

The Role of the Stock Exchange in Corporate Governance

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- I. Introducing Corporate Governance to Japan
- II. The Corporate Governance Code
- III. Application of the CG Code Among Listed Companies

I. INTRODUCING CORPORATE GOVERNANCE TO JAPAN

In the year 1999, the Tokyo Stock Exchange (TSE)¹ began requesting that listed companies disclose their efforts to improve corporate governance (CG). Since then, we have taken many measures to enhance the CG of listed companies, especially through encouraging the appointment of independent directors. In the past, investors, especially those outside of Japan,

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1 The Tokyo Stock Exchange and the Osaka Securities Exchange merged in January 2013 to form the Japan Exchange Group (JPX). Both exchanges have continued to operate their own markets since the merger.

criticised that Japanese companies were reluctant to change CG by themselves, but also that rule-makers like us were too slow to take the initiative. Now, however, we rarely receive such criticisms. Table 1 shows the actions relating to CG that TSE has taken from March 2003, which have been warmly received by European investors.

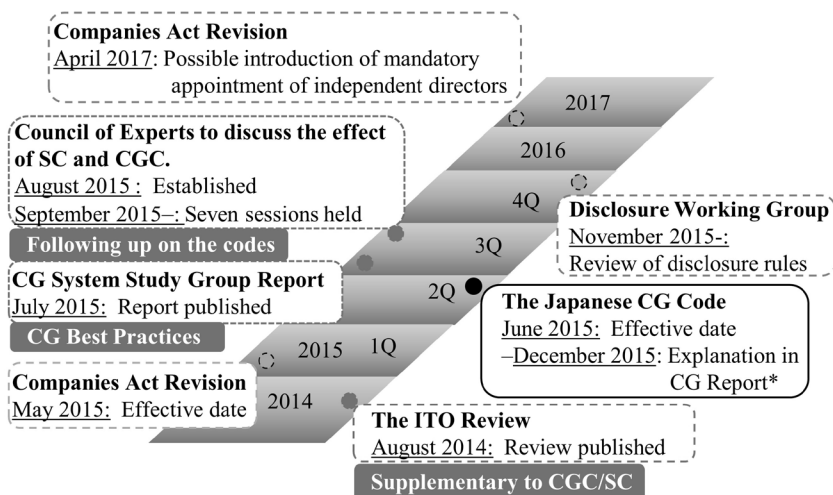
Table 1

| Date | Action |
|-----------|--|
| Mar 2003 | Made disclosure of corporate governance information mandatory in earnings reports. (Disclosure was requested from March 1999.) |
| Mar 2004 | Released “Principles of Corporate Governance for Listed Companies”. |
| Jul 2004 | Established Investor Communications Japan (ICJ), an e-voting platform for institutional investors, in collaboration with Broadridge. |
| Mar 2006 | Established rules for the “Corporate Governance Report”. To allow for easy comparison, TSE requests that listed companies submit reports in a TSE-specified format (in place of disclosure in earnings reports) and posts these reports on the TSE website. |
| Nov 2007 | Clarified viewpoints on corporate governance in listing examinations. |
| Dec 2009 | Began requiring listed companies to appoint at least one independent director/auditor. |
| Mar 2010 | Published “Expected Role of Independent Directors/Auditors”. |
| May 2012 | Expanded disclosure on independence (clients, cross-directorships, donations) and introduced rules to create an environment conducive to the functions of independent directors/auditors. |
| Feb 2014 | Began requiring listed companies to strive to secure at least one independent outside director. |
| June 2015 | The Japanese Corporate Governance Code was added to the Listed Company Code of Corporate Conduct under “Matters to be Observed.”. |

The reason why Japan was able to make these changes was the leadership of Prime Minister Abe. In June 2014, Japanese Prime Minister Shinzo Abe unveiled his comprehensive economic policy package known as “Abenomics”, which included in its third policy arrow the “Japan Growth Strategy Revised 2014”. This programme was targeted to overcome the so-called “deflation mindset” and to enhance the mid- to long-term performance and productivity of Japanese corporations so as to sustainably revive the Japanese economy. One of the programme’s key policies was a further reinforcement of corporate governance. The policy, which would come in the shape of a CG Code, encouraged Japanese corporations to change negative governance practices (concentration of authority in CEO, lack of engage-

ment with shareholders etc.) and work towards robust, transparent and flexible management. To create the Code, the Tokyo Stock Exchange and the Financial Services Agency (FSA) acted as joint secretariat on a Council of Experts. The council included experts from finance, industry, academia and think tanks and based its workings on the British CG Code. Table 2 shows action on CG taken between 2014 and 2017.

Table 2



II. THE CORPORATE GOVERNANCE CODE

Japan's Corporate Governance Code was introduced as part of TSE's rules for listed companies in June 2015. Table 3 shows the structure, with seventy-three principles in all. The most controversial aspects of the Code were:

- Board structure: companies must appoint at least two independent directors (or one-third of the board at the company's discretion).
- Cross-shareholdings: companies must give a detailed analysis or explanation for major holdings.
- Knowledge and skills: companies must provide for director training and have at least one expert in finance/accounting as a statutory auditor.
- Capital policy: companies must provide ample analysis or explanation for takeover defences, offerings, MBOs, etc.

* This is the schedule for companies ending their fiscal year in March (about 70% of listed companies in Japan).

- AGM scheduling: companies must ensure ample information and time for deliberation.
- Shareholder dialogue: companies must actively pursue dialogue and disclose earning plans, capital policy etc.

Table 3

| Structure of Corporate Governance Code | |
|--|--|
| General Principles | 5 General Principles which define good corporate governance in a broad, abstract sense. |
| Principles | 30 Principles which break down each General Principle further. |
| Supplemental Principles | 38 Supplementary Principles which explain the Principles in more detail using examples. |

Under TSE’s revised rules, listed companies must “comply” with or “explain” each principle of the CG Code in a Corporate Governance Report, published soon after their annual general meeting. This is to allow for all different types of company circumstances.

Some of the principles of the Code are:

- Electronic voting/English language notices
- Cross-shareholding analysis/explanations
- Independent whistleblowing contact
- Active participation of women
- Full disclosure, English language disclosure
- Summary of board evaluation
- Two or more independent directors
- Strategy/capital policy explanations

III. APPLICATION OF THE CG CODE AMONG LISTED COMPANIES

Currently, 1,858 companies listed on the 1st and 2nd Sections of the TSE have adopted the CG Code. As shown in Table 4, 11.6% of these (216 companies) fully complied with all principles of the Code. The remaining companies chose the “explain” option for at least one principle. Although there are many companies explaining at least once, we do not consider comply to necessarily be better than explain in all cases. Most investors judge that a good, reasonable explanation is better than simply complying in order to tick a box.

Table 4

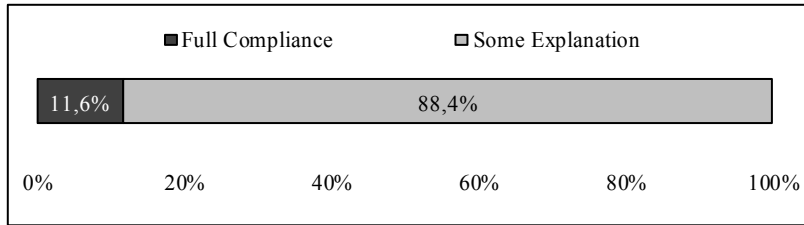


Table 5 shows a breakdown of the most “explained” principles. Topping this list is providing a summarised board evaluation. Board evaluations in Japan are still quite rare, so it has been difficult for companies to introduce this quickly. Even for companies that do comply, most are only doing self-evaluations. In Britain, for example, most evaluations are external. Second on the list is electronic voting and English language notices, and third is having two or more independent directors.

Table 5

| | | |
|--------|---|------|
| 4.11.3 | Summary of board evaluation | 1182 |
| 1.2.4 | Electronic voting/English language notices | 1038 |
| 4.8 | Two or more Independent Directors | 789 |
| 4.2.1 | Mid-long term growth remuneration | 570 |
| 4.10.1 | ID input on remuneration/nomination | 547 |
| 3.1 | Full disclosure | 522 |
| 3.1.2 | English language disclosure | 479 |
| 1.2.2 | AGM convention notice announced sufficiently in advance | 368 |
| 4.8.2 | System for ID to cooperate with board and audit | 361 |
| 4.8.1 | Info exchange among IDs | 328 |
| 4.1.2 | Analysis of mid-term plan failures | 276 |
| 4.1.3 | Board oversight of CEO succession | 258 |
| 4.2 | Board facilitation of risk-taking environment | 206 |
| 5.2 | Strategy/capital policy explanations | 202 |
| 3.2.1 | Standards for EA selection/independence | 191 |
| 1.4 | Cross-shareholding analysis/explanation | 150 |
| 1.2.5 | Material shareholder AGM participation | 139 |
| 4.9 | Disclosure of independence standards | 135 |

| | | |
|-------|--|-----|
| 4.7 | Independent director responsibilities | 109 |
| 2.5.1 | Independent whistleblowing contact | 108 |
| 4.10 | Use organisational options to improve CG | 106 |
| 4.11 | Diverse board/appropriate size | 97 |
| 1.2.3 | Appropriate AGM date-setting | 70 |
| 4.3.1 | Transparent management dismissal procedure | 65 |

There were various reasons why companies chose “explain”. As this was the first time these companies engaged in the process, there were a number of explanations which were not considered satisfactory. Below are some case examples of typical explanations provided by listed companies.

Table 6

| Type of company | “Explained” principle |
|--|--|
| <i>Cosmetics maker</i> | <i>Summary of board evaluation</i> |
| | “We currently do not conduct a regular analysis/review of the board, but...in the future we will consider [doing so] in order to clarify issues relating to board effectiveness and [we will] conduct a PDCA cycle for investigating the outcomes of different necessary projects that have been undertaken...” |
| <i>Transport related equipment maker</i> | <i>English AGM notices</i> |
| | “We will also continue to consider translating AGM notices into English, taking foreign shareholder ratio trends into account.” |
| <i>Info/communications company</i> | <i>Two or more independent directors</i> |
| | “We currently have one independent outside director, but will investigate candidates next fiscal year to increase this to two or more.” |
| <i>Automobile maker</i> | <i>Disclosure of cross-shareholdings</i> |
| | “With respect to voting on our cross-shareholdings, we...will make decisions based on whether or not the proposal will lead to increased corporate value and shareholder returns in the medium to long term, while fully respecting the policy and strategy of [the] management of the company in question.” |
| <i>Bank</i> | <i>Disclosure of cross-shareholdings</i> |
| | “We consider those stocks that are not held for pure investment purposes as “cross-shareholdings”, and as a rule will not hold them. However, we will disclose our holdings of listed stocks that we’ve deemed necessary to hold/increase in light of individual circumstances such as relationship maintenance and upon conducting necessary suitability reviews, etc. ...” |

There is some movement among listed companies themselves to improve governance, although only a little. For board evaluations, the Code allows self-evaluations as well as external ones. There is one company, a beauty

products maker called Kao, which self-evaluates its board from four different viewpoints and publicly releases the results. From these results, we can see that an independent director presides over meetings as chairman, and as a result there is lively debate which isn't limited to internal thinking. This is one good way for us to make sure of the independent director's role in the company.

In another case, there is a company called TDK which also publicly releases its evaluation results, although they use an external evaluator. In that company's results, it is clear that they are making good use of the entire board, including the independent directors. However, it is also written that they need to take more time discussing things such as risk management. This example is a good way for us to judge the company's stance on improving governance.

Finally, there is the case of Seven & I Group, which is the owner of Japan's biggest convenience store chain. At the beginning of April 2015, the 82-year old executive chairman, who had led the company since the 1970s, announced he would step down at the next AGM. This was because he tried to get rid of a CEO whom he disagreed with but was blocked by the independent directors. According to media, an activist fund called Third Point had become a shareholder of the company and had been calling into question the leadership ability of an 82-year-old chairman. This has been seen as a good example of improved corporate governance in Japan, with independent directors having a big effect.

Listed companies are required to hire outside directors under the Companies Act.² However, the definition of "outside" in the Act of 2006 did not exclude people related to parent companies or clients. Because of this, some people claimed that the definition was not sufficient, and there were concerns regarding conflicts of interest between outside directors and internal directors. After much discussion, the Japanese government concluded that in order to enhance companies' governance, it was necessary to introduce a concept of "independence" to the definition of "outside director". (In this case, "independent" means someone who is unlikely to have conflicts of interest with general shareholders. For example, a person with a background in commercial banks would not be able to serve as independent director at a company that received a loan.) However, considering the time it would take to amend the Companies Act, the government decided in 2009 to instead change TSE's more flexible exchange rules and to establish there the concept of an "independent director/auditor". Since then, TSE has required that listed companies hire at least one independent director. This is why there are two similar but

2 *Kaisha-hō*, Law No. 86/2005; as amended by Law No. 63/2015; Engl. transl.: Companies Act, Ministry of Justice (as of 2015), retrieved from <http://www.japanese-lawtranslation.go.jp>.

separate concepts: an “outside director” within the Companies Act and an “independent director/auditor” within the exchange rules.

Table 7 shows the ratio of 1st Section companies (large-size companies) having outside directors from 2004 to 2015, and Table 8 shows the ratio as regards independent directors.

Table 7

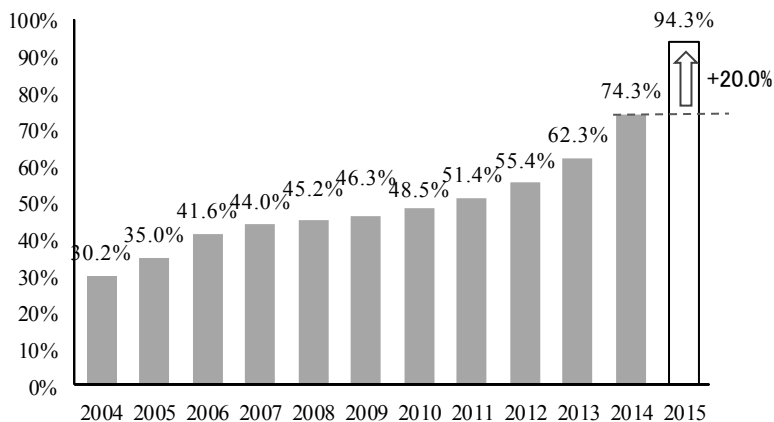
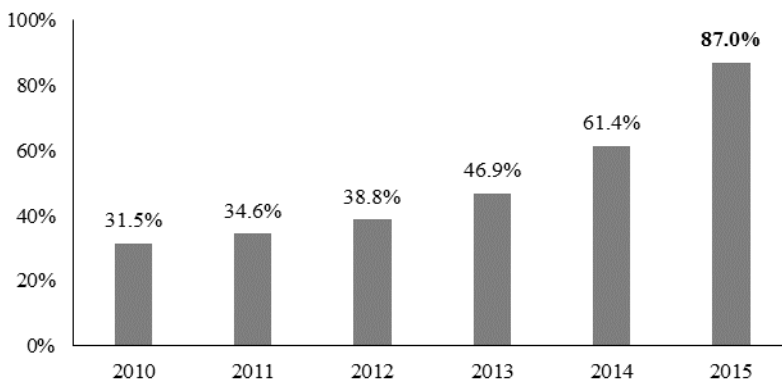


Table 8



As of 2015, 728 companies had one independent director, while 913 had more than one and 246 had none. The average board size on the 1st Section is 8.9 directors.

The number of independent directors is also increasing among small and medium-sized companies. On the 2nd Section, for medium-sized companies, 366 companies had at least one independent director as of 2015, compared to 185 without. This reflects a change from 2014 when there were 168 with and 377 without. Equally, in Mothers and Jasdac, our high growth start-up Sections, 126 out of 212 companies (Mothers) and 417 out of 824 companies (Jasdac) had independent directors in 2015, both large increases as compared to 2014.

In fact, TSE's rules regarding independent directors are now at the same standard as in the UK and the US. Table 9 shows a comparison of the respective rules.

Table 9³

| Outside Director | Independent Director | | | | |
|---|--------------------------------------|-----------|--------|-----------------|-----------------|
| | Current Definitions in Companies Act | Amendment | (Ref.) | US ⁴ | UK ⁵ |
| Executive officer/employee | X | X | X | X | X |
| Executive officer/employee of its subsidiaries | X | X | X | X | X |
| Executive officer/employee of parent/sister companies | 0» | X | X | X | X |
| Family of executive officer/employee | 0» | X | X | X | X |
| Major business affiliate | 0 | 0 | X | X | X |

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4 NYSE Listing Manual, Nasdaq listing standards.

5 UK combined Code of Corporate Governance.