Comments on the Interim Proposal for Revisions to the Company Law System

(Translation from the original Japanese)

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(These public comments represent the author's personal views and do not the views of any organization.)

Introduction

This opinion statement submits comments concerning the revision of the Company Law system as follows.

1. Item: Interim Proposal p.18
Opinion regarding: 3. Revision of electronic notification methods for convocation notices of shareholders' meetings

Summary of opinion

It is desirable to abolish Article 457 of the Companies Act, which provides that dividend payments are obligations to be brought to the recipient, and to abolish dividend payment receipts (including dividend calculation statements) by requiring the recording of email addresses in shareholder registers, etc.

Explanation:

The Financial Services Agency (FSA), the Corporate Governance Code established by the FSA and the Tokyo Stock Exchange, and many investors encourage Japanese listed companies to publish securities reports several weeks or one month before the date of the annual general shareholders' meeting. However, because disclosure of securities reports in early June, prior to the concentration of annual shareholders' meetings in late June, creates significant practical difficulties for many companies, the realistic approaches are either: (i) changing both the dividend record date and voting-rights record date to after the end of April, or (ii) changing only the voting-rights record date to after the end of April.

Under current dividend payment practice, two dividend payments cannot be made using the same record date. Therefore, if approach (i) is adopted, there is a risk that, after a board resolution approving a dividend payment, a shareholder proposal regarding dividends could arise, making it impossible to pay dividends proposed by shareholders. Because this would restrict legitimate shareholder rights, it is unavoidable to separate the voting-rights record date from the dividend record date under approach (ii). However, in that case, the convocation notice and the dividend payment receipt (including dividend calculation statements) would need to be mailed separately.

Because mailing costs can amount to enormous sums, companies may hesitate to change record dates. If dividend payment receipts could be abolished, or at least sent by email, only one mailing of the convocation notice would be necessary, thereby removing one of the bottlenecks to changing record dates.

2. Item: Interim Proposal p.28 and following
Opinion regarding revision of system for companies with three committees
[providing that if there is a majority of outside directors, the board can override decisions by the nominations committee]

Summary of opinion:
Proposal A is reasonable and desirable.

3. Opinion regarding the "supplementary note" in the Interim Proposal, about the "monitoring model"

> **I hereby quote from the "supplementary note" on page 28 of the interim draft:**
> *"As a future matter, a general review of the organizational/governance structure for companies aiming for a monitoring model is a challenge. In this regard, there are ideas such as: (1) requiring that the majority of directors on the board of directors be outside directors in companies with nominating committees, etc.; (2) allowing the appointment of executive officers in companies with boards of auditors and audit and supervisory committees; and (3) creating a new governance structure for companies aiming for a monitoring model."*

Summary of opinion:

- <u>There should be a plan to evolve the Companies Act over the medium to long term</u>. For all listed and public companies (here, deviating from the definition in the Companies Act, meaning companies where shares are widely dispersed), which separate ownership and management, I believe we have reached the stage where institutional reform should be pursued based on the premise of transitioning from "companies aiming for a monitoring model" to "companies that actually implement a monitoring model", in order to attract funds from investors worldwide.

- <u>The statutory "executive officer system" should be introduced to all corporate governance structures</u>. In 2017 and 2018, the Ministry of Economy, Trade and Industry submitted opinions to the Corporate Law Subcommittee of the Ministry of Justice proposing the creation of an "executive officer"[*shikko-yaku*] system under the Companies Act, to be used in all organizational/governance structures, as an alternative to *shikko yakuin* "executive officers, which are not defined in the law and do not bear a fiduciary duty of due care. Since then, the need for this system has only increased. I believe that the "Executive Officer" system, a position defined the

Companies Act, should be uniformly adopted by all three organizational structures as soon as possible.

- Preparatory reform looking toward a future “Public Company Act” is necessary. Because the needs and challenges faced by listed companies differ significantly from those of unlisted companies, it is necessary to consider the enactment of a "Public Companies Act" in the future. By establishing systems suitable for public companies within the current Companies Act, the time required for the transition/convergence process and the burden on listed companies can be reduced. One of the important features of the "Public Companies Act" is that it would require the appointment of a majority of outside directors, in order to protect dispersed shareholders.

Explanation:

- There should be a plan to evolve the Companies Act over the medium to long term. The "supplementary note" above states that "there are ideas such as creating a new governance structure for companies aiming for a monitoring model." Extending this idea, publicly traded companies and listed companies with no restrictions on the transfer of shares have a very high probability of separating ownership and management. For these companies, the system should be designed to *in fact* effectively and substantively "implement a monitoring model."

  While the current Companies Act includes companies that issue shares with transfer restrictions, the needs and challenges faced by listed companies differ significantly from those of unlisted companies. To encourage many publicly traded companies to adopt a substantive and effective monitoring model, preliminary preparations for the Companies Act that could facilitate adoption of a "Public Companies Act" are necessary. Without such preliminary preparations, the transition process will be time-consuming, placing a heavy burden on listed companies.

  Despite the broad scope of the Companies Act, many of the issues addressed in this interim draft of revisions to the Companies Act (related to shares, shareholder meetings, etc.) apply only to listed companies. It is commonly said that the Japanese listed company market has the following notable characteristics: ① compared to other developed countries, Japanese listed companies have consistently underperformed based on shareholder value indicators such as PBR (price-to-book ratio) for many years (although some improvement has been seen recently), and ② accounting frauds and other governance-related scandals continue to occur one after another, leading many domestic and international investors to call for further reform and improvement of corporate governance.

  Despite addressing many of the challenges faced by listed companies, this interim draft proposal, from an investor's perspective, is virtually devoid of proposals aimed at improving "reliable, sound, and effective governance," which is the most important issue for listed companies. Rather, many of the proposals in this interim draft will be perceived by investors as being backward-looking from the perspective of governance improvement, reflecting executives’ self-serving desire to protect

themselves from criticism or ouster.

If things stop here, it seems impossible to ensure the sustainable growth of the Japanese stock market, and consequently the Japanese economy, amidst intensifying competition among developed countries to attract investment capital. It is hoped that the development of legal infrastructure that will give investors a clear vision of the Japanese stock market 10 years from now will be considered soon.

- The statutory "executive officer system" should be introduced into all corporate governance structures.· In 2017 and 2018, the Ministry of Economy, Trade and Industry submitted a proposal to the Ministry of Justice's Corporate Law Subcommittee to create an "executive officer"[*shikko-yaku*] system under the Companies Act, to be used in all organizational/governance structures, as an alternative to *shikko yakuin* "executive officers, which are not defined in the Companies Act and do not bear a fiduciary duty of due care.

  In 2017, the Ministry of Economy, Trade and Industry wrote the following regarding this necessity:

  > "One of the directions in recent corporate governance reforms is considered to be strengthening the supervisory function of the board of directors. Based on the 2014 amendment to the Companies Act and the Corporate Governance Code, the vast majority of listed companies have appointed multiple outside directors, and the composition of the board of directors is changing from the traditional situation centered on internal executive officers.
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  > In the case of companies with a nominating committee, etc., executive officers are not directors but rather executive officers, a separate legal position. Therefore, even if efforts are made to reduce the number of executive officers included in the board of directors so that the board can focus on supervisory duties, it is possible to secure a certain number of executive officers who possess the authority and responsibility of officers under the Companies Act by appointing them as [*shikko yaku*] executive officers."
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  > On the other hand, in companies with a board of auditors or an audit and supervisory committee, the only officers who [legally] perform business execution under the Companies Act are directors. Therefore, if efforts are made to reduce the number of executive officers (executive directors) so that the board of directors can focus on oversight, a situation arises where the number of officers responsible for business execution under the Companies Act decreases, even though the number of persons responsible for execution [which includes *shikko yakuin*] does not decrease.
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  > Therefore, it is conceivable to consider allowing companies with a board of auditors or an audit and supervisory committee to appoint [*shikko yaku*] executive officers or executive directors responsible for business execution by

resolution of the board of directors, and to allow these executive officers to also be selected as representatives of the company."

The problem pointed out above has become even more important now, approximately nine years later, because the proportion of outside directors has increased. From the perspective of improving the effectiveness of governance, the introduction of an executive officer system is urgently needed.

Furthermore, when establishing the Audit and Supervisory Committee system, which allows for the delegation of authority, it would have been rational to introduce an "executive officer" system similar to that of companies with a nominating committee, etc., in order to ensure accountability in a balanced manner, given that the delegation of authority was permitted. However, such a system was not implemented.

In any case, in this era where the number of executive officers and the proportion of outside directors are constantly increasing, the above legal amendments are urgently needed.

Reference:

業統治等に関する規律についての問題意識 [METI, 2017]

会社法制（企業統治等関係）部会資料２１に対する意見 [METI, 2018]
https://www.moj.go.jp/content/001261628.pdf

In 2009, the Delaware Supreme Court reaffirmed its long-standing principle that executive officers have the same duty of care and loyalty as directors:
Gantler v. Stephens, 965 A.2d 695, 708-09 & n.37 (Del. 2009)[1]

- Prior preparation of the Companies Act is necessary for the enactment of a "Public Companies Act." The needs and challenges faced by listed companies differ significantly from those of unlisted companies. Therefore, the enactment of a "Public Companies Act" is necessary. However, without prior preparation of the current Companies Act, the transition process to the new design will be time-consuming, placing a heavy burden on listed companies.

  Under the current Companies Act, (i) listed companies can choose from three different legal governance structures (something rarely seen in other countries); (ii) the possibility or requirements for delegating broad authority to management differ depending on the governance structure; and (iii) the appointment of executive

[1] Reference: Gantler v. Stephens, 965 A.2d 695, 708-09 & n.37 (Del. 2009). "The Court of Chancery has held, and the parties do not dispute, that corporate officers owe fiduciary duties that are identical to those owed by corporate directors. That issue-whether or not officers owe fiduciary duties identical to those of directors-has been characterized as a matter of first impression for this Court. In the past, we have implied that officers of Delaware corporations, like directors, owe fiduciary duties of care and loyalty, and that the fiduciary duties of officers are the same as those of directors. We now explicitly so hold."

officers subject to a duty of due care is limited to one type of governance structure (companies with a nominating committee, etc., for which the number of companies appointed is small). These peculiarities have not only caused considerable confusion among investors, but have also been a major factor in making the Japanese capital market difficult to understand, thereby lowering its attractiveness from the perspective of overseas investors.

I believe that enacting a "Public Companies Act" and converging on a single organizational structure for public companies that is easily understood internationally should be considered. The envisioned organizational structure will likely be primarily modeled after the current nominating committee structure, but it should be an improvement over the current form.

In pursuing this direction, adoption of the "executive officer" system mentioned above would be the first step in the process of evolving into a “public company”.

Furthermore, even without the enactment of a "Public Companies Act," if this interim draft considers ways to limit the liability of executive directors (whose proportion on the board of directors has been declining in recent years due to the increase in outside directors), then theoretically, expanding the executive officer system as an a universal mainstay in governance structure will be unavoidable. Without it, with the decreasing number of executive directors, and especially if their legal liability is limited, a governance vacuum will be created where there are many [*shikko yakuin*] "executive officers" but they bear no responsibility to shareholders whatsoever. From the perspective of effective governance, the duty of due care should primarily rest with the insiders who act as executives on a daily basis, but the current situation is moving in the opposite direction.

In my opinion, one essential feature of the enactment of a "Public Companies Act" should be the obligation to appoint a majority of outside directors. The reason for this arises from the very logic of corporate governance. Without this feature, in a dispersed shareholder structure where ownership and management are separated, the board of directors might not effectively represent the shareholders. For governance to function effectively in such a situation, a group that can firmly control the appointment and dismissal of executives is necessary. Unless a majority of the board consists of individuals who are not part of the management team or executives who may have a potential conflict of interest with the company, it is extremely difficult to adequately fulfill this role.

Reference:

会社の「機関設計」も一体化すべき ～Boys, Be Ambitious～
https://bdti.or.jp/boys-be-ambitious/

Japan Only Needs One Governance Format for Listed Firms, Not Three
[A version with more detail]
https://bdti.or.jp/en/lf/

「CEO 交代困難」「現金ため込み」の欠陥を直せ！高市首相の"コストゼロ改革"で企業の投資環境は劇的改善へ
https://toyokeizai.net/articles/-/923758?display=b

4. Opinion regarding amendment of Article 297(1) of the Companies Act [re the possibility of raising the hurdle for demanding extraordinary general meetings of shareholders]

Summary of opinion:
No amendment is necessary.

Explanation:
Text from the interim proposal is quoted here:

> *"In addition, the committee expressed the opinion that it is worth considering raising the threshold for exercising the right to request the convening of an extraordinary general meeting of shareholders, which currently requires a voting rights holding ratio of 3% or more (Article 297, Paragraph 1 of the Companies Act), taking into account the legal systems of other countries."*

I believe that no change is necessary. The reasons are as follows:

The Japanese stock market differs significantly from other major stock markets, and still has a large number of "cross-shareholders" or similar types of “stable shareholders”. Therefore, from the perspective of promoting necessary management reforms and the effective use of surplus cash and assets, it is necessary to strengthen proactive dialogue with shareholders and governance functions even more than before.

Furthermore, it is not appropriate to simply compare the Japanese market with the stock markets of other countries mentioned in this section of the supplementary explanation. For example, in the United States and the United Kingdom, due to the presence of large institutional investors and long-standing market practices, proactive engagement and dialogue with diverse shareholders, including on a private basis, have been conducted far more extensively than in Japan. On the other hand, in most of the other markets, it is difficult to say that dialogue with shareholders and governance reforms have sufficiently led to market revitalization, and the number of listed companies is significantly lower than in Japan.

Based on these comparisons, I believe there is no need to further tighten the requirements for exercising the right to request the convening of an extraordinary general meeting of shareholders in Japan.

5. Opinion regarding revision of the liability limitation agreement system

Summary of opinion:
The proposals in the interim draft regarding liability limitation agreements are undesirable.

Explanation:

In Japan, I have served as an outside director for 17 years and conducted executive training for directors and executive officers (including candidates) for 15 years. Based on this experience, I feel that the average awareness of potential legal responsibility and liability among Japanese management and executives remains extremely low. The number of shareholder derivative lawsuits against directors is relatively low, and the risk of class action lawsuits, which are frequently seen in the United States, does not exist.

This is a significant difference from the United States. As a consequence, in Japan, there are many cases where directors assume their positions without sufficient understanding or training regarding the liability that may arise from dereliction of duty or lack of knowledge and study.

Therefore, in Japan, it is more important to raise awareness of existing legal responsibilities than to further lower the liability limit. This is especially true for insiders who are involved in the daily execution of business.

Furthermore, the standard of "not a case of gross negligence" in the interim draft is extremely lenient, and the proposed liability limitation of four to six times annual compensation is quite low compared to other countries. On the other hand, under the current Companies Act, if a director acts in good faith, without gross negligence, and if (i) approval is obtained by a special resolution at a shareholders' meeting, or (ii) the articles of incorporation contain provisions for liability reduction, then with the consent of a majority of directors and no objections from 3% or more shareholders, the company can grant a certain degree of liability reduction to a director who lost a shareholder derivative suit. However, in practice, it seems that very few companies utilize this system. (At least, I am not aware of any such cases.)

In other words, if the Companies Act is amended in accordance with the interim draft, companies that were not confident under current law about obtaining approval via a special resolution at a shareholders meeting or keeping the number of shareholders who do not consent to liability reduction below 3% will transition to a system that allows for comprehensive liability reduction without requiring any shareholder approval in individual cases at all. As a result, from the shareholder's perspective, there is a strong possibility that liability reduction will be granted in advance and comprehensively for matters that would normally be judged retrospectively.

Compared to the United States, Delaware law is generally structured as follows.

Regarding compensation for damages, judgments, and settlements in shareholder derivative suits, Delaware law generally does not allow a company to compensate a

director if the court finds the director liable to the company. This principle is based the same basic logic as the Japanese Companies Act, which presently prohibits corporate indemnification for damages in shareholder derivative suits.

On the other hand, compensation for *attorney fees and other defense costs* incurred in responding to litigation may be granted if the director acted in good faith and met requirements such as "reasonably believing that his or her actions were in the best interests of the company, or at least not contrary to its best interests."

However, if a director is found liable to the company in court, compensation for those defense costs is generally limited. Exceptionally, however, the Delaware Court of Chancery and other courts may allow compensation to the extent deemed "fair and reasonable" based on the specific circumstances.

Therefore, the basic direction of current Japanese law regarding director liability is not especially unique or unreasonable compared to Delaware law. Current Japanese law is well-suited to the situation in Japan, and does not need to be changed.