The Corporate Governance Review

Thirteenth Edition

Editor
Will Pearce

The Law Reviews

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PREFACE

Over the past 40 years, corporate governance rules applicable to publicly traded companies have developed around the world, building on the basic corporate law framework governing the relationship between a company, its directors and its shareholders. These rules have taken a different form and legal status depending on the jurisdiction in question, usually ranging from mandatory compliance, or voluntary compliance with mandatory regular public disclosure of non-compliance, through to simple voluntary compliance with best practice or investor expectations.

In general terms, a common framework for corporate governance rules now seen across many jurisdictions comprises some combination of mandatory compliance with corporate law and stock exchange rules (the former focused on substance and the latter focused on disclosure) and voluntary compliance with guidance or best practice recommendations from national or supranational accounting or governance bodies or organisations representing investors.

Initially, corporate governance rules – led in large part by action taken by the Securities and Exchange Commission in the US, following the collapse of Penn Central in 1970 and other corporate scandals of the 1970s and 1980s, and by the publication of the UK's Corporate Governance Code by the Cadbury Committee in 1992 – focused on best practice recommendations for the composition of public company boards (including the important role of independent non-executive directors); the role, responsibilities and composition of board committees; and, in the UK, the separation of the roles of CEO and chair.

Driven by accounting scandals, audit failures and a perceived lack of checks and balances on the risk taken by public company boards, including the collapse of Enron, which declared bankruptcy in 2001, corporate governance rules sought to strengthen the powers and expectations of and oversight exercised by audit committees and the role of internal audit, notably through the adoption of Sarbanes-Oxley in the US in 2002.

Over the 15 years that followed, investor focus switched to the risks taken by and rewards offered to executive management, ultimately resulting in a number of jurisdictions adopting some form of 'say-on-pay' regime to help guard against outsized compensation packages driving excessive risk-taking. Investors also demanded greater gender diversity on public boards, with a consensus view emerging that a more balanced board would offer better decision-making and improved long-term stewardship of public companies for the benefit of all investors. Having made significant progress on gender diversity, a similar approach (with industry-set targets for representation and regular public disclosure of progress) has been adopted in a number of jurisdictions to help progress ethnic diversity.

Most recently, the 'g' of governance has been joined by the 'e' of environmental and the 's' of social, with traditional governance teams at investors now expecting public companies to take a more holistic ESG approach to business. This has driven a number of jurisdictions

to require mandatory disclosure by public companies on environmental issues; the pay gap between executive management and the 'average' employee; and sustainability, supply chain and modern slavery issues.

To assist public companies, advisers and market participants alike, who are seeking to navigate this ever-evolving landscape, we are delighted to present the 13th edition of *The Corporate Governance Review*.

In this edition, we have included chapters covering 21 different jurisdictions. Each chapter provides an overview of the applicable corporate governance regime, roles and responsibilities of directors, details of required public disclosures of corporate governance-related matters, the rules of engagement with shareholders and the extent to which a public company can defend a takeover, together with an update of recent and forthcoming developments.

While every author has taken care to make this review comprehensive, up to date and accurate as at the publication date, please remember that each chapter provides only a summary and overview of a large body of law, regulation and market practice. If readers wish to explore specific issues that are of interest or pertinent to them, we suggest they seek detailed advice from suitably experienced counsel. Contact details for the authors are set out at the end of this review.

Finally, thanks to all of the authors, my colleague Sophie Vacikar Bessisso and Emily Wolfin at *The Law Reviews* for helping to pull together this edition.

Will Pearce
Davis Polk & Wardwell London LLP
London
April 2023

Chapter 11

JAPAN

Mitsuhiro Harada, Tatsuya Nakayama and Takuma Kanasaki[1]

I OVERVIEW OF GOVERNANCE REGIME

i Sources of law and enforcement

In general, companies in Japan are regulated by the Companies Act.[2] Listed companies are also regulated by the Financial Instruments and Exchange Law (FIEL)[3] and the Securities Listing Regulations (SLRs) published by each securities exchange. In publishing these regulations, the securities exchanges generally follow the SLRs published by the Tokyo Stock Exchange (TSE), which is the largest securities exchange in Japan. For this reason, the information we provide hereafter focuses on the regulations published by the TSE, and references to 'SLRs' are to the TSE regulations.

In the event that a company violates the Companies Act, depending on the specific provision that is violated, shareholders or creditors of a company are generally entitled to bring a lawsuit against the company. The Financial Services Agency of Japan (FSA) is responsible for enforcing the FIEL and, depending on the specific provision that is violated, may levy monetary fines or prison sentences, or both, in connection with certain violations thereof. SLRs are enforced by the specific securities exchange that published the applicable regulation. Violations of the SLRs generally lead to the securities exchange requiring that the company submit an improvement plan. In extreme cases, securities exchanges may even delist the shares of the company.

ii Nature and recent developments in the corporate governance regime

The Companies Act, which has been in effect since 2006, allows a company some flexibility with its governance organisation, such as whether to have a board of directors and whether to have a corporate auditor. Revisions to the SLRs on 30 December 2009, however, require a listed company to have one or more independent directors or corporate auditors (i.e., outside directors or corporate auditors (as defined below) who are not likely to have a conflict of interest with the company's shareholders). If an independent director or corporate auditor has business or other relationships with the company (e.g., if the director or corporate auditor is a main business partner, consultant or a major shareholder of the company), this relationship must be disclosed, and the reasons why the person was appointed as an independent director or corporate auditor must also be provided in the company's corporate governance reports

1 Mitsuhiro Harada and Tatsuya Nakayama are partners and Takuma Kanasaki is a senior associate at Nishimura & Asahi.

2 Act No. 86 of 26 July 2005.

3 Act No. 25 of 13 April 1948.

under the SLRs. On 5 February 2014, the TSE announced a revision to the SLRs requesting that listed companies make efforts to elect at least one independent director because, in practice, most listed companies had elected an independent corporate auditor. Further, the Companies Act reform bill, which was enacted on 1 March 2021, requires a large public company[4] with a board of corporate auditors that is obligated under the FIEL to file a securities report to have one or more outside directors.

In addition, the TSE released Japan's Corporate Governance Code (the Code) on 1 June 2015, which was most recently revised on 11 June 2021.[5] The Code, which is applicable to all companies listed on securities exchanges in Japan, establishes fundamental principles for effective corporate governance, including a structure for transparent, fair, timely and decisive decision-making by companies, which pay due attention to the needs and perspectives of shareholders and those of customers, employees and local communities. The Code stipulates that companies listed on the Prime Market[6] should appoint at least one-third of their directors as independent directors (two directors if listed on other markets), and companies that have a controlling shareholder should either appoint at least one-third of their directors (the majority of directors if listed on the Prime Market) as independent directors who are independent of the controlling shareholder or establish a special committee composed of independent persons, including an independent director or directors, to deliberate over and review material transactions or actions that conflict with the interests of the controlling shareholder and minority shareholders.

There were essentially two types of governance systems in Japan prior to enactment of the Reform Act of 2015: a company with a corporate auditor and a company with committees.[7] In a company with a corporate auditor, the corporate auditor is an organisation that audits the directors' execution of their duties. This type of organisation is the primary type of company in Japan. On the other hand, in a company with committees (without a corporate auditor), three stipulated committees perform auditing and monitoring functions: a nominating committee that decides on the agenda of nominating or dismissing directors at shareholders' meetings; an audit committee that audits the execution of duties of executive officers and directors; and a compensation committee that determines compensation for each executive officer and director.

4 Under the Companies Act, a 'large company' means one with either stated capital in the balance sheet at the end of the most recent fiscal year of ¥500 million or more or total liabilities as at the end of its most recent fiscal year of ¥20 billion or more. In addition, under the Companies Act, a 'public company' means a company, typically listed, whose articles do not require, as a feature of all or part of its shares, the company's approval for any transfer of those shares, whether it is a company with a corporate auditor, a company with an audit committee or a company with committees.

5 The Corporate Governance Code is available at www.jpx.co.jp/english/equities/listing/cg/tvdivq0000008jdy-att/20210611.pdf.

6 The TSE adjusted its market segments (the new market segments include the Prime Market, Standard Market and Growth Market, whereas the former market segments included the 1st Section, 2nd Section, Mothers and JASDAQ) on 4 April 2022. The TSE explains that the Prime Market is for companies with highly liquid shares and high levels of governance that are committed to sustainable growth (and medium- to long-term improvement of corporate value) centring on constructive dialogue with investors.

7 Following enactment of the Reform Act of 2015, companies with committees are now called companies with nominating committee, etc., but the meaning of the term is unchanged. As a matter of convenience, we hereinafter refer to this type of company as a 'company with committees'.

Each of these committees must have three or more directors as a member, a majority of which must consist of outside directors. In a company with committees, because a board may delegate substantial parts of its decision-making authority over the management of the company to the executive officers, the board is expected to monitor the execution of the executive officers' duties rather than to make decisions (although a director can serve concurrently as an executive officer). This type of organisation was introduced in 2003 and is used by only a limited number of large companies in Japan (roughly 4 per cent of the companies listed on the Prime Market of the TSE as at August 2022).

The Reform Act of 2015 introduced another type of governance structure – a company with an audit committee – anticipating that this structure makes it easier for Japanese companies to select a monitoring model involving outside directors. A reduction of costs for selecting the monitoring model is achieved by decreasing the number of outside directors and outside corporate auditors. A company with an audit committee is not required to possess a nominating committee or a compensation committee. The audit committee must have three or more directors as members, and the majority of them must be outside directors. The number of companies with an audit committee has been increasing, and as at August 2022, roughly 39 per cent of the companies listed on the Prime Market of the TSE adopt this type.

II CORPORATE LEADERSHIP

i Board structure and practices

Structure and composition

Japanese companies generally use a one-tier board structure. Under the Companies Act, although a company may choose not to have a board of directors, the typical form of management structure is a company with a board of directors that has decision-making authority.

A company with a board of directors is required to have three or more directors. A company with committees and a company with an audit committee must also have a board as well and is therefore required to have three or more directors. No director is required to be a representative of the employees of the company.

Legal responsibilities

Except for a company with committees and a company with an audit committee, a company with a board of directors generally must have a corporate auditor. In a company with a corporate auditor and a board of directors, the board has decision-making authority over the management of the company, and representative directors and other executive directors are responsible for executing the company's management decisions. The corporate auditor generally audits the execution of duties by directors, with a view to compliance with law.

In a company with committees, although the board may have decision-making authority over the management of the company, it usually delegates substantial portions of this authority to executive officers, and executive officers are responsible for executing company management decisions. Accordingly, for example, executive officers may be delegated the authority to decide on the acquisition of important assets, incurrence of significant debt, appointment of important employees and establishment of important organisational changes, whereas these are matters that would be determined by a board of directors in a company with a corporate auditor. The board of a company with committees would then, inter alia, determine the agendas of shareholders' meetings, approve competitive activities and activities that result in conflicts of interests of directors and appoint committee members. The audit

committee audits the execution of duties by executive officers and directors with a view not only to compliance with the applicable laws but also to the appropriate performance of their duties.

In a company with an audit committee, the core role of the board of directors is to set the basic management policy, develop the internal control system and supervise the execution of business by other directors, including representative directors and other executive directors. Although important business decisions, such as disposing of or acquiring important assets, are required to be made by the board of directors, its shareholders can, through the company's articles, enable the board to delegate these decisions to individual directors, such as representative directors or other executive directors. In addition, if the majority of the board is held by outside directors, the board can delegate these decisions to individual directors, such as representative directors or other executive directors.

Delegation of responsibilities

In a company with a corporate auditor and a board of directors (which is typical of Japanese companies), the board often delegates decisions on certain matters regarding day-to-day operations to individual directors, such as representative directors or other executive directors. However, the board may not delegate certain important company matters to individual directors, including:

a disposing of or acquiring important assets;
b incurring significant debts;
c electing or dismissing important employees, including managers;
d issuing shares at a fair price; and
e approving audited financial statements.

In a company with committees, the nominating, audit and compensation committees each have their own authority under the Companies Act and cannot further delegate substantial parts of their responsibilities. Apart from the committees' responsibilities, the board has sole decision-making authority over the management of the company with respect to certain matters, which include basic management policy, matters necessary for the execution of the audit committee's duties and, if there are two or more executive officers, matters relating to the interrelationship between executive officers.

Similarly, in a company with an audit committee, the audit committee has its own authority and cannot further delegate a substantial part of its responsibility. Apart from the audit committee's responsibility, the board has sole decision-making authority over the management of the company with respect to certain matters, which include basic management policy and matters necessary for the execution of the audit committee's duties.

A board of directors in a company with committees often delegates decision-making authority over the management of the company to the executive officers (as described above). However, the board may not delegate certain important matters (in addition to the above-mentioned matters) to executive officers (or to individual directors, because each individual director who does not double as an executive officer in a company with committees generally does not have decision-making authority), including:

a holding of shareholders' meetings;
b appointment or removal of committee members;
c election or dismissal of executive officers; and
d determining the terms of agreements for mergers, demergers or share exchanges.

In a company with an audit committee, although important business decisions, such as disposing of or acquiring important assets, are required to be made by the board of directors, its shareholders can, through the articles, enable the board to delegate these decisions to individual directors, such as representative directors or other executive directors. If the majority of the board is made up of outside directors, the board can also delegate these decisions to individual directors, such as representative directors or other executive directors.

A board typically appoints a chief executive officer (CEO) or the equivalent from among its representative directors (in a company with a corporate auditor and a board of directors and a company with an audit committee) or representative executive officers (in a company with committees). Generally, the CEO will chair board meetings and will perform the role of chair of the board in this sense.

Remuneration of directors and executive officers

In a company with a corporate auditor and a board of directors, the aggregate amount of remuneration of all directors is determined at a shareholders' meeting (if not provided in the articles), and the board determines the remuneration of each director within the parameters of this aggregate amount; the board can delegate this authority to an individual director, typically the CEO. The same would apply to a company with an audit committee. In addition, in a company with an audit committee, the audit committee is given the power to express its view on the election, dismissal, resignation and compensation of other directors at the shareholders' meeting so that the shareholders can make an informed decision on these matters. The Companies Act reform bill, which came into force on 1 March 2021, requires:

a a large public company with a board of corporate auditors that is required under the FIEL to file a securities report; and

b a company with an audit committee to establish the company's policies for determination of the remuneration for each director, except when the remuneration for each director is determined by a shareholders' meeting or the articles.

However, in a company with committees, the compensation committee determines the remuneration of each director and executive officer in accordance with the remuneration policy prescribed by the committee (therefore, shareholders' approval is not required).

A public company must disclose the aggregate remuneration of all its directors, corporate auditors and executive officers to its shareholders in its business report.[8] In addition, a listed company must disclose the following information in its securities report:

a the amount of remuneration and a breakdown by type of payment (e.g., fixed compensation, performance-based compensation, non-monetary compensation or retirement payment) for each director, corporate auditor and executive officer, if his or her remuneration for the relevant fiscal year is ¥100 million or more (of the 2,355 companies whose fiscal year ends at the end of March and that were listed as at 30 June 2022, 663 directors, corporate auditors or executive officers received ¥100 million or more as remuneration for the fiscal year ending March 2022);

8 The Ordinance for Enforcement of the Companies Act reform bill, which came into force on 1 March 2021 to improve the level of disclosure regarding the remuneration of directors, corporate auditors and executive officers, requires public companies to disclose in their business reports roughly the same items that listed companies must disclose in their securities reports (as detailed in the following sentence).

b an explanation of the company's policies for determining an amount of or calculation method for remuneration of directors, corporate auditors and executive officers;

c for a company that pays directors, corporate auditors or executive officers performance-based compensation, an explanation of the company's policies on the payment ratio of performance-based compensation and non-performance-based compensation (if any), indicators for performance-based compensation and reasons why the company chose those indicators, how the amount of performance-based compensation was determined, the targets and performance for the indicators in the most recent fiscal year, and the contents of non-monetary compensation if the performance-based compensation includes non-monetary compensation;

d the name of a person or organisation who has the authority to determine an amount of or calculation method for remuneration of directors, corporate auditors and executive officers, an explanation of that authority, including the range of discretion, and for a company with a board of directors (excluding a company with committees) whose board of directors actually delegates to a director or other person the authority to determine all or a part of the remuneration of each director (excluding a member of an audit committee) for the previous fiscal year:
- that fact;
- the name, position and charge of the person as at the date of determination;
- the contents of the delegated authority;
- the reason for the delegation; and
- the contents of measures taken to ensure the delegated authority is exercised properly (if any); and

e for a company with a committee, including an optional committee, that involves the establishment of company policies for determination of an amount of or calculation method for remuneration of directors, corporate auditors or executive officers, an outline of procedures for involvement of the committee and activities of the board and the committee in the course of determination of an amount of remuneration of directors, corporate auditors and executive officers in the most recent fiscal year.

The Code stipulates that, in addition to making information disclosure in compliance with relevant laws and regulations, listed companies should disclose and proactively provide information regarding their boards' policies and procedures for determining the remuneration of senior management and directors to enhance transparency and fairness in decision-making and ensure effective corporate governance.

Board and company practice in takeovers

The typical anti-takeover measure listed companies use has been a 'precaution-type anti-takeover measure',[9] whereby a company announces a takeover process rule but does not issue any securities at first. Although there are many variations of this measure, generally, a company announces in advance a certain takeover process rule to the effect that a takeover bidder must provide sufficient information to a board of directors about itself and the terms of its bid before the beginning of its takeover, and the bidder refrains from purchasing the shares of the company unless the board of the company completes its analysis of the terms of

9 The Code stipulates that anti-takeover measures must not have any objective associated with entrenchment of the management or the board.

the bid (albeit that the analysis by the board must be completed within a certain period, such as 60 days). If these procedures are respected by the bidder, the board will not implement anti-takeover measures, but if the board decides that the value of the company would be damaged, or maximising value would be difficult under the takeover (including if the bidder does not comply with the procedures), usually based on analysis by an independent committee, certain anti-takeover measures may be implemented, typically the issuance of share purchase warrants free of charge to all shareholders that cannot be exercised by the bidder.

The *Bull-Dog Sauce* case[10] was the first in which actual share purchase warrants were issued to shareholders as an anti-takeover measure. The Supreme Court found that the decision regarding whether control by a specific shareholder would harm the value of the company or damage the common interests of shareholders should ultimately be determined by the shareholders who hold its corporate value, and that if, at a shareholders' meeting, the shareholders decide that the takeover would harm the value of the company or damage the common interests of the shareholders, that decision should be respected. In this case, because the issuance of share purchase warrants was approved by more than 80 per cent of the voting rights, the Supreme Court found that the issuance was valid.

The total number of listed companies that have adopted anti-takeover measures has decreased for 14 consecutive years (from 570 at the end of July 2008 to 271 at the end of November 2022). However, as discussed below, attempts at hostile acquisitions and anti-takeover measures triggered under the situation of hostile acquisitions have been increasing in Japan.

ii Directors

Appointment, nomination and term of office

Directors are elected by a resolution at a shareholders' meeting. In a public company with a corporate auditor and a board of directors, the board generally nominates directors to two-year terms of office, as a maximum. In a company with committees, the nominating committee nominates directors with one-year terms of office (as a maximum). Further, in a company with an audit committee, a director who is a member of the audit committee must be nominated separately from the other directors, and the statutory maximum term of office for a director who is a member of an audit committee is two years, whereas for other directors it is one year.

Directors can be dismissed at any time by a resolution at a shareholders' meeting. Directors can seek damages for dismissal if they are dismissed without justifiable grounds.

Liability of directors

Generally, directors must perform their duties with the duty of care of a prudent manager in a loyal manner in compliance with all laws and regulations, the articles and resolutions of shareholders' meetings.

In addition to the foregoing, the business judgement rule in Japan is applied when considering whether a certain decision of a director complies with the director's duty of care as a prudent manager to the company. Under the business judgement rule, even if a director has made a certain decision that has resulted in damage to the company, the director is deemed, in principle, to have complied with his or her duty of care of a prudent manager,

10 Supreme Court, 7 August 2007.

unless the director made important and careless mistakes in the recognition of facts, or the process and content of the director's decision-making is particularly unreasonable or improper as determined by a management expert. Nevertheless, the courts are not likely to apply the business judgement rule if it can be shown that the director has a conflict of interest.

In the *Apamanshop* case,[11] the business judgement rule was affirmed by the Supreme Court. Apamanshop Holdings bought out the subsidiary's minority shareholders at a price per share higher than that set forth in the valuation report to make the subsidiary its wholly owned subsidiary. The Court cited the business judgement rule in finding that the directors of Apamanshop Holdings did not breach their duty of care, because a smooth purchase of the minority shareholders' shares was beneficial in maintaining good relationships with Apamanshop's member shops, which were shareholders of Apamanshop; the corporate value of the subsidiary after the restructuring was expected to increase; and the decision-making process employed by Apamanshop's directors (i.e., the management committee convened to discuss the purchase and a legal opinion was obtained) was not found to be unreasonable.

The holding of directors' and officers' liability insurance policies[12] is a widespread practice; however, the Companies Act used to have no specific provision in this regard, and the procedure for conclusion of these types of insurance policies was not sufficiently clear. The Companies Act reform bill, which came into force on 1 March 2021, established the procedure for conclusion of these insurance policies (i.e., approval of a shareholders' meeting or, for a company with a board of directors, approval of the board of directors).[13]

Further, in Japan, a common view is that a company may indemnify the losses or expenses of its directors and officers (which are limited to the liability they assume in these roles); however, the interpretation of the applicable limitations on and procedures for this indemnification had not been explicit. The Companies Act reform bill established rules under which companies:

a need to obtain approval of a shareholders' meeting (or approval of the board in companies with a board of directors) to decide the contents of any agreements to be executed for such an indemnification; and

b may indemnify their directors and officers against expenses incurred in defending an action involving their liability as directors and officers even if they were aware of wrongdoing or grossly negligent in performing their duties.

However, a company may not indemnify its directors and officers against losses arising out of payment of compensation or settlement money to a third party involving their liability as directors and officers if those directors and officers were aware of wrongdoing or grossly negligent in performing their duties.[14]

11 Supreme Court, 15 July 2010.

12 Strictly speaking, 'directors and officers' in this paragraph and the next means directors, corporate auditors, executive officers and accounting auditors.

13 In addition, the Ordinance for Enforcement of the Companies Act requires public companies to make a disclosure regarding any directors' and officers' liability insurance policies that they conclude (e.g., an outline of the contents of these types of insurance policies) in their business reports.

14 In addition, the Ordinance for Enforcement of the Companies Act reform bill requires public companies to disclose any such adopted indemnification (e.g., an outline of the contents of an agreement on such indemnification) in their business reports.

Role and involvement of outside directors

'Outside directors' are defined under the Companies Act as directors who are not serving and who have not previously (generally for the past 10 years) served as executive directors, executive officers or employees (including managers)[15] of the relevant company or any of its subsidiaries and who are not serving in these positions at its parent companies or its sibling companies. As for the number of outside directors required for each organisational structure, see Section I.ii ('Nature and recent developments in the corporate governance regime').

The Code stipulates that if the organisational structure of a company is either that of a company with a corporate auditor and a board of directors or that of a company with an audit committee, and independent directors do not constitute a majority of the board, to strengthen the independence, objectivity and accountability of board functions in matters of nomination (including succession plans) and remuneration of senior management and directors, the company should seek appropriate involvement and advice from an optional nomination committee and an optional remuneration committee[16] in the consideration of such important matters.

Legal duties and best practice for outside directors

The legal duties of non-executive directors, including outside directors, are generally the same as those of other directors or executive officers. Where provided for in a company's articles, however, the company may contractually limit the liability (to the company) of its non-executive directors, including outside directors who are not aware of the wrongdoing and are not grossly negligent in performing their duties to the extent of the larger of both an amount determined in advance, within the range provided in the articles, and an amount equal to double their annual remuneration.

Outside directors generally should review the performance of management, conflict of interest issues, the process and propriety of management decisions and general compliance, and work to improve the corporate culture. Although other directors should take on these roles as well, outside directors are expected to do so more effectively because of their objective position.

Many companies in Japan have organised independent committees to audit or review conflict of interest issues, such as management buyout transactions, internal investigations and anti-takeover measures, and an outside director is often included as a member of the committee. The Ministry of Economy, Trade and Industry formulated the Fair M&A Guidelines in June 2019, which stipulate that, in principle, if independent outside directors exist, it is advisable to select members of a special committee[17] from among those directors.

15 Spouses or relatives within the second degree of kinship of executive directors, executive officers, important employees (including managers) or majority shareholders (in the case of natural persons) are not regarded as outside directors either.

16 In particular, the Code stipulates that companies listed on the Prime Market should basically have the majority of the members of each committee be independent directors and should disclose the mandates and roles of the committees, as well as the policy regarding independence of their composition.

17 Under the Fair M&A Guidelines: Enhancing Corporate Value and Securing Shareholders' Interests, a 'special committee' is defined as a deliberative body that is voluntarily established as an independent organ to supplement or substitute for the role that the target company's board of directors is originally expected to perform when structural conflicts of interest may affect the independence of the target company's board of directors and there is a risk that the goals of increasing corporate value and securing the interests of general shareholders may not be properly reflected in the process of formulating transaction terms.

Almost all of the special committees established recently in management buyout transactions or acquisitions of controlled companies by controlling shareholders include outside directors as members, respecting the Fair M&A Guidelines.

In a company with a corporate auditor and a board of directors, a company with committees or a company with an audit committee, if a director intends to carry out any transactions involving a conflict of interest, approval must be obtained at a board meeting in which that director may not participate. At the board meeting, the potentially conflicted director must disclose material facts about the transaction. After the transaction, the director must also report material facts about the transaction to the board without delay.

In addition, in a company with an audit committee, an *ex ante* approval by the audit committee of a self-dealing transaction between a director and the company has the effect of switching the burden of proof regarding the violation of a director's duty from the director to the plaintiff shareholders.

iii Auditors

In a company with a corporate auditor, the corporate auditor audits the execution of the directors' duties, including preparation of financial statements. If a company has a board of corporate auditors, the company is required to have three or more corporate auditors, and half or more of them must be outside corporate auditors. To ensure the independence of corporate auditors, their term of office must continue until the conclusion of the annual shareholders' meeting for the most recent fiscal year ending within four years of their election.

A company with committees does not have a corporate auditor. Instead, an audit committee that consists of directors whose terms of office are one year (as a maximum) audits the execution of directors' duties, including preparation of financial statements (see Section II). Similarly, a company with an audit committee does not have a corporate auditor. In a company with an audit committee that consists of directors whose terms of office are two years (as a maximum), the audit committee is responsible for auditing the execution of directors' duties, including preparation of financial statements.

In addition, a large company and a company with committees are required to have an accounting auditor, which must be either a certified public accountant or an audit firm. An accounting auditor's term of office must continue until the conclusion of the annual shareholders' meeting for the most recent fiscal year ending within one year of his or her election.

To ensure the independence of corporate auditors, the following are given the power to determine the contents of proposals regarding the election and dismissal of accounting auditors to be submitted to a shareholders' meeting: a corporate auditor or a board of corporate auditors in a company with a corporate auditor, an audit committee in a company with committees and an audit committee in a company with an audit committee.

III CORPORATE DISCLOSURE

i Financial reporting and accountability

A representative director or representative executive officer must prepare financial statements within three months of the end of each business year. A large company that is required to file a securities report under the FIEL (e.g., a listed company) must prepare consolidated financial

statements under the Companies Act. However, the FIEL requires all listed companies to prepare a securities report that includes consolidated financial statements (unless they do not have any subsidiaries to be consolidated under the FIEL), as well as a quarterly report.

Under the Companies Act, a company with a board of directors must provide its financial statements and business reports to its shareholders by:

a attaching these documents to the convocation notice of its annual shareholders' meeting; or

b posting these documents[18] on its website electronically three weeks or more before its annual shareholders' meeting or the circulation of the convocation notice, whichever comes earlier.

The provision of financial statements and business reports to shareholders through a website is compulsory for a listed company, and if a shareholder requests that a company provide hard-copy financial statements and business reports, that company must provide some of these documents in hard-copy format.

In addition, under the FIEL, a listed company is required to file its securities report within three months of the end of its fiscal year.[19]

ii Communications with shareholders

Under the Companies Act, directors, corporate auditors and executive officers must sufficiently explain the specific issues concerning the agenda of a shareholders' meeting if an enquiry is made by a shareholder at the shareholders' meeting. To improve investor relations, Q&A sessions during shareholders' meetings are now actively encouraged in Japan. Furthermore, Japanese listed companies often hold informal meetings with investors about financial statements and related issues.[20]

IV CORPORATE SOCIAL RESPONSIBILITY / ESG

i Internal control

Boards of large companies must develop internal control systems that ensure that directors comply with the laws and the articles and that company operations are appropriate. However, there is no legal requirement for internal control systems for companies that are not categorised as large companies, excluding companies with committees and companies with an audit committee.

Additionally, in a company with committees, regardless of its size, the board must develop internal control systems that ensure that executive officers comply with the laws and

18 In this case, reference documents for shareholders' meetings are also required to be provided electronically.

19 Under the reformed disclosure rule of the FIEL, which will apply to listed companies whose fiscal year ends on or after the end of March 2023, listed companies are required to disclose certain information, including the overview of agendas of their governance bodies (i.e., board of directors or other aforementioned committees) in their securities reports.

20 The Code stipulates that listed companies should, proactively and to the extent reasonable, respond to requests from shareholders to engage in dialogue so as to support sustainable growth and increase corporate value in the mid to long term and that the board should establish, approve and disclose policies concerning the measures and organisational structures aimed at promoting constructive dialogue with shareholders.

the articles and that company operations are appropriate. A listed company must file internal control reports that describe the systems that are in place to ensure that the financial reports of the company are properly made in compliance with the laws.

Similarly, in a company with an audit committee, regardless of its size, the board must develop internal control systems that ensure that directors comply with the laws and the articles and that company operations are appropriate.

Specific contents of internal control systems may be decided at the discretion of companies. In its internal control rules, a company often provides for general matters concerning the control of information and documents, crisis management systems, necessary internal rules and organisations, and compliance programmes, among other things.

Under the Whistleblower Protection Act, the employer of a whistle-blower is prohibited from treating the whistle-blower in any disadvantageous manner, such as by demotion, salary reduction or refusal to pay retirement allowance, if this is in response to the employee's whistle-blowing.[21]

ii Corporate social responsibility to employees and wider society

A company in Japan is required to hire a certain number of persons with a disability and to take measures to continue to employ elderly persons under affirmative action-related laws. Activities concerning corporate social responsibility by some companies involve actions to be taken in the interests of their stakeholders, such as preserving the environment, supporting volunteer work and creating jobs, although these are not generally required by law.

iii ESG

Reflecting a growing interest in environmental, social and governance (ESG) in Japan, the Code stipulates that the board should recognise that dealing with sustainability issues, such as taking care of climate change and other global environmental issues, respect of human rights, fair and appropriate treatment of the workforce (including caring for their health and working environment), fair and reasonable transactions with suppliers and crisis management for natural disasters, are important management issues that can lead to earning opportunities as well as risk mitigation and that the board should further consider addressing these matters positively and proactively in terms of increasing corporate value in the mid to long term.[22]

In addition, the Code stipulates that:

a companies should appropriately disclose their initiatives on sustainability when disclosing their management strategies;[23]

b they should also provide information on investments in human capital and intellectual property in an understandable and specific manner, while being conscious of consistency with their own management strategies and issues; and

21 The Code stipulates that as a part of establishing a framework for whistle-blowing, companies should establish a point of contact that is independent of management and that internal rules should be established to ensure the confidentiality of the information provider and prohibit any disadvantageous treatment.

22 The Code also stipulates that the board should develop a basic policy for the company's sustainability initiatives from the perspective of increasing corporate value in the mid to long term.

23 Furthermore, under the reformed disclosure rule of the FIEL, which will apply to listed companies whose fiscal year ends on or after the end of March 2023, listed companies are required to disclose their positions and initiatives on sustainability, such as governance and risk management regarding sustainability, goals and strategies for sustainability, and strategies for human capital (e.g., diversity) in their securities reports.

c in particular, companies listed on the Prime Market should collect and analyse the necessary data on the impact of climate change-related risks and earning opportunities on their business activities and profits and enhance the quality and quantity of disclosure based on the Task Force on Climate-related Financial Disclosures recommendations, which are an internationally well-established disclosure framework, or an equivalent framework.

V ENGAGING WITH SHAREHOLDERS

i Shareholder rights and powers

Voting rights

In general, a company must treat its shareholders equally depending on the class and number of shares owned; therefore, each voting share has the same voting right. The Companies Act does allow for the following exceptions, however: certain minority shareholders' rights, such as rights to propose an agenda for a shareholders' meeting, to inspect accounting books and to apply to a court for dissolution of the company, and different treatment for each shareholder in closed companies in terms of rights to dividends or distribution of residual assets, or voting rights at shareholders' meetings pursuant to the articles.

In a company with a board of directors, matters provided for in the company's articles and the Companies Act may be resolved at a shareholders' meeting. In the sense that each director must observe resolutions passed at shareholders' meetings, shareholders have an influence on the board.

Under the Companies Act, shareholder approval is required for certain matters, including the following:

a amending the articles;

b mergers, corporate demergers, statutory share exchanges, statutory share transfers, assignment of business and reduction of stated capital;

c election or dismissal of directors and corporate auditors; and

d decisions regarding dividends of surplus (if a company has an accounting auditor and a board of corporate auditors or committees, however, and the term of office of its directors is no more than one year, the authority to determine the distribution of dividends of surplus can be delegated to the board by the articles).

Rights of dissenting shareholders

Shareholders who object to the proposed agenda specifically listed under the Companies Act, such as certain amendments to the articles and certain mergers and acquisitions, may demand that the company purchase their shares at a fair price. This price will be determined through negotiation between the parties (i.e., the company and the dissenting shareholders) or by court decision. If a demand is made and the parties are unable to reach an agreement with regard to the share price within 30 days of the effective date, either the dissenting shareholders or the company may file a petition to a court for a determination of a fair price within 30 days of the expiry of the initial 30-day period.

In the *Tecmo* case,[24] the Supreme Court presented a framework for determining a fair price under appraisal proceedings if a joint share transfer (in which two or more companies form a new holding company under the Companies Act) creates synergies. In this decision, the Court found that:

a a fair price should, in general, be the value that the share should have had on the date on which the shareholder made a demand to the company for the repurchase of the share, on the assumption that the share transfer ratio designated in the share transfer plan is fair; and

b if a share transfer comes into effect through procedures that are generally recognised as fair, the share transfer ratio should be seen as fair unless special circumstances existed that hindered the shareholders' ability to make reasonable decisions in the shareholders' meeting.

ii Major shareholders' duties and practice

There are no specific duties of controlling shareholders to companies or other minority shareholders under the Companies Act. In an extreme case where a controlling shareholder abuses a company or other minority shareholders (e.g., a transaction with the company involving extremely unfair consideration or a squeeze-out of minority shareholders at an extremely low price), it may be liable for the abusive acts under the Civil Code or other laws, although there are no clear-cut standards for this type of case. Under the SLRs, if a listed company conducts certain transactions with its controlling shareholder, such as issuing shares or conducting mergers or business alliances, the company must obtain an opinion from a third party who is independent of its controlling shareholder that the transaction would not undermine the interests of minority shareholders of the company.

iii Shareholder activism

Derivative actions

Under the Companies Act, a shareholder can demand that the company file an action to pursue, inter alia, directors or corporate auditors for their liabilities to the company if the shareholder has held shares of the company for the preceding six consecutive months or more. If the company does not file an action within 60 days of receipt of the demand from the relevant shareholder, the shareholder can file an action on behalf of the company.

Further, multiple derivative actions are allowed, subject to certain conditions, in which, inter alia, a director or corporate auditor of a company might be sued by a shareholder of the company's ultimate wholly owning parent company,[25] as long as, inter alia, the shareholder owns 1 per cent or more of the total voting rights or outstanding shares of the ultimate parent company and the book value of the shares of the company constitutes more than 20 per cent of the total assets of the ultimate parent company as at the date of occurrence of the underlying events that gave rise to relevant obligations of the director or corporate auditor.

24 Supreme Court, 29 February 2012.

25 The company that directly or indirectly owns 100 per cent of the shares of the 'subsidiary' company but that is itself not a wholly owned subsidiary of any other company.

Proxy battles

The FIEL stipulates the rules for proxy fights in listed companies. Under the FIEL, a shareholder or the company that solicits a proxy must provide the other shareholders with a certain set of documents (including a proxy and reference materials that set forth the agenda). It is generally considered to be difficult for a shareholder to embark on and succeed in such a proxy fight, mainly because the shareholder does not know the agenda of the shareholders' meeting until the convocation notice is sent by the company. In the past, because the Companies Act could be interpreted as allowing companies to refuse to provide the names, addresses and other information of other shareholders to a shareholder who wishes to solicit the proxy if the bidder is or works for a competitor of the company, the bidder could encounter even more difficulties. However, under the current Companies Act, even if the bidder is a competitor of the company, the company may not refuse to provide information about other shareholders for that reason. In this sense, one of the hurdles to a shareholder embarking on a proxy fight has been alleviated.

iv Takeover defences

As described in Section II.i ('Board and company practice in takeovers'), the number of listed companies that adopt anti-takeover measures has dropped slightly for 14 consecutive years; however, attempts at hostile acquisitions have been increasing historically in Japan. For example, in January 2020, City Index Eleventh Co Ltd commenced a hostile takeover bid against Toshiba Machine Co Ltd but withdrew the tender offer in response to anti-takeover measures triggered by the latter's shareholders' meeting. In January 2021, Freesia Macross Corporation commenced a hostile takeover bid against Nippo Ltd but withdrew the tender offer in response to anti-takeover measures triggered by the board of directors' meeting, based on Freesia Macross Corporation's ignoring of procedures set by Nippo Ltd with the approval of the shareholders' meeting, which the Nagoya High Court judged as valid. In February 2021, City Index Eleventh Co Ltd commenced a hostile takeover bid against Japan Asia Group Limited, ultimately successfully acquiring 58.96 per cent in total; in this case, Japan Asia Group Limited triggered anti-takeover measures only by the board of directors, but it withdrew them because the Tokyo High Court deemed them invalid. In April 2021, Aslead Capital Pte Ltd, through its group funds, commenced a hostile takeover bid against Fuji Kosan Company Ltd but withdrew the tender offer in response to anti-takeover measures triggered by the latter's board of directors subject to the approval of its shareholders' meeting, which the Tokyo High Court judged as valid. Furthermore, in June to July 2021, Asia Development Capital Co Ltd and its group fund hostilely acquired shares in Tokyo Kikai Seisakusho Ltd on the market, acquiring 32.72 per cent in total, and attempted to further acquire shares on the market but gave up in response to the anti-takeover measures triggered by the board of directors of Tokyo Kikai Seisakusho Ltd subject to the approval of its shareholders' meeting, which the Supreme Court judged as valid. On the other hand, from September 2021 to March 2022, Adage Capital LLP and its related persons and companies hostilely acquired 21.63 per cent of the shares in Mitsuboshi Co, Ltd collectively, and the anti-takeover measures adopted by Mitsuboshi Co, Ltd were deemed invalid by the Supreme Court considering the disproportionality of the measures. The court judgments on the validity of the anti-takeover measures taken in the above cases differed, and some measures were deemed invalid; attention must be paid to further development of discussions in courts as well as in practice.

v Contact with shareholders

Under the Companies Act, directors, corporate auditors and executive officers must sufficiently explain the specific issues concerning the agenda of a shareholders' meeting if an enquiry is made by a shareholder at the shareholders' meeting. To improve investor relations, Q&A sessions during shareholders' meetings are now actively encouraged in Japan. Furthermore, Japanese listed companies often hold informal meetings with investors about financial statements and related issues.

VI OUTLOOK

The reform of corporate governance, including ESG disclosure in securities reports, is being discussed continuously by the TSE, the FSA and other relevant authorities. In addition, as discussed above, the number of attempts at hostile acquisitions has been increasing historically in Japan, and some remarkable court judgments have been made regarding the validity of anti-takeover measures. This tendency will not only make hostile takeover and anti-takeover measures hot issues but also accelerate discussions on corporate governance in Japan. Corporate governance will continue to be a hot topic in Japan.

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