



Simmons & Simmons

Amendments to the Japanese Commercial Code

Amendment enacted in May 2002,
in force as of 01 April 2003

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Executive summary

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1. Introduction

The most recent "Partial Amendment of the Commercial Code" (the "Amendment") was enacted in May 2002 and came into force on 01 April 2003. Wide-ranging reform of the Commercial Code began in 2001 but, for the time being at least, the Amendment contains the last reforms.

2. Company organisation

The Amendment comprises a broad review of matters relating to the organisation of limited liability companies (*kabushiki kaisha*) (the "Company" or "Companies"). It includes a review of regulations relating to corporate governance, meetings of shareholders, remuneration of directors and the auditing of Company financial statements. The intention of the Amendment in this regard is to introduce more robust rules relating to corporate governance to align Japanese companies with their US and European counterparts and to reduce unnecessary bureaucracy, particularly the procedures relating to shareholders' meetings.

3. Shares

The Amendment develops the share-related provisions introduced in 2002. It includes new regulations allowing Companies to issue different classes of shares with different rights relating to the appointment and dismissal of auditors and directors. It introduces new systems for invalidating share certificates lost by shareholders, procedures for dealing with absent shareholders and purchasing fractional shares in a Company. Once again, these amendments are designed to both reduce the administrative burden on Companies and promote investment in Japan.

4. Financial statements

The power to establish accounting regulations has been delegated to the Ministry of Justice to ensure that the rules relating to the financial management of Companies keep pace with the rapidly-changing business environment. The Amendment also obliges Large Companies (as defined in paragraph 1.1 of Part A herein) to prepare consolidated financial statements in relation to their group companies to achieve fuller disclosure of the information relating to a Company.

5. Others

The Amendment allows a Company to dispense with the valuation process undertaken by a court-appointed inspector relating to the allotment of shares for non-cash consideration provided that such consideration is certified by a lawyer or other professional. The Amendment also clarifies the procedure for effecting a reduction of share capital and legal reserve (which includes capital reserve and profit reserve) and abolishes the obligation on a foreign company to establish a branch office.

Part A: Company organisation

1. Introduction of the new system of committees

1.1 Eligible Companies

Under the provisions of the Commercial Code prior to the Amendment (the "Pre-amendment Code") Companies were required on incorporation to:

- (A) establish a board of directors,
- (B) appoint a representative director, and
- (C) appoint a statutory auditor.

The role of the statutory auditor (kansayaku) is to oversee the Company's business operations and accounts independently of the Company's management. The statutory auditor's role should be distinguished from that of an outside accounting auditor (kaikai kansanin) which may be appointed to audit the Company's accounts.

As a result of the Amendment, the revised Commercial Code (the "Revised Code") provides that the following companies may dispense with the requirement to appoint statutory auditors by providing in their articles of incorporation for the establishment of three committees to supervise the management of the Company:

- (A) a Company with an issued share capital of at least JPY500 million or liabilities of at least JPY20 billion, which is classified as a large company under the Law for Special Exceptions to the Commercial Code Concerning Auditing Etc. ("Large Company"); and
- (B) a Company with an issued share capital of more than JPY100 million where the Company's articles of incorporation provide that the Company will be audited by an outside accounting auditor ("Deemed Large Company").

The Companies adopting the new system are also required to appoint at least one executive officer (shikkoyaku) and one representative executive officer (daihyo shikkoyaku). The role of an executive officer and a representative executive officer is explained in paragraph 1.2 below.

A Large Company or a Deemed Large Company may adopt the new system by making the appropriate amendments to its articles of incorporation. However, if it chooses not to do so, it will continue to be subject to the system under the Pre-amendment Code.

1.2 The committees and executive officers

A Large Company or a Deemed Large Company that chooses to adopt the new committee system under the Revised Code must establish the following three committees:

- (A) a nomination committee – responsible for preparing proposals to be introduced to the Company’s shareholders at a shareholders’ meeting relating to the appointment and dismissal of the Company’s directors;
- (B) an audit committee – responsible for auditing the activities of the directors and executive officers; and
- (C) a remuneration committee – responsible for reviewing the remuneration of the Company’s directors.

Three or more directors must be appointed to each committee by the Company’s board of directors. The majority of the directors appointed to each committee must be external directors¹.

The board of directors of a Large Company or a Deemed Large Company that chooses to adopt the new committee system must also appoint at least one executive officer and one representative executive officer for a term of one year². The representative executive officer represents the

¹ External director means a non-managing director who has not been a director, an executive officer, a manager, or any other employee who managed the corporate affairs of the Company or any of its Subsidiaries at any time in the past and who is not currently a director or an executive officer who manages the corporate affairs of any Subsidiary, nor a manager or any other type of employee of the Company or any of its Subsidiaries.

² The following provision can be included in the Articles of Incorporation, since it does not contravene the law concerning the term of office

Company and runs its business instead of a representative director, as was the case under the old system.

1.3 Separation of the administration and the supervision

Under the new system, executive officers are provided with extensive authority to run the business providing them with greater flexibility and the ability to make decisions more quickly. The board of directors acts as a supervisory body to oversee the conduct of both the individual directors and the executive officers of the Company.

This system has been introduced to separate the running of the Company's business from the supervision of the Company by its board of directors. In order to expand and enhance the supervisory power of the board of directors, Companies are obliged to establish committees comprised of external directors to independently determine matters for which they are responsible. External directors of a Company are not usually engaged in the running of the day-to-day business affairs of a Company. However, directors may carry out such functions if they are also appointed as executive officers of the Company.

1.4 New treatment

Under the Revised Code, if a Company adopts this new system in its articles of incorporation, the supervisory power of the board of directors will be enhanced and the liability of directors and executive officers will be reduced in comparison to the liability of directors under the Pre-amendment Code.

Under the Revised Code, if certain conditions are satisfied, the appropriation of profits approved by the board of directors will be deemed approved by the Company's shareholders at a shareholders' meeting. The Pre-amendment Code allowed this treatment only in relation to the approval of the balance sheet and the profit and loss statement. Since the discretionary power of appropriation of profits is delegated by the shareholders to the board of directors, the Revised Code

for the new system of committees.

"The term of office for an executive officer that is newly elected during the term of another executive officer shall be the same as the remainder of the term of the executive officer currently in office."

shortens directors' terms of office to one year³ in order to protect the interests of the shareholders.

2. Introduction of the system of an important assets committee

2.1 Eligible Companies

Under the Revised Code, a Large Company or a Deemed Large Company that does not choose to adopt the new system and that meets the following criteria may establish an "important assets committee":

- (A) the board of directors is composed of at least 10 directors; and
- (B) at least one of the directors is an external director.

2.2 The important assets committee

An "important assets committee" must consist of at least three directors and may decide certain matters on the Company's behalf, including:

- (A) the sale or purchase of substantial property of the Company;
and
- (B) the making of substantial loans to third parties.

Under the Pre-amendment Code, all of the above matters had to be decided by the board of directors (Sections 260-2(1) and 260-2(2) of the Current Code). In contrast to the committees described in paragraph 1.2 above, it is not a requirement that an external director be appointed as a member of this committee. The important assets committee is designed to enable a Large Company or a Deemed Large Company, which finds it difficult in practice to convene meetings of the board of directors,

³ The following provision can be included in the Articles of Incorporation, since it does not contravene the law concerning the term of office for the new system of committees.

"The term of office for an executive officer that is newly elected during the term of another executive officer shall be the same as the remainder of the term of the executive officer currently in office."

to decide these matters more easily.

3. Meetings of shareholders

3.1 Shareholders' proposals

The Revised Code provides that the right of a shareholder to propose a resolution at a shareholders' meeting (and to request that it be set out in the notice of the shareholders' meeting) must be exercised at least eight weeks before the date of the meeting. Under the Pre-amendment Code, the right had to be exercised at least six weeks before the date of the meeting.

This amendment is designed to assist Companies in the administration of meetings of shareholders. It affords the Company an extra two weeks to carry out the administrative tasks of incorporating the proposal into the notice of the meeting prior to printing and distributing it to shareholders in order to convene the meeting.

3.2 Right of a minority shareholder to call a shareholders' meeting

The Revised Code alters the position regarding the ability of minority shareholders to convene a shareholders' meeting. Under the Revised Code, minority shareholders may only exercise this right if the Company fails to send a notice of a shareholders' meeting to shareholders within eight weeks of the request for the convening of a meeting made by the minority shareholder. Under the Pre-amendment Code, Companies had to send a notice of a shareholder's meeting within six weeks of the minority shareholder's request.

Again, this amendment affords Companies an extra two weeks to carry out the administrative tasks necessary to convene a shareholders' Meeting.

3.3 Relaxation of the quorum necessary to pass a special resolution

Under the Pre-amendment Code, for a special resolution to be passed,

holders of more than 50% of the voting rights exercisable in relation to the Company had to attend a shareholders' meeting and the holders of at least two-thirds of the voting rights held by those attending had to vote in favour of the resolution.

Owing to the general apathy exhibited by shareholders towards the exercise of their voting rights (particularly institutional investors), it has become increasingly difficult for Companies to pass special resolutions. The Revised Code therefore provides that a Company may amend its articles of incorporation to provide that the quorum for a shareholders' meeting at which a special resolution is proposed may be the holders of at least one-third of the total voting rights rather than a majority. The quorum for a bondholders' meeting for the passing of a bondholders' resolution which may have a significant impact upon the interests of bondholders has been automatically relaxed to be the holders of at least one third of the total voting rights of all bondholders.

3.4 Revisions to the procedure for convening a shareholders' meeting

- (A) Agreement to dispense with the formal procedure for convening a shareholders' meeting

Subject to the consent of all shareholders holding voting rights, the Revised Code provides that a Company may dispense with the formal procedures for convening a shareholders' meeting.

- (B) Reduction of the notice period for convening a shareholders' meeting

The Revised Code provides that Companies whose articles of incorporation include restrictions on the transfer of shares without board approval ("Restricted Share Transfer Companies") may shorten the notice period for shareholders' meetings to one week by including such provision in their articles of incorporation.

(C) Shareholder resolutions

Under the Revised Code, if a director or a shareholder proposes a resolution to be considered at a shareholders' meeting, and all the shareholders who would be able to exercise their voting rights at such a meeting assent to the resolution either in writing or in electronic form, then the resolution will be deemed to have been passed at a shareholders' meeting without having to hold such a meeting.

4. Regulations on the remuneration of directors

The remuneration of directors has to be determined either in the Company's articles of incorporation or at a shareholders' meeting. However, it had become apparent that it was very difficult to determine an exact figure at the time of the shareholders' meeting when a director's remuneration was contingent on, for example, the results of the Company or was to be provided otherwise than in cash.

The Revised Code therefore allows Companies to provide a specific formula for calculating contingent remuneration and to set out a description of any remuneration paid otherwise than in cash. However, at a shareholders' meeting the representative director responsible for proposing the method of calculating the directors' remuneration must disclose the rationale behind his proposal.

Directors' stock options are treated not as remuneration but as "issues of stock options on favourable terms". Therefore, stock options are not subject to the above regulations.

5. Audit by an outside accounting auditor

The financial statements of a Large Company have to be audited by an outside accounting auditor (kaikai kansanin) as well as statutory auditors (kansayaku). However, provided that those auditors' opinions are obtained confirming the legal compliance of its balance sheet and

profit and loss statement, a Large Company does not have to seek the approval of its shareholders in relation to these documents at a shareholders' meeting. The Revised Code allows a Deemed Large Company to take advantage of this procedure as if it were a Large Company.

Part B: Shares

1. Election and dismissal of directors and auditors by different classes of shareholders

The Revised Code allows Restricted Share Transfer Companies to provide in their articles of incorporation that different classes of shareholders may have different rights in relation to the appointment and dismissal of both auditors and directors. For example, the holders of a Company's A Shares may be entitled to elect three of a total of five directors while the holders of a Company's B Shares are entitled to appoint only two directors. The shareholders of each class may exercise their respective rights by voting at meetings of the holders of their class.

The Revised Code ensures that shareholders' agreements which have been a common feature of venture capital financings in Japan are valid and enforceable. Restricted Share Transfer Companies may now allot different classes of shares with varying rights regarding the election and dismissal of directors and auditors to reflect the different levels of investment and risk assumed by their shareholders.

2. New system for invalidating share certificates

The Revised Code establishes a new, simpler system for invalidating share certificates so that, in the event of a shareholder losing his certificate, a Company may issue a new certificate more easily. Under the Pre-amendment Code, an owner of the lost certificate had to file a public notice as well as obtain a judgment of nullification in relation to the lost certificate. Only then was the owner entitled to request that a new certificate be issued by the Company.

The new system provides that, upon the request of the owner, a Company must register the loss of any share certificate in its ledger (which may be inspected by the public). If there is no objection from the holder of the share certificate, the lost certificate becomes invalidated one year from the day following the date the entry is made in the ledger. The owner is then entitled to request that a new share certificate be issued by the Company.

3. Disposal of shares held by shareholders that are uncontactable

A Company is not required to notify a shareholder that it has been unable to contact for five consecutive years at the address stated in its shareholders' register. However, under the Pre-amendment Code, the Company was still required to undertake other administrative tasks relating to the shareholder, thus creating an obstacle to the rationalisation of shareholder administration in Japan.

In an effort to address this problem, under the Revised Code, if a Company has not been able to contact a shareholder for the period of time and in the manner described above, and the shareholder has not received the dividends owing to it by the Company during that same period, then a Company may dispose of the shares owned by the shareholder and end its status as shareholder of the Company. However, in order for a Company to avail itself of this new procedure, it must comply with the following conditions:

- (A) a board resolution must be passed authorising the sale of the shares;
- (B) a public notice must be filed and each of the registered shareholders must be notified; and
- (C) the proceeds from the sale of the shares must be paid to the absent shareholder (NB a Company may be released from this payment obligation by depositing the proceeds from the sale with the Legal Affairs Bureau).

Usually such shares will be sold at auction. However, a Company may sell the shares in another manner or, if duly authorised by the board, a Company may buy the shares itself.

4. Buying fractional shares

Under the Revised Code, a holder of a fractional share in a Company may request that the Company sells further fractional shares to him so that he may come to hold a whole share. In relation to Companies that have adopted an unit share system (under which an unit comprises a designated number of shares and only the holders of complete units are granted voting rights), the Revised Code contains similar provisions in relation to holders of shares of less than one unit.

Part C: Financial statements

1. Accounting requirements to be established by the Ministry of Justice

The approval of the Diet was previously required in order to effect a change to the Commercial Code. This procedural obstacle led to the accounting provisions of the Current Code being criticised as outdated in light of the rapidly-changing business environment.

In order to provide greater flexibility, under the Revised Code, the power to establish accounting regulations has been delegated to the Ministry of Justice. Accounting provisions have therefore been removed from the Revised Code – for example the provisions relating to the information to be included in a Company's financial statements and the method of calculating dividends payable (including interim dividends). This amendment should also ensure consistency between the accounting procedures that apply to Companies generally and the further regulations that are imposed on listed Companies under Japan's securities laws.

2. Large Companies to prepare consolidated financial statements

Under the Revised Code, a Large Company (not including a Deemed Large Company and, for the time being, limited to a Large Company that is required to submit a securities report) is required to prepare consolidated financial statements. Once the consolidated financial statements have been audited by an outside accounting auditor and a statutory auditor and have been approved by the board of directors, the representative director of the Company must report them to the Company's shareholders at a shareholders' meeting.

Part D: Others

1. Certification of non-cash consideration for shares

In relation to the allotment of shares for non-cash consideration both upon incorporation of a Company and subsequently, the Pre-amendment Code provided that the non-cash consideration had to be valued by a court-appointed inspector. This valuation procedure was criticised as being too expensive and time-consuming. Furthermore, because it was difficult to accurately estimate the time required to carry out the valuation, it had proven difficult for Companies to plan restructuring schedules.

Under the Revised Code, Companies may dispense with the valuation process if a lawyer or other professional certifies that the value attributed to the assets is appropriate except in the case of real property where a valuation from a surveyor is required. However, the Revised Code does impose certain liabilities on such professionals in order to ensure that they make an accurate assessment.

2. Clarification of the procedure for reducing a Company's share capital

The provisions of the Pre-amendment Code were ambiguous with regard to what matters had to be dealt with by a special resolution of shareholders in order to effect a reduction of a Company's share capital. The Revised Code clearly sets out the matters to be agreed for effecting a reduction of share capital.

In addition, under the Pre-amendment Code, the details of the reduction of share capital were not included in the public and individual notice given to the known creditors of a Company which demanded that such creditors notify the Company of any objections they had to the proposed reduction of share capital. The Revised Code clearly sets out the items to be included in the public and individual notice to the known creditors of a Company. Similar clarification is provided with respect to the reduction of a Company's legal reserve (which includes capital reserve and profit reserve).

3. Abolition of the obligation on a foreign company to establish a branch office

Under the Pre-amendment Code, a foreign company engaged in transactions on a continuous basis in Japan was required to appoint a representative and establish and register a branch office in Japan. However, as transactions have increasingly been concluded through written correspondence or over the internet, this requirement has rapidly become obsolete.

The Revised Code therefore abolishes the obligation on a foreign company to establish a branch office in Japan, although the foreign company is still required to appoint a representative and register the company.

However, in order to protect the interests of creditors in Japan, the Revised Code does require foreign companies in Japan (i.e. those which are equivalent to kabushiki kaisha in Japan) to publish their balance sheets and to comply with certain procedures when withdrawing from the Japanese market.

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