

Financial Regulation Newsletter

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Trends Toward the Revision of the Corporate Governance Code and Establishment of the Engagement Guidelines — Impact on disclosure practices, etc. for shareholders meetings in June 2018

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1. Introduction

The Financial Services Agency published the “Guidelines for Investor and Company Engagement (draft)” (“**Engagement Guidelines Draft**”) on March 26, 2018, which was followed by the “Japan’s Corporate Governance Code—Seeking Sustainable Corporate Growth and Increased Corporate Value over the Mid- to Long-Term (Draft Revision)” (“**Code Revision Draft**”) published by the Tokyo Stock Exchange on March 30, 2018¹.

It is prospected that, after those drafts are subject to public comments until April 29, 2018, a newly formulated engagement guidelines and a revised corporate governance code will be implemented by June 2018. Although the Code Revision Draft was prepared so as to reflect, and be consistent with, the engagement guidelines to be newly formulated, it also contains several revisions on “disclosure” of those matters, including those relating to the reduction of cross shareholdings and dismissal of management executives (CEO), which would eventually effect the current practices taken at companies.

Hereinafter, we mainly explain the Engagement Guidelines Draft based on the contents of the published Engagement Guidelines Draft and the Code Revision Draft; as for the Code Revision Draft, the comparison table with the current language is inserted at the end of this newsletter. It is possible that, after considering the result of public comments, the contents of the final versions of the engagement guidelines and the revised Corporate Governance Code eventually turn out to differ from the contents of the Engagement Guidelines Draft and the Code

¹ This newsletter basically reflects the provisional English translations concerning the Engagement Guidelines Draft, the Code Revision Draft, and related documents, which were published by the Financial Services Agency and the Tokyo Stock Exchange on their respective websites.

<https://www.fsa.go.jp/en/news/2018/follow-up/20180330-1.html>

<https://www.jpx.co.jp/english/rules-participants/public-comment/detail/d01/e20180330-01.html>

Revision Draft. If this becomes the case, please understand that the following explanation may not be consistent with those final versions of the engagement guidelines and the revised Corporate Governance Code.

2. Purpose and Background — Realization of Corporate Governance Reform Toward the Season for Shareholders Meetings in June, 2018

It is stated that each of the Stewardship Code formed by the Financial Services Agency in February 2014 (revised in December 2017) and the Corporate Governance Code, which came into force at the Tokyo Stock Exchange in June 2015, should be “the two wheels of a cart, and the prevalence and adoption of these codes need to be proactively promoted in order for the sustainable growth of companies to be promoted by both sides of investors and companies respectively” (Cabinet Decision on June 30, 2015, “Japan Revitalization Strategy as revised in 2015”).²

Under these recognitions, in August 2015, the Financial Services Agency and the Tokyo Stock Exchange established the “Council of Experts Concerning the Follow-up of Japan’s Stewardship Code and Japan’s Corporate Governance Code” (“**Follow-up Council Meeting**”) in order to follow up on the prevalence and adoption of both codes while discussing and proposing necessary measures toward further enhancement of corporate governance of the entire listed companies.

Furthermore, in the “New Economic Policy Package” endorsed by the Cabinet on December 8, 2017, it is stipulated that the government “will establish Guidance to encourage companies to take the following measures and review the Corporate Governance Code as necessary through the deepening of dialogue between investors and companies prior to June 2018, the peak season for shareholders meetings (to be held in Japan),” and after that, considering the discussion result at the Follow-up Council Meeting, the Engagement Guidelines Draft and Code Revision Draft were recently published.

Although a certain degree of progress has been seen in the corporate governance reform promoted by various measures including a formulation of both codes, it has been pointed out that decisive business judgments by management are nonetheless insufficient at many companies and engagement between investors and companies is often merely a formality. In light of these issues, the recent trends mainly aim at deepening the corporate governance reform to a more substantial one by establishing new engagement guidelines and revising the Corporate Governance Codes.

3. “Basic Ideas” of the Engagement Guidelines Draft and the Code Revision Draft; and the Practical Effects

(1) Basic ideas

The Follow-up Council Meeting lists five items as “basic ideas” on the Engagement Guidelines Draft and the Code Revision Draft: (i) promotion of management decisions in response to changes in the business environment; (ii) importance of investment strategies and financial management policies; (iii) CEO appointment/dismissal and responsibilities of the board; (iv) reduction of cross-shareholdings; and (v) strengthening of assets owners’ responsibilities mainly for corporate pension funds.

² The Stewardship Code stipulates principles that seems to be beneficial for institutional investors to fulfill their “stewardship responsibilities” (i.e., responsibilities to enhance the medium- to long-term investment return for their clients and beneficiaries (including ultimate beneficiaries) by improving and fostering the investee companies’ corporate values and sustainable growth through constructive engagement, or purposeful dialogue, based on in-depth knowledge of the companies and their business environment). In addition, the Corporate Governance Code defines “corporate governance” as a structure for transparent, fair, timely and decisive decision-making by listed companies, with due attention to the needs and perspectives of shareholders and also customers, employees and local communities and provide main principles that contribute to the achievement.

(2) Position of the Engagement Guidelines Draft

The Engagement Guidelines Draft does not constitute the Corporate Governance Code and the Stewardship Code themselves and are positioned as their “supplemental documents” and intends to encourage the implementation of both codes effectively on a “comply or explain” basis. As such, the individual engagement guidelines to be established would not require companies and institutional investors to take any measures of complying with those or explaining the reasons for non-compliance.

However, the contents of the Corporate Governance Code that would have been revised in accordance with the engagement guidelines to be newly established shall constitute a part of the Corporate Governance Code, resulting in that, if the listed companies do not comply with any of those, they are required to explain the reasons for such non-compliance.

In addition, companies are expected to consider the contents of the engagement guidelines when they comply with any principles of the Corporate Governance Code, including principles calling for disclosure, or, if not, explain the reasons why they are not doing so. Furthermore, in order to enhance constructive engagement between institutional investors and companies, even when a company complies with a principle, it is beneficial for the company to proactively explain its specific implementation activities.³ The Engagement Guidelines Draft also stated that, it is not appropriate to use the engagement guidelines’ agenda as a mechanical checklist, and it is important to have “effective engagement” that takes into consideration each company’s specific circumstances and corporate group status.

(3) Practical effects

In line with the five agenda items indicated under “basic ideas” above, the Engagement Guidelines Draft provides agenda items for engagement that institutional investors and companies are expected to focus on and the Code Revision Draft is proposed in accordance with the items. These agenda items include several agenda items that are expected to affect practical measures.

For example, as for CEO appointment/dismissal and a succession plan, considering the indication that measures are insufficient at many companies, sufficient monitoring by the board of directors and establishment and active involvement of the nomination committee for such monitoring are emphasized.⁴ In addition, in order to ensure the effectiveness of the board of directors, it is expected that further promotion is required for the diverse composition of directors “in terms of gender and international aspects,” in particular, for the standpoints of “whether there are women appointed as directors” or whether a “sufficient number” of independent directors are appointed.

Furthermore, it is expected that cross-shareholdings will make not a small impact on practices of companies’ disclosure and explanation. For example, a policy regarding the “reduction” of cross-shareholdings shall be disclosed; and regarding whether or not to hold “each individual” cross-shareholding, the board specifically examines whether the purpose of cross-shareholding is appropriate and whether the benefits and risks associating with each holding cover the company’s costs of capital relating to such a holding. After the assessment of those factors by the board, the company needs to disclose the results of this assessment in an easily comprehensible manner.)

³ The second paragraph and Note 1 in the box at the beginning of the Engagement Guidelines Draft.

⁴ The Code Revision Draft requires disclosure of “policies and procedures” for CEO’s appointment as well as “dismissal” and disclosure is also required for an “explanation” on each CEO’s appointment/dismissal (Principle 3.1 (iii) and (iv) of the Code Revision Draft).

If the Corporate Governance Code is actually revised, especially as for revisions on the matters relating to “disclosure”, it will be deemed as a situation where any content of reports on the corporate governance is changed, resulting in that companies that have already submitted their corporate governance reports needs to “submit their reports after the change without delay” (Article 419, paragraph 1 of the rules on the listing of securities on the Tokyo Stock Exchange). In this regard, when the Corporate Governance Code firstly comes into force, a six month grace period was provided before the required submission the reports. The same or similar measure was hoped to be taken, the Code Revision Draft actually stipulates that “listed companies shall submit their corporate governance reports immediately after the preparation of the revised version thereof, but no later than the end of December 2018.”

4. The Five Agenda Items of the Engagement Guidelines Draft

- 1. Management Decisions in Response to Changes in the Business Environment**
- 1.1 *Are specific business strategies and business plans established and disclosed to generate sustainable growth and increase corporate value over the mid-to long-term? Are these business strategies and business plans consistent with the company’s business principles?*
- 1.2 *Does management accurately identify the company’s cost of capital, reflecting risks associated with the business in an appropriate manner? Does management manage the business with a recognition of the company’s cost of capital by setting targets on profitability and capital efficiency to generate sustainable growth and increase corporate value over the mid-to long-term? Does management clearly explain why they decided upon such targets? Does the company achieve returns which cover the cost of capital on a mid-to long-term basis?*
- 1.3 *Does management understand the business environment and business-related risks appropriately and make decisions decisively, such as restructuring the company’s business portfolio, including investment in new businesses and exit from or sale of existing businesses, based on the company’s business strategies and business plans? Is a policy on reviewing a business portfolio clearly established, and is the review process effective?*

It has been pointed out that the “reviewing of business portfolios” is not necessarily sufficient in Japanese companies with background that their managements have not yet adequately recognized their companies “costs of capital.”

In the first agenda item of the Engagement Guidelines Draft, in light of these issues, it is clarified that decisive business judgments by management, including reviewing business portfolios, are important, and management should accurately identify a company’s costs of capital in order to make such managerial decisions and manage the company while recognizing the company’s costs of capital. In addition, in the engagement between institutional investors and companies, they should also focus on discussing whether a company is able to achieve returns that cover the costs of capital on a mid- to long-term basis.

The Engagement Guidelines Draft and the Code Revision Draft refer to “costs of capital” repeatedly, and management with recognition of costs of capital is one of the characteristic standpoints. In general, “costs of capital” refer to costs for financing that a company’s management owes to its investors and they are divided into costs of debt for company creditors, such as financial institutions and costs of equity for shareholders. “Costs of capital” in the Engagement Guidelines Draft and the Code Revision Draft refer to the latter costs of equity, i.e., shareholders’ expected rate of returns for a company. If a company achieves a rate of return exceeding costs of capital, this means that the company satisfies its shareholders’ expectation and it is considered that this leads to an increase in stock prices.

- 2. Investment Strategy and Financial Management Policy**
- 2.1 *Are investments in fixed assets, R&D, and human resources to generate sustainable growth and increase*

corporate value over the mid-to long-term carried out strategically and systematically using the company's resources and from the standpoint of generating returns which cover the company's cost of capital on a mid-to long-term basis?

- 2.2 *Is financial management policy (including capital structure decisions and use of cash on hand in recognition of the company's cost of capital) established and managed appropriately based on the company's business and investment strategies?*

Strategic and systematic investments in fixed assets, R&D, and human resources are important for companies to generate sustainable growth and increase corporate value over the mid- to long-term. In making such investments, it is also important to conduct appropriate financial management, which is consistent with investment strategies and recognizes a company's costs of capital. Also, in the second agenda item of the Engagement Guidelines Draft, the importance of investment strategies and financial management is highlighted from the standpoint that recognizes "costs of capital."

3. CEO Appointment/Dismissal and Responsibilities of the Board

[CEO Appointment/Dismissal and Development]

- 3.1 *Is there an established policy on CEO qualifications in order to appoint a CEO who can make decisions decisively to generate sustainable growth and increase corporate value over the mid-to long-term?*
- 3.2 *Is a qualified CEO appointed through objective, timely, and transparent procedures, deploying sufficient time and resources? In order to make these procedures effective, is an independent nomination committee actively involved?*
- 3.3 *Is a CEO succession plan appropriately established and implemented, and are CEO candidates developed or, if necessary, selected from outside the company, systematically deploying sufficient time and resources?*
- 3.4 *Are objective, timely, and transparent procedures established such that a CEO is dismissed when it is determined, via an appropriate evaluation of the company's business results, that the CEO is not adequately fulfilling the CEO's responsibilities?*

[Determination of Management Remuneration]

- 3.5 *Are objective and transparent procedures established to design management remuneration systems such that they operate as a healthy incentive to generate sustainable growth and increase corporate value over the mid-to long-term and to determine actual remuneration amounts appropriately? In order to make these procedures effective, is an independent remuneration committee actively involved? Is the appropriateness of the remuneration system and of the actual remuneration amount clearly explained?*

[Responsibilities of the Board]

- 3.6 *In order to generate sustainable growth and increase corporate value over the mid-to long-term, is the board of directors constituted in a manner such that it is equipped with appropriate knowledge, experience, and skills as a whole and ensures diversity, including gender and international experience? Are there women appointed as directors?*
- 3.7 *Is evaluation of the board's effectiveness as to whether the board fulfills its roles and responsibilities implemented appropriately, and are the evaluation results, including issues identified through such evaluation, clearly disclosed and explained?*

[Appointment of Independent Directors and Their Responsibilities]

3.8 *Is a sufficient number of qualified independent directors appointed? Do the independent directors possess the necessary knowledge to effectively contribute to sustainable growth and increasing corporate value over the mid-to long-term, including knowledge of finance, such as capital efficiency, and understanding of relevant laws and regulations?*

Are appropriate actions taken for the reappointment or retirement of independent directors, taking into consideration the issues and changes facing the company?

3.9 *Do independent directors recognize their roles and responsibilities, and provide advice and monitor management appropriately in response to business issues?*

[Appointment of Kansayaku⁵ and Their Responsibilities]

3.10 *Are persons with appropriate experience and skills as well as necessary knowledge on finance, accounting, and the law appointed as kansayaku?*

3.11 *Do kansayaku conduct business audits appropriately and act effectively to secure proper accounting audits? Is a sufficient support structure for kansayaku established and appropriate coordination between kansayaku and the internal audit department ensured?*

(1) CEO Appointment/Dismissal, etc.

With respect to the appointment/dismissal of a chief executive officer (CEO) of a company, the Engagement Guidelines Draft provides content that is in accordance with the opinion statement published by the Follow-up Council Meeting in February 2016.⁶

As the above-mentioned opinion statement set forth that “under intensifying competition as well as discontinuous and volatile changes in the business environment, the CEO’s ability determines the fate of a company”, CEO appointment/dismissal can be considered to be one of the most important strategic decisions for companies. On the other hand, some argue that what Japanese companies lack the most are talented candidates qualified for the position of CEO. Thus, it is essential for companies to invest sufficient time and resources from a mid- to long-term perspective for working on talent development concerning CEO candidates as well as the actual appointment of the CEO

However, it is pointed out that in many Japanese companies, such efforts for the development and appointment of CEO is insufficient. For example, there has not been progress in the establishment of

⁵ Under the Companies Act (Revised in 2014), companies may choose one of three main forms of organizational structure, such as (i) Company with *Kansayaku* Board (*kansayakukai setchi gaisya*), a system unique to Japan, in which certain governance functions are assumed by the board of directors, *kansayaku*, and *kansayaku* board, (ii) Company with Three Committees (*shimei iinkai tou setchi gaisya*), in which establishing three committees (i.e., nomination committee, audit committee, and remuneration committee) is statutorily required, or (iii) Company with Supervisory Committee (*kansa tou iinkai setchi gaisya*), in which nominating committee and remuneration committee are not required to be established while supervisory committee holds powers equivalent to those held by audit committee in Company with Three Committees and certain rights to make statements regarding nomination and compensation.

The contents of 3-10 and 3-11 of the Engagement Guidelines are also intended to apply to (i) Audit Committee Members (*kansa iin*) of Companies with Three Committees and (ii) Supervisory Committee Members (*kansa tou iin*) of Companies with Supervisory Committee.

⁶ Follow-up Meeting’s Opinion Statement No. 2 titled “Corporate Boards Seeking Sustainable Corporate Growth and Increased Corporate Value over the Mid- to Long-Term” dated February 18, 2016.

https://www.fsa.go.jp/singi/follow-up/statements_2.pdf

standards for CEO appointment/dismissal, and only a few companies sufficiently monitor plans concerning the development of successor candidates for CEO through their board of directors. Under such circumstances, concerning CEO appointment/dismissal, it is necessary to establish “procedures to secure objectivity, timeliness, and transparency”⁷ (with respect to the development of successor candidates for CEO, it is further indicated in parentheses that candidates from outside the company could be appointed if necessary).

In addition, it is important firstly to design management remuneration systems such that they operate as a healthy incentive to facilitate sustainable corporate growth and increase corporate value over the mid- to long-term and secondly to establish “objective and transparent procedures” so as to appropriately determine actual remuneration amounts.

Furthermore, active involvement of an independent nomination committee or remuneration committee is listed as methods to make procedures concerning CEO appointment/dismissal or management remuneration effective.

(2) Responsibilities of the board of directors, independent directors⁸, etc.

The board of directors has the responsibility to support management led by CEO, and it is necessary for the board of directors as a whole to possess appropriate knowledge, experience, and skills.

The “Basic Ideas” of the Follow-up Council Meeting states that “the ratio of female officers at Japanese listed companies is currently only 3.7%, and it is important to ensure sufficient diversity, including gender and international aspects, in order for the board of directors to sufficiently fulfill its responsibilities.” The ratio of female officers is specifically indicated, and it is anticipated that diversity, especially with respect to gender, will gain further emphasis going forward.

4. Cross-Shareholdings

[Assessment of Cross-Shareholdings]

4.1 *Does the company clearly explain the purpose of each cross-shareholding and the status of its cross-shareholdings, including any changes in its cross-shareholdings?*

Does the board assess whether or not to hold each individual cross-shareholding, specifically examining whether the purpose is appropriate and whether the benefits and risks from each holding cover the company’s cost of capital? Does the company appropriately make decisions based on such assessment? Does the company clearly disclose and explain the results of this assessment?

Has the company established appropriate standards that are clearly disclosed with respect to the voting rights as to cross-shareholdings? Does the company vote appropriately in accordance with the standards?

4.2 *As part of its cross-shareholding policy disclosure, does the company make clear its policy regarding the*

⁷ The Code Revision Draft requires disclosure of “policies and procedures” concerning CEO appointment/dismissal and “explanations” concerning individual appointment/dismissal (Principle 3.1 (iii) and (iv) of the Code Revision Draft).

⁸ The Code Revision Draft provides that concerning the number of independent directors, listed companies that believe it needs to appoint at least one-third of directors as independent directors as well as maintain the current standard of at least two independent directors should “appoint a sufficient number of independent directors” accordingly. In contrast, the current Corporate Governance Code merely provides that under such circumstances, companies “should disclose a roadmap for doing so” “in its own judgement,” namely, voluntarily. Hence, it is expected that an increase of the number of independent directors will be further promoted (Principle 4.8 of the Code Revision Draft).

reduction of cross-shareholdings, and take appropriate actions in accordance with the policy?

[Relations with Cross-Shareholders]

- 4.3 *When cross-shareholders (i.e., shareholders who hold a company's shares for the purpose of cross-shareholding) indicate their intention to sell their shares, does the company hinder the sale of the cross-held shares by, for instance, implying possible reduction of business transactions?*
- 4.4 *Does the company engage in transactions with cross-shareholders which may harm the interests of the company or the common interests of their shareholders by, for instance, continuing the transactions without carefully examining the underlying economic rationale?*

(1) Assessment of Cross-Shareholdings

It has been pointed out that, while cross-shareholdings are meaningful in promoting strategic partnerships, the presence of stable/royal shareholders could lead to a lack of management discipline, and that cross-shareholdings are risk assets on company balance sheets that are not proactively used and are, therefore, inefficient in terms of capital management. Since June 2015, when the Corporate Governance Code came into force, megabanks made clear their policies regarding the reduction of cross-shareholdings, and in November 2015, they published “immediate reduction targets” prescribing that they will reduce cross-shareholdings by approximately 30% in the next three to five years. While banks and insurance companies have been trying to reduce cross-shareholdings as stated above, it is pointed out that the decrease by non-financial corporations is relatively modest, and the ratio of voting rights accounted for by cross-shareholdings remains high. Considering these circumstances, it is important for investors and companies to deepen their engagement regarding cross-shareholdings.

With respect to cross-shareholdings, currently, the name, number, amount reported on the balance sheet and purpose are disclosed in companies' annual securities reports. Furthermore, Principle 1.4 of the current Corporate Governance Code provides that (i) companies should “disclose their policy with respect to cross-shareholdings,” (ii) the board should examine the economic rationale and future outlook of “major cross-shareholdings” and give “detailed explanation[s]” of the objective and rationale behind cross-shareholdings, and (iii) companies should “establish and disclose standards” with respect to voting rights and the like.

On the other hand, the Engagement Guidelines Draft (i) with respect to the disclosure of policies concerning cross-shareholdings, lists examples of “policies regarding the reduction of cross-shareholding” and clearly requires the disclosure of policies regarding “the reduction” for the first time, and (ii) with respect to “individual cross-shareholdings,” requires specific examination on whether the purpose is appropriate and whether the benefits and risks from each holding cover the company's cost of capital and “assess cross-shareholdings”, and to “clearly disclose and explain the results of this assessment.”

Since the term “disclosure” and “explanation” are distinguished and used differently, the former is considered to refer to disclosures in corporate governance reports and the latter can be considered as broadly referring to explanations regardless of the format. Furthermore, (iii) with respect to voting rights, it provides that companies has “established appropriate standards that are clearly disclosed” and that companies vote appropriately in accordance with the standards. Through institutional investors and companies focusing on these agenda items in engagement, reasonable solutions are expected to be found.⁹

⁹ Cross-shareholdings include shares that are not directly held by a company but are in practice under the company's control. (Footnote 4 of the Engagement Guidelines Draft)

(2) Relations with Cross-shareholders

Furthermore, it is noteworthy that views concerning disciplines for not only the party who holds cross-shareholdings, but also the party who has others hold cross-shareholdings, are included. That is, reasonable solutions are expected to be eventually found through dialogue/engagement in which institutional investors and companies focus on the agenda items, such as (i) when cross-shareholders (i.e., shareholders who hold a company's shares for the purpose of cross-shareholding) indicate their intention to sell their shares, whether the company hinders the sale of the cross-held shares by, for instance, implying possible reduction of business transactions, and (ii) whether the company engages in transactions with cross-shareholders that may harm the interests of the company or the common interests of their shareholders by, for instance, maintaining the continual transactions without carefully examining the underlying economic rationale for doing so.

5. *Asset Owners*

5.1 *As a pension fund sponsor, does the company take measures to improve human resources and operational practices, such as recruitment or assignment of qualified persons (including hiring outside experts), in order to increase the investment management expertise of corporate pension funds (including stewardship activities such as monitoring the asset managers of corporate pension funds), thus making sure that corporate pension funds perform their roles as asset owners? Are these measures clearly disclosed and explained?*

The role of asset owners who are positioned closest to the ultimate beneficiaries and who encourage and monitor asset managers of corporate pension funds that are the direct counterparties in engagement with companies is extremely important in order to deepen corporate governance reform and promote the smooth functioning of the investment chain.

Among asset owners, while there have been some public pension funds that have instructed asset managers of corporate pension funds to engage in effective stewardship activities in response to the revision of the Stewardship Code in May 2017, actions regarding corporate pension funds have not necessarily been adequate, with only nine corporate pension funds having declared as becoming signatories of the Stewardship Code as of February 19, 2018. In addition, it has been pointed out that corporate pension funds lack human resources – in terms of both quality and quantity – for investment management including stewardship activities.

For such issues, pension fund sponsors are required to fully recognize that the investment management of corporate pension funds impacts asset formation for employees and companies' own financial standing and to take measures on their own initiative in order to improve human resources and operational practices, thus making sure that corporate pension funds fulfil their roles as asset owners.

Furthermore, in engagement, it is necessary to consider whether conflict of interests that could arise between pension fund sponsors and beneficiaries of corporate pension funds are properly managed through those measures taken.¹⁰

5. Code Revision Draft

For the purpose of maintaining consistency with the Engagement Guidelines Draft, the Code Revision Draft for the current Corporate Governance Code is shown in the comparison table as below. When the Corporate Governance Code is actually revised, the items revised will be subject to the “comply or explain” rule; therefore, listed companies need to immediately consider those items. Also, with respect to the items related to “disclosure”

¹⁰ Note 5 of the Engagement Guidelines Draft.

(while, according to the Code Revision Draft, it is prospected that a grace period is given as “not later than the end of December 2018”), it is necessary to prepare for the submission of corporate governance reports anyway.

Current Corporate Governance Code	Revised Corporate Governance Code (Draft)
<p>Principle 1.4 Cross-Shareholdings</p> <p>When companies hold shares of other listed companies as cross-shareholdings, they should <u>disclose their policy with respect to doing so</u>. In addition, the board should examine the mid- to long-term economic rationale and future outlook of <u>major cross-shareholdings</u> on an annual basis, taking into consideration both associated risks and returns. The annual examination should result in the board’s detailed <u>explanation</u> of the objective and rationale behind cross-shareholdings.</p> <p>Companies should establish and disclose standards with respect to the voting rights as to their cross-shareholdings.</p>	<p>Principle 1.4 Cross-Shareholdings</p> <p>When companies hold shares of other listed companies as cross-shareholdings, they should <u>disclose their policy with respect to doing so, including their policies regarding the reduction of cross-shareholdings</u>. In addition, the board should annually <u>assess whether or not to hold each individual cross-shareholding, specifically examining whether the purpose is appropriate and whether the benefits and risks from each holding cover the company’s cost of capital</u>. The results of this assessment should be <u>disclosed</u>.</p> <p>Companies should establish and <u>disclose specific standards</u> with respect to the voting rights as to their cross-shareholdings, <u>and vote in accordance with the standards</u>.</p> <p><u>Supplementary Principles</u></p> <p><u>1.4.1 When cross-shareholders (i.e., shareholders who hold a company’s shares for the purpose of cross-shareholding) indicate their intention to sell their shares, companies should not hinder the sale of the cross-held shares by, for instance, implying a possible reduction of business transactions.</u></p> <p><u>1.4.2 Companies should not engage in transactions with cross-shareholders which may harm the interests of the companies or the common interests of their shareholders by, for instance, continuing the transactions without carefully examining the underlying economic rationale.</u></p>
	<p><u>Principle 2.6 Roles of Corporate Pension Funds as Asset Owners</u></p> <p><u>Because the management of corporate pension funds impacts stable asset formation for employees and companies’ own financial standing, companies should take and <u>disclose</u> measures to improve human resources and operational practices, such as the recruitment or</u></p>

	<p><u>assignment of qualified persons, in order to increase the investment management expertise of corporate pension funds (including stewardship activities such as monitoring the asset managers of corporate pension funds), thus making sure that corporate pension funds perform their roles as asset owners. Companies should ensure that conflicts of interest which could arise between pension fund beneficiaries and companies are appropriately managed.</u></p>
<p>Principle 3.1 Full Disclosure</p> <p>In addition to making information <u>disclosure</u> in compliance with relevant laws and regulations, companies should disclose and proactively provide the information listed below (along with the <u>disclosures</u> specified by the principles of the Code) in order to enhance transparency and fairness in decision-making and ensure effective corporate governance:</p> <ul style="list-style-type: none"> i) Company objectives (e.g., business principles), business strategies and business plans; ii) Basic views and guidelines on corporate governance based on each of the principles of the Code; iii) Board policies and procedures in determining the remuneration of the senior management and directors; iv) Board policies and procedures in the appointment of the senior management and the nomination of directors and <i>kansayaku</i> candidates; and v) Explanations with respect to the individual appointments and nominations based on iv). <p>Supplementary Principles</p> <p>3.1.1 These <u>disclosures</u>, should add value for investors, and the board should ensure that information is not boiler-plate or lacking in detail.</p>	<p>Principle 3.1 Full Disclosure</p> <p>In addition to making information <u>disclosure</u> in compliance with relevant laws and regulations, companies should disclose and proactively provide the information listed below (along with the <u>disclosures</u> specified by the principles of the Code) in order to enhance transparency and fairness in decision-making and ensure effective corporate governance:</p> <ul style="list-style-type: none"> i) Company objectives (e.g., business principles), business strategies and business plans; ii) Basic views and guidelines on corporate governance based on each of the principles of the Code; iii) Board policies and procedures in determining the remuneration of the senior management and directors; iv) Board policies and procedures in the appointment/<u>dismissal</u> of the senior management and the nomination of directors and <i>kansayaku</i> candidates; and v) Explanations with respect to the individual appointments/<u>dismissals</u> and nominations based on iv). <p>Supplementary Principles</p> <p>3.1.1 These <u>disclosures</u>, including <u>disclosures</u> in <u>compliance with relevant laws and regulations</u>, should add value for investors, and the board should ensure that information is not boiler-plate or lacking in detail.</p>
<p>Principle 4.1 Roles and Responsibilities of the Board (1)</p>	<p>Principle 4.1 Roles and Responsibilities of the Board (1)</p>

<p>Supplementary Principles</p> <p>4.1.3 Based on the company objectives (business principles, etc.) and specific business strategies, the board should engage in the appropriate oversight of succession planning for the CEO and other top executives.</p>	<p>Supplementary Principles</p> <p>Based on the company objectives (business principles, etc.) and specific business strategies, the board should proactively engage in the <u>establishment and implementation</u> of a succession plan for the <u>CEO</u> and other top executives and appropriately oversee <u>the systematic development of succession candidates, deploying sufficient time and resources.</u></p>
<p>Principle 4.2 Roles and Responsibilities of the Board (2)</p> <p>Supplementary Principle</p> <p>4.2.1 In order for management remuneration to operate as a healthy incentive for sustainable growth, the proportion linked to mid- to long-term results and the balance of cash and stock should be set appropriately.</p>	<p>Principle 4.2 Roles and Responsibilities of the Board (2)</p> <p>Supplementary Principle</p> <p>4.2.1 <u>The board should</u> design management remuneration systems such that they operate as a healthy incentive to generate sustainable growth, and <u>determine actual remuneration amounts appropriately through objective and transparent procedures.</u> The proportion of management remuneration linked to mid- to long-term results and the balance of cash and stock should be set appropriately.</p>
<p>Principle 4.3 Roles and Responsibilities of the Board (3)</p>	<p>Principle 4.3 Roles and Responsibilities of the Board (3)</p> <p>Supplementary Principles</p> <p>4.3.2 <u>Because the appointment/dismissal of the CEO is the most important strategic decision for a company, the board should appoint a qualified CEO through objective, timely, and transparent procedures, deploying sufficient time and resources.</u></p> <p>4.3.3 <u>The board should establish objective, timely, and transparent procedures such that a CEO is dismissed when it is determined, via an appropriate evaluation of the company’s business results, that the CEO is not adequately fulfilling the CEO’s responsibilities.</u></p>
<p>Principle 4.8 Effective Use of Independent Directors</p> <p>Independent directors should fulfill their roles and responsibilities with the aim of contributing to sustainable growth of companies and increasing</p>	<p>Principle 4.8 Effective Use of Independent Directors</p> <p>Independent directors should fulfill their roles and responsibilities with the aim of contributing to sustainable growth of companies and increasing corporate value over the mid- to long-term. Companies</p>

<p>corporate value over the mid- to long-term. Companies should therefore appoint at least two independent directors that sufficiently have such qualities.</p> <p>Irrespective of the above, if a company <u>in its own judgement</u> believes it needs to appoint at least one-third of directors as independent directors based on a broad consideration of factors such as the industry, company size, business characteristics, organizational structure and circumstances surrounding the company, it should <u>disclose a roadmap for doing so</u>.</p>	<p>should therefore appoint at least two independent directors that sufficiently have such qualities.</p> <p>Irrespective of the above, if a company believes it needs to appoint at least one-third of directors as independent directors based on a broad consideration of factors such as the industry, company size, business characteristics, organizational structure and circumstances surrounding the company, it should <u>appoint a sufficient number of independent directors</u>.</p>
<p>Principle 4.10 Use of Optional Approach</p> <p>Supplementary Principle</p> <p>4.10.1 If the organizational structure of a company is either Company with <i>Kansayaku</i> Board or Company with Supervisory Committee and independent directors do not compose a majority of the board, in order to strengthen the independence, objectivity and accountability of board functions on the matters of nomination and remuneration of the senior management and directors, the company should seek appropriate involvement and advice from independent directors in the examination of such important matters as nominations and remuneration by, for example, establishing optional advisory committees under the board to which independent directors make significant contributions.</p>	<p>Principle 4.10 Use of Optional Approach</p> <p>Supplementary Principle</p> <p>4.10.1 If the organizational structure of a company is either Company with <i>Kansayaku</i> Board or Company with Supervisory Committee and independent directors do not compose a majority of the board, in order to strengthen the independence, objectivity and accountability of board functions on the matters of nomination and remuneration of the senior management and directors, the company should seek appropriate involvement and advice from independent directors in the examination of such important matters as nominations and remuneration by establishing <u>independent</u> advisory committees under the board, <u>such as an optional nomination committee and an optional remuneration committee</u>, to which independent directors make significant contributions.</p>
<p>Principle 4.11 Preconditions for Board and <i>Kansayaku</i> Board Effectiveness</p> <p>The board should be well balanced in knowledge, experience and skills in order to fulfill its roles and responsibilities, and it should be constituted in a manner to achieve both <u>diversity</u> and appropriate size. In addition, at least one person who has appropriate expertise on finance and accounting should be appointed as <i>kansayaku</i>.</p> <p>The board should endeavor to improve its function by analyzing and evaluating effectiveness of the board as</p>	<p>Principle 4.11 Preconditions for Board and <i>Kansayaku</i> Board Effectiveness</p> <p>The board should be well balanced in knowledge, experience and skills in order to fulfill its roles and responsibilities, and it should be constituted in a manner to achieve both <u>diversity, including gender and international experience</u>, and appropriate size. In addition, <u>persons with appropriate experience and skills as well as necessary knowledge on finance, accounting, and the law should be appointed as <i>kansayaku</i></u>. <u>In particular</u>, at least one person who has <u>sufficient</u> expertise on finance and accounting should be appointed as</p>

<p>a whole.</p>	<p><i>kansayaku.</i></p> <p>The board should endeavor to improve its function by analyzing and evaluating effectiveness of the board as a whole.</p>
<p>Principle 5.2 Establishing and Disclosing Business Strategy and Business Plan</p> <p>When establishing and disclosing business strategies and business plans, companies should articulate their earnings plans and capital policy, and present targets for profitability and capital efficiency. Also, companies should provide explanations that are clear and logical to shareholders with respect to the allocation of management resources and human resources, and specific measures that will be taken in order to achieve their plans and targets.</p>	<p>Principle 5.2 Establishing and Disclosing Business Strategies and Business Plans</p> <p>When establishing and disclosing business strategies and business plans, companies should articulate their earnings plans and capital policies, and present targets for profitability and capital efficiency <u>after accurately identifying the company’s cost of capital</u>. Also, companies should provide explanations that are clear and logical to shareholders with respect to the allocation of management resources, <u>such as reviewing their business portfolio and investments in fixed assets, R&D,</u> and human resources, and specific measures that will be taken in order to achieve their plans and targets.</p>

(Source) Prepared by the authors, based on “Japan’s Corporate Governance Code — Seeking Sustainable Corporate Growth and Increased Corporate Value over the Mid- to Long Term” published by the Tokyo Exchange Group, Inc. on June 1, 2015, which is currently in effect, and “Japan’s Corporate Governance Code (Draft Revision)” published by the Tokyo Stock Exchange on March 30, 2016.



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