

Japan's Corporate Governance Code Revised to Require Cost of Capital Consideration, Boards Tasked with CEO Selection and Removal

Annual assessment of each cross shareholding's risks and benefits compared to cost of capital newly added, assessment results to be disclosed

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Revision of the Corporate Governance Code and the CGS Guidelines, and Establishment of the Guidelines for Investor and Company Engagement

Introduction and Highlights

On June 1, 2018, Tokyo Stock Exchange, Inc. (the “**TSE**”) announced revisions to Japan’s Corporate Governance Code¹. Also as of this date, Japan’s Financial Services Agency (the “**FSA**”) finalized the Guidelines for Investor and Company Engagement² (the “**Engagement Guidelines**”). The Engagement Guidelines are intended to supplement Japan’s Corporate Governance Code and Stewardship Code. Later, on September 28, 2018, Japan’s Ministry of Economy, Trade and Industry (“**METI**”) announced revisions to Japan’s Corporate Governance System Practical Guidelines³ (the “**CGS Guidelines**”). The CGS Guidelines were originally released in March 2017 as a set of practical guidelines for corporate governance. In this alert, we summarize and analyze the revisions to the Corporate Governance Code and their potential impact on investors and others.

Highlights include (i) a requirement to establish a policy on financial management including the amount of cash on hand, (ii) a requirement to assess and disclose the purpose of each individual cross-shareholding in light of the associated risks and cost of capital, and their policy on reduction of cross-shareholdings, both among the more frequent subject matters targeted by activist shareholders in Japan. Another significant change is the clarification that the responsibility for selection and removal of the CEO and other top executives, as well as succession planning, rests with the board of directors.

¹ https://www.jpx.co.jp/english/news/1020/b5b4pj00000jvxr-att/20180602_en.pdf All citations to the Corporate Governance Code and revisions available at this URL unless otherwise noted.

² <https://www.fsa.go.jp/en/news/2018/follow-up/20180601/01.pdf>

³ English outline of the revision: http://www.meti.go.jp/english/press/2018/0928_005.html
Full text of the old version: http://www.meti.go.jp/english/press/2017/pdf/0331_005b.pdf

Background

The Japanese government has worked on corporate governance reforms in recent years through a number of measures, including developing and promoting adoption of the Stewardship Code in February 2014 and the Corporate Governance Code in June 2015. The Stewardship Code provides a voluntary code of conduct for institutional investors and fund managers to adopt “to promote the sustainable growth of companies through investment and dialogue.”⁴ The Corporate Governance Code “establishes fundamental principles for corporate governance at listed companies in Japan” with a view to attaining “Sustainable Corporate Growth and Increased Corporate Value over the Mid- to Long-Term.”⁵

The FSA and the TSE established a “Council of Experts Concerning the Follow-up of Japan’s Stewardship Code and Japan’s Corporate Governance Code” in August 2015, consisting of Japan-based academics, fund executives, representatives of legal advisors and accounting firms, and one UK-based leader of an investor-led governance think-tank,⁶ to periodically follow up on the level of awareness and adoption of the Stewardship Code and the Corporate Governance Code , as well as to receive opinions from its members.

The revisions to the Corporate Governance Code were developed based on the discussion at this Council of Experts, following revisions to the Stewardship Code in June 2017.

As mentioned above, the FSA established the Engagement Guidelines simultaneously with these revisions. The Corporate Governance Code requires listed companies to either comply with its principles or explain why they did not, known as the “comply-or-explain” rule. Although institutional investors and companies are not required to “comply-or-explain” with the Engagement Guidelines, they are expected to take the Engagement Guidelines into account in explaining their compliance with the Corporate Governance Code.

In addition, the revisions to the CGS Guidelines were announced in response to the revisions to the Corporate Governance Code, per the release announcement⁷, to provide a more concrete level of recommendations for effective corporate governance.

Revision Details

The revisions to the Corporate Governance Code provide that listed companies should take additional measures, including not only mere disclosure but also additional board involvement in assessment and decision-making, in order to handle the following issues perceived to have persisted notwithstanding governance reform efforts to date. Listed companies to which the Corporate Governance Code is applied must submit corporate governance reports based on the revised Corporate Governance Code by the end of this year.

| Issues | Measures to be taken by listed companies |
|-------------------------------------|---|
| 1. Existence of Cross-Shareholdings | <ul style="list-style-type: none">• To disclose the company’s stance on cross-shareholdings, including its stance and thought-process regarding the reduction of cross-shareholdings⁸• Board to annually assess the appropriateness of each cross-shareholding by examining its purpose and analyzing its benefits and risks, and to disclose the results of the assessment⁹• The disclosed standards based on which the company will vote its cross-shareholdings should be made specific, and the company should vote in accordance with those standards¹⁰ |

⁴ <https://www.fsa.go.jp/en/refer/councils/stewardship/20170529/01.pdf>

⁵ Refer to footnote 1.

⁶ <https://www.fsa.go.jp/en/refer/councils/follow-up/01-1.pdf>

⁷ http://www.meti.go.jp/english/press/2017/0331_005.html

⁸ Revised Principle 1.4 of Corporate Governance Code.

⁹ Id.

¹⁰ Id.

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|---|---|
| | <ul style="list-style-type: none"> Companies whose cross-shareholders indicate an intent to sell should not imply a possible reduction of business transactions or otherwise hinder the sale of the cross-held shares¹¹ Companies should not transact or continue to transact with cross-shareholders without carefully examining the underlying rationale or otherwise engage in transactions which may harm the interests of the company or the common interests of its shareholders¹² |
| 2. (1) Inadequate measures for and disclosure of CEO appointment, dismissal, and training | <ul style="list-style-type: none"> Board assigned responsibility to appoint a qualified CEO through objective, transparent and timely procedures¹³ Board to establish objective, timely and transparent procedures to dismiss CEO when not adequately fulfilling the CEO's responsibilities Board to actively engage in the establishment and implementation of a succession plan for the CEO and other top executives, and to ensure systematic training for candidates¹⁴ Board assigned responsibility to design management compensation systems and determine actual compensation amounts, and to do so objectively and transparently¹⁵ |
| (2) Diversity and experience of the board of directors and statutory auditors | <ul style="list-style-type: none"> To specify that diversity at the board should include gender and international experience To add law as a helpful expertise to consider in selecting statutory auditors¹⁶ |
| 3. Expertise in handling corporate pension funds; conflicts of interest | <ul style="list-style-type: none"> To implement human-resources and management measures such as strategic recruitment and assignment of employees with expertise in managing corporate pension funds To ensure that conflicts of interest between companies and pension fund beneficiaries are appropriately managed¹⁷ |
| 4. (1) Inadequate management decisions in response to changes in the business environment (2) Non-standardized investment decisions in fixed assets, R&D, and human resources while internal reserves increase | <ul style="list-style-type: none"> To include valuable and useful information on financial standing, business strategy, risk and ESG¹⁸ |

¹¹ Supplementary Principle 1.4.1

¹² Supplementary Principle 1.4.2

¹³ Supplementary Principle 4.3.2

¹⁴ Revised Principle 4.1.3

¹⁵ Supplementary Principle 4.2.1

¹⁶ Revised Principle 4.11

¹⁷ Revised Principle 1.6

¹⁸ Revised Note to General Principle 3

The Engagement Guidelines provide a list of suggested topics for discussion between companies and investors regarding the issues mentioned above.

First, regarding issue 1, the existence of cross-shareholdings, the Engagement Guidelines provide for comprehensive discussion of cross-shareholdings and the role of the company as a pension fund sponsor in ensuring its pensions act appropriately. This discussion is contemplated to include the purpose of each cross-shareholding, the board's assessment thereof and associated risks in light of cost of capital, the adequacy of associated disclosure and voting of its cross-shareholdings. Further, companies are expected to disclose their efforts to prevent themselves from interfering with selling or reducing holdings by their cross-shareholders, such as by threatening to take away business.

Regarding issue 2, issuers and investors are to discuss the appointment, dismissal, succession planning and compensation of the CEO, executive compensation, the board's knowledge, experience, skills, diversity and effectiveness, and whether sufficient numbers of qualified independent external directors and statutory auditors have been appointed.

On issue 4(1), issuers and investors are to discuss specific management strategies and policies and the disclosure of the same. They are to discuss whether the business is being run with due consideration of the cost of capital, including a proper understanding of the cost of capital and with targets set for profitability and capital efficiency. Investors are to discuss with issuers whether management decisions, including to reorganize the issuer's portfolio of businesses, are being made with an understanding of the businesses and the related risks.

On issue 4(2), issuers and investors are to discuss whether the issuer is making investments in fixed assets, R&D, and human resources strategically and in a planned manner, taking into consideration the cost of capital, and whether appropriate financial management policies, including with respect to the use of fixed assets and cash reserves, are being drawn up and implemented.

The CGS Guidelines provide working-level guidance for consideration and practical examples with a focus on the state of: the function of the Board of Directors, the use of outside directors, the nomination and compensation of management, and strengthening the leadership of management. The CGS Guidelines provide various suggestions to management and others tasked with corporate governance responsibility at Japanese listed companies in examining their companies' approaches to such issues. The revised CGS Guidelines reflect changes with respect to, among other things, the appointment of the president/CEO and succession planning, selection of the Chair the Board of Directors, enhancement of the effectiveness of the nomination committee and the compensation committee, and the use of outside directors.

Impact on investors

Many market participants in Japan have observed that there has frequently been wide divergence in the view of listed companies, on the one hand, and investors, on the other, with respect to (a) what companies should prioritize and (b) how much the company's need to disclose and discuss with investors (if at all). Many listed companies are said to have adopted a formalistic approach to dialogue with investors. For example, according to the Life Insurance Association of Japan's "2017 Life Insurance Association Report – Initiatives aimed at improving share value," many investors feel companies have excessive cash on hand, beyond that required for growth investment. Many companies lack any specific criteria for the appropriate level of cash on hand. Accordingly, many investors feel that explanations of the appropriateness of these levels are insufficient.

The Engagement Guidelines present a more meaningful vision of shareholders' engagement than has been the practice in Japan to date. If implemented as described, they will provide many institutional investors and fund shareholders with opportunities for a level of engagement that has been largely unavailable to investors in Japan to date. The revisions to the Corporate Governance Code, the Stewardship Code, the Engagement Guidelines and the CGS Guidelines, to the extent effectively implemented, would also represent a significant change in the role of boards in Japan in terms of control over management selection, management compensation and capital deployment.

We will be interested to see to what degree these changes impact the June 2019 proxy season*.

* Our client alert regarding the June 2018 Japan proxy season, dated July 18, 2018 can be found at <https://www.whitecase.com/publications/alert/japans-2018-proxy-season-results-announced-shareholder-activism-update-2>.

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