



FINANCIAL SERVICES AGENCY  
GOVERNMENT OF JAPAN

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February 14 , 2003

Mr. Jonathan G. Katz  
Secretary  
Securities and Exchange Commission  
450 Fifth Street, N.W.  
Washington, D.C. 20549-0609

Re: Proposed Standards Relating to Listed Company Audit Committees (File No. S7-02-03)

Dear Mr. Katz:

As the Deputy Commissioner for International Affairs of the Financial Services Agency of Japan (“FSA”), I am pleased to submit this letter on behalf of the FSA in response to the request of the Securities and Exchange Commission (“SEC”) for comments on its proposed rule (“Proposed Rule”) under Section 301 of the Sarbanes-Oxley Act of 2002 on standards relating to listed company audit committees, as contained in Release Nos. 33-8173; 34-47137; and IC-25885. This letter is sent to you based on the FSA’s agreements of the relevant ministries of the Japanese government, including the Ministry of Justice which is in charge of the Commercial Code and the Law for Special Exceptions to the Commercial Code concerning Audits, etc. of Corporations (“Special Law”).

## I . Introduction

The Sarbanes-Oxley Act is an important accomplishment for restoring confidence in the United States securities markets. We recognize that the issues addressed by the Sarbanes-Oxley Act are global. From this viewpoint, the FSA also has been working to reform the Japanese securities markets for the same purpose, taking into account the international developments including those related to the International Organization of Securities Commissions (“IOSCO”) and the Sarbanes-Oxley Act. The FSA plans to submit bills for the necessary amendments of the relevant laws to promote securities markets reform and further strengthen auditor independence and auditor oversight to the current regular session of the Diet (Japan’s national legislature). Japan also has recently further enhanced its corporate governance system by revising the Commercial Code and the Special Law.

Since the Sarbanes-Oxley Act includes the clauses which affect some Japanese institutions, we have a strong interest in how the Sarbanes-Oxley Act has been, and will be, implemented. We greatly appreciate constructive dialogues we are having with the SEC. As has been already discussed on various occasions, we have concerns with some

provisions of the Sarbanes–Oxley Act, which are in conflict with the Japanese legal framework. Section 106 (Foreign Public Accounting Firms) and Section 301 (Public Company Audit Committees) are the provisions with which we have the most serious concerns. Based on these concerns, *we have respectfully requested that the SEC provide appropriate exemptions from Section 106 to Japanese audit firms and from Section 301 to Japanese “issuers” within the meaning of the Sarbanes–Oxley Act.*

## II. Japanese Corporate Governance System

In Japan, the Special Law provides “large corporations” (which definition covers all Japanese issuers registered with the SEC) with a choice between two alternative corporate governance systems from April 2003. These two systems are briefly explained in note 88 of the Proposed Rule.

One option, which is the only available option at present, is to have within the corporation a board of corporate statutory auditors, which is a legally separate and independent body from the board of directors. This system (*board of corporate statutory auditor system*) has been enhanced several times in recent years. For example, the latest amendment, which was enacted in 2001, provided such measures as the increase in the required number of outside corporate statutory auditors from one to at least half of the members of the board of corporate statutory auditors, and the strengthening of the definition of an “outside” corporate statutory auditor (both effective May 2005). Each corporate statutory auditor is to be appointed and dismissed at shareholders’ meetings, and has strong and detailed legal powers for auditing affairs of the corporation including investigation powers.

The other option, which will become available in April 2003, is to establish nominating committee, audit committee and compensation committee by and among the board of directors (*committee system*). Each of the three committees is to consist of three or more directors, and in each committee a majority shall be outside directors. Member directors of the committees are decided by the board of directors. The designated members of the audit committee have strong and detailed legal powers for auditing affairs of the corporation including investigation powers.

It is an essential aspect of the Special Law that large corporations are free to choose between the two systems. There is no preference for either system under the Special Law. We believe that *the Japanese corporate governance system (both the current system and the alternative system available from April 2003 under the Special Law) provides a governance structure that is substantially equivalent to the one contemplated by the provisions relating to the audit committee under the Sarbanes–Oxley Act.*

The Technical Committee of the IOSCO made public last October the Statement titled “Principles of Auditor Independence and the Role of Corporate Governance in Monitoring an Auditor’s Independence.” The Statement, which is referred as “internationally accepted best practices in corporate governance” in note 90 of the Proposed Rule, refers to the role of the “audit committee,” which is defined as “any governance body or bodies with responsibilities for overseeing the external auditor,

regardless of whether they have that title.” This shows that the IOSCO fully recognizes and respects differences in corporate governance systems among the IOSCO members’ jurisdictions. For the same reason, ***we continue to respectfully request the SEC to respect the substantially equivalent Japanese corporate governance system in finalizing the Proposed Rule and in implementing the final rule.***

### **III. Comments on the Proposed Rule**

Let me first emphasize that we appreciate that the Proposed Rule includes the general exemption clause for foreign private issuers in paragraph (c)(2), although there are some areas we would have preferred a broader exemption for Japanese issuers. From the viewpoint of recognition of the Japanese corporate governance system in the final rule, we would like to make the following comments on the Proposed Rule.

#### **(1) “Sunset Date”**

You have asked whether you should provide a “sunset date” for the proposed exemption for foreign private issuers from jurisdictions that operate with boards of auditors or similar bodies. We do not believe this is appropriate or necessary with respect to the exemption as applicable to Japanese private issuers. It is clear that the Japanese regulatory framework provides substantially equivalent protections to those intended by the Sarbanes–Oxley Act and that there is no need to provide for a required reconsideration of this issue. We believe that, in these circumstances, a built-in “sunset date” would be inconsistent with an appropriate level of respect for the corporate governance system in Japan, and such respect should be maintained on a permanent basis.

Therefore, ***we strongly disagree with the idea of providing a “sunset date” for this SEC rule to allow the SEC to reconsider its effectiveness and to reexamine the trend towards audit committees in other jurisdictions.***

#### **(2) Committee System**

Second, the Proposed Rule does not explicitly provide an exemption for listing of securities of Japanese private issuers which adopt the committee system. Since an audit committee under the committee system is established within the board of directors, the committee system does not satisfy the requirement of “separate from the board of directors” stipulated in paragraph (c)(2)(i)(B) of the Proposed Rule. Although the Japanese committee system provides a substantially equivalent governance structure to the audit committee system under the Sarbanes–Oxley Act, there are some differences on the requirements for independence and responsibilities relating to audit firms, such as the definition and required minimum number of “outside directors.”

Some Japanese private issuers with extensive international business operations have already announced their intention to adopt the committee system. We also recognize that some Japanese corporations, which have an intention to be listed in the United States securities markets, are considering adopting the committee system. If the final rule does not include an explicit provision for providing an appropriate exemption

for the committee system for Japanese issuers, the adoption of the committee system among current and future Japanese private issuers would be discouraged or even halted. This is not in line with the spirit of the Special Law which provides two equally effective corporate governance systems to large Japanese corporations, and such an outcome should be contradictory to the Proposed Rule which seems to welcome the trend towards audit committees in foreign jurisdictions.

Therefore, ***we respectfully request the SEC, in finalizing the Proposed Rule, to specifically provide an appropriate exemption, as part of the general exemption clause in paragraph (c)(2) of the Proposed Rule, for the Japanese issuers with the committee system from the requirements for independence and responsibilities relating to registered public accounting firms,*** in addition to the general exemption for the Japanese issuers with the board of corporate statutory auditors system. ***One way to achieve this would be to delete or revise the phrase “separate from the board of directors” stipulated in paragraph (c)(2)(i)(B) of the Proposed Rule.***

### **(3) Required standard of funding**

Third, paragraph (b)(5) of the Proposed Rule stipulates the required standard of funding for payment of compensation. This provision deals with payment of compensation to “any registered public accounting firm engaged for the purpose of rendering or issuing an audit report or related work or performing other audit, review or attest services for the listed issuer.” On the other hand, paragraph (c)(2)(i) of the Proposed Rule exempts a foreign private issuer from the requirement of paragraph (b)(2) which obligates the audit committee to be directly responsible for, among other things, compensation of any registered public accounting firm. It is contradictory to impose on a foreign private issuer an obligation to provide for appropriate funding, as determined by the audit committee, for payment of compensation to any registered public accounting firm under paragraph (b)(5)(i) of the Proposed Rule. To be consistent with the purpose of the general exemption, foreign private issuers should be exempted from this provision.

Therefore, ***we respectfully request the SEC to revise “the requirements of paragraphs (b)(1) or (b)(2) of this section” under paragraph (c)(2)(i) of the Proposed Rule to “the requirements of paragraphs (b)(1), (b)(2) or (b)(5)(i) of this section,” or to address the issue in another appropriate way.***

Under the Commercial Code each corporate statutory auditor can request any expense necessary for performing its auditing functions to the corporation, including payment of compensation to any adviser. The corporation cannot refuse the request unless it proves that the expenses are not necessary for the performance of auditing functions. Members of an audit committee under the committee system are given the same power under the Special Law. Therefore, ***Japanese listed issuers meet the requirement of paragraph (b)(5)(ii) of the Proposed Rule.***

In case you determine that paragraph (b)(5)(i) of the Proposed Rule should apply to Japanese listed issuers, ***they meet the requirement of paragraph (b)(5)(i) of the Proposed Rule.*** The Commercial Code and the Special Law do not have an express provision on the powers of corporate statutory auditors or an audit committee in this

respect. However, both corporate statutory auditors and the audit committee have a legal power to make an audit on the issue of funding for payment of compensation as part of broad overall audit powers over business and financial matters of corporations. In addition, corporate statutory auditors are legally required to attend meetings of the board of directors and express their opinions on the issue when necessary. Furthermore, each Japanese listed issuer can establish as its corporate practice under the Commercial Code and the Special Law that the determination (decision or consent) by the board of corporate auditors or the audit committee is required for payment of such compensation.

#### **(4) Requirement of listing or quotation outside the United States**

Fourth, in response to the question included in the Proposed Rule of “would any foreign issuers that currently maintain a U.S. listing seek to delist their securities because of these requirements,” we would like to take up the issue of paragraph (c)(2)(i)(A) of the Proposed Rule. This provision stipulates the requirement of listing or quotation on securities markets outside the United States for the general exemption of foreign private issuers. We think that this requirement is in general reasonable because it requires foreign private issuers to be subject to listing or quotation requirements of foreign jurisdictions including a requirement for corporate governance.

On the other hand, the Japanese corporate governance system for large corporations is in principle established under the Commercial Code and the Special Law, but not pursuant to the listing or quotation requirements of stock exchanges or the OTC market. Although, for example, the Tokyo Stock Exchange established last December the task force composed of outside experts to study issues of corporate governance of listed corporations, it is clearly the case that the current listing or quotation requirements in Japan play a less important role with respect to corporate governance than those in the United States, which has the federal system.

Currently, there are two Japanese corporations which are not listed or quoted on the Japanese securities markets but quoted on the NASDAQ Stock Market. These corporations have enjoyed the benefits of the quotation on the NASDAQ Stock Market because of such needs as dollar funding for their international businesses. If paragraph (c)(2)(i)(A) of the Proposed Rule were applied without an appropriate revision, these corporations could not help but become delisted from the NASDAQ Stock Market. Such outcome would be not only damaging to these corporations, but also not productive for the further development of the United States securities markets which are the leading securities markets in the world.

As explained above, the Japanese corporate governance system under the Commercial Code and the Special Law provides an substantially equivalent governance structure to the one provided by the corporate governance system under listing or quotation requirements in the United States. From this viewpoint, ***we respectfully request the SEC to revise the Proposed Rule so that those Japanese private issuers which are “large corporations” under the Special Law and not listed or quoted on the Japanese stock exchanges or the OTC market are allowed to be continuously listed or quoted on the United States securities markets.***

## **(5) Requirements for the general exemption of foreign private issuers**

Fifth, paragraph (c)(2)(i) of the Proposed Rule sets the requirements for the general exemption of foreign private issuers, and we appreciate it very much. We would like to explain below that these requirements reflect the systems of foreign jurisdictions, including Japan's, very well. ***The Japanese board of corporate statutory auditors system meets all of these requirements, and the Japanese committee system including an audit committee meets all of these requirements if the phrase "separate from the board of directors" in paragraph (c)(2)(i)(B) is deleted or appropriately revised,*** as explained in (2) above.

### **(A) Requirement of Listing or Quotation outside the United States**

We have already explained our comments in (4) above.

### **(B) Establishment and Selection pursuant to Home Country Requirements**

As briefly indicated in note 88 of the Proposed Rule, large Japanese corporations shall "establish" as their corporate governance structure either the board of corporate statutory auditors system which is separate from the board of directors or the committee system including an audit committee established among the board of directors (which will be available from this April), and are free to "select" between these two systems under the Special Law.

Therefore, ***both systems meet this requirement except "separate from the board of directors" requirement with regard to the committee system.***

### **(C) Members of the Board**

Corporate statutory auditors are elected at shareholders' meeting under the Commercial Code. The consent of the board of corporate statutory auditors is required for the submission of proposals on the election or dismissal of corporate statutory auditors to shareholders' meetings by managing directors under the Special Law. Corporate statutory auditors cannot be directors or employees of the corporation and its subsidiaries.

Regarding an audit committee under the committee system, its members are selected by the board of directors, but they are also elected as directors at shareholders' meetings pursuant to the nomination by the nomination committee, a majority of the members of which are outside directors. Its members shall not be executive officers or employees of the corporations or directors, executive officers or employees of its subsidiaries under the Special Law.

### **(D) Standards for independence**

Corporate statutory auditors and designated members of an audit committee have strong and detailed legal powers for auditing affairs of the corporation including investigation powers under the Commercial Code and the Special Law. These powers

shall be exercised independently from the management.

Corporate statutory auditors cannot be directors or employees of the corporations and its subsidiaries. In addition, at least half of the members of the board of corporate statutory auditors shall be outside corporate statutory auditors (effective May 2005). An outside corporate statutory auditor is defined under the Special Law as a person who has never been a director, an executive officer or an employee of the corporation or its subsidiaries (effective May 2005).

A majority of the members of an audit committee under the committee system shall be outside directors. An outside director is defined under the Commercial Code as a director who is not a managing director or an employee of the corporation and who has not been a managing director, an executive officer or an employee of the corporation and any of its subsidiaries and who is not serving as a managing director, an executive officer or an employee of any of its subsidiaries.

#### **(E) Responsibilities relating to oversight of the work of registered public accounting firms**

Although the Special Law does not explicitly provide corporate statutory auditors or the audit committee with the powers such as “resolution of disagreements between management and the auditor regarding financial reporting”, both corporate statutory auditors and the audit committee have broad legal powers of auditing business and financial matters of corporations under the Commercial Code and the Special Law, which can be exercised for oversight of the work of an external accounting auditor, and strong explicit powers of oversight of the work of an external accounting auditor under the Special Law, such as follows:

- When an external accounting auditor has, in performing its functions, found any unjust acts or serious facts in violation of laws and ordinances or the articles of incorporation regarding performance of directors’ functions, the external accounting auditor shall report it to the board of corporate statutory auditors or the audit committee.
- Corporate statutory auditors or designated members of the audit committee can seek reports from the external accounting auditor when necessary to perform their functions.
- The external accounting auditor shall submit the audit report to the board of corporate statutory auditors or the audit committee.
- Corporate statutory auditors or designated members of the audit committee can request the external accounting auditor to explain its audit report.
- The board of corporate statutory auditors or the audit committee shall make its own audit report and submit it to the board of directors.
- The audit report by the board of corporate statutory auditors or the audit committee shall include inadequacy of the method or result of audit by the external accounting auditor and the reason why it is recognized. Each corporate statutory auditor or each member of the audit committee can add his/her opinions to the audit report.
- The copies of audit reports by the board of corporate statutory auditors or the audit committee and the external accounting auditor shall be sent to shareholders

when the notice of convening shareholders' meeting are sent.

- Corporate statutory auditors are required to attend meetings of the board of directors and express their opinions when necessary.

Therefore, both corporate statutory auditors and the audit committee can exercise oversight powers over the work of an external accounting auditor, including "resolution of disagreements between management and the auditor regarding financial reporting."

#### **(F) Responsibilities relating to the appointment and retention of registered public accounting firms**

External accounting firms are elected and dismissed at shareholders' meetings under the Special Law. We confirm that, with respect to Japanese large corporations, the "requirement in paragraph (b)(2) or (c)(2)(i)(F) of this section does not conflict with, and does not affect the application of, any requirement under an issuer's governing law or documents or other home country requirements that requires shareholders to ultimately elect, approve or ratify the selection of the issuer's auditor," as stated in Instruction 1 to the Proposed Rule.

Both Japanese corporate governance systems meet the requirement that "if the issuer provides a recommendation or nomination of an auditor to its shareholders, the audit committee of the issuer, or body performing similar functions, must be responsible for making the recommendation or nomination." The details are as follows:

- The consent of the board of corporate statutory auditors is required for the submission of proposals on the election, reappointment or dismissal of external accounting auditors to shareholders' meetings by managing directors. The board of corporate statutory auditors can request managing directors to take up the agenda of the appointment, reappointment or dismissal of an external accounting auditor at shareholders' meetings.
- The audit committee decides proposals on the appointment, reappointment or dismissal of external accounting auditors to be submitted to shareholders' meetings.
- The external accounting auditor can be dismissed by the board of corporate statutory auditors or the audit committee in such cases as the violation of its duties.

### **III. Conclusion**

As is explained in this letter, the Japanese corporate governance system is designed to achieve the same goals and provides a governance structure that is substantially equivalent to the one contemplated by the provisions relating to the audit committee under the Sarbanes-Oxley Act and the Proposed Rule. ***We respectfully request that the SEC take full account of our comments in promulgating the final rule.***

Yours Sincerely,

Makoto Hosomi



Deputy Commissioner for International Affairs  
Financial Services Agency  
Government of Japan