

January 31, 2012

Counselor's Office, Civil Affairs Bureau
Ministry of Justice
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To Whom it May Concern:

The American Chamber of Commerce in Japan (ACCJ) appreciates the opportunity to submit the following comments in response to the invitation to comment (comment period: 12/14/2011 – 1/31/2012) on the Interim Proposal concerning Revision of the Company Law (the “Proposal”) published in December 2011 by the Counselor's Office, Civil Affairs Bureau of the Ministry of Justice.

In light of the recent corporate scandals in Japan, we agree whole-heartedly that this is the appropriate time to take bold action to reform Japanese corporate governance in order to better protect the interests of shareholders and to restore both domestic and international investor confidence in Japanese corporations.

We recognize that the Proposal contains several positive measures such as the additional requirements for a director to be deemed to be an outside director. However, taken as a whole, we believe that the Proposal will be completely ineffective in achieving the objectives of improving corporate governance and restoring investor confidence because:

- the Proposal mandates only a single independent outside director (or none at all), which is entirely insufficient, from both a legal and psychological standpoint, to materially influence decision-making on a company's board of directors and is unlikely to prevent malfeasance of the type leading to recent scandals;
- The Proposal allows persons related to important business counterparties and subsidiaries of the parent company of the listed company, who may have interests in the listed company that differ substantially from those of other shareholders, to serve as “outside” directors and “outside” company auditors; and
- the Proposal fails to implement a legal mechanism allowing and encouraging key decisions to be determined by a “special committee” or “special board” comprised solely of independent outside directors in cases where inside

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directors have an inherent self-interest that conflicts with the interests of shareholders.

Furthermore, we have grave concerns that the Proposal, by creating the illusion of meaningful change purporting to address current public concerns regarding corporate governance, will actually hinder future, more positive changes.

Summary Recommendations:

The ACCJ recommends the following specific changes to Japanese law and regulation with respect to all listed companies¹ in Japan:

- (a) amend the Company Law to require that at least one-half of the members of the board of directors be independent outside directors;
- (b) amend the Company Law, consistent with global best practices, to require that persons serving as outside directors and outside company auditors (1) not be employees or other related persons of another company that has a significant business relationship with the listed company and (2) not be employees or other related persons of a subsidiary of the listed company's parent company;
- (c) add detailed rules to the Company Law and/or the Financial Services Agency (FSA) regulations to require each listed company to: (i) identify which, if any, directors or director nominees fit the definition of independent outside director; (ii) for each director or director nominee that is identified as independent, disclose any transactions or relationships that were considered by the company's board of directors in determining that the director is independent; and (iii) disclose the company's policy with regard to director training, both with respect to training of executive directors before nomination, and continuing education of all directors;
- (d) amend the Company Law to permit a board of directors to formally delegate decision-making authority on specific matters to a "special board" comprised entirely of independent outside directors, along the lines of Article 373 of the Company Law; and
- (e) where no such "special board" consisting solely of at least three independent outside directors is utilized with regard to specified types of board resolutions where the risks of self-interest and conflicts of interest are inherently high, amend the Company Law to shift the burden of proof to the board of directors with regard to satisfaction of its duty of due care and duty of loyalty.

¹ For purposes of our recommendations, a "listed company" means any company that currently has no "transfer restrictions" on its shares and was listed on a stock exchange at any point during the previous three years.

Background and Analysis

The Need for Independent Outside Directors

The predominance of insider directors on the boards of directors of Japanese public companies creates significant risk that inherent self-interest and conflicts-of-interest can reduce corporate value, especially because such situations do not fit within the narrow definition of “conflict of interest” under Japanese law. For instance, decisions with respect to control of the company (including an MBO), nomination of directors and compensation of directors, and special investigations of suspected malfeasance by internal board members inevitably carry significant risks of bias by insider directors, which greatly concern investors and other stakeholders.

There is ample and persuasive evidence that the presence of independent outside directors contributes to corporate value, including in Japan. Research by Professor Takuji Saito of Kyoto Sangyo University demonstrates that the introduction of outside directors into all-insider boards at Japanese listed companies significantly improves firm performance and the quality of forward earnings estimates, and that investors’ reaction to the introduction of outside directors is significantly positive.² And it is also clear that such benefits derive from the election of *independent* directors rather than of just “outside” directors who are not independent. Studies by Professors Abe and Jung (2004)³ and Mr. Irie and Professor Noma (2008)⁴ indicate that only the presence of independent outside directors – those without significant ties to the company, its company’s majority shareholder or its bankers – shows a positive correlation to the company’s performance.

In 2005, in the “Corporate Value Study Group” report (the “CVSG Report”) endorsed by both METI and the MOJ, Japan adopted the so-called “Delaware model” of corporate governance, because as a policy decision it opted in favor of board-centric systems where a company’s board of directors has discretion to decide matters affecting corporate control, such as takeover defenses. However, Japan did not adopt the most crucial element of that “Delaware model” which ensures that corporate value is maintained and maximized: that is, a) incentives and requirements for independent outside directors who can serve as neutral decision-makers on those matters for which intense managerial self-interest exists; and b) legal infrastructure allowing – and requiring – boards to delegate certain decisions to committees composed solely of such independent directors.

² Takuji Saito, Boards with and without Outside Directors: An Empirical Comparison (working draft), pp. 4-6.

³ Naohito Abe and Taehun Jung, Cross-Shareholdings, Outside Directors, and Managerial Turnover: The Case of Japan, August 2004, p. 5.

⁴ Kazuhiko Irie and Mikiharu Noma, Shagai-Yakuin no Dokuritsusei to Kigyo Kachi-Gyoseki (Independence of Outside Directors and Corporate Value/Financial Performance), *Keiei-Zaimu Kenkyu*, Vol. 28, No. 1 (2008), pp. 51-52.

The failure to include independent outside directors as a component of Japanese corporate governance resulted in boards establishing informal “special committees” or “third-party committees” comprised of non-directors to consider and make recommendations on key corporate decisions, such as the introduction of takeover defenses and the sale of corporate control. As described more fully below, these extra-legal committees are not subject to legal liability, and therefore raise significant issues concerning director liability and accountability to the company’s shareholders.

Over the past 20 years, the concept of mandating requirements and incentives for the use of independent outside directors has ceased to be mainly a U.S. phenomenon. Following the 1992 Cadbury Report and the European Commission’s 2004 Recommendation of the Role of (Independent) Non-Executive or Supervisory Directors, the vast majority of major economies – both developed and developing - around the world have implemented systems requiring or encouraging the use of independent outside directors. For instance, a 2010 report by the Asian Corporate Governance Association, “Rules & Recommendations on the Number of Independent Directors in Asia” describes independent director requirements (whether in “hard law” or “soft law” such as corporate governance codes) in China, Hong Kong, India, Korea, Malaysia, the Philippines, Singapore and Taiwan.

However, Japan has significantly lagged with respect to adopting this “essential other half” of the legal model of corporate governance (the “Delaware model”) that it adopted in 2005. The Tokyo Stock Exchange’s (TSE) recent listing rule requiring one board member to be “independent” is a start, but, inasmuch as it allows statutory auditors (who cannot vote) to fulfill this role and only requires one such person, it does not even come close to being a satisfactory method for addressing issues of managerial self-interestedness and potential conflicts of interest.

The Requirements for Independent Outside Directors and Outside Company Auditors

The Proposal indicates that further consideration is necessary to determine whether related persons of a subsidiary of the listed company’s parent company or related persons of a significant business counterparty should be allowed to serve as outside directors and outside company auditors. Such persons may have interests in the listed company that differ substantially from those of public shareholders, and therefore should not qualify as independent outside directors or outside company auditors. For example, an employee of a significant business counterparty or a subsidiary of a parent company may desire to maintain or increase the amount of business with a listed company or to preserve the status quo rather than maximizing corporate value for all shareholders. Although Proposal’s requirement that an outside director and an outside company auditor not be a related person of the listed company’s parent company is a step in the right direction, the failure to also disqualify related persons of the parent company’s subsidiaries is not consistent with international best practices, allows the requirement to be easily circumvented and is a distinction of form rather than substance.

The Need for Legally Valid Committees or “Special Boards”

In order that independent directors can perform their expected role, we recommend amendment of the Company Law so as to allow companies with boards of directors to formally delegate

decision-making authority on specific matters to a board committee comprised of elected directors, including a legally valid committee or “special board” comprised solely of independent outside directors.

This feature is essential in order for independent directors to be effective. It is especially important because: a) clearly, it is not appropriate for inside directors (managers) to be present and watching at all times when certain decisions are made, whereas they can be called as observers to the committee, at its discretion; b) committees or special boards make better, more prudential decisions when the spotlight of legal liability risk is focused upon their members rather than shared with all other directors; and c) there are major questions about the legal validity and position of the “third-party committees” comprised of non-directors that with increasing frequency are being appointed to advise boards of Japanese companies concerning takeover defense plans, special investigations, MBOs and a range other matters. Under the Company Law, unlike directors, the members of such “committees” owe no duty of due care to the company and cannot be sued by shareholders.

Under current Japanese law: (a) both “third-party committees” and “special committees” are extra-legal – there exists no legal basis for the creation, composition or administration of such committees; (b) a board of directors is not legally allowed to delegate board decision-making to outsiders or even to a committee comprised of directors; (c) even when directors sit on such committees, it is unclear whether they are acting in their full capacity as directors, bearing full fiduciary duties such as would make them subject to shareholder lawsuits, or whether the committee has some special status, allowing it to sue and be sued, or to be immune from suit. Furthermore, non-directors cannot be sued in shareholder derivative lawsuits at all.

Based on this present legal reality, the ACCJ believes that the CVSG Report correctly stressed that the ultimate responsibility for decisions concerning defenses or takeovers resides with all directors on the board, and that under current law this is a fundamental duty that cannot be shifted to any other person or persons, or smaller group of directors. Furthermore, the CVSG Report correctly points out that “it is necessary to effectively guarantee independence from management” and that the role of independent outside directors is very important.

However, this ultimate responsibility of the board can only be reconciled with the importance of independent judgment if the board is statutorily enabled to create and delegate decision-making authority to board committees or “special boards” that are comprised entirely of independent outside directors.

In implementing changes to the Company Law necessary to allow a company to create such legally valid special committees comprised of independent outside directors, the ACCJ recommends that the Ministry of Justice look to the framework that it has already established in Article 373 of the Company Law. Article 373 authorizes a company to establish a “Special Board” of three or more directors selected in advance from the full board to vote to approve sales or purchases of significant assets or significant borrowings. Meetings convened under Article 373 are considered actual meetings of the board of directors subject to all of the normal procedures, including the taking of minutes, the presence of statutory auditors and formal voting.

Article 373 is a convenient basis for amendments to the Company Law enabling boards to establish the equivalent of legally authorized special committees of independent outside directors.

Shifting Burden of Proof to Interested Directors.

As noted above, the ACCJ strongly supports a mandatory requirement that all Japanese public companies appoint independent directors constituting at least one-half of the board of directors. In order to ensure that board decisions with respect to which managers have an inherent conflict or self-interest are decided solely by such independent outside directors, we recommend shifting the burden of proof from shareholder plaintiffs to defendant directors in connection with shareholder derivative claims alleging that a director breached his or her duty of due care in approving such board decisions, unless such decision was made by a “special board” comprised solely of independent outside directors. This change should be accompanied by an amendment permitting a board of directors to formally delegate decision-making authority on specific matters to a “special board” comprised entirely of independent outside directors, along the lines of Article 373 of the Company Law.

The board decisions subject to this rule should include: (a) matters relating to the compensation of board members, (b) the nomination and/or recommended termination of board members and statutory auditors, (c) approval of material transactions with affiliated parties (such as majority shareholders), and (d) decisions relating to the control of the company, such as resolutions to adopt takeover defenses or to recommend or approve extraordinary transactions such as mergers, share exchanges, MBO's or other transactions resulting in de-listing or loss of liquidity to the public shareholders, and (e) any other matters in which any directors participating in the board's decision have material self-interest at stake, such as investigations of board member malfeasance.

If these decisions are approved by a special board comprised solely of independent outside directors, the business judgment rule would apply in the normal fashion and a plaintiff alleging that the decision resulted in damages to the company would bear the burden of proof to show a breach of fiduciary duties. If the decisions are approved by a board including directors who are not independent and if the plaintiff shareholder demonstrates that the damages resulted from the board's decision, the directors who voted for the decision would be required to demonstrate that they fulfilled their duty of care and duty of loyalty in connection with such decision. In short, those directors would be held accountable for explaining their decision without requiring the plaintiff to succeed in the nearly impossible task of acquiring full information and facts about an internal board decision. (This task is especially difficult in Japan because there are very few effective discovery methods that can be used, either before or during a trial.)

Shifting the burden of proof to directors in respect of decisions not approved by disinterested independent outside directors is a tested approach in Delaware, the most common jurisdiction in which U.S. public companies are incorporated. It is part and parcel of the “Delaware Model” which Japan purportedly adopted in 2005.

As in Japan, most actions by a Delaware corporation's board of directors are protected by the “Business Judgment Rule”. Under the Business Judgment Rule, actions by a board of directors will be protected by the courts unless the plaintiff stockholder can prove by a preponderance of

the evidence that the directors' decision involved a breach of fiduciary duty. In decisions where directors have a material interest in the decision (such as a personal financial benefit in a transaction that is not available to all stockholders), the decision will not be protected by the Business Judgment Rule and the burden of proof shifts to the interested director to show that the transaction was entirely fair, unless the decision is made by a committee of independent outside directors or where a majority of the board's directors is independent and disinterested.

We note this heightened standard of care under Delaware law just as an example – we are not at this time proposing that Japan adopt a similar higher standard. Here, we are merely proposing shifting the burden of due care in certain cases, while keeping the existing standard of due care at its present “low” level.

We believe that our proposal would protect shareholders from board decisions improperly influenced by management conflict or self-interest while simultaneously providing an incentive to Japanese public companies to voluntarily appoint independent outside directors.

The ACCJ appreciates the opportunity to comment on the Proposal. If you have any questions regarding our comments on the proposed rule, please contact the ACCJ External Affairs Department at 03-3433-7358 / external@accj.or.jp.

Sincerely,

American Chamber of Commerce in Japan