

Key Points Concerning the Revision to Japan's Corporate Governance Code

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In June 2021, the revision to Japan's Corporate Governance Code (CGC) was released.^[1] The CGC is a set of corporate governance guidelines for companies listed on the Tokyo Stock Exchange (TSE). The revisions mainly focus on promoting board independence and enhancing diversity and sustainability efforts, and have been made in advance of the upcoming restructuring of the TSE, which is scheduled for April 2022.

This post outlines the key points of the CGC revisions and steps companies can take to comply.

Overview of the CGC

The CGC is a set of principles for listed companies in Japan, aiming to ensure their sustainable growth, as well as to enhance their mid- to long-term corporate value. Companies listed on the TSE are required to comply with the CGC or explain why they are not in compliance (comply-or-explain approach). In addition, the CGC is a counterpart to the Stewardship Code—a set of principles for institutional investors—and both codes serve to promote overall economic growth through constructive dialogue between investors and companies.

The latest CGC consists of 83 principles and is organized into three layers: five General Principles, 31 Principles, and 47 Supplementary Principles. The General Principles that form the pillars of the CGC are:

1. Securing the Rights and Equal Treatment of Shareholders;
2. Appropriate Cooperation with Stakeholders Other Than Shareholders;
3. Ensuring Appropriate Information Disclosure and Transparency;
4. Responsibilities of the Board; and
5. Dialogue with Shareholders.

Background to the revision

The CGC was originally formulated by the TSE and became effective in June 2015. The CGC is designed to be revised every three years. It was first revised in June 2018, and this is its second revision. The June 2021 revision is in line with global Environmental, Social, and Governance (ESG) trends and recognizes the Sustainable Development Goals (SDGs) as well as the drastic changes in the business environment due to the COVID-19 pandemic. The new CGC calls for listed companies to make substantial governance reforms to effectively address unique business challenges.

The revision is also part of the preparations for the TSE restructuring scheduled for April 2022.^[2] The TSE currently has five segments: First Section, Second Section, Mothers, JASDAQ Standard, and JASDAQ Growth. Beginning in April 2022, it will be reorganized into only three segments: Prime Market, Standard Market, and Growth Market. Essentially, companies currently listed on the First Section are expected to move to the Prime Market segment, while those currently in the Second Section and the JASDAQ Standard will move to the Standard Market segment, and those in the Mothers segment and the JASDAQ Growth segment will move to the Growth Market segment. Since the Prime Market segment will be for companies with higher market capitalization, liquidity, and governance levels, the revised CGC includes specific rules for companies that will be included in the Prime Market segment.

Key points of the 2021 CGC revision

This revision to the CGC newly establishes or changes 16 of the Principles and Supplementary Principles.^[3] The main points of these revisions are as follows.

1. Enhancing the functions of the board of directors

The first category of revisions aims to encourage companies to strengthen their boards by appointing qualified, independent directors. The following directives are included in this revision:

- Appoint independent outside directors to comprise at least one-third of the board in the Prime Market segment (if a company listed on the Prime Market segment believes it necessary,^[4] a majority of the board members should be independent outside directors) (Principle 4.8);
- Establish a nomination committee and compensation committee (in the Prime Market segment, a majority of the committee members should be independent outside directors) (Supplementary Principle 4.10.1);
- Disclose a list of each board member's knowledge, experience, and skills (skills matrix) (Supplementary Principle 4.11.1); and
- Appoint independent outside directors with managerial experience at other companies (Principle 4.11 and Supplementary Principle 4.11.1).

Since the CGC's formulation in 2015, Japanese companies have made progress in increasing the proportion of outside directors. In this context, the 2021 revision requires companies to build systems to further enhance the effectiveness of the board of directors in its management oversight and decision-making functions. As of July 2021, 72.8% of companies listed on the First Section of the TSE have appointed independent outside directors to at least one-third of their board positions, but only 7.7% have selected a majority of independent outside directors.^[5] As described below, companies planning to list on the Prime Market segment need to comply with the new principles for the Prime Market or explain why they do not by the time they submit a corporate governance report after April 4, 2022.

2. Promoting diversity in managerial positions

The revised CGC requires companies to set and disclose voluntary measurable goals for ensuring diversity in managerial positions by appointing women, non-Japanese people, and mid-career hires. In addition, companies must disclose their human resource development policies for ensuring diversity, along with the status of their implementation (Supplementary Principle 2.4.1).

The ratio of female executives in 2,220 Japanese listed companies for fiscal years ending March 2021 is only 7.4%.^[6] It will take time to promote diversity at the managerial level. In order to ensure true diversity, listed companies need to make continuous efforts to promote a diverse workforce with a long-term perspective.

3. Addressing issues surrounding sustainability

The revised CGC requires listed companies to develop and disclose initiatives to promote sustainability (Supplementary Principles 3.1.3 and 4.2.2). Companies listed on the Prime Market segment will need to enhance the quality and quantity of climate change disclosures based on the Task Force on Climate-related Financial Disclosures (TCFD) recommendations^[7] or equivalent international frameworks (Supplementary Principle 3.1.3).

Although the original 2015 CGC included references to sustainability, the revised CGC requires companies to take a more advanced approach to sustainability in response to the global trend toward ESG/SDGs and the drastic changes in the business environment caused by the COVID-19 pandemic. It will be important for companies to explain how social and economic issues related to sustainability bring about business opportunities and what kind of risks are associated with their business.

timeline for the revised cgc and the TSE restructuring

The revised CGC came into effect on June 11, 2021. Listed companies are required to submit a corporate governance report concerning the new CGC to the TSE by the end of December 2021 at the latest. In addition, listed companies need to select a new market segment between September and December 2021. TSE will announce the new market segment of each listed company on January 11, 2022, and the transition to the new segments is scheduled to be completed on April 4, 2022.^[8] Companies listed on the Prime Market segment must submit a corporate governance report based on the rules covering only the Prime Market without delay after their annual shareholders meeting on or after April 4, 2022.

Conclusion

The global trend of ESG/SDGs and the pandemic have significantly changed the business environment around the world, and Japanese listed companies are no exception. As a result of this revision, they will be required to focus more attention on the functions and independence of their boards of directors, workplace diversity, and sustainability initiatives. The most pressing deadline is to complete corporate governance reports and make their new market selections by the end of this year. U.S. companies that do business in Japan or invest in companies listed on the TSE should keep these points in mind and continue to monitor Japan's corporate governance reform efforts.

^[1] The revised Code is available in English at <https://www.jpix.co.jp/english/news/1020/b5b4pj0000046kxj-att/b5b4pj0000046i07.pdf>.

^[2] An overview of the TSE restructuring is available in English at <https://www.jpix.co.jp/english/equities/market-restructure/market-segments/index.html>.

^[3] There were no revisions to the five General Principles.

^[4] Principle 4.8 states that companies should consider the following factors in determining whether a majority of the board should be independent outside directors: "the industry, company size, business characteristics, organizational structure and circumstances surrounding the company." According to TSE's response to the public comments on the CGC, it is up to each company to decide whether it is necessary to appoint a majority of independent outside directors.

^[5] See Tokyo Stock Exchange, "Appointment of Independent Directors and Establishment of Nomination/Remuneration Committees by TSE-Listed Companies" (August 2, 2021), available in English at <https://www.jpix.co.jp/english/news/1020/b5b4pj00000496mq-att/b5b4pj00000496pe.pdf>.

See TOKYO SHOKO RESEARCH, LTD., “Survey on Ration of Female Executives in 2,220 Listed Companies for the Fiscal Year Ending March 31, 2021” (July 16, 2021), available only in Japanese at https://www.tsr-net.co.jp/news/analysis/20210716_03.html.

An overview of the TCFD recommendations is available at <https://www.fsb-tcfid.org/recommendations/>.

TSE's initial assessment in July 2021 showed that 664 of the 2,191 companies listed on the First Section did not meet the listing criteria for the Prime Market segment. However, there are transitional measures for currently listed companies which allow them to maintain their listing by submitting a plan for compliance with the new listing criteria. Therefore, it does not necessarily mean that the above 664 companies will not be able to list on the Prime Market segment in April 2022.

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