, any existing capital relationship between the issuing company and the third-party, details of any business-related agreements or arrangements, details of the third-party's existing shareholding in the company and the details of the policy concerning shareholding, etc. In addition, the listed company should be required to

[3] In the UK, Germany and France, as a general rule, issuances of new shares are first offered to existing shareholders; and if new shares are offered to persons other than shareholders, a resolution at the shareholder meeting is required. In the US, according to corporate law (such as in the State of Delaware), as in Japan, new shares can be issued to a third party by board resolution; but under the stock exchange rules, issuance of new shares beyond a certain threshold requires a special resolution at the shareholder meeting.

confirm how the third-party is raising finance necessary to subscribe for the shares issued for the capital increase, and to appropriately disclose the method used to ascertain the information and the results. The study group is expecting appropriate action in statutory disclosure and stock exchange rules.

Furthermore, where there is a risk that the planned third-party share issuance can be classified as favorable issuance, in order to ascertain its legality, the stock exchange should require an official opinion of the statutory auditors, which should be published.

(2) Responding to large-scale capital increases through third-party share issuance that entail significant dilution of control, or transfer of control, etc.

Large-scale capital increases through third-party share issuance that entail a significant dilution of control or transfer of control have the potential to cause major problems, particularly in terms of investor protection. Such cases should only be justified in truly unavoidable circumstances (such as during corporate rehabilitation), where such actions are consistent with the wishes and interests of shareholders, including minority shareholders, and where they are conducted in a transparent manner.

Consequently, with regard to capital increases through third-party share issuance that entail a considerable dilution of control or transfer of control, the stock exchange should ensure full transparency, and measures should be implemented depending on the degree of dilution or other factors, to ensure due process are carried out, such as obtaining the opinions of person(s) who are deemed independent of management, and verifying the wishes of shareholders by means of a resolution at a formal shareholders' meeting or through other means; and it would be appropriate that companies be required to disclose this information as part of their statutory disclosure.

Furthermore, with particularly problematic cases, where there are strong suspicions of shareholders' rights being unfairly restricted, the stock exchange should undertake an in-depth examination. Where a problem has been ascertained, rigorous and effective steps, including delisting, should be taken depending on the severity of the problem, and measures should be diversified to enable flexible response.

(3) Responding to MSCB issuance

In recent years, use of problematic financing instruments, such as Moving Strike Convertible Bonds (MSCBs) and Moving Strike warrants (MS warrants), have been frequently observed.

MSCBs and similar instruments can be issued following a board resolution. In addition to the risk of shareholder rights being undermined as a result of the dilution of control or transfer of control, another problem has been raised – because one of the inherent characteristics of such instruments as MSCB is that they provide incentives for the holders to convert them into shares and sell them, and in the process they could impair the price formation functionality of the secondary market.

While rules concerning appropriate disclosure requirements and standardised terms of MSCB conversion have been developed by the stock exchanges and by Japan Securities Dealers Association (JSDA), a problem remains whereby these rules are insufficient to regulate instruments that are economically similar to MSCBs. A point has also been raised concerning insufficient disclosure of information to assess the reasonableness of issuance terms, and an ongoing disclosure concerning the exercise of conversion rights following their issuance.

Therefore, in addition to the initiatives as discussed in (1) and (2) above, stock exchanges and JSDA should extend the remit of the MSCB rules to capture schemes that are economically similar to MSCBs. In addition, they should also stipulate disclosure requirements to enable assessment of the MSCB issuance terms, and to disclose on a regular basis concerning the exercise of conversion rights. The statutory disclosure regime relating to MSCB and similar instruments should also be enhanced from these perspectives.

(4) Improving enforcement capabilities and enhancing cooperation among the regulators, stock exchanges and others

In order to detect, in a timely fashion, the issuance of securities that unfairly undermine the shareholder rights or the fairness and transparency of the market, and in order to protect the rights of investors, it is important not only to improve the appropriate statutory disclosure regime and stock exchange rules but also to rigorously enforce these rules. Therefore, the Financial Services Agency (FSA), the Securities and Exchange Surveillance Commission (SESC), the stock exchanges, and JSDA should work together to improve their enforcement capabilities.

In this regard, in dealing with problematic cases, in addition to applying specific provisions concerning the spreading of rumors, market manipulation, insider trading and other prohibited acts as stipulated in the Financial Instruments and Exchange Act (FIEA), ideally it would be useful to actively utilize Article 157 of FIEA, which prescribes the general prohibition of wrongful acts, such as use of wrongful means, schemes or techniques. Under the existing law, only criminal penalties are prescribed for the violations of this Article, but in order to enable more active application of this Article further consideration should be made, including amending the Article to allow administrative monetary penalties.

Furthermore, with regard to Article 192 of the FIEA, which enables the Courts to issue prohibition and suspension orders, the 2008 amendment to the

Act resulted in enabling the petitions to be filed not only by the Commissioner of the FSA but also by the SESC. In working together with the stock exchanges and other bodies, further consideration should be made as to how these measures can be utilized effectively.

2. On Squeeze-outs

Recently, there have been cases whereby existing shareholders of listed companies were forced to surrender their ownership (squeeze-outs of minority shareholders in exchange for cash) during MBOs, and other transactions resulting in the transfers of control using such measures as combined reverse stock-splits and issuance of share options, the use of multiple-class shares or by other means.

A squeeze-out unilaterally relinquishes shareholders of their status as shareholders against their free will. In other countries, at least 85 – 95% of voting rights need to be acquired by the major shareholder before squeezing out minority shareholders. However, in Japan this can be done in principle with a special resolution requiring a two-thirds majority at a shareholders meeting, unless simplified mergers and other schemes are undertaken whereby over 90% ownership is required prior to undertaking squeeze outs.

In light of this situation, careful and full consideration needs to be given to the reasonableness and appropriateness of squeeze-outs by listed companies from the perspective of protecting the rights of shareholders. Appropriate disclosure also needs to be made in advance to shareholders who are potential targets of such an action.

Accordingly, where there is a risk of minority shareholders' rights being unduly violated through squeeze outs by listed companies, there should be rigorous examination by the stock exchanges. Where there is a problem such as unfair restrictions on the rights of shareholders, strict measures should be implemented by the stock exchange. In addition, where companies are planning to undertake a squeeze-out following a third-party share issuance, etc., companies should be obliged to disclose such plans by statute to disclose such plans, along with specific details.

Incidentally, it has been pointed out that in the event of a reverse stock split, no procedures exist for shareholders to contest the amount of payment made to shareholders under the existing CA, and therefore this issue warrants further review from a legislative standpoint.

3. On governance of group companies

Since 1997, when the ban on holding companies was lifted in Japan, an increasing number of corporate groups has adopted holding companies and other such structures. There have been instances of the core company within a group becoming a wholly-owned subsidiary of the holding company.

In this backdrop, issues have been raised concerning this type of corporate group structure to the effect that shareholders of the parent company have limited supervisory authority over business activities of subsidiaries, which may impact the group, and that the accountability of the subsidiary management to the shareholders of its parent company remains insufficient.

It is important that the corporate governance principles as promoted by stock exchanges are applied not only for the parent company, but also to the group as a whole. Stock exchanges should ensure that their corporate governance principles are clear on this point. At the same time, stock exchanges should also ensure that for subsidiaries that may significantly impact the business of their parent company, the views of the subsidiary management on its significant activities and its business conditions are adequately disclosed to the shareholders of its parent company alongside the views of the management of its parent company.

In addition to the initiatives by the stock exchanges, in light of the trend for the formation of group company structure, it is important to develop a legislative framework focused on the corporate group from the viewpoint of ensuring corporate governance. As such, it is hoped there will be further review from a legislative standpoint.

4. On subsidiary listings

At present, there are a considerable number of publicly listed companies that are owned by a parent company.

With respect to the listing of a company that has a parent company, there have been suggestions that it would not be appropriate to deny such listings purely on the basis of this fact. Justifications provided for such a suggestion includes an assertion that even though investors can only obtain minority shareholdings, investors may be willing to trade shares in such companies, and investors may appreciate governance by the parent company.

Nevertheless, there have also been suggestions that such listing arrangements may not necessarily be desirable. There may be inherent potential for conflicts of interest between the parent company and the minority shareholders of its listed subsidiary, and there may be danger that the shareholders’ rights of a listed subsidiary will not be fully protected due to the control exerted by the parent company.

Taking these issues into account, due consideration should be given as to if and how the public listing of these subsidiaries ought to be in the future. At the very least, adequate measures need to be implemented to protect the rights of minority shareholders by eliminating the undesirable effects of conflicts of interest and control by the parent company.

For this reason, if the subsidiary listings continue to take place in the future, the stock exchanges should consider introducing rules to ensure that the conflicts of interest are properly managed and that the parent company does not abuse its power, through such measures as requiring the appointment of outside directors and auditors who are not from the parent or sister companies and who can give sufficient consideration to the interests of minority shareholders.

5. On cross shareholdings

Cross shareholdings had been on a decline since the 1990s, but the trend reversed in recent years. A number of issues have been raised with regard to this practice, including the resultant hollowing out of capital and voting rights, and reducing the governance function performed by shareholders into a mere formality. Furthermore, cross-holdings between listed companies may possibly affect their management and therefore information concerning such cross-holdings are important for investors when making investment decisions. This is because, through the ownership of shares, market price fluctuations may, for instance, affect the financial conditions of the listed companies, or the cross-holding leads to a business relationship that is not contained in the contractual relationships and control structures captured by the financial statements.

Under these conditions, some companies have already begun voluntarily disclosing the status of their cross-holdings, and it is appropriate to promote this kind of disclosure. Further consideration should be made with a view to institutionalizing the disclosure requirement so that, it would be possible to obtain information on cross shareholdings that are occurring under explicit or implicit agreements to hold shares reciprocally or multilaterally.

In relation to this, with respect to the shareholdings by banks and cross-shareholdings between banks and business corporations, so as to ensure sound management of banks and to prevent excessive contraction of credit, acquisition of shares and other securities by Banks' Shareholdings Purchase Corporation has resumed as a time limited measure until 31 March, 2012. From the perspective of reducing cross-shareholdings and strengthening the governance function performed by shareholders, it is hoped that this measure will be used actively. Furthermore, in order to facilitate the shift in the ownership structure of shares through this and other means, it is also important to promote investment by individuals and by institutional investors whose ultimate beneficiaries are individuals. In this regard further developments of infrastructure should be promoted, including the introduction of a scheme designed to encourage asset formation among individuals as has been recommended by this study group.[4]

[4] "Interim Summary of Issues" announced by this study group on June 13, 2007.

III. Structural aspects of corporate governance

In considering the desired form of corporate governance among the listed companies in Japan, one very important aspect is the governance structure of directors, auditors and so forth. Strong interest on this issue has been shown by domestic and foreign investors alike.

The previous chapter discussed the issues concerning capital policies, including raising capital through third-party share issuance. In considering how the authority should be best shared between the shareholders and the board for decisions relating to these corporate actions, an important factor for consideration will be the question of whether the board of directors has secured enough confidence from shareholders.

With respect to the structural aspect of corporate governance, a diverse range of measures has been taken by way of legislation, stock exchange rules and so forth in recent years. For example, the "Company with Committees" system was introduced as an alternative to the statutory auditor system. A requirement was also introduced for large companies and listed companies to require establishment of a board of auditors, comprising of at least three auditors, at least half of whom must be external auditors. Nevertheless, there are still strong calls from investors, in particular demanding for further change in governance structures. The governance structure guarantees the legitimacy of management authority within the company, and in this regard there have also been calls for further examinations on the part of companies and management, as to whether their governance structure can secure the confidence of shareholders and other stakeholders.

From the perspective of attaining high quality management among listed companies in Japan and securing the confidence of investors, this study group conducted intensive discussions on how governance structures should be in listed companies in Japan.[5]

1. The structure of board of directors

Under the "Company with Committees" system, which was introduced as an

[5] Statements of opinion were received from the following guests, and these were used as reference in the discussions.

Mr. Charles D. Lake II, Chairman, American Chamber of Commerce in Japan
Mr. Taiji Okusu, Secretary General, Japan Corporate Governance Forum
Ms. Michiko Tomonaga, Deputy President, the Japanese Institute of Certified Public Accountants
Mr. Shinichiro Ito, Deputy Chairman, Advisory Panel of Experts, Japan Corporate Auditors Association
Mr. Atsushi Saito, President & CEO, Tokyo Stock Exchange Group, Inc.
Mr. Toru Nagashima, Chairman, Teijin Limited
Mr. Hiroshi Komori, IR Group Head, Stock Transfer Agency Department, The Sumitomo Trust and Banking Co., Ltd.

alternative to the existing statutory auditor system, the executive authority of the board of directors is substantially delegated to executive officers, and the board is expected to exercise a high-level supervisory function as a body that supervises business operations. Furthermore, in each of the committees established within the board of directors (the nominating committee, the compensation committee and the audit committee), more than half of the directors are required to be outside directors, thereby guaranteeing a fair degree of externality. Furthermore, since an audit committee, which conducts audits under the "Company with Committees" system, is placed in the board of directors, consequently it has wide-ranging authority, including audit of not only issues of legality but also appropriateness.

From the perspective of strengthening the supervisory function of a board of directors, this "Company with Committees" system can be thought of as one of the frameworks of corporate governance that is easy for domestic and foreign investors to understand. However, only 2.3% of all companies listed on the Tokyo Stock Exchange has adopted the "Company with Committees" system (as of August 2008), and therefore it seems unrealistic for many companies to be adopting this system in the near future.

Next, with respect to strengthening the supervisory function of the boards of statutory auditor companies which currently account for the majority of listed companies, opinions have been received from domestic and foreign investors that at least one-third or one-half, for instance, of the board of directors should be (independent) outside directors. In connection with outside directors, while some doubts have been raised about appointing as directors persons who may not necessarily be well acquainted with the management of the company in question, based on the expectation that they will fulfill such roles as ensuring the accountability of executive directors in ordinary times, ensuring that decisions in emerging situations take into account external views, and as a safety valve preventing reckless actions of executive directors, outside directors are suggested to be effective from the perspective of strengthening the supervisory function.

Nevertheless, it has been suggested that requiring listed companies to establish a board staffed mainly of outside directors may lead to duplication with the existing requirements for the establishment of a board of auditors as required by the CA.

In the case of the statutory auditor companies, the Japanese legal framework assigns statutory auditors as the body to supervise the execution of duties by directors. As mentioned previously, large companies and listed companies in particular are required to establish a board of auditors comprised of at least three auditors, at least half of whom need to be outside auditors.

Nevertheless, although auditors attend the board meetings, comments have been raised concerning the limits of their authority. Auditors do not have voting rights at the board meetings, including the election of officers, and the audits by the auditors are confined, in principle, to audits on legality. Suggestions have also been made that the personnel and systems that support the audits by the auditors have not been sufficient, and in reality, despite repeated reviews related to the statutory auditor system, in many cases, statutory auditors are unable to fulfill their functions satisfactorily.

On the other hand, in recent years, a great deal of importance has been attached to the role of internal audits and internal control in listed companies, and efforts have been made to develop and improve systems for this purpose. However, these duties and systems are controlled by directors in charge of internal audits and internal control, and so are not directly reportable to the board of auditors.

Under these circumstances, however, there have been examples of listed companies in Japan that have adopted progressive approaches in terms of their governance systems by appointing one or more highly independent outside directors and having them cooperate closely with the board of auditors and officers in charge of internal audits and internal control. This type of governance system can compensate for the authoritative and systemic deficiencies relating to auditors while effectively utilizing the functions of auditors, and it enables the supervisory function over management to be strengthened. It has the potential to serve as a preferred, realistic model that maintains consistency with Japan's legal system while also being acceptable by international standards.

Naturally, the best form of corporate governance will differ depending on the organization, size, line of business and other aspects of each individual company; but in spite of the difficulties in applying the same rule to all companies, if the above line of thinking is adopted one can say that there is room for improvement, since there is a considerable gap between this and the reality that 55% of companies listed on the Tokyo Stock Exchange have not appointed any outside director.

The stock exchanges should present a model of corporate governance in line with the above thinking, which is regarded as suitable for the majority of listed companies for securing the confidence of shareholders, investors and others. Based on this, stock exchanges should adopt measures that would require companies to sufficiently disclose the details of their respective governance systems and the reasons for selecting a particular system. Furthermore, with respect to the details of statutory disclosure relating to the status of corporate governance, revisions should also be made if necessary, in conjunction with the matters described in the rest of this chapter.

2. Strengthening the function of statutory auditors

A statutory auditor is a body that performs audits on the execution of duties undertaken by the board of directors. Their supervisory function has been strengthened in part as a result of the succession of amendments to the CA and related regulations.

Nevertheless, it has been suggested that there are cases where the effectiveness of audits is inadequate, the independence of outside auditors is low, and their specialized finance and accounting knowledge is insufficient. Therefore, at present, auditors are not necessarily capable of meeting the expectations of shareholders and investors.

For this reason, from the perspective of strengthening the functions of auditors within listed companies, it is hoped that measures such as the following will be implemented:

1. Maintain adequate human resources and infrastructure to support the statutory auditors who carry out audits (cooperating with internal audit and internal control divisions for this purpose);
2. Appoint highly independent outside auditors; and
3. Appoint auditors with an in-depth knowledge of finance/accounting.

For the purpose of promoting listed companies to implement these measures, stock exchanges should stipulate these measures as desirable, and develop frameworks for disclosing the status of each listed company.

3. Independence of outside directors and auditors

Under the CA, a person from within a company or subsidiary cannot be selected to be an outside director or auditor; but persons from its parent company, a sister company, a major corporate shareholder or a major business affiliate can be appointed. However, if these persons are selected as outside directors or auditors of a listed company, then there is a concern that the objective of supervising from an independent standpoint will not be fully satisfied.

With regard to the treatment of persons from a parent company or a sister company, this is an issue relating to the public listing of a company that has a parent company. As mentioned in the previous chapter under "4. On subsidiary listings", the stock exchanges should give urgent consideration as to how the public listing of these subsidiaries ought to be, and to measures for protecting the interests of minority shareholders.

With respect to persons from the company's major corporate shareholder or major business affiliate, whilst it is possible that these persons could hardly qualify as being "independent," it has also been pointed out that excluding all such persons indiscriminately using formulaic standards may not necessarily be appropriate when considering the effectiveness, specialization and other requirements of a supervising body. Therefore, although the stock exchanges currently require a certain degree of disclosure on the relationships that outside directors and auditors have with the company, it would be appropriate for them to require the disclosure of more specific details on this point, and also to require appropriate disclosures about the company's views on the independence of the persons in question.

4. Authority to determine the agenda for electing accounting auditors and their compensation

For statutory auditor companies, under the CA, in determining the agenda for the appointment of accounting auditors and on determining the audit fees, the authority resides with the board of directors, and statutory auditors have the right to consent in respect to these decisions. For the "Companies with Committees "system, while the authority for determining the agenda for appointment resides with the audit committee, the audit committee have the right to consent on determining audit fees.

In this way, accounting auditors enter into an audit contract with and receive the audit fee from the managers of the audited company. Such a system contains "incentive distortions," and the question of how to overcome these is an important issue.

On this point, from the perspective of eliminating incentive distortions, ensuring the appropriateness of financial information and strengthening the cooperation between accounting auditors and statutory auditors, it was proposed that the authority to nominate the prospective nominee for the appointment and to determine the remuneration of accounting auditors be given to statutory auditors (and for "Companies with Committees", the authority to decide on remuneration matters be given to the audit committee), and the relevant authorities were urged to give urgent and serious thought.[6] On this occasion, the study group calls for accelerated deliberation taking existing practices into consideration.

5. Enhancing the disclosure of executive compensation

With respect to executive compensation, the CA requires the total amount for each type of officer to be disclosed to shareholders. The FIEA and related regulations use the example of "content of executive remuneration" as a disclosure item within the "status of corporate governance" disclosure section in the annual securities reports and other statutory disclosures. Most public disclosure companies disclose executive compensation details.

[6] Report by the Subcommittee on Certified Public Accountant System, Financial System Council "Enrichment and Enhancement of the Certified Public Accountants and Audit Corporation Systems" (December 22, 2006). Also, in the supplementary resolutions attached to the Bill for the Partial Amendment of the Certified Public Accountants Act (Committee on Financial Affairs, House of Representatives, June 8, 2007; Committee on Financial Affairs, House of Councillors, June 15, 2007), it was stated, "With respect to measures for giving statutory auditors the authority to make decisions on the appointment of accounting auditors and the authority to make decisions on audit fees, serious deliberations should be continued and efforts should be made to draw a conclusion without delay."

Nevertheless, with respect to disclosure under the FIEA and related regulations, there is no specific requirement for disclosure; and even in cases where statements are made voluntarily, the itemized breakdown of remuneration by type and the policy used for determining executive compensation are not often disclosed, because the way in which those statements should be made has not been clearly stipulated by law or regulations. Executive compensation is regarded as one of the important pieces of information for shareholders and investors from the perspective of management incentive structures. Furthermore, it has been said that excessive remuneration and stock options provide incentives to the management to focus too much on the short-term, and in this regard it is important to strengthen the accountability regarding how executive compensation is determined. Therefore, companies should disclose their existing executive remuneration policies, and also improve disclosures of pay, with a breakdown according to the type of incentives provided to executives, including stock options.

IV. Monitoring of management by shareholders

In order to improve the governance of listed companies through the market, in conjunction with the efforts on the part of companies, it is important that shareholders and investors also actively monitor management actions. Moreover, this is the duty of shareholders and investors.

In particular, with regard to raising capital from the market and governance structure, this report has repeatedly suggested that improvements should be made to the corporate governance of listed companies under the supervision of the market through the effective use of disclosure regime. It would not be an exaggeration to say that whether this measure will work properly would depend on the actions of shareholders and investors.

Companies are responsible to a large number of stakeholders, not just to shareholders and investors. While attaching too much importance to shareholders and investors is obviously not appropriate, in many cases, there are no significant conflicts between the shareholders, investors and other stakeholders. Furthermore, in reality, as far as forms of governance for listed companies go, nothing can be found that is more effective than the governance by shareholders and investors. The importance of governance by shareholders and investors should not be denied.

1. Investment based on an appropriate valuation of the firm

One example of actions taken by shareholders and investors that may promote good corporate governance for a listed company is for shareholders to “sell poor-performing stocks”. For this purpose, investment behavior based on appropriate firm valuations is important, and in order to provide sufficient environment to enable such activities, further efforts should be promoted, aimed at improving disclosure, including the timely, fair, and accurate provision of information, enhancing analyst functions and facilitating an efficient price discovery function in the market.

2. Effecting governance through the exercise of voting rights

(1) Appropriate exercise of voting rights based on fiduciary duty[7]

In order to ensure that the governance of listed companies is functioning appropriately, it is important for the behavior of listed companies to be subject to proper scrutiny of shareholders and investors exercising their voting rights.

Particularly in recent years, investors have become more institutionalized, leading to pension funds and those managing their pensions and other funds wielding greater influence on the market. Institutional investors owe a fiduciary duty to a large number of underlying ordinary policyholders and beneficiaries, and the exercise of voting rights constitutes an important element of the fiduciary duty of institutional investors. It is important to further clarify this point and promote the proper exercise of voting rights by institutional investors.

In relation to this, consideration should be made of the introduction of legislation like the ERISA[8] in the US, which stipulates fiduciary duties related to pensions; and the clarification of the responsibility concerning the exercise of the voting rights by relevant parties. It is expected that this point will be examined further.

(2) Preparation and disclosure of guidelines relating to the exercise of voting rights

In order to ensure that voting rights are appropriately exercised under the monitoring by the market, it is important that institutional investors prepare appropriate guidelines to act as the standard when they are making decisions, and to disclose such guidelines.

In general, with respect to voting guidelines for institutional investors, preparation of such guidelines are already required under the industry rules or

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7 As in the "Interim Summary of Issues" announced by this study group on June 13, 2007, here, the term "fiduciary" is not synonymous with the term "trustee" generally used in trust agreements in Japan, but is used as a broad concept that refers to "fiduciary" in the Western context, that is, a person who is required to perform a certain range of duties under the mandate of another party. Various responsibilities assumed by the fiduciary are collectively and broadly referred to as "fiduciary duties". Fiduciary duties specifically consist of the duty to explain, the duty of loyalty (duty to prevent conflict of interest), and the duty of care of a good manager.

8 The Employee Retirement Income Security Act (ERISA) stipulates unified provisions for the design and administration of private-sector pension plans and benefit plans, and was enacted in the US in 1974. ERISA provides for fiduciary duties of pension funds and asset managers vis-à-vis subscribers and beneficiaries.

other means, and each firm has a guideline following such requirement. However, only a portion of them are required under the industry rules to go as far as publicly releasing these guidelines. In addition to improving the content of the guidelines, the disclosure rule of the guidelines should be established by way of industry rules or other means.

(3) Disclosure of the results of vote execution

In addition to disclosing their guidelines, having institutional investors disclose the actual results of vote execution is expected to have the benefit of raising the visibility of whether or not institutional investors are exercising their voting rights appropriately.

At present, although some institutional investors have summarized, tabulated and disclosed the results of their voting activities, in Japan the number of such cases remains small. In order to improve governance through the exercise of voting rights, the industry should work to establish industry rules or other means to follow matters pertaining to the summarizing, tabulating and disclosing by each institutional investor of the results of vote execution.

Since 2003, SEC rules and regulations have required US investment companies to disclose the results of voting rights exercised for each proposal. With respect to Japan introducing similar rules, concerns have been expressed that there would be a greater danger of investment companies and the like coming under pressure from issuing companies and various external organizations regarding the exercise of voting rights, resulting in the freedom to exercise voting rights instead being inhibited. As such, this needs to be further examined from a broad perspective.

(4) Disclosure by listed companies of ballot results at shareholder meetings

At present, the disclosure of the outcome of the ballot on resolutions at shareholder meetings for the majority of listed companies only extends as far as disclosing whether the resolution was accepted or rejected. They do not disclose the number of votes cast for and against. Disclosing the number of votes cast for and against will clarify shareholder intentions, and is expected to also have a restraining influence on management through the market.

Accordingly, from the perspective of achieving accountability to shareholders, the results of individual resolutions should be disclosed, including the number of votes cast for and against, and rules should be developed by means of statutory disclosure and stock exchange rules.

Although there are negative opinions for disclosure on the grounds of administrative burden associated with collating the votes exercised at the shareholders meeting, the majority of voting rights are usually exercised before the day of the shareholders meeting, and it is believed that even requiring the disclosure of the balance of votes as ascertained on the day before a meeting could serve as disclosure of reasonable significance.

(5) Improving the environment related to the exercise of voting rights

The stock exchanges have been calling for listed companies to facilitate the exercise of voting rights by shareholders through such measures as company codes of conduct. Nevertheless, domestic and foreign investors alike have still expressed strong desires for improvements in the environment surrounding the exercise of voting rights, including the staggering of days on which shareholders meetings are held, earlier dispatch of proxy materials and posting it on the websites of stock exchanges, better explanations of meeting agendas, and the promotion of English translations, etc. Further effort will be required to improve the environment surrounding the exercise of voting rights.

(6) Promoting the use of electronic voting platforms

Amid the advances made in information technology, the development of an environment that enables voting rights to be exercised via electronic means is becoming more and more important. Nevertheless, current participation by listed companies in electronic voting platforms remains low, at about one-tenth of all listed companies. Under these circumstances, institutional investors among others have expressed a strong desire to encourage listed companies to utilize electronic voting platforms in order to ensure a sufficient period of time for them to examine the agenda. The stock exchanges need to take positive action aimed at encouraging listed companies to utilize electronic voting platforms, including for instance, considering the feasibility of requiring certain listed companies to use such a platform.

Moreover, upon listed companies being encouraged to utilize electronic voting platforms, institutional investors will also need to actively use the electronic voting platforms so that participation in electronic voting platforms can effectively lead to reductions in administrative costs for the listed companies.

(7) Submission of annual securities reports and internal control reports to shareholders meetings

From the perspective of ensuring the accountability of managers to shareholders and investors, there have been suggestions that annual securities reports and internal control reports based on the FIEA should be included in the matters to be reported at shareholders meetings.

With regard to this point, under the current FIEA and related regulations, the financial statements and business reports that have been reported at a shareholders meeting are required as documents to be attached to the annual securities report. It is pointed out that the existence of this provision could act as a constraint. Necessary amendments should be made with respect to the FIEA and related regulations.

3. Better dialogue with management by shareholders and investors

Shareholders and investors should not confine themselves to monitoring management just through the trading of shares and the exercising of voting rights. Backed by this, it is important that they also routinely enrich constructive discussion on management amid their dialogue with managers.

This will contribute to the creation of an environment where the top management of listed companies appropriately explain their business policies and so forth using the language of shareholders and investors, thereby enhancing their communication with shareholders and investors. Furthermore, if such an environment can be created, it could be expected that, even in such situations as company takeovers for instance, emotional responses will be avoided, and instead, responses will be encouraged where managers can explain their business policies and other related matters to shareholders and investors clearly.

In order to improve the governance of companies in Japan, the question of how to secure a base of investors who talk to management constructively is important, and from this perspective, greater efforts are expected of the parties concerned.

V. Framework to effect the governance discipline on listed companies

The expected standard of corporate governance for a listed company is higher than a normal company as it has access to a greater number of investors through the markets. From this standpoint, there are prominent calls for new legislative framework specifically to address the corporate governance of listed companies.

Given the medium to longer term transition towards a market-based financial system, it remains highly important for the joint stock company system to be utilized by listed companies in an appropriate manner, and for the capital markets to function effectively. Also, if one assumes that the main participants of the stock market are individuals (i.e., citizens) as ultimate investors, this plan has significance from the perspective of protecting the civil society from abuse of the joint stock company system.

On the other hand, protection of shareholders and investors in this country has been afforded by an appropriate combination of the CA, which is a civil law governing the private law aspects of the rights and obligations associated with a company, and the FIEA, which regulates market participants from the perspective of market rules. Therefore, before a new law such as "the public company law" is to be legislated based on the above plan, there will be a number of issues to be overcome, given the existing legal framework.

In particular, the approaches taken by the CA, which is a civil law, and the FIEA, which regulates from the market rule perspective, differ widely in terms of the applicable scope, effects and enforcement methods, and therefore, careful substantive assessment of each of the issues from this perspective is required in determining the optimal way to deal with each issue.

Therefore, there needs to be further study on determining the optimal legal framework for corporate governance of listed companies from a broader perspective, but at the same time it has been suggested that the legal framework provided by the CA and FIEA do not mesh seamlessly, resulting in overlaps and gaps. It is therefore necessary to continue further analysis of the consistency between the regulations of the two legal frameworks so as to avoid overlaps and gaps, and provide appropriate protection for investors and shareholders.

This study group has also undertaken an extensive discussion concerning the role of the stock exchange rules as a way to provide market discipline, in connection with the corporate governance of listed companies.

On this issue, there were at times voices against the notion of allowing the stock exchanges rules to be used as a way to enforce market discipline on matters related to the core aspects of the CA. However, in terms of fulfilling the responsibility of ensuring proper functions of the market, it is vitally important, and indeed is the primary mission of the stock exchanges to enforce proper market discipline by stock exchange rules, whilst maintaining consistency with the CA.[9] In addition, by virtue of its operating the market and being close to the market, the stock exchanges are best placed to determine the finer details of operational rules and efficient operation of such rules through daily market monitoring.

It has been commented with regard to the stock exchange rules, that in the past there was an emphasis for such rules to be supplementary to the laws, and thus giving an impression of such rules as being inferior. It is worth stating here that stock exchange rules are essentially expected to provide a particularly high standard of discipline for listed companies.

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[9] The FIEA requires stock exchanges to appropriately regulate securities firms and listed companies in order to ensure fairness of securities and derivatives trading in the market and to protect investors. As such, applying appropriate discipline on listed companies and ensuring a high level of corporate governance can be considered to constitute an important part of the stock exchanges' business.

Furthermore, the stock exchange rules have traditionally been regarded as rules which apply to listed companies and market intermediaries, and did not include investors themselves in the framework despite being the main market participant. However, taking as an example the need to maintain fairness during buyouts, or the need for shareholders to exercise their voting rights appropriately as discussed in this report, it would be feasible to consider cases where going forward, the stock exchanges will directly enforce discipline of investors as market participants. Further wide-ranging discussion will need to take place in determining the appropriate manner in which the stock exchanges conduct market discipline on participants.

VI. Concluding remarks

In Japan, there has been a move towards a market-based financial system under the slogan “from savings to investments”. Even though the current financial turmoil leading to the contraction of the markets may temporarily reverse the trend towards emphasis on the traditional indirect financing, in the medium to long term the significance of the transition towards a market-based financial system must not be forgotten.

Having said this, reliance on the traditional indirect financing remains high, and for many companies it is difficult to say that the capital market has assumed the role of being the primary place for raising capital. The reason for Japanese companies not always paying sufficient attention to investors may in part be due to this fact.

In the future, if the capital markets succeed in assuming the role primarily as a place for raising capital, companies will naturally be inclined to pay more attention to investors and shareholders, resulting in the strengthening of corporate governance practice. Conversely, if good corporate governance is not ensured, investor confidence in capital markets will not improve, in which case progress on “from savings to investments” will be unachievable.

In this way, the fate of the transition “from saving to investments” and “strengthening of corporate governance of listed companies” is entwined, and the effort to attain these objectives must therefore be strenuously and simultaneously pursued.