Corporate Governance and Directors' Duties in Japan: Overview

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A Q&A guide to corporate governance law in Japan.

The Q&A gives a high-level overview of the main forms of corporate entity used; the corporate governance legal framework; board composition and restrictions; directors' remuneration; management rules and authority; directors' duties and liabilities; transactions with directors and conflicts; and internal controls, accounts and audits.

Corporate Entities

1. What are the main forms of corporate entity used?

Stock Company (*kabushiki kaisha*) (KK)

A KK is the most common form of corporate entity in Japan. As of 31 July 2022, 91.2% of Japanese corporate entities were KKs.

KKs are generally classified according to the transfer restrictions imposed on their shares, as follows:

- **Close KKs (private companies).** KKs that have provisions in their articles of incorporation (articles) that require the company's approval for any acquisition or transfer of the company's shares. Close KKs are commonly used in Japan, especially for small and medium-sized companies.
- **Open KKs (public companies).** KKs that are not classified as close KKs. Generally, only securities issued by open KKs can be listed on a securities exchange in Japan. As of April 2024, about 3,900 companies were listed on a securities exchange in Japan.

Legal Framework

2. What is the main corporate governance legislation? What are the authorities that enforce it?

Corporate governance and directors' duties are regulated by:

- The *Companies Act*.
- A company's articles.

Listed KKs (*see Question 1*) are also regulated by:

- The *Financial Instruments and Exchange Law*.
- Securities Listing Regulations published by the securities exchanges (including the CG Code). Although Securities Listing Regulations are binding on listed KKs, some portions (including the CG Code) constitute non-binding guidance. The *Tokyo Stock Exchange* (TSE) is the largest securities exchange in Japan.

The *Ministry of Justice* is the administrative authority in charge of the Companies Act . The *Legal Affairs Bureau* is the authority responsible for company registration.

The *Financial Services Agency* (FSA) is the administrative authority in charge of the Financial Instruments and Exchange Law, and the regulation of listed KKs. TSE is responsible for the regulation of listed KKs whose shares are listed on its exchange.

As of 31 March 2024, 334 institutional investors had accepted the Principles for Responsible Institutional Investors (Stewardship Code), which set out principles that are considered helpful for institutional investors in fulfilling their stewardship responsibilities with regard to both their clients and beneficiaries and the investee companies.

Institutional investors have been active in monitoring corporate governance matters and many institutional investors have published their principles of corporate governance and guidelines on the exercise of shareholder voting rights. Institutional Shareholder Services (ISS) and other proxy voting advisers also have influence in corporate governance matters.

3. Has your jurisdiction adopted a corporate governance code?

The CG Code became effective on 1 June 2015 and was amended on 1 June 2018 and 11 June 2021.

The general principles of the CG Code are concerned with:

- Securing the rights and equal treatment of shareholders.
- Appropriate co-operation with stakeholders other than shareholders.
- Ensuring appropriate information disclosure and transparency.
- Responsibilities of the board.
- Dialogue with shareholders to achieve effective corporate governance.

The CG Code adopts a principles-based approach to achieving effective corporate governance based on each company's unique situation. The CG Code adopts a "comply or explain" approach. Therefore, if a company considers a certain principle inappropriate to its circumstances, the company does not need to comply with the principle, but must fully explain the reasons for non-compliance.

Listed KKs (*see Question 1*) are required to submit corporate governance reports describing the status of their compliance with the CG Code. The number of principles that apply to a listed KK differs depending on the market segment to which it belongs. The majority of companies listed on the Prime Market, to which the strictest standards apply, comply with most of the principles set out in the CG Code.

Board Composition and Restrictions

4. What is the management/board structure of a private company?

Structure

Open KKs (*see Question 1*) must have a board of directors (board). Close KKs can establish a board, if provided by their articles, but are not required to. A KK with a board can establish three committees, or a supervisory committee, if provided by its articles. Management structure varies accordingly.

KKs with a board. The board must be unitary and has decision-making authority over the management of the company.

KKs with a board and three committees. A KK with a board can establish three committees within the board, which are:

- A nominating committee.
- An audit committee.
- A compensation committee.

Although both close and open KKs with a board can choose to have three committees, this structure is not common. As of April 2024, only 95 of a total of about 3,900 listed companies had three committees.

Voluntary committee(s). Although it is not common for KKs to have three committees as specified in the Companies Act, it is quite common for listed KKs with company auditors or listed KKs with a board and supervisory committee to have either or both of a nominating committee or a compensation committee, on a voluntary basis. The CG Code also provides that these KKs should establish an independent nominating committee and compensation committee.

KKs with a board and supervisory committee. A KK with a board can establish a supervisory committee within the board. This structure has been widely adopted by KKs with a board. About 1,600 listed companies had chosen to become KKs with a board and supervisory committee as of April 2024.

Close KKs without a board. Close KKs can choose not to have a board. Decisions regarding the management of the company in close KKs without a board are made by a majority of the directors.

Management

KKs with a board. The board must appoint one or more representative directors from among its directors to whom the board delegates the authority to represent the company. Representative directors as well as other executive directors appointed by board resolution are responsible for carrying out the decisions made by the board and have the authority to represent the company within the scope of the authority granted.

KKs with a board and three committees. The board must appoint one or more executive officers (*shikko-yaku*) and must appoint one or more representative executive officers from among the executive officers. These representative executive officers are responsible for carrying out the decisions made by the board or the executive officers and have authority to represent the company. The board can delegate substantial decision-making authority over the management of the company to the executive officers. Directors can serve concurrently as executive officers.

KKs with a board and supervisory committee. The board must appoint one or more representative directors from among its directors to have authority to represent the company. Representative directors and other executive directors appointed by board resolution are responsible for carrying out the decisions made by the board and have the authority to represent the company. The board can delegate substantial decision-making authority over the management of the company to representative directors and other executive directors, as long as the articles allow for such delegation or the majority of directors are outside directors.

Close KKs without a board. Each director of a close KK without a board is responsible for carrying out the decisions made by the majority of the directors, and has authority to represent the company unless a representative director is elected.

Board Members

KKs with a board or KKs with a board and supervisory committee. All board members (including members of the supervisory committee) must be directors of the company. For KKs with a company auditor, company auditors must attend board meetings and must state their opinions where necessary.

KKs with a board and three committees. All board members must be directors of the company. Executive officers must attend board meetings when requested by the board and provide explanations on matters requested by the board.

Employees' Representation

Employees are not entitled to board representation under the Companies Act.

Number of Directors or Members

Close KKs without a board. A close KK without a board must have at least one director.

KKs with a board. A KK with a board must have at least three directors.

KKs with a board and three committees. A KK with a board and three committees must have at least three directors. Directors can serve concurrently as members of three committees.

KKs with a board and supervisory committee. A KK with a board and supervisory committee must have at least four directors (three supervisory committee members and one executive director).

5. Are there any general restrictions or requirements on the identity of directors?

General Restrictions

The following persons cannot serve as a director:

- A corporation.
- A person who has been sentenced to a penalty for violating the Companies Act or certain other laws, within two years of the date on which execution of the sentence was completed or the sentence ceased to apply.
- A person who:
    - violated other laws and regulations;
    - was sentenced to imprisonment or a more severe penalty; and

- has not completed the sentence or to whom the sentence still applies (excluding persons whose sentence has been suspended).

Age

There are no age restrictions on serving as a director.

Nationality

There are no nationality restrictions on serving as a director.

Corporate Directors

Only a natural person can serve as a director.

Diversity

There are no legally binding diversity quotas. However, the CG Code (*see Question 3*) provides that the board should be constituted in a manner designed to achieve diversity, including gender, international experience, work experience and age.

The CG Code also provides that a listed company should disclose the combination of skills of each director as part of a "skills matrix", and that independent director(s) with management experience at other companies should be included on the form.

The Japanese Government published a gender equality policy in June 2023. Based on this policy, in October 2023, the TSE set targets for the appointment of female executives, such as directors, by listed companies on the Prime Market of:

- At least one in or around 2025.
- 30% or more of total executives by 2030.

(Basic Policy on Gender Equality and Empowerment of Women (the Intensive Policy for Gender Equality and the Empowerment of Women 2023.))

The TSE also recommends listed companies to develop action plans to achieve these numerical targets.

6. Are non-executive, supervisory, or independent directors recognised or required?

Recognition

Outside directors. Outside directors are directors who:

- Are not executive directors (*gyomushikko-torishimariyaku*), executive officers or employees (including managers) of the company (or any of its subsidiaries) and any of the parent company's subsidiaries.
- Have not occupied any of these positions in the company (or any of its subsidiaries) in the previous ten years.
- Are not directors, executive officers or employees (including managers) of the parent company.
- If they filled any of the role of non-executive director, accounting advisor or company auditor within the company (or any of its subsidiaries) in the past ten years, had not been executive directors, executive officers or employees of the company (or any of its subsidiaries) within ten years before assuming those roles.
- Do not assume control of management of the company.
- Are not close relatives of directors and executives of the company.

Executive directors are representative directors, directors other than representative directors who are appointed by board resolution to execute the company's operations, and directors other than these two types of directors who have executed the company's operations.

Independent officers. Independent officers are outside directors or outside auditors who are not likely to have a conflict of interest with the company's shareholders (TSE Securities Listing Regulations).

Outside auditors are company auditors who:

- Have not occupied the position of director, accounting advisor, executive officer, or employee of the company (or any of its subsidiaries) in the previous ten years.
- If they served as company auditors of the company (or any of its subsidiaries) in the past ten years, had not been directors, accounting advisors, executive officers or employees of the company (or any of its subsidiaries) within ten years prior to assuming those roles of company auditors.
- Are not directors, executive officers, company auditors, or employees of the parent company.
- Are not executive directors, executive officers, or employees of any of the parent company's subsidiaries.
- Do not assume control of management of the company.
- Are not close relatives of directors and executives of the company.

Non-executive directors and supervisory directors. Non-executive directors are directors who are not executive directors. Supervisory directors are not recognised; however, if a company has a supervisory committee or three committees, members of the supervisory committee or the audit committee supervise the management of the company.

Board Composition

KKs with a board and three committees or supervisory committee. For KKs (*see Question 4*) with a board and committee(s), a majority of the members of each committee must be outside directors. The members of the audit committee and the supervisory committee must be non-executive directors.

Listed KKs. Listed KKs must have one or more independent officers. Under the Companies Act, open and large companies (*see Question 1 and Question 23*) required to submit annual securities reports must have at least one outside director (*see Question 6*).

In addition, under the CG Code (*see Question 3*):

- At least one-third of the directors of KKs listed on the Prime Market should be independent directors (two if listed on other markets).
- Listed KKs that have a controlling shareholder should either appoint at least one-third of their directors as independent directors (a majority of directors, if listed on the Prime Market) or establish a special committee composed of independent persons.

Independence

Outside directors. Directors, executive officers or employees (including managers) of the parent company or any of the parent company's subsidiaries, and close relatives of directors and executives of the company, are not eligible to be outside directors. However, directors of companies with a business relationship are eligible to be outside directors, and often serve as outside directors in practice.

Independent officers. A listed company must disclose its independent officers' details in its corporate governance reports. If an independent officer has certain relationships with the company (for example, is a main business partner, a consultant, or a major shareholder), this relationship must be disclosed upon the designation of the individual as an independent officer. In addition, the CG Code provides that the board of a listed company should establish and disclose its own standards of independence for independent directors and that independent directors should include director(s) with management experience at other companies.

7. Are the roles of individual board members restricted?

There are no legal restrictions on the roles of individual board members. A chief executive officer of a company can concurrently serve as the chairperson of the board. As of July 2022, 96.2% of listed companies appointed their president or company chairperson as the chairperson of the board. However, the Corporate Governance System Guideline published by the Ministry of Economy, Trade and Industry (revised in July 2022) encourages companies to consider appointing non-executive directors as the chair.

8. How are directors appointed and removed? Is shareholder approval required?

Appointment of Directors

Directors are elected by an ordinary resolution at a shareholders' meeting. An ordinary resolution can be passed at a shareholders' meeting by a majority of the votes cast, where the majority of the shareholders entitled to vote are present, unless the articles specifically provide otherwise (where permissible). Generally, directors are nominated by the board, but in companies with three committees, directors must be nominated by the nominating committee.

Removal of Directors

Directors (other than directors who are supervisory committee members) can be dismissed at any time by an ordinary resolution of the shareholders' meeting. Directors who are supervisory committee members can be dismissed by an extraordinary resolution of the shareholders' meeting. An extraordinary resolution requires a two-thirds supermajority of the votes cast, where a majority of the shareholders entitled to vote are present, unless the articles specifically provide otherwise (where permissible). Directors can seek damages for dismissal from the company if they are dismissed without justifiable grounds.

9. Are there any restrictions on a director's term of appointment?

KKs without Committees

A director's term of office continues until the end of the annual shareholders' meeting for the last fiscal year ending within two years after the director's election. In close KKs (*see Question 1*), this period can be extended to ten years.

KKs with Three Committees

A director's term of office continues until the end of the annual shareholders' meeting for the last fiscal year ending within one year after the director's election.

KKs with a Supervisory Committee

The term of office of a director (other than a director who is a supervisory committee member) continues until the end of the annual shareholders' meeting for the last fiscal year ending within one year after the director's election. The term of a director who is a supervisory committee member continues until the end of the annual shareholders' meeting for the last fiscal year ending within two years after the director's election (this supervisory committee member's term cannot be reduced).

Directors' Remuneration

10. Must directors be employees of the company? Can shareholders inspect directors' service contracts?

Directors Employed by the Company

KKs without committees. Although it is not necessary in KKs (*see Question 1*) without committees, in practice, directors often serve concurrently as employees of the company. This does not apply to representative directors, who cannot serve as employees.

KKs with three committees or KKs with a supervisory committee. Directors who are members of the three committees or a supervisory committee cannot serve concurrently as employees, including as managers of the company.

Shareholders' Inspection

Shareholders do not have statutory rights to inspect directors' service contracts, if any. Traditionally, it was not common to have individual service contracts with directors; however, recently, there have been some cases where companies have service contracts with directors.

11. Are directors allowed or required to own shares in the company?

Directors can own shares in the company, however, they are not required to do so. The articles of an open KK (*see Question 1*) cannot stipulate that a director must be a shareholder.

12. How is directors' remuneration determined, and must it be disclosed? Is shareholder approval required?

Determination of Directors' Remuneration

KKs without committees. For KKs (*see Question 1*) without committees, directors' remuneration is determined by the articles or an ordinary resolution (*see Question 8*) at a shareholders' meeting. Approval by a shareholders' meeting is binding. In practice, only the maximum aggregate remuneration for all directors is determined by a shareholders' resolution, and the board, with the authority delegated by the shareholders' resolution, determines the distribution of the remuneration among the directors (or the board delegates these responsibilities to the representative director).

KKs with three committees. The remuneration for each director and executive officer is determined by the compensation committee in accordance with the remuneration policy prescribed by the committee. Shareholder approval is not required.

KKs with a supervisory committee. The remuneration for directors who are members of a supervisory committee must be determined separately from that of other directors by the articles or a shareholders' meeting. Approval by a shareholders' meeting is binding.

In practice, only the maximum aggregate remuneration for members of the supervisory committee and other directors is determined by shareholders' resolution. The members of the supervisory committee determine the distribution of remuneration among the members of the supervisory committee and the board determines the distribution of remuneration among other directors (or the board delegates these responsibilities to the representative director).

The Companies Act requires the boards of open and large KKs (*see Question 1 and Question 23*) to submit annual securities reports and KKs with a supervisory committee establish a policy for determining the remuneration to individual directors (excluding members of the supervisory committee), unless individual remuneration is established by the articles or a resolution of a shareholders' meeting.

Disclosure

An open KK must disclose the following information to its shareholders in its business report. In its business report, a company with outside directors must make separate disclosures concerning the amount of remuneration, stock and stock options paid or provided to outside directors and those who are not outside directors.

- The aggregate remuneration of its directors (in KKs with a supervisory committee, this includes directors who are members of the supervisory committee and other directors) or the respective remuneration of each director. If the remuneration includes performance-linked or non-pecuniary remuneration, the aggregate amount of each.
- Details of the performance index used to calculate performance-linked remuneration, the reason for selecting it, the method for calculating such remuneration, and the results of the performance index.
- Details of non-pecuniary remuneration.
- Details of the provision in the articles or the resolution of a shareholders' meeting regarding remuneration.
- Details of policies for determining the amount and distribution of remuneration to individual directors (if a KK establishes such policies).
- For a KK with a board (excluding a KK with three committees), the details of distribution of remuneration as determined by the delegated director or voluntary committee.
- Details of the stock or stock options granted and the number of directors who have stock or stock options (if directors are given stock or stock options).

In addition, a listed KK must disclose in the securities report under the Financial Instruments and Exchange Law, the amount of remuneration and a breakdown by the type of payments (for example, salary, bonus, stock option or retirement payment) for each director, if their remuneration for the relevant fiscal year is JPY100 million or more.

A resolution at a shareholders' meeting must be obtained to grant stock or stock options as remuneration for directors.

Shareholder Approval

Shareholders' meeting approval is required and binding in KKs without committees and those with a supervisory committee, and is not required in KKs with three committees.

Management Rules and Authority

13. How is a company's internal management regulated?

For KKs (*see Question 1*), internal management is regulated by the Companies Act, the articles, other internal regulations (for example, board regulations) or resolutions of the board.

Notice of a board meeting must be provided to each director (for KKs with company auditors, to each director and each company auditor) no later than one week before the day of the board meeting.

Resolutions at board meetings are approved by an affirmative vote of a majority of the directors present, where the majority of the directors entitled to participate in the vote are present. Directors with a conflict of interest cannot participate in the vote.

14. Can directors exercise all the powers of the company or are some powers reserved to the supervisory board (if any) or a general meeting? Can the powers of directors be restricted and are such restrictions enforceable against third parties?

Directors' Powers

Shareholders' approval is required for certain matters, including the following:

- Amending the articles.
- Mergers, company splits, share exchanges, share transfers, assignment of business and reduction of stated capital.
- Election or dismissal of directors and company auditors.
- Issuing new shares in a close KK (*see Question 1*).
- Dividends of surplus. However, a KK with a board can provide in the articles that it can distribute a one-time interim cash dividend of surplus by board approval. In addition, in a company with an accounting auditor that has a board of company auditors, three committees or a supervisory committee, where the term of its directors is no more than a year, the responsibility to determine the distribution of dividends of surplus can be delegated to the board by the articles.

Restrictions

Close KKs without a board. Shareholders' meetings can resolve any and all matters regarding the company, and the directors must comply with the shareholders' resolutions.

KKs with a Board. Shareholders' meetings can resolve only the matters provided for in the company's articles and the Companies Act. A company's articles can require shareholders' approval and restrict the board's powers in relation to certain matters. However, these restrictions are not enforceable against third parties, unless the third parties knew or should have known of the restrictions. If the company issues class shares with veto rights, the board's powers can be restricted in relation to matters where the class shares have veto rights.

15. Can the board delegate responsibility for specific issues to individual directors or a committee of directors? Is the board required to delegate some responsibilities, for example for audit, appointment or directors' remuneration?

KKs with a Board

For KKs (*see Question 1*) with a board, the board often delegates decisions on certain matters regarding the company's day-to-day operations to individual directors, such as representative directors or other executive directors. However, the board cannot delegate certain important company matters to individual directors, including:

- Disposing of or acquiring important assets.
- Incurring significant debt.
- Electing or dismissing important employees, including managers.
- Establishing, changing or abolishing important organisational bodies, including branch offices.
- Developing internal control systems.

KKs with a Board and Three Committees

The board has decision-making authority over the management of the company, including matters that cannot be delegated to individual directors, such as establishment of basic management policy and the development of internal control systems.

A board can delegate decision-making authority over the management of the company to the executive officers (in KKs with three committees) or to representative directors and other executive directors (in KKs with a supervisory committee whose articles allow for such delegation, or where a majority of the directors are outside directors). However, the board cannot delegate certain important matters (in addition to the matters mentioned above) including:

- Approval of a share transfer in close KKs.
- Contents of agreements or plans for mergers, company splits, share exchanges or share transfers.

Directors' Duties and Liabilities

16. What is the scope of a director's general duties and liability to the company, shareholders and third parties?

Directors must perform their duties:

- With the care of a prudent manager.
- In compliance with all laws and regulations, the articles and resolutions of shareholders' meetings.
- In a loyal manner.

(Article 644, Civil Code; Article 355, Companies Act.)

Directors who neglect their duties are liable to the company for the resulting damages. Where directors are grossly negligent or knowingly fail in performing their duties, such directors are also liable to third parties or shareholders for the resulting damages.

Directors are also liable to the company for the following:

- Distributions of surplus dividends or repurchases of shares that exceed the distributable amount under the Companies Act at the time of the distribution or repurchase of shares.
- The occurrence of a shortfall of the distributable amount under the Companies Act after the distribution of surplus dividends or repurchase of shares, at the end of the fiscal year when those distributions or repurchases took place.
- Giving property benefits to any person for the exercise of shareholders' rights.

However, if directors can demonstrate that they did not fail to exercise their duty of care in the performance of their duties, they will not be held liable. If there are two or more directors who are liable, they are jointly and severally liable to the company.

17. Can a director's liability be restricted or limited? Can the company indemnify a director against liabilities?

A director's liability to the company under the Companies Act can be restricted or limited as follows:

- A director can be exempted from liability with the unanimous consent of all shareholders.
- Directors who are both unaware of the wrongdoing and not grossly negligent in performing their duties (*see Question 16*) can be partially exempted from liability by an extraordinary resolution of a shareholders' meeting (*see Question 8*), for damages above the minimum liability limits, which are:

- for representative directors, six times their annual remuneration;
- for executive directors other than representative directors, four times their annual remuneration; and
- for other directors, double their annual remuneration.

- For KKs (*see Question 1*) with company auditor(s) that have more than two directors, or KKs with committee(s), decisions on a partial exemption of a director's liability can be delegated to directors (or to the BoD where there is one) by the articles.
- If the articles allow it, a company can contractually limit the liability of its directors (excluding executive directors) who are both unaware of the wrongdoing and not grossly negligent in performing their duties (*see Question 16*). Liability is limited to the larger of:
    - an amount determined in advance, within the range provided in the articles;
    - an amount equal to double the director's annual remuneration.
- A company can enter into agreements with directors by means of a resolution of shareholders' meeting (or the board) under which the company will indemnify the relevant director(s) against certain liabilities arising from the performance of their duties under certain disclosure requirements.

18. Can a director obtain insurance against personal liability? If so, can the company pay the insurance premium?

Directors can obtain directors' and officers' (D&O) liability insurance covering personal liability that indemnifies them against the legal costs of a lawsuit, as well as against personal liability to third parties and to the company, by means of a resolution of shareholders' meeting (or the board) under certain disclosure requirements. The company can pay and bear the cost of these insurance premiums.

19.Can a third party (such as a parent company or controlling shareholder) be liable as a de facto director (even though they have not been formally appointed as a director)?

A person who has not been formally appointed as a director but who manages the company can be found liable to a third party as a de facto director. For example, a person who is complicit in misrepresenting themselves as a director on the corporate registry, or a person who mainly carries out management decisions with respect to the operations of the company, can be found liable to the company or a third party as a de facto director.

Transactions with Directors and Conflicts of Interest

20. Are there general rules relating to conflicts of interest between a director and the company?

As part of the duty of care and the duty of loyalty to the company (*see Question 16*), a director has a general obligation not to look to their own interests at the cost of the company's interests.

Close KKs without a Board

For KKs (*see Question 1*) without a board, if a director intends to carry out any transaction between the company and themselves (for themselves or for another person) that results in a conflict of interest, approval for the transaction must be obtained at a shareholders' meeting. The director must disclose material facts about the transaction at a shareholders' meeting.

KKs with a Board

If a director intends to carry out any transactions involving conflicts of interest, approval must be obtained at a board meeting. A director with a conflict of interest cannot participate in the board meeting. A director must disclose material facts about the transaction at the board meeting. After the transaction, the director must also report material facts about the transaction to the board without delay.

21. Are there restrictions on particular transactions between a company and its directors?

Close KKs without a Board

For KKs (*see Question 1*) without a board, approval at a shareholders' meeting must be obtained if a director intends to carry out transactions that:

- Compete with the company (for themselves or for another person).
- Benefit themselves or any third party (including receiving a loan from the company).
- Involve any conflicts of interest (including a guarantee given by the company for the benefit of a director) (*see Question 20*).

The director must disclose material facts about the transaction at a shareholders' meeting.

KKs with a Board

Approval at a board meeting must be obtained if a director intends to carry out transactions that:

- Compete with the company (for themselves or another person).
- Benefit themselves or any third party (including receiving a loan from the company).
- Involve any conflicts of interest (including a guarantee given by the company for the benefit of a director) (*see Question 20*).

The director that is about to carry out such transaction cannot participate in the vote as they have a conflict of interest (*see Question 20*).

22. Are there restrictions on the purchase or sale by a company director of the shares and other securities of the company?

The Companies Act does not restrict the purchase or sale by a director of the company's shares and other securities. However, some restrictions are imposed on a director of a listed company under the Financial Instruments and Exchange Law.

Under the insider trading rules, a director of a listed KK (*see Question 1*) who has come to know material, non-public information about a company cannot purchase or sell the company's shares and other securities.

A director of a listed KK who purchases or sells shares or other securities issued by that company must submit a report to the authorities. A listed KK can require a director to return to the company short-swing profits from certain transactions within six months.

Internal Controls, Accounts and Audit

23. Are there any formal requirements or guidelines relating to the internal control of business risks?

KKs without committees

For KKs (*see Question 1*) without a committee, the requirements relating to internal control systems under the Companies Act vary depending on whether companies are large or small companies. Large companies are companies with either:

- Stated capital in the balance sheet at the end of the most recent fiscal year of JPY500 million or more.

- Total liabilities as of the end of its most recent fiscal year of JPY20 billion or more.

Companies not falling within the definition of a large company are small companies.

Boards of large companies must develop internal control systems that ensure compliance with the law and the articles by directors and in company operations (Companies Act).

There is no formal requirement for internal control systems for small companies. However, some courts have found that directors must establish appropriate internal control systems in some circumstances. A board approval is also required if a small company voluntarily develops such an internal control system.

KKs with three committees or a supervisory committee

Regardless of size, boards must develop internal control systems that ensure compliance with laws and the articles by executive officers and in company operations (*Companies Act*).

Listed KKs

Listed KKs must submit an internal control report that describes the systems in place to ensure the accuracy of financial accounting information and the financial report. In addition, a listed KK must disclose the status of its corporate governance (including organisation, related persons and process) in its securities report (Financial Instruments and Exchange Law).

24. What are the responsibilities and potential liabilities of directors in relation to the company's accounts?

Companies Act

Directors who breach laws and regulations in relation to the company's accounts, such as accounting fraud, will be liable to the company, third parties and shareholders for damages arising as a result of a breach of the director's general duties.

Directors who make false statements about important matters in financial statements and business reports, or in their supplementary schedules, can be liable to third parties or shareholders for damages arising as a result, unless they prove that they did not fail to exercise due care in the performance of their duties.

Financial Instruments and Exchange Law

Directors who submit securities reports containing misstatements of any important matters, can be both civilly and criminally liable for the misstatements.

25. Do a company's accounts have to be audited?

A company's accounts must be audited, unless the company chooses not to have a company auditor (*see Question 26*), where it is either:

- A small and close KK (*see Question 1*) with a board (excluding KKs with committees) that does not have a company auditor, in which case it must have accounting advisers (*kaikei-sanyo*) to prepare its financial statements with directors.
- A small and close KK without a board.

26. How are the company's auditors appointed? Is there a limit on the length of their appointment?

Company Auditors

Company auditors audit the execution of directors' duties including financial statements and are elected by resolutions at shareholders' meetings. Directors must obtain the consent of the company auditors to submit a proposal for the election of a company auditor.

Company auditors' terms of office continue until the conclusion of the annual shareholders' meeting for the last fiscal year which ends within four years from the time of their election. Close KKs (*see Question 1*) can extend the terms of office of company auditors until the conclusion of the annual shareholders' meeting for the last fiscal year which ends within ten years from the time of their election.

Company auditors generally have both the authority to audit directors' execution of their duties and the authority to audit accounting activities. However, the articles of close KKs (excluding KKs with a board of company auditors and KKs with an accounting auditor) can limit the authority of company auditors to accounting audits only.

Audit Committee

KKs with three committees do not have company auditors. Instead, the audit committee audits the execution of directors' duties including financial statements, while the accounting auditor also audits the financial statements. Members of audit committees are appointed from among the directors by resolution at board meetings.

In KKs with three committees, the directors' terms of office continue until the conclusion of the annual shareholders' meeting for the last fiscal year which ends within one year from the time of their election.

Supervisory Committee

KKs with a supervisory committee do not have company auditors. Instead, the supervisory committee supervises and audits the execution of directors' duties including financial statements, while the accounting auditor also audits the financial statements. Members of a supervisory committee are elected by a resolution at a shareholders' meeting, separately from other directors.

In KKs with a supervisory committee, the terms of office of directors who are supervisory committee members continue until the conclusion of the annual shareholders' meeting for the last fiscal year which ends within two years from the time of their election.

Accounting Auditor

An accounting auditor audits the company's financial statements and is appointed at a general meeting of shareholders. Companies with three committees or a supervisory committee must have an accounting auditor. Large companies (*see Question 23*) also must have an accounting auditor. The company auditors, audit committee or supervisory committee propose candidates for the election of an accounting auditor.

Accounting auditors' terms of office continue until the conclusion of the annual shareholders' meeting for the last fiscal year which ends within one year from their election. An accounting auditor is deemed to have been re-elected at the annual shareholders' meeting, unless otherwise resolved at the annual shareholders' meeting.

27. Are there restrictions on who can be the company's auditors?

Company Auditors

A company auditor cannot concurrently serve as a director, employee (including manager), accounting adviser or executive officer of the company or of any of its subsidiaries.

For a company with a board of company auditors, there must be three or more company auditors and at least half of the company auditors must be outside company auditors, whose qualifications are similar to outside directors (*see Question 5*). There are no professional requirements for serving as a company auditor.

Audit Committee and Supervisory Committee

An audit committee and supervisory committee must have three or more members, and the majority of members must be outside directors (*see Question 5*). There are no professional requirements for serving as a member of the audit committee or the supervisory committee. A member of the audit committee or the supervisory committee who is not an outside director cannot concurrently serve as an:

- Executive officer or executive director of a company with a committee or of its subsidiaries.
- Accounting adviser or employee (including manager) of a subsidiary of a company.

Accounting Auditor

An accounting auditor must be a certified public accountant or an audit firm.

A certified public accountant cannot serve as an accounting auditor if they have:

- A significant interest in the company.
- Been an officer or employee of the company during the preceding fiscal year.
- Provided certain non-audit work (such as management consultancy) to the company.
- Certain other relationships with the company.

An audit firm cannot serve as an accounting auditor if:

- The firm has a significant interest in the company.
- A member of the firm who is involved in the audit work has been an employee of the company during the preceding fiscal year.
- The majority of the members of the firm have provided certain non-audit work (such as management consultancy) to the company.
- Certain other relationships with the company exist.

28. Are there restrictions on non-audit work that auditors can do for the company that they audit accounts for?

Company Auditors

A company auditor cannot do non-audit work that would violate the restrictions on auditors (*see Question 26*).

Accounting Auditor

A certified public accountant who serves as an accounting auditor cannot do certain non-audit work (such as management consultancy) for the company. If an audit firm serves as an accounting auditor, the number of members who perform non-audit work must be less than half.

29. What is the potential liability of auditors to the company, its shareholders, and third parties if the audited accounts are inaccurate? Can their liability be limited or excluded?

A company auditor or an accounting auditor who neglects their duties, such as through accounting fraud, is liable to the company for resulting damages. If the breach of duty is with the auditor's knowledge or gross negligence, they are liable to third parties or shareholders for damages arising as a result.

A company auditor or an accounting auditor who make false statements about important matters in audit reports is liable to third parties and shareholders for resulting damages, unless they can prove that they did not fail to exercise due care in the performance of their duties.

If an accounting auditor wrongly certifies that there are no misstatements in securities reports that are then submitted, they are subject to both civil and criminal liability (Financial Instruments and Exchange Law).

There are several ways of restricting or limiting liability under the Companies Act:

- A company auditor or accounting auditor can be exempted from liability with the unanimous consent of all shareholders.
- If a company auditor or accounting auditor is unaware of the breach and is not grossly negligent in performing their duties, they can, by an extraordinary resolution of a shareholders' meeting (*see Question 8*), be partially exempted from liability for neglecting their duties for amounts in excess of the minimum liability limit, which is double their annual remuneration. In KKs (*see Question 1*) with company auditors that have more than two directors or companies with committees, decisions on partial exemption of a company auditor's or accounting auditor's liability can be delegated to directors (or to the board where there is one) by the articles.
- If the articles so provide, a company can, through contracts with the company auditor and accounting auditor, limit their liability to the extent they are unaware of breaches and are not grossly negligent in performing their duties. Liability is limited to the larger of:
  - an amount determined in advance, within the range provided in the articles; and
  - an amount equal to double the annual remuneration.

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RESOURCE HISTORY

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This document has been reviewed by the author as part of its periodic maintenance to ensure it reflects the current law and market practice on 01 May 2024.

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