Capital Markets Alert

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Corporate Governance Exemptions Available to Japanese Companies Seeking to List on Nasdaq

The United States Securities and Exchange Commission (SEC) and the stock exchanges, including the Nasdaq Stock Market, impose various corporate governance requirements for all U.S. domestic companies listing on a U.S. stock exchange. For example, a company listing on Nasdaq is generally required to have a majority of independent directors on its board of directors, an audit committee consisting solely of independent directors who also satisfy the SEC's independence requirements for audit committee members, a compensation committee of at least two members consisting solely of independent directors and director nominees selected or recommended by independent directors or a nominating committee. However, companies that qualify as "foreign private issuers" benefit from certain exemptions to these requirements.

Foreign Private Issuers

According to Rule 3b-4 under the Securities Exchange Act of 1934, the term "foreign private issuer" generally includes any foreign company, except where more than 50% of the company's outstanding voting securities are held by U.S. residents and: (i) the majority of the executive officers or directors are U.S. citizens or residents; (ii) more than 50% of the assets of the company are located in the U.S.; or (iii) the company's business is administered principally in the U.S.

A foreign private issuer listing on Nasdaq may voluntarily follow all listing requirements of domestic U.S. companies, but is permitted to take advantage of various exemptions to Nasdaq's corporate governance requirements.

As a general rule, a foreign private issuer may follow its home country practices in place of Nasdaq's corporate governance requirements. However, there are certain corporate governance requirements the company must follow.

Independent Directors

As a general rule, a U.S. domestic issuer listing on Nasdaq must have a board of directors composed of a majority of independent directors. Nasdaq's Corporate Governance Requirements define an independent director as "a person other than an Executive Officer or employee of the Company or any other individual having a relationship which, in the opinion of the Company's board of directors, would interfere with the exercise of independent judgment in carrying out the responsibilities of a director."

Pursuant to Nasdaq's Corporate Governance Requirements, the following persons are not considered independent:

1. A director who is, or at any time during the past three years was, employed by the company.

2. A director who accepted, or who has a family member who accepted, any compensation from the company in excess of $120,000 during any period of 12 consecutive months within the three years preceding the determination of independence, other than the following: (a) compensation for board or board committee service; (b) compensation paid to a family member who is an employee (other than an executive officer) of the company; or (c) benefits under a tax-qualified retirement plan, or nondiscretionary compensation.

For purposes of this rule, family member means a person's spouse, parents, children, siblings, mothers- and fathers-in-law, sons- and daughters-in-law, brothers- and sisters-in-law, and anyone (other than domestic employees) who shares such person's home.

A foreign private issuer may instead follow home country practices in lieu of this majority independent director requirement (unless required for purposes of an Audit Committee, as described in more detail below). Pursuant to the Companies Act of Japan (Act No. 86 of 2005), there is no specific requirement for a Japanese corporation to have independent directors. Appointing independent directors under Nasdaq and SEC rules, even if not a majority of the board, would be seen positively by the market and Nasdaq for purposes of maintaining appropriate corporate governance for a Nasdaq listed company, however. Further, pursuant to the Companies Act, if a Japanese corporation selects an Audit and Supervisory Committee, the majority of the board of directors must be "outside directors." In general, an outside director would meet the independence standards of the SEC and Nasdaq due to similar requirements under Japanese law.

Audit Committee

Nasdaq Requirements

As a general rule, a U.S. domestic company listing on Nasdaq must have an audit committee of at least three members who meet strict independence standards. The role of the audit committee is primarily to act as independent oversight of the company's financial reporting, including the internal control over financial reporting and the external, independent audit process.

With regard to the oversight function, typically the responsibility of a U.S. company's audit committee, a foreign private issuer may either establish a U.S.-style audit committee or have a board of auditors (or similar body) or statutory auditors complying with the requirements of Section 10A-3 of the Securities Exchange Act of 1934. Historically, because of the availability of a "Board of Corporate Auditors" or an "Audit and Supervisory Committee" consistent with Japanese law, and the detailed requirements for a U.S.-style audit committee, it has been very uncommon for Japanese companies to elect to establish a U.S.-style audit committee.

Generally, a foreign private issuer may elect to have either a board of auditors (or similar body) or statutory auditors if:

1. The board or body, or statutory auditors, is established and selected pursuant to home country legal or listing provisions expressly requiring or permitting such a board or body, or statutory auditors.
2. The board or body, or statutory auditors, is required under home country legal or listing requirements to be either separate from the board of directors or composed of one or more members of the board of directors and one or more members who are not also members of the board of directors.
3. The board or body, or statutory auditors, is not elected by management of the company, and no executive officer of the company is a member of such board or body, or statutory auditors.
4. Home country legal or listing provisions specify standards for the independence of the board or body, or statutory auditors, from the foreign private issuer or its management.
5. The board or body, or statutory auditors, in accordance with any applicable home country legal or listing requirements or the company's governing documents, is responsible, to the extent permitted by law, for the appointment, retention and oversight of the work of any registered public accounting firm engaged (including, to the extent permitted by law, the resolution of disagreements between management and the auditor regarding financial reporting) for the purpose of preparing or issuing an audit report or performing other audit, review or attestation services for the company.

To the extent permitted by home country law, the board or body, or statutory auditors, must also establish procedures for the receipt, retention and treatment of complaints received by the company regarding accounting, internal accounting controls or auditing matters; and for the confidential, anonymous submission by employees of the listed company of concerns regarding questionable accounting or auditing matters.

Additionally, to the extent permitted by law, the board or body, or statutory auditors, must have the authority to engage independent counsel and other advisers, as it determines necessary to carry out its duties. Finally, the company must provide for appropriate funding, as determined by the board or body, or statutory auditors, for payment of compensation to any registered public accounting firm engaged for the purpose of preparing or issuing an audit report or performing other audit services for the company; compensation to any independent counsel and other advisers engaged by the board or body, or statutory auditors; and ordinary administrative expenses of the board or body, or statutory auditors, that are necessary or appropriate in carrying out its duties.

Japanese Law Application

Typically, both a Board of Corporate Auditors and an Audit and Supervisory Committee satisfy the U.S. legal requirements above. The Companies Act sets forth the various requirements related to the establishment and selection of Boards of Corporate Auditors and Audit and Supervisory Committees, which are established by a shareholders meeting approving articles of incorporation setting forth the requirement of the Japanese corporation to establish these bodies.

The Board of Corporate Auditors must be comprised of three or more corporate auditors, and at least half of them must be outside corporate auditors. Similarly, the Audit and Supervisory Committee must be comprised of three or more directors, and a majority of them must be outside directors. Corporate auditors, who comprise the membership of a Board of Corporate Auditors, and directors, who comprise the Audit and Supervisory Committee, are elected at a shareholders meeting.

Although a Japanese corporation may elect to have only one corporate auditor, without a Board of Corporate Auditors or an Audit and Supervisory Committee, doing so would not be considered appropriate corporate governance for a listed company in the U.S. as a matter of market expectations, in light of the availability of a Board of Corporate Auditors or an Audit and Supervisory Committee under Japanese law. Further, under Japanese law, a "large company," which is defined as a company with stated capital of 500 million yen or more, or liabilities of 20 billion yen or more, must generally have a Board of Corporate Auditors if it does not have an Audit and Supervisory Committee. From a practical standpoint, companies listing on Nasdaq are highly likely to fall into the category of large companies. The overwhelming majority of Japanese companies listing on Nasdaq in recent years have a corporate governance system with a Board of Corporate Auditors.

Pursuant to the Companies Act, a Board of Corporate Auditors and an Audit and Supervisory Committee are separate from the board of directors, and function to oversee the board of directors and independent accounting auditors. For example, a Board of Corporate Auditors performs the following duties:

1. Preparation of audit reports
2. Appointment and removal of full-time corporate auditors
3. Determination of audit policy, methods for investigating the status of the operations and financial status of the company, and other matters regarding the execution of the duties of corporate auditors

If a Board of Corporate Auditors so requests, individual corporate auditors must report the status of the execution of their duties to the Board of Corporate Auditors at any time.

Similarly, the Audit and Supervisory Committee performs, among other duties, the following:

1. Audit of execution of the directors' duties and preparation of the audit report
2. Determination of the proposals regarding the election and dismissal of an accounting auditor and the refusal to reelect an accounting auditor to be submitted to a shareholders meeting

The Board of Corporate Auditors or the Audit and Supervisory Committee has the authority to dismiss the company's accounting auditors under specified circumstances, and to determine the proposals on the election and dismissal of the company's accounting auditor and the refusal to reelect an accounting auditor to be submitted to a shareholders meeting. Further, the board of directors must obtain the consent of the Board of Corporate Auditors or the Audit and Supervisory Committee to determine the compensation of accounting auditors.

If accounting auditors detect, during the performance of their duties, misconduct or material facts in violation of laws and regulations or the company's articles of incorporation in connection with the execution of the directors' duties, they must report the same to the Board of Corporate Auditors or the Audit and Supervisory Committee without delay.

If it is necessary for the purpose of performing their duties, a corporate auditor comprising the Board of Corporate Auditors or the Audit and Supervisory Committee may request reports on the financial audits from the accounting auditors.

Compensation of Executive Officers

As a general rule, a U.S domestic company listing on Nasdaq must have a compensation committee of at least two members. The role of the compensation committee is primarily to act as independent oversight of executive officer compensation. Accordingly, each compensation committee member must be an independent director as defined by Nasdaq. In addition, Nasdaq imposes an additional independence test for compensation committee members. In determining the independence of any director who will serve on the compensation committee, the board of directors must consider all factors specifically relevant to determining whether a director has a relationship to the company that is material to that director's ability to be independent from management in connection with the duties of a compensation committee member, including the source of compensation of such director, such as any consulting, advisory or other compensatory fee paid by the company to the director, and whether the director is affiliated with the company, a subsidiary of the company or an affiliate of a subsidiary of the company.

A foreign private issuer may follow home country practices in lieu of this requirement. The Companies Act does not prescribe requirements for determining compensation of executive officers. As a matter of practice, many Japanese companies currently listed on Nasdaq have a board of directors that collectively participates in the discussions and determination of compensation for its executive officers and directors, and other compensation-related matters. This structure, among others, would be sufficient as a home country practice in lieu of Nasdaq requirements regarding compensation of executive officers.

Nomination of Directors

As a general rule, director nominees of U.S domestic companies listing on Nasdaq must be selected, or recommended for the board's selection, either by independent directors constituting a majority of the board's independent directors in a vote in which only independent directors participate or by a nominations committee comprised solely of independent directors.

Nasdaq also notes that independent director oversight of nominations enhances investor confidence in the selection of well-qualified director nominees as well as independent nominees as required by the rules. This rule is also intended to provide flexibility for a company to choose an appropriate board structure and reduce resource burdens, while ensuring that independent directors approve all nominations.

A foreign private issuer may follow home country practices in lieu of this requirement. The Companies Act provides that directors are elected by a resolution at a shareholders meeting. This structure would be sufficient as home country practice in lieu of Nasdaq's requirements regarding nomination of directors.

Disclosure Requirements

Although a foreign private issuer may follow home country practices in lieu of the corporate governance requirements discussed above, Nasdaq requires any company utilizing these exemptions to disclose the exemptions used and the home company practices the company follows in lieu of the Nasdaq requirement. For example, a foreign private issuer making its initial public offering or first U.S. listing on Nasdaq must disclose in its registration each requirement that it does not follow, and must describe the home country practice followed by the company in lieu of such requirements. Further, a listed foreign private issuer that follows a home country practice in lieu of any of Nasdaq's listing rules must disclose in its annual reports on Form 20-F filed with the SEC each requirement that it does not follow, and must describe the home country practice followed by the company in lieu of such requirements. Additionally, a foreign private issuer that follows a home country practice in lieu of the requirement to have an independent compensation committee must disclose in its annual reports on Form 20-F filed with the SEC the reasons why it does not have such an independent committee.

Related Professionals

The article above is meant to be only a summary, and does not include a discussion of all exemptions available to foreign private issuers. Further, the exemptions applicable to foreign private issuer are very detailed and depend on the company's circumstances.

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