

A world first? New guidance issued for listed companies conducting internal investigations

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Introduction

The release of the Panama Papers was the latest major incident 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 stand-out events. In line with the increased vigilance of regulators globally, in early 2016 the Japan Exchange Regulation (JPX) released its Principles for Listed Companies Dealing with Corporate Malfeasance. The advice sets 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.

Background

The principles were fuelled by concerns over the independence and effectiveness of previous internal investigations, both in Japan and abroad. Walmart's well-publicised Mexico bribery scandal and the fact that one of its officers who had allegedly authorised 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 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 publicised. 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 realisation 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.

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Principles

The principles are not legally binding; they resemble the 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 designed 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 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 analyse investigative reports that are publicly disclosed by other companies and actual malfeasance scenarios, to ensure that they are better prepared should they have to determine and implement an investigative approach to an actual or suspected case of corporate wrongdoing in their own or their clients' organisations. 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. 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 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 organisation 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 emphasises that effective remedial measures must include effective follow-up implementation checks throughout the relevant parts of the organisation.

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.

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.

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