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COMMENTARY

Japanese Corporate Governance Is Changing with the Adoption of a New Code in 2015

In the past, Japan may not have enjoyed high scores in the area of corporate governance, but this may change soon. The "Japan Revitalization Strategy (Revised in 2014),"[1] commonly known as the third arrow of the "Abenomics" (the economic policies advocated by Japanese Prime Minister Shinzō Abe), places a high priority on the enhancement of corporate governance of Japanese companies. Japan is moving quickly to adopt the corporate governance code (the "Code"). A draft of the Code, titled "Japan's Corporate Governance Code—Seeking Sustainable Corporate Growth and Increased Corporate Value over the Mid- to Long-Term" (the "Draft Code"), was released in December 2014 for public comment.[2] In this *Commentary*, we provide background on the discussions of the Code as well as a summary of its key provisions, based on the Draft Code, which is the only version currently available to the public.

Background of the Discussions and Status

Following the announcement of the Japan Revitalization Strategy in June 2014, the Council of Experts Concerning the Corporate Governance Code (chaired by Kazuhito Ikeo, Professor of Economics and Finance, Keio University) (the "Council of Experts") was formed and started discussions in August 2014. The Council of Experts has 12 members, consisting of four from the business community, four from the investment community, one prominent law professor, one law practitioner, one from an accountant association, and one from the *kansayaku* corporate auditor association. The Financial Services Agency ("FSA") and the Tokyo Stock Exchange ("TSE") act as joint secretariats, and the Council of Experts also has an advisor from the Organization for Economic Cooperation and Development ("OECD").

The next meeting of the Council of Experts is expected to be held in late February to early March 2015, at which public comment on the Draft Code will be considered and necessary revisions to the Draft Code will be discussed and approved. The final version of the Code is expected to be announced by the TSE in March 2015, together with revisions to the listing rules of the TSE.

Scope of Application

The Draft Code presumes that the Code will apply to all companies listed on the TSE and other stock exchanges in Japan, including Jasdaq and TSE's Mothers (Market of the high-growth and emerging stocks). However, it was noted in the Draft Code that some special consideration may be needed in connection with application of the Code to those listed on stock exchanges other than main sections of the exchanges (i.e., the TSE's First and Second Sections). Details of modification when the Code is applied to companies listed on such other markets will be announced in due course.

Introductory Comments on the Code

As the discussions of the Code were driven by government policy to revitalize the Japanese economy, the Code has a clear objective of promoting the growth of businesses, and it places more emphasis on proper risk-taking by management (rather than avoidance of all risk).

Since the Japan Revitalization Strategy stated that discussions of the Code should be based on and refer to the OECD Principles of Corporate Governance, the Draft Code reflects the essence of those principles. In this connection, the head of the Corporate Affairs Division of the OECD attended and made a presentation on the OECD Principles at the second meeting of the Council of Experts held in September 2014.

Prior to the adoption of the Code, Japan had put in place the "Principles of Responsible Institutional Investors (Japan's Stewardship Code)" (the "Stewardship Code")[3] adopted in February 2014. As such, when discussions on the Code by the Council of Experts began, institutional investors had already been urged to be more proactive and engage in a constructive dialogue with investee companies under the Stewardship Code.[4]

The Code and the Stewardship Code both show an expectation that shareholders, including institutional investors, and investee companies will engage in a constructive dialogue toward achieving sustainable growth and an increase in the mid- to long-term value of such companies. In that connection, the Stewardship Code uses a phrase that companies and investors are like "two wheels of a cart" with a common goal. Similarly, the same phrase is used in the Draft Code—that the Code and the Stewardship Code are like "two wheels of a cart" and are expected to work together to achieve the effective corporate governance of Japanese listed companies.

The Code takes the "Principles-Based Approach" and "Comply or Explain Approach." As such, the Code is not prescriptive, and certain principles are purposely drafted in general terms to leave flexibility. The Code expects companies to apply the spirit of the principles set forth under the Code, not follow literally the text of the principles as if they were statutory provisions. The Code leaves room for companies to consider what should work for them to achieve effective corporate governance, and it permits them to decide whether to comply with the principles under the Code or choose not to do so, with a proper explanation of the reasons for not doing so.

Finally, in order to better understand the Code, it is important to know unique features of the Companies Act of Japan, which provides for the three types of corporate governance structures for Japanese listed companies to choose: (i) a company with the board of *kansayaku* corporate auditors, (ii) a company with three committees (nominating, compensation, and audit committees), and (iii) a company with an audit committee with supervisory functions. Legally, these three types of governance structures are treated equally under Japanese law, and the Code is neutral as to these three governance structures. There are, however, a certain number of Code provisions that are intended to apply primarily to companies with the board of *kansayaku* corporate auditors since it is not required to have external directors or to have nomination or compensation committees.

Corporate Governance Structures in Japan

Company with Board of *Kansayaku* Corporate Auditors. This is the original governance structure for Japanese companies, accounting for more than 98 percent of listed companies in Japan. For this type of governance structure, a company has a board of directors and the board of *kansayaku* corporate auditors (which board consists of no less than half of external *kansayaku* corporate auditors). However, a company is not required to have any external directors (*shagai torishimariyaku*) under Japanese law. [5] [6]

Company with Three Committees. This is a governance structure introduced in 2002 by way of the amendments to the then Commercial Code,[7] in order to provide an alternative governance structure appealing to overseas investors. However, it has not gained popularity among Japanese companies, and a total of only approximately 60 listed companies have this type of governance structure.[8] For this type of structure, a company has a board of directors, with three statutorily mandated committees (nomination, compensation, and audit committees). Each committee consists of three or more directors, and a majority of each committee must be external directors. Since it has an audit committee, the company does not have the board of *kansayaku* corporate auditors for this governance structure.

Company with Audit Committee with Supervisory Functions. This third type of governance structure is being made available with effect from May 2015, when the amendments to the Companies Act take effect. For this governance structure, a company has a board of directors and an audit committee with supervisory functions, but it is not required to have either a nomination or compensation committee. Instead, the audit committee is given certain supervisory functions as to the nomination and compensation of directors (including the senior management). These companies will not have the board of *kansayaku* corporate auditors.

Overview of the Code

The Draft Code has five Chapters and corresponding five General Principles with multiple Principles and Supplementary Principles: Chapter 1—Shareholder Rights and Equal Treatment of Shareholders; Chapter 2—Proper Cooperation with Stakeholders; Chapter 3—Proper Disclosure and Transparency; Chapter 4—Responsibilities of the Boards; and Chapter 5—Shareholder Engagement.

A brief overview of key Code provisions, based on the Draft Code, follows.

Responsibilities of Boards. General Principle 4 of the Draft Code provides for three main responsibilities of a board of directors: (i) setting the overall direction of the company and approval of corporate strategy, (ii) support of proper risk-taking by management, and (iii) effective oversight of the management from an independent and objective standpoint. Regardless of their corporate governance structures, all companies are urged to ensure the effective monitoring by the board of business operations. These may appear too obvious to overseas investors, but such clear delineation of the responsibilities of the board is unprecedented in Japan.

Executive Compensation. Members of the Council of Experts voiced a concern that generally the management of Japanese companies is risk averse, and they suggest, from the perspective of promoting sustainable growth and increase in mid- to long-term corporate value of listed companies, that the Code should send a clear message to encourage proper risk-taking in business operations. The Draft Code provides that the board of directors should design executive compensation so that it provides proper incentives for management to exercise healthy entrepreneurship, toward the sustainable growth of the company. The board should consider a proper percentage of compensation linked to mid- to long-term performance and strike a proper balance of cash and equity components, and the compensation policy should be disclosed in a clear manner.

Appointment and Dismissal of Management. The Draft Code provides that boards of directors should properly conduct the evaluation of business performance and reflect the evaluation results in the nomination of senior management. The policy and procedure of nomination of director candidates as well as the senior management should be disclosed to ensure transparency and fairness. The Draft Code provides (but only in general terms) that the board of directors should oversee succession planning. It is a big step forward that such a sensitive subject as succession planning is mentioned in the Code, but actual practice among Japanese companies may differ substantially.

Voluntary Use of Committees. As among the three corporate governance structures, only one is required to have nomination and compensation committees. The Draft Code urges other types of companies to consider voluntarily establishing a committee (or committees) for nomination and compensation. Under the "Comply or Explain Approach," it is left for each company to decide whether to implement such a voluntary committee mechanism or to provide a clear explanation for not doing so. In relation to the composition of such voluntary committee(s), the Draft Code provides only that independent directors be primary members, without either strict or specific requirements for such composition. The functions of such committee are also left for the company to decide.

Independent Directors. With regard to the number of independent directors, the Draft Code provides that a company should appoint at least two independent directors who possess competencies to contribute to the sustainable growth of the company and increase corporate value over the mid- to long-term. In addition, if a company, in its own judgment, considers it necessary to appoint no less than one-third independent directors, it should disclose a policy with respect thereto.

From the perspective of most leading stock markets, the Draft Code provision requiring only two independent directors appears insufficient. However, given the current status of the actual number of independent directors serving on the board of Japanese listed companies,[9] this requirement is a modest but practical and positive first step forward for many Japanese companies. In this connection, the ISS's Japan Proxy Voting Guidelines (2015 benchmark policy recommendations)[10] provides for an "against" recommendation for the election of top executive(s), starting in the 2016 proxy season, if a company does not have two or more external directors who meet ISS's independence criteria after the annual general shareholders meeting. Institutional investors and other shareholders may be successful in moving independent representation forward faster.

Standards for Independent Directors. The Draft Code does not have specific standards for independent directors but provides generally that the board should establish and disclose its own independence standards, with reference to the standards promulgated by the TSE or other applicable stock exchanges. As indicated in the commentaries provided in the background section of the Draft Code, the independence standards provided under the listing rules of the TSE are expected to be amended while the Code is being finalized. The details should be available in due course, presumably around the time of the finalization of the Code in March 2015.

Board Composition and Evaluation of the Board. The Draft Code provides that the board of directors as a whole should be well balanced in terms of knowledge, experience, and competencies necessary for fulfilling its roles and responsibilities. It should also be constituted to have a proper balance of diversity and size as well. The board should establish its own position as to the composition of the board, diversity, and size, and disclose such position, together with the policy and procedure for nominating directors.

The Draft Code also provides that the board should conduct an annual evaluation of its effectiveness as a whole and disclose a summary of the results of such evaluation.

Concurrent Position. The Draft Code provides only generally that directors and *kansayaku* corporate auditors should devote sufficient time and efforts required to fulfill their respective roles and responsibilities, and that the number of other offices concurrently being held by directors/*kansayaku* corporate auditors should be limited to a reasonable number. Companies should disclose relevant information annually.

Training. The Draft Code provides that directors and *kansayaku* corporate auditors should deepen their understanding of their respective roles and responsibilities and should endeavor to acquire and update necessary knowledge and skills through orientation and continuous training. In that regard, the Draft Code further provides that listed companies should provide and arrange training opportunities suitable to each director and *kansayaku* corporate auditor, and that the board should confirm whether such opportunities are properly provided. The Draft Code also provides for disclosure of the training policy for directors and *kansayaku* corporate auditors.

Shareholder Engagement. The Draft Code provides that, with a view toward achieving a sustainable growth and increase in corporate value over the mid- to long-term, listed companies should engage in a constructive dialogue with shareholders and, to the extent reasonable, honor the requests from shareholders for a constructive dialogue. Further, senior management and directors, including external directors, are urged to engage in such a dialogue to the extent reasonable. Listed companies should disclose their policy regarding shareholder engagement.

Cross-Shareholdings. The Draft Code provides that listed companies that hold shares of other listed companies in a cross-shareholding relationship should disclose their policy with respect thereto, and that the board should review on an annual basis the economic rationale and future prospect of such cross-shareholdings.

In addition, the Draft Code provides that companies should establish and disclose standards for the exercise of voting rights with respect to their cross-shareholdings. As to shareholdings by listed companies, a member of the Council of Experts expressed a view at a meeting that by way of analogy, a concept of stewardship responsibilities relating to an exercise of voting rights by institutional investors should also apply to listed companies in connection with the exercise of voting rights of shares in a cross-shareholding.[11]

When the Code Begins to Apply

It is expected that the Code will begin to apply on June 1, 2015. As the announcement of the Code in final form is expected in late February to early March 2015, it leaves only a limited amount of time for companies to implement any measures necessary to comply with the Code. As such, realistically some companies may find it difficult to complete the implementation of necessary reforms in their governance before the Code's application. In that connection, the Draft Code suggests that a company should not be viewed negatively simply because of noncompliance as long as it explains clearly its plan and schedule for its actions toward compliance with specific provisions of the Code, if it diligently prepares for compliance with such Code provisions but cannot complete preparations in time.

Concluding Comments

Corporate governance is an area in which Japanese companies have been viewed as lagging behind their peers in other developed countries. Recent developments appear to change this perception, including increasing shareholder pressure through the exercise of voting rights. The ratio of "against" votes in Japanese listed companies is in fact higher than generally expected. As a result, management is becoming more responsive to shareholders than in the past. The introduction of the Code is expected to further shareholder engagement in connection with governance-related issues. At its last meeting in 2014, the Council of Experts' chair stated: "Japan excels at catching up." We will soon see whether that holds true for corporate governance.

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Endnotes

1 http://www.kantei.go.jp/jp/singi/keizaisaisei/pdf/honbunEN.pdf.

2 http://www.fsa.go.jp/en/refer/councils/corporate governance/20141226-1/01.pdf.

3 http://www.fsa.go.jp/en/refer/councils/stewardship/index.html.

4 The numbers of domestic and foreign institutional investors (including trust banks, investment advisors and managers, insurance companies, pension funds, and proxy advisors) who have notified the FSA that they have become signatories of the Stewardship Code on a quarterly basis is gradually increasing: 127 (as of May 31, 2014), 160 (as of August 31, 2014), and 175 (as of November 30, 2014).

5 "External director" is a legal concept defined under Japanese law, while "independent" director is a concept used primarily under the TSE rules. "Independent" director is defined under the TSE rules to mean an external director not likely to pose a risk of conflict of interests with shareholders at large. The determination of independence is made on the basis of facts relevant to a particular external director, with reference to negative factors listed in the independence standards under the TSE rules. While the definition of "independence" may not change, the independence standards under the TSE rules are expected to change in conjunction with the announcement of the Code.

6 The Companies Act (Act No. 86 of 2005), as amended as from May 2015, will require that a company that does not have an external director explain the reasons why it is inappropriate for such company to have external director(s).

7 The Commercial Code (Act No. 48 of 1899), as amended by Act No. 44 of 2002 (effective from April 2003). The provisions of the Commercial Code regarding companies have subsequently been replaced with (and succeeded by) the Companies Act, as of May 1, 2006.

8 *See* the data compiled and announced by Japan Association of Corporate Directors, as of October 2014.

9 According to the report issued by the TSE in July 2014, the number of listed companies with two or more independent directors are, in the case of the TSE's First Section, 390 companies (representing 21.5 percent of 1,814 companies listed on the First Section) and, in the case of the TSE's Second Section, 18 companies (representing 3.3 percent of 545 companies listed on the Second Section). The average number of directors of all TSE listed companies was 8.13 (according to the "White Paper of Corporate Governance of TSE Listed Companies (2013)" issued in February 2013).

10 http://www.issgovernance.com/file/policy/2015japanvoting guidelines.pdf.

11 "Institutional investors should have a clear policy on voting and disclosure of voting activity. The policy on voting should not be comprised only of a mechanical checklist: it should be designed to contribute to sustainable growth of investee companies" (Principle 5 of the Stewardship Code).