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31 January 2012

Attention: Ministry of Justice, Japan  
c/o Counselor, Civil Affairs Bureau

*Re: Review of Companies Act – Interim Report*

The CFA Institute Standards and Financial Market Integrity Division and CFA Society of Japan are pleased to comment on the *Review of Companies Act – Interim Report*, put forward by the Ministry of Justice, Japan, on 14 December 2011. The CFA Institute Standards and Financial Market Integrity Division represents the views of investment professionals to regulators and standard setters worldwide on issues that affect the practice of financial analysis and investment management, as well as the integrity of global financial markets. CFA Japan represents close to 900 investment professionals in Japan, and is a member society of CFA Institute.

### **General Comments**

We commend the Ministry of Justice in Japan for addressing the regulatory regime relating to the future of corporate governance in Japan, paying particular attention to the accountability of corporate boards. This area is generally regarded to have room for improvement related to investor protection, and tackling related issues can be expected to lead to an increased level of attraction of the Japanese equity market internationally. The consulting paper demonstrates that the Japanese Ministry of Justice understands not only the ramifications of the current situation but also its urgency, and that the Ministry of Justice is prepared to apply the lessons from the current crisis through proactive regulation. This bodes well for the Japanese government's effort to internationalize its capital markets, especially since a visible improvement in corporate governance practices at firms in Japan is very likely to be associated with higher levels of investor protection.

The Ministry of Justice is correct in identifying board accountability as an important area of reform in Japan. The lack of independent directors on Japanese corporate boards, and the subsequent lack of sufficient board oversight have widely been criticized by global investors as a reason of concern, especially when compared to jurisdictions in Europe or the US. We think that strengthening investor protection mechanisms through the planned reforms will induce board directors to place more emphasis on fulfilling their implied fiduciary duty towards investors.

CFA Institute has repeatedly suggested ways for improvement of governance practices through different means, including the publication of research on issues of corporate governance in Japan. Relevant research can be downloaded from [www.cfainstitute.org](http://www.cfainstitute.org), in English; selected reports are available for download in Japanese from [www.cfasociety.org/japan](http://www.cfasociety.org/japan). With regards to the current

document for which public comments are invited, the following reports published by the CFA Institute may be of particular interest to the Ministry of Justice:

- “Inter-Corporate Network Dealings and Minority Shareholder Protection – Cases in Japan” 「企業ネットワークにおける取引と少数株主保護 - 日本の事例」
- “Asia-Pacific REITs Building Trust through Better REIT Governance” 「アジア太平洋地域の REIT ガバナンスの改善を通じて信頼を築く」
- “Independent Non-Executive Directors – A Search for True Independence in Asia” (not translated into Japanese)
- “The Corporate Governance of Listed Companies: A Manual For Investors, Second Edition” 「上場企業のコーポレートガバナンス 投資家のためのマニュアル第2版 2009年」
- "Shareowner Rights across the Markets: A Manual for Investors" 「世界における株主権の現状 投資家のための手引き」
- “Environmental, Social, and Governance Factors at Listed Companies: A Manual for Investors” 「上場企業の ESG (環境・社会・ガバナンス)要因 投資家のためのマニュアル」
- "Shareholder Rights in Asia: Are Shareholders Flexing Their Muscles to Protect Themselves?" 「アジアにおける株主権 株主は自らの保護に努めているか？」
- “Director Professionalism A Review of Director Training Programs in Asia-Pacific” 「取締役の専門性 アジア太平洋地域における取締役研修の状況」

The CFA Institute Standards and Financial Market Integrity Division and CFA Society of Japan would like to comment on the main item in the document, namely on the introduction of independent directors.

#### **Part 1, Item 1-1: Oversight Function on the Board**

We laud the initiative by the Ministry of Justice to enhance investor protection by making it mandatory for listed corporations to establish an oversight function by means of introducing at least one independent director on the corporate board of listed companies. Throughout the document the Japanese term for “outside director” is used, and at times this term appears to be used in the sense of “independent director”. CFA Institute takes the position that the important point here is not to simply introduce a director from the outside, but an independent director, who in the best case would be free from any kind of conflict of interest.

Of the 3 proposals (i.e. proposal A: make it mandatory for large listed companies with an auditing board to elect at least one outside director; proposal B: make it mandatory for listed companies which are obliged by law to submit an annual report as part of regulatory reporting to elect at least one outside director; proposal C: no change to the existing company act in this regard) we favor proposal B. The reason for this is that regardless of the size of the firm, it would be against the

principle of fairness if investors in one firm would not have the same level of legal protection as in another firm of different size.

In order to improve corporate governance practices at Japanese firms we think that the introduction of at least one independent director is indispensable. We recommend this plan as a first step. To further minimize the possibility of moral hazard on part of management, as evidence in the recent cases of Olympus or Daio Paper, just to name a few, the existence of more than one independent director would be desirable. Although it is difficult to recommend a certain number of independent directors as best practice we believe that more than one independent directors would have more power to act together if they believe shareholder rights are being compromised. In this regard we note that, for example, the minimum number required on a board is two (or 20 percent) in the Philippines, a third in Singapore and India, and at least three in Hong Kong.<sup>40</sup> In fact, India mandates that if the chairman is an executive or a promoter, the proportion of independent directors must increase to at least 50 percent. A majority of independent directors on the board would be considered international best practice.

Moreover, to ensure proper fulfillment of the function of independent director CFA Institute strongly suggests proper training of directors. An induction course introducing new directors to the company, its operations and strategy, as well as the applicable legal and regulatory framework the organization works in is the absolute minimum level of training that should be required. We believe increasing director training to a level at which directors can pursue a formal certification would benefit all stakeholders. Companies are finding it difficult to appoint appropriate directors; establishing a certification program that is well recognized in the region should make it easier for them to identify a qualified pool of directors. If the program is accepted by directors, encouraged by investors, and advocated by regulators, then over time, director education will increase and directors will gain a greater understanding of what it means to be a director. Nomination experts will then have an alternative to the old boys' club, as is typical in a number of jurisdictions, and an incentive from investors and regulators to choose qualified directors. The qualification will strengthen the ethical practices of directors and ultimately benefit investors.

Several institutes of directors (IoDs) in Asia are starting to focus on director education. The Australian Institute of Company Directors (AICD), which is affiliated with the IoD in the United Kingdom, has a well-established Company Directors Course that leads to an internationally recognized qualification. The AICD has recently helped the Thai IoD establish a similar program. The Indonesian Institute of Corporate Directorship and the Philippine Institute of Corporate Directors are also trying to develop a program.

We recommend establishing a director certification program to develop director education and improve the effectiveness of independent directors, as well as the director community in general. There is currently no well-established director qualification in Japan, so it would be a long-term goal for the country, and it will be a good way to build a strong, educated supply base for nomination committees to choose from. Having a formal certification should not be mandatory but, instead, seen as best practice. There is more value in the qualification if it is something people believe they should obtain to be seen as credible rather than being a license that every director needs.

This part of the document focuses on the necessity for independence of an outside director and suggests several ways of limiting potential conflicts of interest with regards to the relationship of an outside director with the parent company. We laud the efforts by the Ministry of Justice to consider reforming the current legal environment by including an outside director's and auditor's relationship with the parent company in the legal framework.

When inviting an outside director to serve on a board great attention must be given to the degree of independence of that person in order to minimize potential conflicts of interest. We believe that an independent non-executive director should NOT:

- be a current or past employee of the company or its subsidiaries,
- be connected to the management/board of the company or its subsidiaries,
- be a substantial shareholder or connected to, or represent, a substantial shareholder,
- represent other interest groups that could exert significant influence (suppliers, customers, creditors, etc),
- be an employee/partner of a professional firm that has a current or past business relationship with the company/subsidiaries or a related party,
- participate in the company's share option or performance-related pay scheme or receive financial assistance from the company/subsidiaries or a related party,
- receive an income from the company other than directors fees,
- have conflicting cross-directorships,
- serve as a independent director for more than the specified length of time

We believe that an independent board director should emphasize independent and objective judgment through:

- a high level of professionalism, integrity, and ethics,
- relevant experience and knowledge that can be shared with the board,
- good communication and interpersonal skills to facilitate board discussion, and
- the ability to ask probing questions and give constructive feedback.

In the case of companies with a committee system in place current legal requirement in Japan call for the majority of committee members to come from the outside. In reality, however, there have been cases in which the majority of committee members were not independent within the framework of the above-mentioned guidelines, and further reform in this regard is desirable.

Regarding the nomination of independent directors we take the position that minority shareholders should play an important role in this process. Minority shareholders should be given sufficient influence over the nomination and election of directors to have an impact. Controlling shareholders effectively have the ability to control the nomination and election of all directors. The nomination process can be improved by first allowing minority shareholders who own a minimum threshold percentage of shares to directly nominate candidates for election and second by introducing cumulative voting.

Cumulative voting, which is not commonly practiced in Asia, allows shareholders to cast all of their votes for one board candidate. For example, if a shareholder owns one million shares, each share is allowed one vote. So, if 10 board members are up for election, that shareholder is able to cast 10 million votes for one director instead of one million votes for each individual director.

Cumulative voting improves the chances of a minority shareholder naming a representative to the board. It can be effective in contested board elections and also useful in uncontested elections because it can be used to increase the number of 'no' votes for a nominee. This recommendation will give minority shareholders a greater voice and will enhance the current nomination and election process for directors in Asia.

Yours sincerely,

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