[Translation]

February 28, 2008

Role of Governance Codes in Corporate Governance

Seiichi Ochiai

1. Introduction

(1) Purpose of this Speech

It is a pleasure to have been given a chance to talk today about the approach to corporate governance in Japan. Specifically, I would like to introduce the New Corporate Governance Principles 2006 published in December 2006 by a nongovernmental organization called the Japan Corporate Governance Forum. I would like to use the Principles to highlight the basic problems with corporate governance that Japan is facing and discuss the attempts to solve these problems. Although the New Corporate Governance Principles 2006 are a proposal for improving Japan's corporate governance, improving corporate governance is a common issue throughout the world and therefore I assume that there may be something in Japan's approach that could also provide ideas on these issues in your countries.

(2) About the Japan Corporate Governance Forum

First, let me introduce the Japan Corporate Governance Forum. The Forum is a private nonprofit academic research group established in October 1994 and its purpose is to research matters regarding corporate governance and to make proposals for improvement. There are currently approximately 250 individual members and 20 corporate members of the Forum. Since the Forum is a research organization in which academics and business people cooperate, it has adopted a system whereby, a person from the academic and a person from the business world are respectively elected to co-chair the board of directors and jointly supervise the conduct of the organization. The current co-chairman from the business world is Mr. Kakutaro Kitashiro, the Senior Advisor of IBM Japan, Ltd. and I am the co-chairman from the academic world.

The Forum has already published three Corporate Governance Principles as the result of research, in May 1998, October 2001, and December 2006. At the time the Forum was established, the term "corporate governance" was not yet widely known in Japan, and it can be said that the activities of the Forum have contributed to the popularization of the term. I believe that the proposals of the Corporate Governance Principles made by the Forum in such environment have massively impacted the academic and business world. The 2001 Principles proposed the establishment of three committees within boards of directors, which are: the nominating committee, the compensation committee, and the audit committee. I believe that this proposal prompted the introduction of the committee-type governance system in Japan through the revision of the Commercial Code in 2002.

The New Corporate Governance Principles 2006, which I will talk about today, are the most recent Principles which take into consideration the circumstances arising

after the passing of the Companies Act in 2005, and respond to such circumstances. As you may appreciate from the handout, they do not just propose principles for corporate governance, but they also indicate specific guidelines for publicly-traded firms.

I would like to mention at this point that the subject of today's speech is corporate governance of publicly-traded firms. That is to say, firms which do not trade their shares on the market are outside the scope of today's topic. This is because there is a significant difference in governance between publicly-traded firms and closely-held firms. Separate examination of each is necessary, but there is no time to examine both today.

(3) Meaning of Corporate Governance

I have already used the term "corporate governance" many times today, however, a question arises regarding what the term "corporate governance" means. In the first place this term has several meanings and is used in various ways. In this speech, I would like to use the term with the meaning, "what a company's internal structures should be organized, in order to ensure that the management of joint stock companies is conducted efficiently and fairly." The reason I use the term with this particular meaning is that this is the most appropriate understanding of the term when fully taking into account its relationship with the governance regulations in the Companies Act, and also because it corresponds with the purpose of this speech.

2. Role of Governance Codes

(1) Hard Law and Soft Law

When thinking about corporate governance, soft law such as social norms and customs are also important in addition to the hard law, which is the Companies Act, a statute. Compared with hard law which is supported by the coercion of the governmental authorities, soft law is not backed by such coercion. However, soft laws are rules which we are generally expected to act in accordance with, and if there are acts done in violation of soft law, social sanctions will generally be imposed. For example, we are forced to pay checks at restaurants under a hard law, but it is a soft law rule that we should leave tips.

(2) Governance Principles as a Soft Law

Corporate governance principles which are proposed by private groups, and which I will talk about today, are categorized as soft law. However, the effects of corporate governance principles or corporate governance codes varies from country to country.

For example, the UK Combined Code is not a statute but it is practically enforceable to a certain extent against listed firms through stock exchange rules. If the Code is not complied with, the firm in question is required to explain why (this is called the "comply or explain" principle). The German Corporate Governance Code introduced by Article 161 of the German Stock Corporation Act (Aktiengesetz) in

2002 has a similar effect. These codes are soft laws, but it can be said that they are still backed by practical coercion.

In contrast, the Corporate Governance Principles of the Japan Corporate Governance Forum are not supported by any listing rules or statutes. The Principles are optional rules suggested by a private group, and merely appeal for autonomous adoption by each company. There is a nongovernmental organization which is newer than the Japan Corporate Governance Forum and which has similar influence. The organization is the Japan Association of Corporate Directors. This is a research group, rather than an academic group, composed of directors of listed companies, however, it published the Governance Best Practice Code for Companies with both a Board of Directors and Board of Corporate Auditors in August 2005. This code is similar to the Forum's Governance Principles in that it appeals for optional adoption.

The Tokyo Stock Exchange also published the Principles of Corporate Governance for Listed Companies. You might imagine that they are similar to the UK Combined Code, but actually, they are not similar at all. The Principles list five principles: (i) the rights of shareholders; (ii) the equitable treatment of shareholders; (iii) the relationship with stakeholders in corporate governance; (iv) disclosure and transparency; and (v) the responsibilities of the board of directors, auditors or board of corporate auditors, and other relevant group(s). However, these respective principles are very short, and merely express general and somewhat vague concepts. In other words, they described at a high level of generality. Therefore, they cannot be regarded by publicly-traded firms as specific guidelines for their governance. Thus they are very different from the UK Combined Code in this regard. The Principles of Corporate Governance of the Tokyo Stock Exchange are a statement of general and abstract principles and lack concreteness. So, it can be said that the "comply or explain" principle is not applied to listed companies of the Tokyo Stock Exchange with respect to these Principles.

(3) Governance Principles' Effectiveness as a Soft Law

Accordingly, you might think that, taking into account that the Corporate Governance Principles are soft law, any coercion behind the Principles of the Japan Corporate Governance Forum would be weak indeed. However, I believe that they have significant influence.

The first reason for this belief is that the provisions of the Japanese Companies Act of 2005 are stipulated very flexibly in order to enable companies to identify corporate governance suitable for each company's individual circumstances, and therefore it is common that there are no explicit provisions even on important matters regarding governance. For example, as I will mention later on, the Act does not include explicit provisions on, for example, the purpose of corporate governance, independence of directors, and defense measures against hostile takeover bids. Without explicit provisions, such matters must be decided by each company. It is a frequent practice that the Corporate Governance Principles of the Japan Corporate Governance Forum is referred to when companies decide such matters.

The second reason is that, as I mentioned before, the stock exchanges in Japan merely indicate self-evident general principles, and does not provide any detailed guidelines on governance that listed firms are specifically required to "comply" with

or to "explain." Due to this situation, publicly-traded firms inevitably require guidelines to refer to when deciding about their corporate governance. The principles or codes prepared by groups which are highly regarded and which take practical matters of business into consideration and, such as the Japan Corporate Governance Forum or the Japan Association of Corporate Directors in particular, understandably have significant influence even on business. These proposals are not issued from ivory towers.

The third reason is that if publicly-traded firms in practice refer to the Governance Principles, the matters stipulated therein may be deemed a *de facto* standard of governance, and if they are a *de facto* standard, the courts will take them into consideration. That is to say, the guidelines described in the Governance Principles will be referred to by the courts when deciding on the specific substance of a directors' fiduciary duty to the company.

In a word, I believe that the Corporate Governance Principles of the Japan Corporate Governance Forum can be regarded as a soft law of Japan.

3. Purpose of Corporate Governance

(1) Shareholders or Other Stakeholders?

Now, I would like to look at the substance of the Governance Principles more specifically. The first point to mention is the purpose of corporate governance. That is to say, who is corporate governance for? This point is commonly discussed with respect to the following question: is corporate governance for shareholders, or should the interests of stakeholders other than shareholders also be taken into consideration?

It is often noted in such discussions that in the U.S. corporate governance system, shareholders' interests are treated as first priority, and in contrast, in Japan or in Germany, the interests of stakeholders other than shareholders are also taken into consideration. In fact, in Germany, governance has a Two-tier System composed of a Supervisory Board and a Management Board. The Supervisory Board, which has the right to elect and dismiss the directors, consists of the representatives of employees and management, with equal numbers from both sides, and therefore, employees' participation in management is ensured by hard law. It can be said that it is guaranteed that the interests of stakeholders other than shareholders will be taken into account, especially the interests of employees.

In Japan, it is different. Japan basically has a One-Tier System of governance consisting of a board of directors, and employees' participation in management is not provided for by hard law. However the law does not prohibit such involvement, so if employees' participation in management is desirable, it would have been optionally adopted by each company. Having said that, it is rare to find examples of companies that have directors who are employee representatives, and I have heard no argument made that the German-style system should be introduced in Japan.

(2) The Stance of the Governance Principles

Now let us take a look at what kind of guidelines the Governance Principles provide with respect to this point. If you look at Article 1.2 of the General Rules, entitled the "Purpose of the Company," the purpose is increasing the long-term value of the company. The article's explanation then notes that increasing the long-term shareholder profits do not conflict increasing stakeholders' profit. It is not clear whether the Principles make shareholder profits first priority, but if you look at the last sentence of the Article explanation, it says that when conflicts actually occur between long-term shareholder profits and the interest of other stakeholders, the former is given preference. Furthermore, Article 1.1 says that the mechanism for corporate governance should be designed to ensure the responsibilities entrusted to company officers by shareholders are fulfilled, and this means that, as a whole, the Governance Principles adopt a standpoint that puts shareholder profits as first priority.

Actually, there was an extensive discussion regarding this expression within the Forum. There was a conflict between two opinions: one insisted that, since the stance of putting shareholder profits in first priority was clearly expressed in the 2001 Governance Principles, such clear expression should be maintained in the 2006 Principles as well. The other insisted that it is appropriate to use a milder expression as the new guidelines regarding CSR and the role of employees were to be introduced for the first time. However, this conflict is a matter of semantics. The view of the Forum is that corporate governance is for shareholders.

(3) Social Responsibility (CSR)

Corporate Social Responsibility (CSR) is emphasized in Japan as well as in other countries. Accordingly, the Forum decided that it is necessary and beneficial to indicate guidelines on how to treat CSR in corporate governance.

There are provisions in Articles 1.1.1 and 1.1.2 in the General Rules. Article 1.1.1 provides that companies' compliance with laws and social norms is part of CSR. Article 1.1.2 provides that business activities shall be conducted taking into consideration the profits of stakeholders such as creditors, employees, consumers, clients, governments, regional communities, as well as shareholders. Such reference to taking into consideration stakeholder profits with respect to CSR is a new concept which was not included in the past published Principles.

The guidelines regarding CSR may be considered to cover self-evident matters. However, a difficult problem lies behind this; that is, a question about which parties should be given priority when conflicts occur between the profits of shareholders and stakeholders other than shareholders, and such conflicts cannot be resolved. This problem is ruled by the guidelines regarding the purpose of corporate governance, which I mentioned before, so the shareholder profits should have priority.

(4) The Role of Employees

The Principles also provide guidelines on the role of employees. These guidelines were also not included in the former Principles. To increase the value of the

company, the role of employees is important and therefore the Forum intends to provide for their role.

There are provisions regarding this in Article 2.6 of the Detailed Rules of the Principles. The provisions state that employees have a role in contributing to the improvement of the management of the company, and are required to play an active role. Needless to say, the provisions do not refer to employees' participation in management.

4. Outside Directors

The Japanese Companies Act of 2005 allows publicly traded companies to adopt either a governance structure, centered on a board of directors and a board of statutory auditors or a structure, centered on a board of directors and three committees. The former governance structure may, but are not required to, have outside directors on the board. The latter governance structure must abolish the board of statutory auditors and establish committees of the board for audit, nomination and compensation. Each committee must have at least three members, a majority of whom are outside directors. However, the Companies Act's definition of outside director does require an outsider's involvement, but does not compel independence. Being an outsider means that the person has not and is not engaged in the execution of the business as an officer or employee of the company or its subsidiaries. Independence from the influence of the CEO is not included in the requirements of 'outsider.

Although independence from management is necessary to enable directors effectively monitor the management, including the CEO, on behalf of shareholders, the Companies Act does not require such measures. However, companies with a board of statutory auditors and companies with committees may of course autonomously appoint independent persons in order to reinforce the monitoring of the management. The Principles therefore suggest in Article 2.3 of the Detailed Rules that when inviting outside directors into the company, they should be persons of independence. In addition, as a way to make the monitoring conducted by independent directors effective, apart from electing multiple outside directors, a meeting of only by the outside directors is required. The Article's explanation also insists that a so-called lead outside director should also be appointed.

5. Defense Measures against Hostile Takeover Bids

(1) Hostile Takeover Bids in Japan

Nowadays, hostile takeover bids are not unusual in Japan. The hostile takeover bid case for Nippon Broadcasting System, Inc. made by Livedoor Co., Ltd. in 2005 became popular amongst the public, with the aid of the unique character of Mr. Takafumi Horie, the then representative director of Livedoor with the famous nickname "Horiemon." As a result, terms such as "poison pill" and "white knight" are now widely used in everyday life. In 2006, there was a case involving a takeover bid by Steel Partners Japan Strategic Fund (Offshore), L.P. of Bull-dog Sauce Co., Ltd. This case became the first court case decided by the Supreme Court of Japan regarding defense measures against hostile takeover bids.

If management is not managing the company in a way which increases its value, it is disadvantageous not only to the shareholders, creditors, employees, and other stakeholders of the company, but also for Japan's economy. Therefore, hostile takeover bids are advantageous and should be made easy to conduct only if they replace the incompetent management and increase the value of companies. However, hostile takeover bids which decrease the value of a company must be restrained. That is to say, defense measures against hostile takeover bids damaging the value of the company should be accepted.

(2) Case Law regarding Hostile Takeover Bids

The problem is, how should the legal rules for triggering defense measures be stipulated? This problem arises from the lack of explicit provisions regarding defense measures against hostile takeover bids in the Japanese Companies Act of 2005. The Companies Act is a legislation which modernized the Japanese company system to a great degree, but since it was not passed in a context where threats of hostile takeover bids were imminent, it was not discussed at all at the Companies Act Modernization Sectional Meeting of the Legislative Council, where modernization was discussed, and which I attended as a member. Therefore, this is a matter of interpretation, and the final decision on the propriety of defense measures is to be made by the court.

According to the case law regarding hostile takeover bids, I assume that the attitude of the courts is to attach importance to the following two factors. The first factor is that the defense measures and their trigger are subject to the shareholders' intent. The second factor is that the defense measures do not damage the fair and proper interests of the shareholders.

With respect to the court attaching importance to the shareholders' intent, which I mentioned as the first factor, it may be understood that the approval of the shareholders' meeting is required not only at the point of the introduction of the defense measures, but also at the point they are triggered. This understanding is underpinned, in particular, by the Supreme Court decision concluding that the Bull-dog Sauce's defense measures, the introduction and trigger for which were approved by special resolution of the shareholders' meeting, were legal. However, it is unclear whether it always has to be special resolutions of shareholders' meetings and whether other types of resolutions are accepted.

The protection of shareholders' fair and proper interests, which I mentioned as a second factor, is emphasized in the Nireco Corporation case, and the scope of the shareholder interests to be protected seems significantly broad. Although the Supreme Court decision on the Bull-dog Sauce case indicates that the fact the bidder is put at a disadvantage compared to other shareholders is not necessarily a breach of the shareholder equality principle, it is still unclear what level of economic disadvantage to a bidder will be tolerated, setting aside the dilution of the number of voting shares owned by the bidder. With respect to the defense measures in the Bull-dog Sauce case, Bull-dog Sauce purchased the shares held by Steel Partners, the hostile bidder, at a price equivalent to that which the bidder proposed at the TOB against Bull-dog Sauce. It means that the hostile bidder could gain a huge amount of profit even if his hostile bid was rejected. Therefore it is said that Bull-dog Sauce gave money to the "thief" who tried to steal from you. As a legal argument, the subject to be discussed henceforth is to what level should the company indemnify a hostile bidder who is likely to damage the value of the

company, against economic loss when the company triggers takeover defense measures.

(3) Guidelines on Defense Measures in the Principles

With respect to defense measures against hostile takeover bids, the first guideline of Article 3.2 of the Detailed Rules of the Principles, insists upon the establishment of an independent third party committee and that must examine whether the value of the company will be damaged or whether it is appropriate to trigger defense measures. This is based on the idea that an examination by an independent third party committee is essential to prevent the current management from triggering defense measures for the purpose of protecting their own interests. The second guideline in the same article, states that defense measures may not be triggered against hostile takeover bids that increase the value of the company, and that sufficient explanation to shareholders is required upon introduction of defense measures.

The Principles adopted the stance that, with regard to defense measures against hostile takeover bids, defense measures may be triggered by the board of directors alone, but to prevent the current management from triggering such defense measures for the a purpose of protecting their own interests, it is essential to make reference to the decision of a third party committee. This stance can be inferred from the explanation of the second guideline in Article 3.2 which says that the shareholders' intent should be respected but it is not necessary to obtain approval of the shareholders' meetings. In a word, the guidelines on defense measures in the Principles basically adopted a stance similar to that which the courts of the State of Delaware in the United States take.

However, it seems as the Japanese courts attach extreme importance to shareholders' intent indicated through the shareholders' meeting for the reason that it is shareholders that select the management, and their stance is that they basically do not accept an American-style trigger of defense measures which is conducted by the board of directors alone. This stance is similar to the European Takeover Directive in 2004 which impose a duty of strict neutrality on the board of directors of the target company, and in the case where defense measures are taken, they require the approval of the shareholders' meeting. The Japanese company law moved closer to the American legal system through the modernization in 2005. However, the courts' stance is closer to the European law regarding the trigger of defense measures. I think that further examination is necessary to decide whether there is a consistency between the court's standpoint and the system established by the Companies Act in 2005. I believe that, in order ensure that independent directors are established in Japan as well, the stance which the Principles take should be promoted.

6. Closing

Today, I have examined some important problems regarding corporate governance in Japan by using the recently published Governance Principles of the Japan Corporate Governance Forum. International competition on a global basis is intensifying, and each country is endeavoring to develop competent companies and to establish attractive investment markets and Japan is certainly no exception. It

is necessary to make various efforts to ensure the governance of publicly-traded firms. I hope this speech was of a little help to you. Thank you for listening.