

Urgent Recommendations Concerning Corporate Governance

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Keidanren
(Japan Federation of Economic Organizations)

The issue of corporate governance in Japan is now the subject of widespread discussion of various sorts. In order to maintain and strengthen their international competitiveness into the twenty-first century in the context of an age of megacompetition, Japanese businesses must realize a form of corporate governance that meets global standards.

Corporations are working on a regular basis to improve their management efficiency and to implement policies giving greater priority to stockholders interests, but in addition they are now expected to achieve corporate governance that is effective in firmly establishing corporate ethics and ensuring sound management. This requires consideration of such matters as the proper shape of corporate organs, the way in which they exercise restraint on each other, and the arrangements for checks on management.

Some corporations are already taking appropriate steps to deal with these concerns. As their example indicates, it is possible even within the existing legal framework for individual organizations to take the initiative in responding and carrying their reforms. At Keidanren, however, we are deeply disturbed by the recent string of corporate scandals, and we therefore wish to recommend a strengthening of the function of corporate auditors and a review of the system of shareholder derivative lawsuits as measures to be implemented soon to deal with the issue of corporate governance. Our recommendations, which take into account the framework of the present Commercial Law and the history of its revisions to date, are as follows:

1. Strengthening of Auditors' Function

The Commercial Law has already been revised to strengthen the authority of corporate auditors. However, the function of auditors cannot be said to be in full play, because their independence from the board of directors and the solidity of their status have not been secured. It is therefore necessary to carry out the following improvements, directed in principle at all companies listed on domestic stock exchanges or registered for trading on the over-the-counter market.

1. Stricter requirements concerning outside auditors

Under the existing Commercial Law, an auditor must "be a person other than a director, manager, or employee of the corporation or subsidiary thereof or those in such position during five years immediately before assuming the post of the auditor". This provision should be changed to exclude anyone who has ever been a director, manager, or employee of the corporation or a subsidiary thereof.

2. Increase in number of outside auditors

The present requirement that there be at least one outside auditor should be strengthened to a requirement that when auditors are appointed, at least half must be outside auditors.

3. Board of auditors' consent to proposal of new auditors.

The board of directors should obtain the consent of the board of auditors to its proposal for the appointment of new auditors before submitting it to the meeting of shareholders for approval.

4. Explanation of midterm resignations of Auditors

If an auditor resigns before the end of his or her term of office, the board of auditors should be

required to give an explanation directly to shareholders at the meeting of shareholders.

5. **The following measures are also desirable in order to enhance auditing by certified public accountants (CPAs):**
 - Strengthening of coordination between CPA auditors and regular auditors;
 - Rotation of responsible CPAs within auditing corporations; and
 - Peer reviews conducted by separate CPAs.

2. Review of Derivative Lawsuit System

When the Corporation Law was amended in 1993, the court fees for shareholder derivative lawsuits were changed (lowered in effect), but there has been no overall review of the system since it was introduced in 1950, and it now has a number of shortcomings.

Review is required in the following areas:

1. **Standing requirement of the plaintiffs**
 - Plaintiffs should be required to have corporate stocks at the time of the occurrence of material facts giving basis of cause of action.
 - Other condition of standing requirement of the plaintiffs should be subjected to future consideration.
2. **Involvement of corporations on the side of defendant directors**

In order to reflect the judgment of the corporation (shareholders in general) in derivative lawsuits, it should be permitted for corporations to intervene in the action or offer support for the defendant directors, provided the board of auditors gives its unanimous approval. The system should also be revised to allow courts to dismiss suits on the basis of unanimous motion from the board of auditors. Along with these changes, the period of 30 days allowed for consideration (by the board of auditors) after a date of complaint from plaintiff shareholder(s) should be extended to 60 days.
3. **Directors' liability**

Corporations should be allowed to include provisions in their articles of incorporation setting the maximum amount for directors' personal liability for damages to the corporation. It should also be made possible to discharge or lighten directors' liability in specific cases with a special resolution at the meeting of shareholders (proposal of such resolution should be submitted to the meeting of shareholders by the board of auditors with approval of all the auditors).
4. **Business Judgment Rule**

The business judgment rule that has been commonly adopted in the United States should be explicitly included in Japanese law.
5. **Others**

Consideration should also be given to amendments of the law to deal with (a) reimbursement of legal expenses incurred by defendant directors who win their cases, (b) settlement of derivative lawsuits, and (c) statute of limitation and inheritance of directors' liability.

3. Initiatives by Corporations

1. Corporations should formulate their own guidelines for corporate behavior and strive to achieve full compliance with them.
2. Measures should be considered to invigorate the functioning of the board of directors.
3. Auditors should be permitted to attend major management or executive meetings when they request to do so.

4. Future Issues

Keidanren will continue to consider the following issues:

1. The proper functioning of the board of directors;
 2. Review of the operation of general meetings of shareholders; and
 3. Other
Positioning of other corporate stakeholders vis-a-vis each other and shareholders; and measures to improve disclosure.
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