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Corporate Governance

Japan

Nagashima Ohno & Tsunematsu

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Law and Practice

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Nagashima Ohno & Tsunematsu has an established reputation as a leading Japanese law firm in the area of corporate governance. With a team of approximately 50 partners, having various backgrounds ranging from corporate/M&A and capital markets to litigation and investigations, the firm regularly advises on corporate governance matters. It provides practical and strategic advice related to corporate governance based on relevant laws, regulations and guidelines as well as current practices. The key areas of the firm's practice in the corporate governance sector include: conduct of shareholder meetings; proxy statements, securities reports and other disclosure materials; investor relationships; dealing with shareholder activists; management composition and governance structure; management compensation; internal control systems; risk and crisis management; and fiduciary duties, the business judgment rule and directors' liability. The firm primarily advises listed companies in the corporate governance context, but from time to time advises individual investors as well.

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1. Introduction

1.1 Forms of Corporate/Business Organisations

The following are the principal forms of corporate/business organisations in Japan.

- *Joint stock company (kabushiki kaisha or KK)* – a joint stock company is the most commonly used form of corporate/business organisation in Japan. All Japanese listed companies are joint stock companies. This form is commonly used for closely held companies as well. All shareholders of a joint stock company enjoy limited liability up to their respective contribution amounts. This form is not a pass-through entity for Japanese tax purposes.
- *Limited liability company (godo kaisha or GK)* – the form of a limited liability company is used only for closely held companies. Because the governance structure and rights of equity holders (including the allocation of profit distributions among equity holders) can be determined in a flexible manner by the articles of organisation, this form is suitable for joint ventures and wholly owned subsidiaries. All equity holders of a limited liability company enjoy limited liability up to their respective contribution amounts. This form is not a pass-through entity for Japanese tax purposes.
- *General partnership company (gomei kaisha) and limited partnership company (goshi kaisha)* – the form of a general partnership company and that of a limited partnership company are used only for closely held companies, but are not commonly used. General partners in these companies have unlimited liability; limited partners enjoy limited liability. These forms are not pass-through entities for Japanese tax purposes.
- *Limited liability company established under the Commercial Code (prior to enactment of Companies Act in 2006) (yugen kaisha or YK)* – this 'legacy' form of a limited liability company is still used for closely held companies and is treated as a joint stock company under the Companies Act. All equity holders of this type of entity enjoy limited liability up to their respective contribution amounts. This form is not a pass-through entity for Japanese tax purposes.
- *Limited liability partnership (LLP)* – the form of a limited liability partnership is used for joint ventures. The number of limited liability partnerships has been increasing but, despite its pass-through nature for Japanese tax purposes, has not become very popular because of some practical inconveniences arising from its lack of legal personality.

Explanations in **1.2 Sources of Corporate Governance Requirements**, below, and later sections focus on the joint stock company unless otherwise indicated.

1.2 Sources of Corporate Governance Requirements

There are various sources of corporate governance requirements for companies in Japan. The following are the principal sources.

- *Companies Act (Act No 86 of 2005, as amended)* – the Companies Act, together with its subordinate regulations, provides the basic corporate governance requirements for companies, whether listed or not.
- *Financial Instruments and Exchange Act (Act No 25 of 1948, as amended) (FIEA)* – the FIEA, together with its subordinate regulations, requires listed companies and certain other publicly held companies to make disclosures related to corporate governance in various filings.
- *Securities Listing Regulations published by the Tokyo Stock Exchange (the 'TSE Regulations')* – The TSE Regulations require companies listed on the Tokyo Stock Exchange, among other things, to file corporate governance reports and to appoint 'independent officers' and file independent officer notices.
- *Corporate Governance Code* – the Corporate Governance Code is a part of the TSE Regulations. The Tokyo Stock Exchange requires listed companies to 'comply or explain' with respect to the principles included in the Corporate Governance Code and to disclose some corporate governance matters in their corporate governance reports.
- *Guidelines and Study Reports* – Japanese governmental agencies or study groups organised by them from time to time publish various guidelines or study group reports with respect to corporate governance issues, which include the Corporate Governance System Guidelines published by the Ministry of Economy, Trade and Industry.

1.3 Corporate Governance Requirements for Publicly Traded Companies

Listed companies are subject to various corporate governance requirements, including the following.

- *Governance structures* – having a board of directors is mandatory. Listed companies must choose one of the three governance structures:
  - (a) company with a board of statutory auditors;
  - (b) company with an audit and supervisory committee; or
  - (c) company with nominating and other committees.

The form of a company with a board of statutory auditors is the traditional and most popular governance structure in Japan. The form of a company with an audit and supervisory committee was introduced by the 2014 amendment to the Companies Act, and the number of companies adopting this form is rapidly increasing. The number of companies with nominating and other committees still remains limited.

- *Outside/independent members* – no less than 50% of the statutory auditors in a company structured with a board of statutory auditors must meet the 'outside statutory auditor' criteria under the Companies Act. A company with a board of statutory auditors is not currently required to have any outside director under the Companies Act but must explain at a shareholder meeting why it is not appropriate to have an outside director if it does not have one. See also **2.2 Current Issues and Developments**, below, for the contemplated amendment to the Companies Act in this regard. Each committee of a company with an audit and supervisory committee, or a company with nominating and other committees, must have committee members the majority of whom are outside directors. The TSE Regulations require listed companies to appoint one or more directors or statutory auditors who meet the 'independent officer' criteria determined by the Tokyo Stock Exchange and to file independent officer notices. The TSE Regulations further require listed companies to make efforts to secure at least one independent outside director as a board member. The Corporate Governance Code provides that listed companies should have two or more independent outside directors, but listed companies may decide not to comply with this requirement by explaining why they do not so comply.
- *Appointment and dismissal of directors and statutory auditors* – appointment of directors and statutory auditors must be approved by a majority of the votes at a shareholder meeting. Dismissal of directors (excluding directors who are members of an audit and supervisory committee) must be approved by a simple majority of the votes at a shareholder meeting. Dismissal of statutory auditors and directors who are members of an audit and supervisory committee must be approved by a two-thirds supermajority of votes at a shareholder meeting. Taking into consideration the shareholder proposal right mentioned below, a staggered board does not effectively work as a hostile takeover defence.
- *Management compensation* – compensation of directors must be approved at a shareholder meeting. In most listed companies (excluding companies with nominating and other committees), only the maximum aggregate amount of annual compensation of all the directors (excluding directors who are members of an audit and supervisory committee) is approved at a shareholder meeting, and then the board of directors decides the compensation of each director within the approved maximum aggregate amount. It is also common that the board of directors further delegates the determination of the compensation of each director to the president/CEO, who determines it in consultation with a compensation advisory committee which the company voluntarily establishes. In the case of a company with nominating and other committees, compensation of directors and officers must be determined by the compensation committee. Regardless of governance structure, the aggregate annual compensation of directors (and officers, if applicable) must be disclosed in an annual business report, with a breakdown by inside directors and outside directors (and by officers, if applicable). In addition, the list of directors (and officers, if applicable) who receive annual compensation of JPY100 million or more is disclosed with the respective amounts they receive in annual securities reports.
- *Shareholder proposal right* – shareholders who hold 1% or more of the total voting rights or 300 or more of the votes for six months or longer may make a proposal of agenda (including appointment and dismissal of directors) by notifying the company at least eight weeks (or a shorter period if so provided in the articles of incorporation) prior to a shareholder meeting, and requesting the company to include the proposal in the company's proxy statements at the company's cost and expense.
- *Director liability* – directors owe a fiduciary duty to the company and are liable to the company if they breach the fiduciary duty and cause damage to the company. A shareholder may bring a shareholder derivative lawsuit against directors on behalf of the company subject to certain procedures.
- *Internal control system* – a board of directors must determine the basic principles of its internal control system and disclose such principles in its annual business reports. It is among the management's duty to establish and maintain a proper internal control system in the company, failing which the management may be liable for any damage suffered by the company.

2. Corporate Governance Framework

2.1 Key Rules and Requirements

In addition to 'hard law' (ie, black-letter law, such as the Companies Act and the FIEL), so-called 'soft law' is becoming more important in the corporate governance context in Japan. 'Soft law' includes the TSE Regulations, the Corporate Governance Code and the Corporate Governance System Guidelines.

The Stewardship Code published by the Council of Experts on the Stewardship Code, established by the Financial Services Agency, is another important 'soft law' in the corporate governance context, although it is not directly applicable to listed companies but to institutional investors. Many major institutional investors have published their own proxy voting policies in response to the Stewardship Code, will vote at shareholder meetings in accordance with their own policies, and will have engagement discussions with the management of listed companies to encourage mid- to long-term growth. Therefore, listed companies must pay close attention to the Stewardship Code and proxy voting policies published by major institutional investors.

Case law regarding M&A transactions, including MBO transactions, and director liability is another important source of corporate governance requirements, which dictates the code of conduct for directors in the relevant situations.

2.2 Current Issues and Developments

An amendment to the Companies Act is the most important recent movement in the corporate governance context in Japan. The amendment has been discussed before the Legislative Council and the bill for the amendment is scheduled to be submitted to the legislature later in 2019. The amendment covers various corporate governance issues including, among other things:

- provision of proxy statements in digital form;
- countermeasures against abusive shareholder proposals;
- enhanced disclosure of management compensation policies;
- rules and procedures regarding management indemnification arrangements;
- rules and procedures regarding D&O insurance; and
- mandatory appointment of outside directors by listed companies.

Other key topical issues in relation to corporate governance in Japan include:

- introducing incentive plans for directors with more emphasis on performance-based and equity-based compensation packages;
- creating a succession plan of president/CEO and making use of nomination committees;
- increasing outside/independent directors with more diversity in terms of nationality and gender; and
- reduction or dissolution of cross-shareholding.

3. Management of the Company

3.1 Bodies or Functions Involved in Governance and Management

Shareholder Meeting/Directors/Board of Directors

All joint stock companies are required to have a shareholder meeting and directors. If a company has a board of directors, it must appoint three or more directors. A listed company is required to have a board of directors.

Statutory Auditors/Audit and Supervisory Committee/ Nominating and Other Committees

A company may have one of the following bodies:

- a statutory auditor (*kansayaku*) and, as the case may be, a board of statutory auditors (*kansayakkai*);
- an audit and supervisory committee (*kansatou-iinkai*); and
- nominating and other committees (*shimei-iinkai-tou*).

If a company has any of a board of statutory auditors, an audit and supervisory committee or nominating and other committees, it must also have a board of directors. A listed company that is a large-size company (*daigaisha*) (ie, a company that has recorded on its audited and approved balance sheet for its most recent fiscal year either JPY500 million or more in stated capital or JPY20 billion or more in liabilities) is required to have one of these bodies.

The main role of a statutory auditor is to audit the execution of the duties of the directors. A listed company with statutory auditors is required to have a board of statutory auditors.

An audit and supervisory committee consists of three or more audit and supervisory members (*kansatou-iin*), who are also directors of the company elected as such by its shareholder meeting. A majority of the audit and supervisory members must be outside directors. The main role of the audit and supervisory committee is to audit and supervise the execution of the duties of the directors.

Nominating and other committees means a set of a nominating committee (*shimei-iinkai*), an audit committee (*kansa-iinkai*) and a compensation committee (*hoshu-iinkai*). Each committee consists of three or more directors, and a majority of each committee's members must be outside directors. The main roles of a nominating committee, an audit committee and a compensation committee are, respectively, to determine the candidates for directors, to audit and supervise the execution of the duties of the management, and to determine the compensation of each management member. In a company with nominating and other committees, an executive officer (*shikkoyaku*) is supposed to have the broader authority to decide the execution of the company's operation as compared to other types of companies. A representative executive officer (*daihyo-shikkoyaku*) appointed from among the executive officers by a board of directors represents the company.

Accounting Auditor

In addition, a large-size company must have an accounting auditor (*kaikei kansanin*) who is expected to audit the accuracy of the company's financial statements. An accounting auditor must be appointed from among external accounting firms or licensed accountants. A company with an audit and supervisory committee or nominating and other committees is also required to have an accounting auditor.

3.2 Types of Decisions Made by Governing Bodies

The roles of a shareholder meeting and directors may differ depending on whether or not a company has a board of directors. In the case of a company without a board of directors, a shareholder meeting may adopt any action on behalf of the company, and a director has the broad authority to decide and execute the company's operation.

If a company has a board of directors, the authority of a shareholder meeting is more limited. In this case, the shareholder meeting may adopt only such matters as provided under the Companies Act or the articles of incorporation. A board of directors typically delegates to the representative director and other executive directors the authority to decide the execution of the company's operation except for the matters specifically prescribed under the Companies Act. Such prescribed matters include the transfer and acquisition of important assets, significant borrowing, appointment and dismissal of important employees (including managers), establishment of, changes to or closing of important organisations (including branch offices), issuance of bonds, establishment of an internal control system, discharge of director's or officer's liability pursuant to the articles of incorporation, and any other important matters regarding the company's operation. The Companies Act also provides other matters that must be decided by a board of directors.

However, in the case of a company with nominating and other committees, a board of directors may delegate to the executive officer the broader authority to decide the execution of the company's operation, and the matters that the board of directors is required to decide are fairly limited as compared to other types of companies. In this sense, the corporate governance of a company with nominating and other committees is designed as monitoring model. Likewise, a company with an audit and supervisory committee may take a similar approach if:

- a majority of its directors consist of outside directors; and
- it is so provided in the articles of incorporation.

3.3 Decision-making Processes

At the board level, unless otherwise provided in the articles of incorporation, a decision by a board of directors is made by a majority of the directors present at a board meeting, as long as a majority of the directors who are entitled to participate in the vote are present. Directors who have a special interest in the resolution may not participate in the vote. A board meeting may be held through a video conference or conference call system.

If so provided in the articles of incorporation, a board resolution may be made without holding a physical meeting if all directors who are entitled to participate in the vote agree in writing (whether physically or electronically) to a proposal submitted by a director. That being said, circulation of board minutes to the board members together with their signatures on the minutes is not deemed to be a board resolution.

4. Directors and Officers

4.1 Board Structure

A board of directors consists of three or more directors and is required to appoint one or more representative directors. Under the Companies Act, appointment of an outside director is not a mandatory requirement for a board's structure, but a proposed amendment to the Companies Act suggests that a listed company is obligated to have an outside director. In the case of a joint stock company with an audit and supervisory committee or nominating and other committees, a majority of each committee's members must be outside directors. In the case of a company with nominating and other committees, members of each committee may serve as members of other committees.

4.2 Roles of Board Members

The board members are, in general, divided into the following categories:

- representative directors;
- other executive directors; and
- outside directors.

The role of the representative director is to execute the company's operation and represent the company. The authority of the representative director extends to all actions (whether judicial or non-judicial) in connection with the company's operation. The representative director may also decide the company's operation to the extent permitted by law as long as the board of directors authorises him or her to do so. Other executive directors may not represent the company without a delegation from the representative director but may decide and execute the company's operation, as is the case with a representative director subject to the same condition. However, in the case of a company with nominating and other committees, directors (other than executive officers) are not generally allowed to decide and execute the company's operation because such functions are carried out by an executive officer. Outside directors are expected to supervise the management of the company from an independent point of view.

4.3 Board Composition Requirements/ Recommendations

A company with an audit and supervisory committee or nominating and other committees must have two or more outside directors. There are several requirements or recommendations for listed companies. Firstly, the TSE Regulations require listed companies to make efforts to secure at least one independent outside director as a board member. Second, the Corporate Governance Code recommends that listed companies appoint at least two independent outside directors.

In addition, the Corporate Governance Code recommends that a board of directors of a listed company be composed in a manner to achieve diversity, including in terms of gender and international experience.

4.4 Appointment and Removal of Directors/Officers

Directors are appointed by a resolution of a shareholder meeting. Unless otherwise provided in the articles of incorporation, this resolution must be made by a majority of the votes of the shareholders present at the meeting if a quorum is satisfied (ie, by the presence of shareholders representing a majority of those who are entitled to exercise their voting rights). The company may lower the quorum for the appointment of directors down to a third pursuant to the articles of incorporation. A cumulative voting system is also available although this is not common in Japan. In the case of a company with an audit and supervisory committee, directors who are audit and supervisory members must be appointed separately from the other directors of the company. Other management members, including an executive officer in a company with nominating and other committees, are appointed by the board of directors. In addition, the Corporate Governance Code recommends that a listed company, unless it has nominating and other committees or its independent outside directors constitute a majority of its board of directors, seek the involvement of, and advice from, independent outside directors in relation to the nomination of directors and other management members by means of establishing an independent advisory committee mainly consisting of such independent outside directors.

Directors may be dismissed at any time by a majority of the vote at a shareholder meeting, except audit and supervisory members, whose dismissal requires two thirds of the votes at a shareholder meeting. However, a dismissed director is entitled to seek damages arising out of the dismissal except in cases where justifiable grounds exist. Typically, a dismissed director may claim the compensation it would have received during his or her remaining term. In addition, if a director engages in any misconduct or commits a material violation of law or the articles of incorporation in connection with the execution of his or her duties as a director and a proposal to dismiss the director is rejected at the shareholder meeting, then a shareholder holding, for the preceding six months or longer, not less than 3% of the voting rights of all shareholders may file a lawsuit to dismiss the director.

Other management members, including an executive officer in a company with nominating and other committees, may be dismissed by a board of directors. A dismissed executive officer may seek damages, as in the case of a dismissed director.

Statutory auditors are appointed by a majority of the votes at a shareholder meeting. However, dismissal of statutory auditors requires two thirds of the votes at a shareholder meeting. As in the case of directors, a dismissed statutory auditor is entitled to seek damages arising out of the dismissal, except in cases where justifiable grounds exist.

4.5 Independence of Directors and Conflicts of Interest

An outside director is a director who does not execute the company's operations, has no relationship with its affiliate companies or their management, etc. A more detailed definition of an outside director is provided in the Companies Act. A company having an audit and supervisory committee, or nominating and other committees, must have two or more outside directors. Other types of companies are not obligated to have outside directors under the Companies Act. However, a listed company that is a large-size company and has a board of statutory auditors but does not have an outside director is required, at its shareholder meeting, to give a justifiable reason for not having an outside director and describe this reason in the convocation notice of the shareholder meeting as well as its business report.

Furthermore, the TSA Regulations and the Corporate Governance Code have certain requirements or recommendations in relation to 'independent' outside directors. An independent outside director is an outside director who satisfies the 'independent officer' criteria as established by the Tokyo Stock Exchange. According to these criteria, an outside director who is an executive director or officer of one of the company's main business partners, or an expert who receives a substantial amount of fees or compensation from the company, is not qualified to be an 'independent' outside director. In this sense, the 'independent officer' criteria is more stringent than the 'outside director' criteria under the Companies Act. Under the Corporate Governance Code, if a listed company does not appoint two or more independent outside directors, it must publicly explain the reason why.

4.6 Legal Duties of Directors/Officers

Directors owe a fiduciary duty to the company. The Companies Act specifically provides that directors of a company must perform their duties to the company in a loyal manner, with this duty of loyalty being construed as part of a fiduciary duty. As part of their fiduciary duty, directors are required to establish an internal control system of the company. Furthermore, directors have a duty to supervise other directors' execution of the company's operation.

In connection with the decision on a company's operation, the business judgement rule applies, whereby directors are given broad discretion in making business decisions and are not to be held liable for those decisions unless the business decision or the process thereof is construed as significantly unreasonable.

If a director intends to carry out any transaction:

- with the company;
- that competes with the business of the company; or
- that results in a conflict of interest between the director and the company,

then the director is required to disclose the material facts relating to the transaction to the board of directors and obtain its approval.

4.7 Responsibility/Accountability of Directors

In general, directors owe their duties to the company. However, if a director breaches its fiduciary duty or any other duties, it may be held liable not only to the company but also to any third party that has suffered damage arising from the breach.

4.8 Breach of Directors' Duties

If a director engages, or is likely to engage, in an act in violation of law or the articles of incorporation (such acts include breach of a fiduciary duty) and this act is likely to cause substantial damage to the company, a shareholder holding shares in the company for six consecutive months or longer (or a shorter period if so provided in the articles of incorporation) may seek injunctive relief. In the case of a closely held company, the restriction on the shareholding period does not apply. In the case of a company with statutory auditors, an audit and supervisory committee or nominating and other committees, injunctive relief is granted only if the company is likely to suffer irreparable damage because statutory auditors or the relevant committee members are expected to audit and supervise the directors. In these types of companies they are entitled to seek injunctive relief.

If a director or a statutory auditor breaches his or her duties, the company may seek compensation for the damage caused by the breach. In addition, a shareholder may also file a shareholder derivative action on behalf of the company if the shareholder requests that the company file a lawsuit against a breaching director or statutory auditor but the company does not do so within 60 days of such a request. Moreover, if a third party suffers damage arising from the performance of the duties by a director or a statutory auditor who had knowledge that his or her conduct was inappropriate or was grossly negligent, then the third party may seek recovery of the damage from the director or statutory auditor.

Even if a director or a statutory auditor fails to perform his or her duties, his or her liability arising from such failure may be discharged or limited through:

- the consent of all shareholders;
- a resolution of a shareholder meeting; or
- a resolution of a board of directors (or, in the case of a company without a board of directors, consent of a majority of directors) pursuant to the articles of incorporation.

In addition, a director who is neither a representative director nor an executive director or a statutory auditor may enter into an agreement with a company to limit his or her liability, if so permitted by the articles of incorporation.

A director may enter into an indemnification agreement with a company, pursuant to which in certain circumstances the company indemnifies the director for the costs (including attorneys' fees) and damage that the director has incurred if a lawsuit is filed against or a governmental investigation is conducted of the director in connection with the performance of his or her duties. D&O insurance is widely available in Japan.

4.9 Other Bases for Claims/Enforcement Against Directors/Officers

In relation to corporate governance, a third party is able to make claims against directors, statutory auditors and other officers for damage incurred in connection with misrepresentations in a company's financial statements, business reports or any other documents unless the directors, statutory auditors or other officers can prove that they have exercised due care. Directors, statutory auditors and other officers of a listed company are also liable for misrepresentations in the public disclosure documents of the company, such as annual securities reports (*yukashoken-hokokusho*), under the FIEA.

4.10 Approvals and Restrictions Concerning Payments to Directors/Officers

Compensation to directors must be approved by a shareholder meeting unless it is provided in the articles of incorporation. In usual circumstances, a shareholder meeting approves the maximum aggregate amount of compensation of all directors and delegates to the board of directors the authority to decide the compensation to be paid to each director within the approved maximum aggregate amount. In the case of a company with an audit and supervisory committee, the compensation of audit and supervisory members must be determined separately from other directors, and the allocation of compensation among audit and supervisory members is determined based upon their discussion unless a shareholder meeting resolves otherwise or the articles of incorporation provide differently. In the case of a company with nominating and other committees, a compensation committee determines the compensation of each director and executive officer.

In addition, the Corporate Governance Code recommends that a listed company, unless it has nominating and other committees or its independent outside directors constitute a majority of its board of directors, seek involvement of and advice from independent outside directors in relation to the compensation of directors and other management members by means of establishing an independent advisory committee mainly consisting of such independent outside directors.

The Corporate Governance Code also considers that listed companies should reflect mid- to long-term business results and potential risks in determining the compensation of the management and recommends that the proportion of management compensation linked to mid- to long-term results and the balance of cash and stock paid as compensation, respectively, be set appropriately.

Compensation of statutory auditors must also be approved by a shareholder meeting unless it is provided in the articles of incorporation. If a company has two or more statutory auditors, compensation of each statutory auditor may be determined based on their discussions, within the maximum aggregate amount of compensation approved by a shareholder meeting or provided by the articles of incorporation.

4.11 Disclosure of Payments to Directors/Officers

A listed company must disclose the compensation of its directors, statutory auditors and other officers in its business report. Such disclosure is required with respect to the total amount of the compensation on a position-by-position basis along with the number of persons appointed to each position. In the case that a company has outside directors/statutory auditors, the total amount of the compensation paid to them and the number of such outside directors/statutory auditors must also be disclosed. Furthermore, a listed company is required to disclose the compensation of individual directors, statutory auditors and other officers in its annual securities report under the FIEA if the amount of such individual compensation is JPY100 million or more. In the case of a closely held company, while there is no such disclosure requirement, it may have to make available the total amount of compensation paid to its directors, statutory auditors and other officers in its financial statements.

5. Shareholders

5.1 Relationship Between Companies and Shareholders

Shareholders, through their ownership of shares, have equity interests in a joint stock company. The basic and primary rights of shareholders are:

- the right to receive dividends;
- the voting right at shareholder meetings; and
- the right to receive residual assets upon the liquidation of the company.

Shares are issued only upon the full payment of the issuance price by a shareholder; accordingly, there exists no obligation of shareholders to make an additional investment/payment in their capacity as shareholders. Additionally, unlike in some other jurisdictions, it is generally construed that a controlling shareholder does not owe any fiduciary duty in relation to the operation of the company.

Accordingly, in principle, the risk assumed by shareholders is limited to the equity amount invested in the company. However, in limited circumstances, a doctrine to pierce the corporate vail exists pursuant to court precedent where the benefit of the corporate form is abused or the existence of the corporate form becomes a mere facade.

5.2 Role of Shareholders in Company Management

Shareholders are not directly involved in the management of a company.

Rather, shareholders, in their capacity as members of a shareholder meeting, vote on agenda items presented at the shareholder meeting and make resolutions on such proposed matters. In the case of a company with a board of directors, the shareholder meeting only has the power to make resolutions on the matters stipulated by law or stipulated in the articles of incorporation. Accordingly, it is not expected that a shareholder meeting will make resolutions regarding the day-to-day management of the company.

Once a resolution is passed by a shareholder meeting, the directors of the company owe a duty to act in accordance with such resolution.

In the case that a director or a company is to take certain actions that are likely to adversely affect shareholders or the company, under limited circumstances satisfying the criteria stipulated in the Companies Act, a shareholder may demand that the company or director refrain from taking such actions. Additionally, a shareholder may bring a claim against the company or directors as explained in **5.4 Shareholder Claims**, below.

For the purpose of monitoring the company's management, when satisfying the requirements provided under the Companies Act:

- a shareholder holding 3% or more of the voting rights may request the court to appoint an inspector for the company's business;
- a shareholder holding 3% or more of the voting rights may request the disclosure of the accounting books and related documents of the company; and
- a shareholder may request, with the court's permission, the disclosure of the minutes of meetings of the board of directors.

5.3 Shareholder Meetings

Types of Shareholder Meetings

A company is required to have an annual shareholder meeting once every fiscal year. At an annual shareholder meeting, the financial statements/business reports are approved or reported and annual dividends may be declared. The appointment of directors or statutory auditors may also take place. The articles of incorporation usually set forth that the

shareholders as of the end of the relevant fiscal year will have voting rights at the annual shareholder meeting, and such annual shareholder meeting is required to be held within three months after the end of the relevant fiscal year.

An extraordinary shareholder meeting may be convened from time to time. For a company whose shares may be transferred without restriction (including listed companies), the company must set a record date by giving public notice in order to identify the shareholders who may exercise their voting rights at the relevant shareholder meeting.

Convocation Procedure
The convocation of a shareholder meeting by the company is required to be made by a resolution of the board of directors and, in general, a convocation notice is required to be sent out to the shareholders at least two weeks prior to the scheduled date of the shareholder meeting.

In the case of a listed company, the required content of the reference materials for a shareholder meeting is stipulated in the relevant regulations, and the company is required to prepare such reference materials in printed form and send such materials together with a convocation notice. Accordingly, the board of directors' convocation resolution should be made well in advance, taking into account the time period required for printing and packaging those materials.

In the case of a closely held company with a limited number of shareholders, if all the shareholders agree to have a shareholder meeting with a shortened notice period, a shareholder meeting may be validly held in accordance with such agreement. Additionally, if all the shareholders approve the proposed agenda unanimously in writing (or by e-mail), then the resolution of a shareholder meeting will be deemed to have been made without having an actual physical meeting.

Apart from the convocation of a shareholder meeting by the company, a shareholder holding 3% or more of the voting rights may, with the court's permission, convene a shareholder meeting.

Proposal by Shareholder
When the company convenes a shareholder meeting, within the scope of an agenda item proposed by the company, a shareholder may make a counter proposal during the meeting. For example, if the company proposes one individual as a director candidate, a shareholder may make a counter proposal to make another individual a director candidate during the meeting.

Further, a shareholder holding 1% or more of the voting rights (or holding 300 or more voting rights) may request the company to add a certain agenda item for an upcoming shareholder meeting by making the request eight weeks prior to the scheduled date of the shareholder meeting.

Resolution Requirement
The voting/quorum requirements for a shareholder meeting resolution differ depending on the agenda item to be resolved.

A supermajority vote, requiring two thirds or more of the affirmative votes among the shareholders present at the meeting, is required for some important matters such as amendments of the articles of incorporation, approval of mergers, dissolution of the company and others. The quorum requirement, which is the attendance of shareholders holding more than half of all the voting rights, may be relaxed by the articles of incorporation.

A simple majority vote, requiring more than half of the affirmative votes among the shareholders present at the meeting, applies to general matters such as the approval of financial statements, distribution of dividends, appointments of directors or statutory auditors, and others. The quorum requirement is the attendance of shareholders holding more than half of all the voting rights, which may be relaxed by the articles of incorporation.

There are some other resolution requirements for certain exceptional matters.

Disclosure of Result of Resolution
In the case of a listed company, the voting results for each agenda item (ie, the number of affirmative votes, negative votes and abstentions) are required to be disclosed to the public.

5.4 Shareholder Claims

A shareholder has the right to request the company to institute a suit against a director by itself seeking indemnification of the company by the director (or statutory auditors or an accounting auditor). If the company does not bring such suit by itself within 60 days of such demand being made by the shareholder, the shareholder may, on behalf of the company, bring a suit (a derivative suit) against the director (or statutory auditors or an accounting auditor). In limited circumstances satisfying the requirements under the Companies Act, a shareholder may also bring a derivative suit against the directors (or statutory auditors or an accounting auditor) of a wholly owned subsidiary.

A shareholder may also file an action with the court to nullify certain corporate actions taken by the company, such as the issuance of new shares, merger, company split and resolution of a shareholder meeting, if there exist grounds for such nullification.

5.5 Disclosure by Shareholders in Publicly Traded Companies

For publicly traded companies, a large shareholding report system exists. A shareholder holding more than 5% of the

outstanding shares, as calculated pursuant to the relevant regulations, is required to file a large shareholding report within five business days of it satisfying such requirements. Thereafter, as long as the shareholder satisfies the requirements, the shareholder is required to file updated reports when material changes occur with respect to the information contained in the report, including the case of an increase or decrease of 1% or more in the shareholding ratio. In the case of institutional investors, some exceptions exist to relax the reporting timing and reduce the reporting contents.

The Council of Experts on the Stewardship Code, established by the Japanese Financial Services Agency, published 'Japan's Stewardship Code'. This Code is not a law or a legally binding regulation, but many institutional investors have accepted it and make disclosure in accordance with it. Under the Code, institutional investors should have a clear policy on voting and publicly disclose the same. Additionally, under the Code, institutional investors are expected to disclose voting records for each investee company on an individual agenda item basis.

6. Corporate Reporting and Other Disclosures

6.1 Financial Reporting

The Companies Act provides for annual financial reporting requirements for all joint stock companies. Following the end of each fiscal year, a joint stock company is required to prepare:

- financial statements (consisting of a balance sheet, profit and loss statement, statement of changes in shareholders' equity, and notes to financial statements);
- a business report; and
- supplementary statements to each of the foregoing.

When finalised, the financial statements and business report will ultimately be submitted to the company's annual shareholders meeting for either approval or report to the shareholders.

Depending on the governance structure of the relevant joint stock company, the procedural requirements for finalising such documents will vary. In the case of a company with a board of directors, which is the most typical structure, its financial statements, business report and supplementary statements must be reviewed by the company's statutory auditor or a board of statutory auditors (as applicable), and the financial statements and their supplementary statements must be reviewed and audited by the company's accounting auditor (*kaikei kansanin*) (if applicable). The board of directors will then approve such documents, which will be approved by the shareholders, or reported to the shareholders (in the case where the company's accounting auditor has issued an unqualified opinion as to the company's financial statements and other conditions are met), at annual shareholder meetings.

Publicly traded companies (in this context, listed companies and other companies that are required to file annual securities reports under the FIEA) are required to prepare consolidated financial statements as well. In addition, under the FIEA, a publicly traded company is required to submit an annual securities report, which must contain audited financial statements (consolidated and non-consolidated) and be filed within three months of the fiscal year end. A publicly traded company is also required to submit a quarterly report (if listed on a Japanese stock exchange) or a semi-annual report, both of which contain summary financial information and must be filed within 45 days of the relevant quarterly end. Financial information contained in quarterly reports is required to undergo quarterly review by the accounting auditor.

With a view to providing more timely financial information to public shareholders, the TSE Regulations also require that Japanese listed companies publish annual and quarterly summaries of consolidated financial results (*kessan tanshin*). Financial information contained in such summaries is not required to have been audited or reviewed by the accounting auditor. The Tokyo Stock Exchange requests that such summaries be made public within 30 days of the quarterly end, and no later than 45 days thereafter.

6.2 Disclosure of Corporate Governance Arrangements

Disclosure of corporate governance arrangements is generally required for publicly traded companies. The FIEA requires a publicly traded company to disclose certain matters related to corporate governance in registration statements or annual securities reports. Such matters include a summary of the company's corporate governance system, internal audit and statutory audit system, outside directors and statutory auditors and their relationships with the company, cross shareholdings and measures to prevent conflict of interest transactions with shareholders.

In addition, the TSE Regulations require that each listed company submit a corporate governance report. In the corporate governance report, each listed company must explain:

- its basic policy on matters included in the Corporate Governance Code established by the Tokyo Stock Exchange;
- the reasons for non-compliance with any of the principles of the Corporate Governance Code (if applicable);
- any disclosures required under the Corporate Governance Code;

- the composition of shareholders (eg, foreign shareholders, top ten largest shareholders, controlling shareholders, if any); and
- the measures for protection of minority shareholders in relation to transactions with controlling shareholders.

6.3 Companies Registry Filings

A joint stock company is required to file certain matters in a commercial registry, which is administered by the legal affairs bureau, upon incorporation and whenever any change to such matters arises. Matters required to be so registered include:

- a corporate name, business purposes, amount of paid-in capital, the class and number of shares;
- the type and number of stock acquisition rights (*shinkabu yoyakuken*);
- directors, statutory auditors, accounting auditor, branch manager (*shihainin*) and other statutory organs;
- branches;
- merger, demerger and other statutory reorganisations; and
- dissolution and liquidation.

Matters registered in the commercial registry are publicly available, while the filings made to the legal affairs bureau are not.

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7. Audit, Risk and Internal Controls

7.1 External Auditors

The following categories of joint stock companies must appoint an accounting auditor (*kaikei kansanin*):

- a large-size company (*daigaisha*) (ie, a joint stock company that has recorded on its most recent fiscal year either JPY500 million or more in stated capital or JPY20 billion or more in liabilities);
- a company with an audit and supervisory committee; and
- a company with nominating and other committees.

An accounting auditor must be appointed from among external auditing firms or licensed accountants. For publicly traded companies, the accounting auditor usually provides audit certification on the financial statements filed under the FIEA.

In order to ensure independence of an accounting auditor, the Companies Act bars interested firms or persons with ties to the company from serving as an accounting auditor. Also, with the aim of shielding an accounting auditor from undue influence from the management, the board of statutory auditors (or their equivalent), rather than the board of directors, has the right to approve the appointment, removal and compensation of the accounting auditor.

7.2 Management Risk and Internal Controls

The Companies Act requires any large-size company (*daigaisha*), any company with an audit and supervisory committee and any company with nominating and other committees to determine and establish its internal control system to ensure that the company and its corporate group operate in a compliant and appropriate manner. In the case of a company with a board of directors, the board must decide the basic framework of the internal control system to be established. The establishment and implementation of an appropriate internal control system are generally considered to form part of the duties of due care of directors.

A joint stock company is required to outline the decisions made by the board of directors with respect to its internal control system and outline the implementation of the internal control system in its annual business report. The internal control system is audited by statutory auditors and the board of statutory auditors.