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Application Status and Issues of the Revised Corporate Governance Code: in connection with corporate governance reforms

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Abstract

Efforts by corporations to strengthen governance are making steady progress overall as has been seen in the first section of the Tokyo Stock Exchange, JPX-Nikkei 400 companies, and companies with the highest market capitalization. However, the understanding of the necessity for supervision by external directors regarding the appointment and remuneration of management has not permeated.

On June 14, 2013, the government policy for reviewing corporate governance was announced. Also, on June 1, 2018, the corporate governance code was revised and items on the use of voluntary nomination committees, compensation committees, and the supervision of management succession plans for boards of directors were expanded.

Corporate governance reform is in the process of deepening from form to substance. For example, a few companies have systematized and practiced successor candidate development.

In this paper, we focus on the application status and issues of the revised corporate governance code. We also examine the status of nomination and compensation committees, the roles of and requirements for outside directors, and the development of managers.

Key words

Corporate Governance Code, Corporate Governance Reforms, Outside Directors, Boards of Directors, Executive Development

Ⅰ. Introduction

The corporate governance code published by the Tokyo Stock Exchange on June 1, 2015 was revised on June 1, 2018 and is applied to listed companies on the first and second sections of the Tokyo Stock Exchange. The corporate governance code consists

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of 78 principles (73 principles before revision) centered on 5 basic principles. The listed company is required to improve profitability in the medium to long term under an effective management strategy while appropriately collaborating with various stakeholders. Since the introduction of the corporate governance code, the board of directors and the management council have been holding concrete discussions, including the ideal and direction of governance of the company, which has triggered a review of the governance system of the company.

Whether a company chooses three forms of corporate governance (company with auditors, company with nominating committee, etc., company with audit and supervisory committee) depends on the environment in which the company is located and the way the company has a management strategy. Corporate governance is not all-purpose, and it is necessary to understand the advantages and disadvantages and verify the disadvantages. In recent years, securing outside directors has become a problem. An outside director is not a shareholder of a company, but an independent outside director who has no relationship with the company. Independent outside corporate auditors have the same meaning. It is important for companies to share information and accept outside perspectives and opinions in collaboration with outside directors or outside corporate auditors.

The corporate governance code is a rule that companies should comply with, but it is not necessary to comply with all things, and explanations should be given accordingly as necessary. There are no legally binding or penalties, and how the corporate governance code is addressed depends on corporate policy and discretion. On the other hand, it has been pointed out that the corporate governance code is a formal response because it is relatively easy to apply. In addition to securing outside directors, there are problems such as the utilization of voluntary nomination committees and compensation committees, supervision of management succession plans at the board of directors, and the small number of women and foreigners appointed as directors.

This paper considers the application status and issues of the revised corporate governance code in companies. Specifically, it discusses corporate governance reforms in Japan, and discusses the characteristics of the revised corporate governance code, the status of establishment of nominating committees and compensation committees, issues regarding the application status of the corporate governance code, and the roles required of outside directors. I would like to consider the matters to be considered and present the findings and remaining issues.

Ⅱ. Japan's Corporate Governance Reform

The concept of corporate governance common to Japanese companies is to speed up decision-making, separate supervision and execution, improve management efficiency, clarify management responsibilities, enhance / strengthen compliance system, enhance / strengthen risk management system, and manage. It is the transparency of the company, and we aim to improve the corporate value with these. Looking roughly at Japan's corporate governance reforms, in June 1997 Sony introduced Japan's first executive officer to separate management supervision and execution[1]. What should be done with the governance of overseas subsidiaries acquired by Sony was the beginning of corporate governance reform in the 1990s.

In the 2000s, corporate scandals continued, so the purpose was to prevent corporate scandals. The companies act came into effect on May 1, 2006, and the applicable companies have three forms of corporate governance. The Financial Instruments and Exchange Act came into effect on September 30, 2007, and the internal control reporting system started.

Since 2010, the Japanese version of the stewardship code has been published on February 26, 2014（revised on May 29, 2017）in order to improve the earning power of Japanese companies promoted by the government, and on May 1, 2015. The corporate law was amended in 2015, and the corporate governance code（revised on June 1, 2018）was applied on June 1, 2015[2.] In the background, as the Japanese economy continued to stagnate for a long period of time, it was necessary to review corporate governance so that institutional investors and general shareholders would support corporate efforts, so the government has taken measures with earning power as the keyword. Was done. Specifically, as the realization of aggressive governance, introduction of outside directors, ROE（return on equity）of 10% or more, evaluation to enhance the effectiveness of the board of directors, information disclosure and dialogue with institutional investors, management training, etc. Has been considered[3].

Ⅲ. Basic Principles and Basic Concepts of the Corporate Governance Code

The corporate governance code is a code of conduct that defines matters to be observed in corporate governance. The corporate governance code consists of（1）ensuring the rights and equality of shareholders,（2）appropriate collaboration with stakeholders other than shareholders,（3）ensuring appropriate information disclosure and transparency,（4）responsibilities of the board of directors, and（5）dialogue with shareholders. It is composed of 78 principles centered on the five basic principles of[4]. Table 1 newly summarizes this with reference to the Tokyo Stock Exchange（2018）.

As mentioned at the beginning, the corporate governance code is not legally binding. It is based on the concept of comply or explain that, in principle, the content stipulated in the code of conduct should be observed, but if it cannot be done（or not done）, a reasonable reason should be explained.

Table 1 Five Basic Principles of the Corporate Governance Code

<Ensuring shareholder rights and equality> Listed companies should ensure the rights and equality of shareholders. Substantial securing of shareholder rights → Measures to ensure that shareholders have sufficient time to consider the proposal of the general meeting (early delivery of convocation notice, etc.). Policy holding of shares → Disclosure of policy, explanation of aim of holding based on verification of economic rationality, formulation and disclosure of voting rights exercise criteria.
<Appropriate collaboration with stakeholders other than shareholders> The company should recognize that the sustainable growth of the company is the result of the contributions of stakeholders such as employees, customers, business partners, and local communities, and strive for appropriate collaboration. Appropriately respond to issues related to sustainability, including social and environmental issues. Promotion of ensuring diversity, including promoting the active participation of women within the company.
<Appropriate information disclosure and ensuring transparency> The venue company should properly disclose information based on laws and regulations and accurately provide information that is highly useful to users.
<Responsibilities of the Board of Directors, etc.> In order to promote the sustainable growth of the company and improve profitability and capital efficiency, the board of directors (1) presents major directions such as corporate strategy, (2) creates an environment that supports appropriate risk taking by management, and (3) becomes independent. From this standpoint, they should fulfill their roles and responsibilities such as highly effective supervision. Utilization of independent outside directors → Two or more persons who can contribute to sustainable growth and improvement of corporate value over the medium to long term should be appointed. Companies that think that more than one-third of independent outside directors are needed disclose the policy for that purpose.
<Dialogue with shareholders> The company should engage in constructive dialogue with shareholders from the perspective of contributing to sustainable growth.

(Source) Created by the author with reference to the Tokyo Stock Exchange (2018).

Table 2 Basic Concept of the Corporate Governance Code

<Realization of aggressive governance> Ensuring the transparency and fairness of company decision-making and promoting prompt and decisive decision-making.
<Promotion of medium- to long-term investment through dialogue with shareholders> Positioning medium- to long-term shareholders as important partners for the company, we expect the effect of encouraging medium- to long-term investment through dialogue between shareholders and the company with a constructive purpose.
<Principle-based approach (principle principle)> After confirming the purpose and spirit of the abstract and grabbed principles and sharing them with each other, whether or not their efforts are truly appropriate in light of the purpose and spirit rather than formal wording and description judgment.
<Comply or Explain> Unlike laws and regulations, the Corporate Governance Code is not a legally binding norm, so if there is a principle that a company considers inappropriate to implement in the light of individual circumstances, it is necessary to fully explain the reason. It is also assumed that the principles of the department will not be implemented.

(Source) Created by the author with reference to the Tokyo Stock Exchange (2018).

Of the five basic principles, it is clearly stated that two or more members should be appointed to utilize independent outside directors in the responsibilities of the board of directors. According to the Tokyo Stock Exchange, the percentage of listed companies in Part 1 with two or more outside directors was 15.0% in 2011, 16.7% in 2012, 18.0% in 2013, 21.5% in 2014, and 2015. Is 48.4%, 2016 is 79.7%, 2017 is 88.0%, 2018 is 91.3%, and 2019 is 93.4%. It can be seen that it has increased since 2015 when the corporate governance code was applied. The percentage of outside directors required by overseas institutional investors is 6.4% in 2014, 12.2% in 2015, 22.7% in 2016, 27.2% in 2017, 33.6% in 2018, and 2019. Is 43.6%.

As shown in Table 2, the basic concept of the Corporate Governance Code is as follows: (1) Realization of aggressive governance, (2) Promotion of medium- to long-term investment through dialogue with shareholders, (3) Principle-based approach (principle principle), (4) Comply or ・ Four points of explain. Listed companies to which the corporate governance code has been applied need to explain in a report on corporate governance (statutory disclosure) whether or not to implement it.

Ⅳ. Characteristics of the revised Corporate Governance Code

The revised Corporate Governance Code has changed and newly established 14 principles and supplementary principles. As shown in Table 3, there are three main items: (1) strengthening the functions of the board of directors, (2) selecting and dismissing management, strengthening the transparency of remuneration, and (3) promoting dialogue with investors.

Table 3 Revised Corporate Governance Code Changes and New Establishments

Item	Summary of revision
①Strengthening the function of the board of directors	<Utilization of independent outside directors> If it is necessary to appoint one-third or more of independent outside directors, a sufficient number of directors should be appointed. <Utilization of an independent advisory board> Utilization of an independent advisory board for voluntary nominations and compensation. <Ensuring the diversity of the board of directors> Ensuring diversity, including gender and internationality, on the board of directors. Appointment of Audit & Supervisory Board Members with knowledge of finance, accounting and legal affairs.
② Appointment and dismissal of management, strengthening transparency of compensation	<Procedure for selecting and dismissing managers> Explanation of the appointment and dismissal of individual executives and the nomination of candidates for directors and corporate auditors. Establish objective, timely, and transparent procedures for CEO appointment and dismissal. <Procedure for determining compensation for managers> Management's remuneration system design and remuneration amount determination according to objective and transparent procedures. <Involvement in succession planning> Independent involvement of the board of directors in succession planning.

③Promote dialogue with investors	<Formulation of management plan, etc.> Presenting policies and goals such as management plans after accurately grasping the cost of capital of the company. Explanation of business portfolio review, equipment, R & D, and investment in human resources. <Reduction of strategically held shares> Formulation and disclosure of policies and ideas regarding the reduction of strategically held shares. Verification of suitability of holding individual strategically held shares and disclosure of verification details. Formulation and disclosure of specific voting rights exercise standards and response in line with those standards. <Relationship with policy-holding shareholders> The holding side does not prevent the sale of shares. Verification of economic rationality regarding transactions with policy-holding shareholders. <Corporate pension as an asset owner> Efforts and disclosure such as promotion of human resources with investment qualities to corporate pensions. Appropriate management of potential conflicts of interest between corporate pensioners and the company. <Disclosure of ESG information> Highly useful disclosure for users regarding non-financial information including ESG factors.

(Source) Created by the author with reference to the Tokyo Stock Exchange (2018).

① is the utilization of independent outside directors, the utilization of independent advisory boards, ensuring the diversity of the board of directors, etc. ② is the procedure for selecting and dismissing the manager, the procedure for determining the remuneration of the manager, and involvement in the successor plan. ③ requests explanations on the reduction of strategically held shares, relationships with strategically held shareholders, and disclosure of ESG information.

According to the Ministry of Economy, Trade and Industry (2018b), the change of management and the nomination of a successor are important decisions that affect corporate value, and it is pointed out that sufficient time and resources will be spent on succession planning. There is utilize the statutory nominating committee (company with nominating committee, etc.) or voluntarily established nominating committee (company with auditors, company with audit and supervisory committee) for the selection and dismissal of management and supervision of successor plans you need to consider that[5]. Under the companies act, the election and dismissal of management is the authority of the board of directors. The election and dismissal of directors is decided at a general meeting of shareholders. Since the nomination committee and the compensation committee have a substantial supervisory function on the nomination and compensation of management, whether the board of directors and the committee are functioning effectively as one is related to the effectiveness evaluation of the board of directors.

ESG is an acronym for Environment, Social, and Governance, and is considered to be an element that influences the sustainable growth of a company. Companies are actively promoting ESG as non-financial information that is difficult to quantify. This is because the United Nations published the Principles for Responsible Investment in April 2006, which showed that consideration of ESG factors could affect investment performance, which increased interest in ESG investment among institutional investors[6].

Ⅴ. Nominating Committee, Status of Remuneration Committee Establishment

According to the Ministry of Economy, Trade and Industry (2018a), many companies set up a nominating committee and a compensation committee because of their independence, objectivity, increased accountability, and improved stability of the decision-making process. The reason why the nomination committee and compensation committee are not established is that the advice of outside directors is obtained at a place other than the board of directors, the establishment of individual committees is excessive, and it is included in the duties of the audit and supervisory committee[7].

According to the Tokyo Stock Exchange (2019a), the percentage of listed companies that have a nominating committee (legal / voluntary) is 49.7% for Part 1 and 76.3% for JPX-Nikkei 400 (see Figure 1). The ratio of listed companies in which the majority of the nominating committee (voluntary) is outside directors is 61.4% for Part 1 and 64.4% for JPX-Nikkei 400[8]. The ratio of listed companies that have a remuneration committee (legal / voluntary) is 52.4% for Part 1 and 77.6% for JPX-Nikkei 400 (see Figure 2). The ratio of listed companies in which the majority of the compensation committee (voluntary) is an outside director is 60.6% in Part 1 and 63.2% in JPX-Nikkei 400[9].

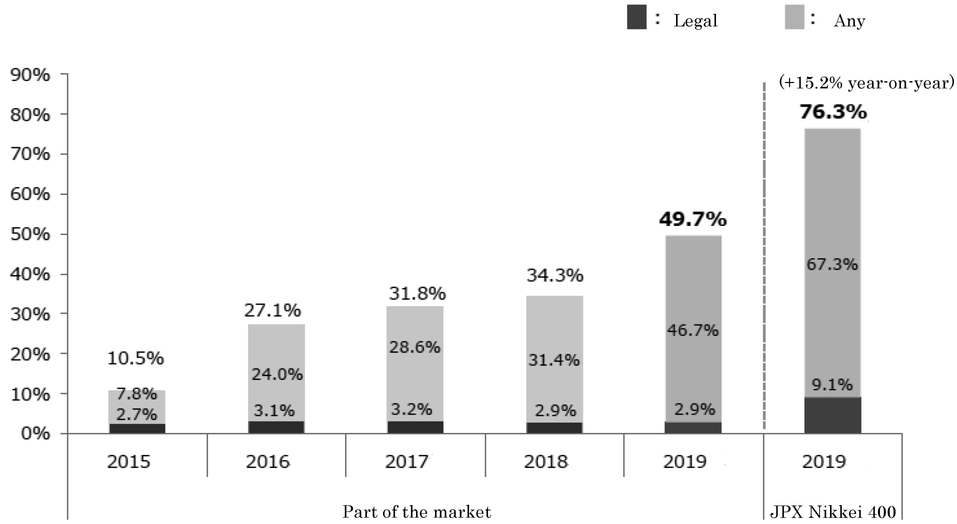

Figure 1 Setting Status of the Nominating Committee
(Source) Created by the author with reference to page 8 of the Tokyo Stock Exchange (2019a).

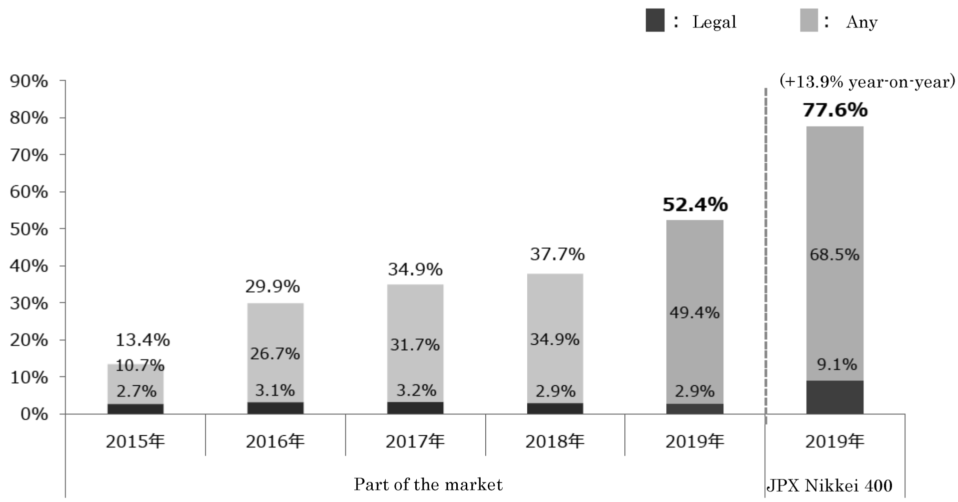

Figure 2 Status of Establishment of Remuneration Committee
(Source) Created by the author with reference to page 11 of the Tokyo Stock Exchange (2019a).

Ⅵ.Application Status of the Corporate Governance Code

Since the application of the corporate governance code, corporate initiatives have progressed, including the introduction of outside directors, an increase in the number of directors, a review of the ideal and direction of the board of directors, and an increase in the agenda standard of the board of directors. The current situation is that the criteria for selecting and dismissing managers and the process have not been clarified.

According to the Ministry of Economy, Trade and Industry (2018a), 50.0% of companies are considering implementing the corporate governance code as much as possible, and 40.0 companies are considering including explaining the reasons for not implementing it. Although it is being implemented, 28.0% of companies have only formalized measures and have not made substantial efforts (see Figure 3).

According to the Tokyo Stock Exchange (2019b), the percentage of listed companies that implement the principles of 90% or more of the Corporate Governance Code is 85.3% in Part 1 (93.0% in 2017)[10]. The ratio of implementing the 78 principles is 18.1% in Part 1 (31.6% in 2017) and 1.2% in Part 2 (4.0% in 2017). It can be seen that the implementation rate has declined as a whole after the revision of the Corporate Governance Code.

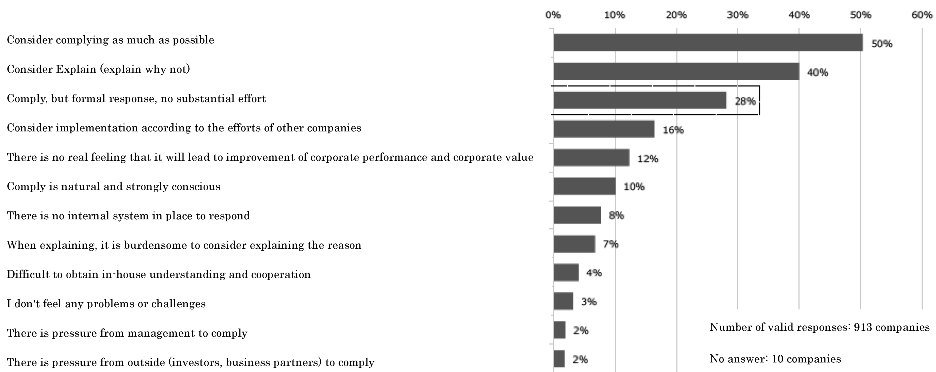

Figure 3 Correspondence to the Corporate Governance Code

(Source) Created by the author with reference to page 58 of the Ministry of Economy, Trade and Industry (2018a).

Below, we will introduce some of the cases of the three companies on the First Section of the Tokyo Stock Exchange with reference to the report on corporate governance.

ITOCHU is working on corporate governance based on the corporate philosophy of "committed to the global good". In response to the corporate governance code, the number of outside directors has increased, a board evaluation system, and an executive officer system have been introduced. In 2017, the ratio of outside directors was increased to more than one-third, and non-executive directors were realized[11].

Panasonic has adopted a company system, with each of the four companies establishing a management system independently and establishing a corporate strategic headquarters with the aim of increasing the corporate value of the entire group. All corporate governance codes have been implemented, and the board of directors and executive officer system have been established, the nomination and compensation advisory board has been established, and group strategy meetings have been held to disclose information[12].

In June 2017, Tsumura changed from a company with a board of auditors to a company with an audit and supervisory committee for the purpose of strengthening its corporate governance system. Two out of three members have set up an audit and supervisory committee consisting of outside directors, aiming for soundness and transparency of management. A voluntary nomination and remuneration advisory board consisting mainly of outside directors has been established to strengthen the independence, objectivity and accountability of the board of directors[13].

Ⅶ. Challenges in applying the Corporate Governance Code

It has been pointed out that there is a shortage of management experience in securing outside directors. Although the introduction of outside directors has progressed, many companies find it difficult to find candidates with management knowledge and high insight. It is necessary to expand the human resources pool of outside directors, mainly those with management experience. It has been pointed out that it is useful to assume the position of outside director of other companies, including retired managers. It is pointed out that Japanese companies do not have a mechanism to develop human resources with experience and ability suitable for managers, so this is one of the most important issues in the future.

According to the Ministry of Economy, Trade and Industry (2018b), many companies recognize that outside directors play a role in supervising and advising management. On the other hand, he points out that outside directors may not be playing a sufficient role in the areas such as the appointment and dismissal of management, supervision of compensation, and the reflection of opinions of minority shareholders and stakeholders.

Strengthening the functions of the Board of Directors of the Corporate Governance Code requires ensuring diversity in the Board of Directors, including gender and internationality. According to the Ministry of Economy, Trade and Industry (2018a), 29.0% of companies appoint one woman as an outside director, and 5.0% appoint a foreigner as an outside director[14]. It turns out that the composition of the board of directors is inadequate. According to Toyo Keizai's "Executive Quarterly Report," the number of female officers is on the rise, but the ratio of female officers is 4.1% (2018)[15]. In the Fourth Basic Plan for Gender Equality, the government has set a target of 10% of women among listed company officers by 2020.

One of the issues of the board of directors is that the management's succession plan and medium- to long-term management strategy have not been sufficiently examined. Many companies are working on sending materials in advance and narrowing down the agenda as a device to enhance the discussions of the board of directors, but considering the Carlos Ghosn problem of Nissan Motor and the subsequent change of top personnel, the criteria for selecting and dismissing managers are established. It is expected that the number of companies considering this will increase rapidly.

Ⅷ. Roles and Considerations Required of Outside Directors

The independence of outside directors is one of the important qualities and backgrounds, but it is necessary to consider not only independence but also other qualities and background diversity. It is necessary to consider what the qualities and background are necessary to play a practical role as an outside director, taking into consideration the ideal form of the board of directors and the balance of internal directors.

When considering, it is important for the Board of Directors to have a perspective of ensuring diversity of directors, including gender and internationality, in order to play a sound role. Companies that do not have any female directors should actively consider appointing female outside directors on the premise of ensuring quality as directors.

As a type of outside director, opinions from the perspective of a person with management experience may be expected. You may or may not have experience with the company's business, but you will be asked how your knowledge and experience will be demonstrated as abilities. Although not a person with management experience, an outside director may be considered when opinions based on specialized knowledge and knowledge are expected. They may have expertise in corporate practice or they may have academic expertise. Once the qualities and background required of outside directors are determined, candidates for outside directors who have those qualities will be appointed.

Ⅸ. Concluding Remarks

The corporate governance code covers a wide range of areas, including securing outside directors, improving the effectiveness of the board of directors, nominating management and voluntary nominating committees related to remuneration, utilizing remuneration committees, and disclosing ESG information. While companies are working toward the realization of aggressive governance, there is a reality that corporate scandals are endless. In particular, there is the issue of how to manage the governance of acquired overseas subsidiaries such as Toshiba. This is exactly in line with the issue of corporate governance reform in the 1990s. The background of the times and the business environment will change, but the question will be how to steer the governance of the group in the future. Building an internal system to promote corporate governance is indispensable and is involved in the responsibilities of management.

The role of outside directors in strengthening corporate governance is important, but different economic organizations have different views on the debate over outside directors. It is actually difficult to say that if the formal requirements for outside directors are set, corporate value will increase, management transparency will be ensured, and buds that will become a hotbed for corporate scandals will be picked. It is almost impossible for a part-time outside director to get the truth if the management intentionally hides it. Even if there are outside corporate auditors, the internal audit department does not have the authority to order investigations. It has been pointed out that it is difficult for outside directors and outside corporate auditors to disagree with the strong intentions of management, even as independent officers. Focusing on the creation of a corporate governance system, the effectiveness of governance by outside directors and outside corporate auditors is questioned[16].

In order to prevent and prevent repeated corporate scandals, it is necessary to improve the soundness of management. Corporate scandals ultimately relate to self-consciousness, behavior, and ethics. There is a longing for a manager who can demonstrate leadership based on a firm management philosophy and management ethics as a management professional. One of the most important issues is to develop managers who can strategically use the system rather than creating a corporate governance system.

Notes

1 Sony has reduced its 38 directors to 10（3 are outside directors）and 27 executive officers（7 internal directors are also serving）.

2 The government has submitted to the extraordinary diet session in October 2019 a bill to amend the companies act to oblige listed companies to appoint outside directors and strengthen disclosure of executive compensation decisions, which is scheduled to come into effect in 2020.

3 For more details, see Aoki（2018）.

4 For more details, see Aoki（2018）.

5 Ministry of Economy, Trade and Industry（2018b）page 41.

6 For more details, see Aoki（2017）.

7 For more details, Ministry of Economy, Trade and Industry（2018a）.

8 Tokyo Stock Exchange (2019a) page 9.
9 Tokyo Stock Exchange (2019a) page 12.
10 Tokyo Stock Exchange (2019b) Page 4.
11 https://www.itochu.co.jp/ja/files/corporate_governance.pdf (Accessed September 1, 2019)
12 https://www.panasonic.com/jp/corporate/ir/pdf/pcg.pdf (Accessed September 1, 2019)
13 https://www.tsumura.co.jp/corporate/governance/pdf/governance.pdf (Accessed September 1, 2019)
14 Of the nine directors (three are outside directors), Ajinomoto is the first woman to become a director and managing executive officer, and one outside director is also a woman. Of the 10 directors (4 are outside directors) of SEGA SAMMY HOLDINGS, a female foreigner became the first outside director.
15 According to 30% Club Japan, among the listed companies on the First Section of the Tokyo Stock Exchange, the ratio of female executives of companies that make up the stock index (TOPIX) 100 is 10.5% (2019).
16 For more details, see Aoki (2016).

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