I. Introduction

The release of the Panama Papers was one of the latest major incidents to shine a global light on corporate malfeasance. Japan has also experienced its share of business scandals: the Toshiba accounting irregularities and the Mitsubishi Motor fuel economy data manipulation being recent standout events. In line with the increased vigilance of regulators globally, in early 2016 the Japan Exchange Regulation (the ‘JPX’) released its Principles for Listed Companies Dealing with Corporate Malfeasance. These set out four broad principles that Japanese public companies must follow when investigating suspected cases of corporate misconduct.

The principles appear to be the first example of a national stock exchange setting out specific guidelines on how a corporation should behave when faced with a corporate scandal. As such, they are an example of Japan leading the way in an increasingly important area of corporate governance.

II. Background

The principles were fuelled by concerns over the independence and effectiveness of previous internal investigations, both in Japan and abroad. Walmart's well-publicized Mexico bribery scandal and the fact that one of its officers who had allegedly authorized the bribes had led the company's internal investigation raised concerns over the independence of traditional company-managed investigations. Such investigations are usually conducted by a company's legal or human resources department – sometimes in collaboration with the company's lawyers or accountants – with the company's management controlling the process and often the outcome. Had Mitsubishi Motor's investigation into its mid-2000s automobile defects cover-up been more effective and wide-ranging, it may have been able to solve its most recent data manipulation issues before they became global front-page news.
The principles reflect a slowly growing tendency of listed Japanese companies to appoint independent third-party committees to investigate serious misconduct (in place of or in addition to company-run investigations). These committees usually comprise leading jurists or former bureaucrats with little or no prior relationship with the company, whose final report is expected to be made public. The third-party committee commissioned by Olympus to investigate the 2011 accounting fraud is an example of this trend.

As in the United States and other countries, company-run investigations remain the norm in Japan. However, there appears to be a growing realization in Japan that in serious, potentially company-destroying cases of malfeasance, corporate value and reputation may be best protected by engaging independent, third-party committees to investigate and publicly report on the misconduct. While such disclosure may invite harsh criticism and damage in the short term, it may help to restore the company's reputation in the long term.

III. The Principles

The principles are not legally binding; they resemble Japan’s Corporate Governance Code (effective from June 2015) insofar as they are a principles-based set of guidance on how companies should react to and handle investigations into wrongdoing, rather than a rules-based set of guidance. However, the JPX has emphasised that it will consider the extent to which a company has followed the principles when determining penalties, including a potential delisting. The principles are expected to have a broad influence on how listed companies handle investigations and the JPX expects both listed and private companies conducting investigations to refer to them.

Principle 1: Ascertain Fundamental Cause of Malfeasance

Principle 1 requires an investigation of sufficient depth and breadth to uncover the 'fundamental cause' of the malfeasance (and not just the relatively easy to ascertain 'who did what and when'). It states that:

"When investigating and uncovering the cause of malfeasance, the scope and depth of the investigation should be sufficient to uncover not only the obvious effects and causal relationships of the malfeasance, but also the underlying fundamental cause and background factors leading to the malfeasance. To achieve this, companies should ensure that an appropriate investigative corporate environment, including sufficient investigatory systems, are established to ensure a sufficient investigation can be conducted. For these purposes, the relevant officers and employees of the company, including independent directors and auditors, should take the lead to ensure investigatory functions are effective."

In practice, it can be difficult to assess whether a company's investigation was in-depth or merely cursory. However, the JPX considers that an in-depth root-cause analysis of malfeasance is essential for the design and implementation of an effective remedial plan to avoid future recurrence of the problem, and has therefore placed significant emphasis on this aspect of the investigation. In-house counsel and legal advisers are encouraged to study and analyze investigative reports that are publicly disclosed by other companies and actual malfeasance scenarios, to ensure that they are better prepared should they have to design and implement an investigative approach to an actual or suspected case of corporate wrongdoing in their own or their clients'
organizations. In addition, there are increased expectations regarding the roles of independent directors and auditors in investigating wrongdoing.

**Principle 2: Establish Independent Neutral and Expert Third-Party Investigation Committee**

Principle 2 advocates third-party committees as a viable option in certain situations, including when the subject matter is extremely serious or there are doubts over whether the company's management can be trusted to conduct a proper investigation particularly when a member of management is suspected of involvement in the misconduct. It states that:

"The establishment of a third-party committee to secure the independence, neutrality and expertise of an investigation is a viable option if (i) there is considerable uncertainty regarding the efficacy of the internal controls or the credibility of the subject company's management (ii) there are substantial threats/damage to the corporate value of the subject company or (iii) the subject matter is complex or may have a serious societal impact. When setting up a third-party committee, consideration should be given to matters including the process of selecting the members in order to secure the aforementioned independence, neutrality and expertise. However, companies should avoid dressing up a careless and insufficient investigation with an 'appearance' of objectivity and neutrality based simply upon the investigation taking the form of a third-party committee."

This is the most controversial and problematic of the principles because, unlike company-run investigations, third-party committee investigations either deprive or limit the amount of control a company's management has over the investigation process. In addition, the principles do not specifically define 'third-party committee'. In practice, third-party committees take many different forms and have varying degrees of independence. Ultimately, companies and their advisers will need to interpret this principle to determine whether the company's situation necessitates a third-party investigation and, if so, the optimum way to establish a third-party committee and appoint its membership in light of the particular wrongdoing.

**Principle 3: Promptly Implement Effective Remedial Measures**

Principle 3 recommends the determination of effective remedial measures and their prompt and effective implementation. It states that:

"Effective remedial measures responsive to the fundamental cause of the malfeasance should be determined and promptly and effectively implemented. Remedial measures should not be limited to just making organizational changes or amending internal rules and the like. Rather, it is crucial that the principal aim of the remedial measures be reflected in how daily business/operations are conducted. Accordingly, checks should be conducted to ascertain whether remedial measures are being applied in line with their objectives throughout the relevant parts of the organization."

Corporations are often quick to establish remedial measures in the aftermath of a malfeasance investigation. However, the implementation can be inconsistent across the organization or cease over time. Further, a lack of management buy-in regarding remedial measures is often seen as a reason why some companies experience repeated cases of malfeasance. Therefore, Principle 3 emphasizes that effective remedial measures must include effective follow-up
implementation checks throughout the relevant parts of the organization.

**Principle 4: Prompt and Appropriate Information Disclosure**

Principle 4 advocates prompt and appropriate public disclosure of information once misconduct is uncovered. It states that:

"Public disclosure of information concerning corporate malfeasance must as required be made promptly and appropriately from the moment the malfeasance is uncovered until the implementation of remedial measures. Efforts must be made to ensure transparency when publically disclosing such information by carefully explaining the background and nature of the case, the company's opinion in relation to the case and other relevant matters."

Much discussion is expected regarding the interpretation of this principle. Even now, Japanese security exchanges set out in their listing requirements various rules concerning timely disclosure. However, disclosure under Principle 4 is not expected to be limited to timely disclosure as required under the listing rules, but to entail faster, more extensive disclosure. As public disclosure carries certain risks – including the risk of inducing litigation both nationally and internationally – it must be managed carefully with experienced advisers. The 24-hour media cycle and the reputational risks of poor or badly timed public disclosures amplify the need for experienced counsel.

**IV. Comment**

The Principles for Listed Companies Dealing with Corporate Malfeasance provide useful guidance for companies facing serious compliance issues that need to launch investigations, and will likely influence the way that Japanese companies and non-Japanese corporations operating in Japan investigate cases of malfeasance. As Japan appears to be the first major economy to issue stock exchange-led guidelines of this type, this is an important development in an increasingly important aspect of corporate governance and is worthy of close attention.
I. **Introduction**

In our May 2015 issue of this newsletter, we discussed two significant reforms to the corporate governance regime of Japanese listed companies that were being implemented. They are:

(i) effective on May 1, 2015, the amended Companies Act introduced a new governance structure and additional requirements relating to outside directors; and

(ii) starting June 1, 2015, the Japanese Corporate Governance Code (the ‘Code’) was adopted by the Tokyo Stock Exchange (the ‘TSE’).

These reforms, particularly the Code, have had a major impact on the practice of corporate governance by Japanese listed companies. This article summarizes some of the major developments of the last 18 months in response to the 2015 reforms and touches upon the future direction of Japanese corporate governance.

II. **Major Developments Following the 2015 Corporate Governance Reforms**

We have identified five notable developments that have been prevalent among Japanese listed companies following the 2015 Corporate Governance Reforms.

**High Percentage of Compliance with the Code**

Consisting of five guiding principles, 30 principles and 38 supplementary principles, the Code employs a ‘comply or explain’ approach. Under this approach each listed public company can either comply with the Code or, if it considers that any part of the Code is not appropriate for the company given its circumstances, explain why the company does not comply with the Code. As of July 2016, 21% of the companies listed on the First and Second sections of the TSE stated that they comply with all 73 principles of the Code, while 84.5% of the companies stated that they comply with 90% or more of the Code.

However, such a high rate of compliance may not be as positive as it may seem. Critics argue that some companies have merely created the appearance – without the substance – of complying with the principles of the Code in order to avoid analyzing and explaining whether a certain principle is beneficial to the corporate governance of the company.

**Appointment of Independent Outside Directors**

The Code’s requirement that listed companies should appoint at least two independent outside directors (in Japanese, ‘dokuritsu shagai torishimariyaku’) shocked many Japanese boards, which have long been dominated by internally appointed members. In stark contrast to prior to the Code’s introduction, where more than 30% of all TSE-listed companies had no outside directors, today approximately 80% of the companies listed on the TSE’s First section have appointed two or more independent outside directors.

While Japanese companies and shareholders recognize the benefits of having independent outside board members, an insufficient pool of experienced and qualified candidates, and outside directors simultaneously holding two or three board positions, remain as challenges to be overcome.
Major Shift to the New Corporate Governance Structure with Audit and Supervisory Committees

Introduced in May 2015 by the amended Companies Act, the third choice of corporate governance structure, a company with an audit and supervisory committee (in Japanese, ‘kansatoutinkai sechikai kaisha’), has enjoyed continued popularity among Japanese companies. In the last 18 months, as many as 700 TSE-listed companies, or approximately 18% of all TSE-listed companies, have shifted to this new governance structure from the traditional governance structure with statutory auditors.

The traditional governance structure has long been unpopular among foreign investors due to the unfamiliarity with the concept of statutory auditors. When a U.S.-style governance structure with nomination, audit and compensation committees was first introduced in 2003, it was not welcomed by most Japanese companies who were wary of outside directors making decisions at the three committees as their majority members. The audit and supervisory committee is a hybrid of the traditional governance structure and the U.S.-style governance structure.

The surging popularity of the audit and supervisory committee structure has generally been attributed to the Code’s principle recommending multiple independent outside directors as discussed above. Under the Code, companies with the above-mentioned traditional governance structure are required to have at least two outside directors in addition to at least two outside statutory auditors. On the other hand, companies with the audit and supervisory committee structure are only required to have a minimum of two outside directors who serve as the majority members of the audit and supervisory committee.

Establishment of an Advisory Nomination and Compensation Committee

The Code recommends that boards of listed companies establish an advisory committee with independent outside directors serving as principal members regarding the nomination and compensation of directors. Largely due to this recommendation, these kinds of advisory committees are quickly becoming more common and 18% of TSE-listed companies now have either an advisory nomination committee or an advisory compensation committee, or both.

There are no statutory or regulatory requirements as to how these optional committees should be composed or operated. In approximately half of the voluntary committees, external board members comprise a majority of the members, while a majority of the committees are chaired by an internal director. Ordinarily, optional nomination and compensation committees serve as an advisory committee to the board of directors with respect to either proposed directors or the allocation to each director of the total compensation approved by the shareholders.

Performance-Based Director Compensation

Given that one of the roles of the board is to support appropriate risk-taking by management, the Code encourages implementing an executive compensation scheme designed to provide proper incentives for management through an appropriate ratio of compensation linked to mid- to long-term performance and a well-balanced allocation of cash and equity.

With the amendment to Japanese tax laws in March 2016 to allow certain types of restricted stock to be recognized as an expense, it is expected that restricted stock will become more widely accepted as a form of director compensation in Japan.

III. Ongoing Discussions and Future Direction

In September 2015, Japan’s Financial Services Agency established an advisory council that reviews and publishes guidance on the progress of the implementation by Japanese companies of the Code and the Japanese stewardship code published in February 2015.
The council has identified the following three issues as being the most pressing regarding the strengthening of corporate governance in Japan:

(i) implementing a mechanism to remove CEOs and appoint qualified CEOs that best fit the mid- to long-term strategic goals of each company;

(ii) developing a succession plan to replace long-standing or founding family CEOs; and

(iii) shifting the role of the board of directors from company decision-making to monitoring management.

Now that Japan has a regulatory framework in place to bring corporate governance up to global standards, it is up to each Japanese listed company to interpret and implement the principles laid out in the Code taking into account its individual circumstances and the benefit to its stakeholders. After all, the ultimate purpose of the Code is to promote sustainable growth and increase corporate value over the mid- to long-term through self-motivated governance and action, rather than to introduce another layer of ruled-based regulation.