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Proposed Revision of Japan's CG Code: continuous discussion for effectiveness of governance reforms

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Executive Summary

Japan's Corporate Governance Code is in the process of being revised for the first time in its three years of existence. The current Code is said that many companies' compliance is still a mere formality and the Code's directives are not driving improvement in governance. The Code will likely need to be periodically revised on an ongoing basis to effectively broaden compliance to smaller companies and other still-noncompliant companies.

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On March 26th, the Financial Services Agency (FSA) released a draft revision of Japan's Corporate Governance Code (CGC) and proposed Guidelines for Investor and Company Engagement (the "Engagement Guidelines") on its website[1]. How much has Japanese corporate governance improved over the three years since the CGC was first adopted? The following looks at the improvements targeted by the draft revisions and their likely effectiveness.

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

Overview of proposed CGC revisions

The FSA's proposed CGC revisions cite five perceived deficiencies in the status quo. First, engagement between investors and companies is still a mere formality in many cases. Second, companies' management are often not sufficiently aware of their companies' cost of capital. Third, many companies' Boards lack adequate CEO appointment/dismissal process and diversity. Additionally, relatively few Boards have nominating committees. Fourth, companies have not made much progress in unwinding cross-shareholdings. Fifth, pension funds need to step up their stewardship activities as asset owners.

In addition to proposed revisions and newly added principles to address these deficiencies, the FSA also released the newly drafted Engagement Guidelines. The main proposed revisions and additions to the CGC are as follows.

(1) Stronger language wording for unwinding of cross-shareholdings, revision of CGC Principle 1.4 (Cross-Shareholdings) and addition of two supplementary principles regarding cross-shareholdings. The added provisions include annual assessment of cross-shareholdings' economic rationality and a prohibition against dissuading strategic shareholders from selling their shareholdings.

(2) Addition of a new principle regarding corporate pensions' role as asset owners to CGC General Principle 2 (Appropriate Cooperation with Stakeholders Other Than Shareholders). The new principle directs companies to assign qualified personnel to manage their pension funds and conduct stewardship activities.

(3) Revision of General Principle 4 (Responsibilities of the Board) to emphasize the importance of appointing qualified CEOs and setting compensation. Regarding Board diversity, the proposed revisions specifically mention "gender and international experience." They also address CEO succession planning.

(4) Addition of a know-your-cost-of-capital directive to Principle 5.2 (Establishment and Disclosure of Business Strategies and Business Plans) in the context of engagement with shareholders. The aforementioned Engagement Guidelines also address engagement with shareholders.

In sum, the proposed revisions mostly render the CGC's directives more explicit with respect to the aforementioned deficiencies. The CGC's three-tier hierarchy of over 70 General Principles, Principles and Supplementary Principles remains unchanged[2]. Will the CGC's first revision succeed in upgrading Japanese corporate governance a notch?

2) This was written during the public comment period and therefore does not reflect subsequent revisions in response to public comments.

Will the revisions make the CGC more effective?

The proposed revisions clarify the CGC in response to frequent criticisms of it. While some welcome such clarification, there are concerns about whether the revisions are far-reaching enough to make the CGC more effective with respect to small- and mid-cap companies and other companies currently unable to comply with the CGC.

Whether smaller companies in particular should be subject to the same governance code as large companies has been a topic of discussion by the FSA's Council of Experts on the Corporate Governance Code since before the CGC was adopted. Is it advisable for the proposed revisions to not address this point? Under the existing CGC, all companies listed on stock exchanges' first and second sections are supposed to comply with the CGC while other companies are supposed to explain their state of compliance with the CGC's General Principles. This broad scope of applicability is unique to Japan. The UK's Corporate Governance Code applies only to companies listed on the LSE's Main Market. Moreover, even among Main Market-listed companies, those not in the

FTSE 350 index are granted a partial exemption from compliance with the Code. The effectiveness of Japan's CGC, with its broader scope, has been questioned.

However, the recent series of Japanese corporate governance reforms originated in the aim of spurring corporate growth. Such being the case, more priority should be placed on giving a boost to smaller companies and companies that have their growth potential, but lack thereof, have governance difficulties. Promoting governance reforms at smaller companies fulfills the CGC's original intent. However, CGC discussions to date have been based on a large-company template. It is hard to envision smaller companies with few institutional shareholders reforming their governance through compliance with the CGC. The UK's Financial Reporting Council (FRC), currently in the process of revising the UK Corporate Governance Code, has planned to expand the Code's applicability to small companies. In its draft revision, the FRC decided to forgo detailed prescriptions in favor of a more principle-based approach. Some investors have voiced support of the increased compliance flexibility that a more principle-based approach affords to small companies[3].

3) On the other hand, I have heard UK investors express concerns about the difficulties that small companies in particular face in terms of figuring out how to comply with an excessively principle-based corporate governance code.

Additionally, while the proposed revisions noted that engagement between companies and investors is still "a mere formality," commentators both in Japan and abroad have warned that, by making many of the CGC's principles more detailed, the proposed revisions pose a risk of reducing companies' flexibility to suitably improve their governance and of promoting "box-ticking" compliance. Over the three years since the CGC was first adopted, companies willing and able to substantively comply with CGC have presumably already completed the process of complying. The proposed revisions are targeted at companies that have yet to comply. The proposed revisions regarding cross-shareholdings, for example, call upon companies to pursue economic rationality and improve disclosure, but will they induce companies that still own cross-held shares to divest them? Even if more detailed language is added to many of the CGC's principles, compliance is unlikely to improve unless the reasons that companies have failed to comply have been identified. Directly resolving the causes of noncompliance may not be the CGC's role, but engagement between companies and investors by itself is unlikely to do much to rectify those causes.

Discussions around governance need to continue

In the UK, the FRC updates the Corporate Governance Code biennially. When it does, it addresses new issues. Many involved with the UK Corporate Governance Code advise, based on their own experience, that governance reforms take time. The UK's efforts to reform corporate governance date back to well over a decade ago. Reforms require lengthy discussions. The FSA's proposed revisions deserve credit for being focused on major issues that need to be addressed at present but they should set a timeline for updating the CGC again in the future. At some point, even the CGC's structure and composition should be radically revamped.

While the FSA's proposed revisions take the form of recommendations by a "follow-up" Council of Experts, I would like the FSA to also provide forums for discussion with various stakeholders. Such a forum devoted exclusively to smaller companies, for example, might be a good idea.

The manner in which the FSA is discussing corporate governance has been gradually evolving over the three years since the CGC's adoption, but it seems to favor intensive discussion of selected high-priority issues. While discussing issues deeply is good, continuously incorporating new perspectives into discussions is important to keep them vibrant and relevant. Ensuring that arrangements for diverse discussions are in place is arguably part of the CGC's role.

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