New corporate group governance guidelines

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White Collar Crime, Japan

Introduction

Certain large corporate groups in Japan have been criticised for having antiquated group governance structures that do not provide adequate protection against corporate malfeasance. It has been recognised that poor group design and governance often play at least an indirect role in white collar crime.

As part of ongoing efforts to address these issues, the Ministry of Economy, Trade and Industry (METI) published the Practical Guidelines on Group Governance Systems (GGS Guidelines) on 28 June 2019.**(1)** The GGS Guidelines complement the Practical Guidelines for Corporate Governance Systems (CGS Guidelines), which were published in March 2017 and subsequently updated in September 2018.**(2)**

The CGS Guidelines were created as part of the Cabinet Office's Japan Revitalisation Strategy 2016, which aimed to promote the "enhancement of corporate value through... corporate governance reforms".**(3)** The CGS Guidelines set out specific actions that Japanese corporates may take in order to implement the primary principles contained in the Corporate Governance Code 2015.

The purpose of the GGS Guidelines is to provide guidance to corporates operating within a group structure by building on a series of 'ideal approaches' to the design of corporate governance systems contained in the CGS Guidelines. The thinking is likely that groups with robust governance structures are more likely to have good corporate cultures which should help to protect against the risk of inappropriate management and conduct.

As Japan's population continues to shrink, overseas markets are becoming more significant to Japanese corporates looking for growth, and creating more effective group governance structures in line with international best practices is an increasingly important issue. As such, the GGS Guidelines contain a number of suggestions in this regard.

Overview of GGS Guidelines

The GGS Guidelines provide 'ideal approaches' with regard to:

- group design;
- business portfolio management;

- internal controls;
- the appointment and compensation of subsidiary senior management; and
- the governance of listed subsidiaries.

The GGS Guidelines are aimed at listed companies with subsidiaries (particularly large groups with significant operations overseas), but many of the recommendations are equally relevant to smaller corporate groups with primarily domestic operations.

A few themes emerge in the GGS Guidelines, including:

- defensive and offensive governance; and
- risk management during business-as-usual operations and times of crisis.

Both themes are discussed further below.

Ideal approaches

Group design

'Group design' is the process of determining the structure and distribution of authority within a corporate group and is the basis upon which effective group governance is built. The GGS Guidelines suggest that companies should consider the following when seeking to design an effective group structure:

- whether to spin off certain business units by giving them a separate legal personality as a subsidiary or maintain a single company, taking the benefits of separation (eg, interception of management risks, clarification of where responsibilities lie and faster decision-making) and the costs (eg, of establishing and operating the subsidiary's board of directors) into consideration;
- striking the right balance between centralisation (ie, maintenance of control at group headquarters) and decentralisation (ie, delegation of authority to each subsidiary or business division); and
- finding the optimal combination of financial synergies (eg, use of surplus funds and tax shields) and business synergies (eg, cost reductions, realisation of economies of scale and sharing of brand know-how) to create a corporate value that exceeds the sum of the constituent group parts.

In addition, the GGS Guidelines recommend the following initiatives to help mitigate the risk of inadequate oversight of subsidiaries:

- A group's management philosophy, values and code of conduct should be shared with group companies and senior management should regularly communicate these messages directly to employees.
- A group-wide framework should be established for subsidiary management, including rules for the allocation of decision-making authority between the parent and subsidiaries in accordance with the management policies of each group company.
- Subsidiary management should follow a risk-based approach (ie, the risks of each subsidiary should be assessed according to its size and the business area in which it operates. This will inform the requisite type of management and supervision).
- Decision-making authority should be decentralised from the parent to the subsidiaries. Consideration should be given to the appointment of directors from the board of the parent to the boards of the subsidiaries. This should help to reduce the parent's formal management time yet still ensure monitoring of subsidiaries' activities.
- Proactive communication between executives at the parent and subsidiaries should be promoted. The parent's board of directors should monitor whether such communications are regular and effective.
- A system should be established under which the parent has the authority to determine the composition and compensation of the subsidiaries' senior management.

Business portfolio management
In a diversified company that operates multiple businesses, it is important to optimise management resources by implementing effective business portfolio management, such as strengthening core businesses, nurturing next-generation growth areas and withdrawing from under-performing businesses after carrying out an appropriate assessment. The GGS Guidelines highlight the following governance points in relation to business portfolio management:

- Parent or holding companies should:
  - establish criteria for new investment, including M&A, as well as the time horizon for project evaluation, withdrawal from unprofitable divisions and exit from non-core businesses; and
  - clarify the entities and processes to be examined.
- The board of directors of the parent or holding company should review these criteria and processes and independent non-executive directors should be actively engaged in these discussions. Chief financial officers are expected to play a leading role in the development of a concrete framework from the perspective of the appropriate allocation of management resources.
- Group accounting and IT systems should be integrated to ensure efficient business portfolio management through the sharing of centralised information.

Internal controls
Given that corporate compliance issues can have a destructive impact on shareholder value, compliance risks should be mitigated to the extent possible by effective risk management (so-called 'defensive' governance) – for example, the 'three lines of defence' model – and by effective crisis management. Equally, in order to maintain and improve shareholder value over the medium to long term, business operations should be conducted in a flexible manner based on appropriate risk-taking (so-called 'offensive' governance).

Risk management – three lines of defence
The GGS Guidelines stipulate that the three lines of defence model should be considered in the construction and operation of an internal control system. The model consists of:

- the business divisions in charge of business execution (first line);
- the administrative divisions in charge of supporting and monitoring the business divisions, such as the legal and compliance divisions (second line); and
- the internal audit division (third line).

The first line (business divisions) has the following areas of responsibility:

- Develop a risk management system for the entire group, implementing both concrete measures (eg, development of internal rules, clarification of business flow and development of IT infrastructure) and soft skills (eg, penetration of compliance awareness based on corporate culture and management philosophy).
- Senior management at group headquarters should regularly disseminate compliance messages to help foster and embed a culture of compliance.
- Performance targets and evaluations should be feasible and should not create an atmosphere (whether intentionally or unintentionally) where wrongdoing is more likely to occur.
- Along with monitoring changes in profits and other conditions to ensure that risk information can be ascertained at an early stage, senior management should be highly visible in order to help create an open atmosphere. This includes making site visits where board-level executives engage directly with employees.
- Incentives should be provided to encourage reporting and consultation with the parent, such as the parent bearing the cost of investigating issues at subsidiaries.

In relation to the second line (legal and compliance divisions):

- reporting lines and personnel evaluation for the second-line functions should be separated as much as possible from the business divisions to ensure independence and the parent and the subsidiary second-line functions should be directly linked to each other; and
- the board of directors is responsible for fostering an environment that supports appropriate risk-taking. In order to facilitate appropriate risk-taking, thereby enhancing corporate value over the long term, the role of the board of directors is important. A company's general counsel or head of legal should be made a senior officer (ie, director or executive officer) and that person should have independence in the execution of their duties.

In relation to the third line (internal audit divisions):

- in order to establish independence from the first and second lines, internal audit departments should report directly to the board members responsible for audits or to the audit committee itself. These reporting lines should be clearly defined in group policies and procedures; and
- it should be determined whether:
    - the parent's internal audit function will audit the subsidiary taking into account the circumstances of the subsidiary's audit resources; or
    - internal audits of subsidiaries will be conducted by the subsidiary and supervised by the internal audit division of the parent.

- Management should seek to increase the internal audit function's expertise and knowledge of the business through medium-to-long-term personnel development and by providing incentives for career development and promotion. Internal audit personnel should participate in training courses and seek to acquire specialist qualifications. The internal audit function should also be a route for the development of future executive candidates.
- Consideration should be given to the use of IT and data analytics to improve the efficiency and accuracy of internal audits and aim to centralise data infrastructure within the group.

Crisis management
The GGS Guidelines provide a number of recommendations for responding to crises effectively:

- When a crisis occurs, it is important to first assess the significance of the incident and the necessity of public disclosure. To determine whether the company should disclose the matter, it is necessary to consider the extent of the damage (eg, does it affect the physical safety or health of individuals inside or outside the company?) and the scope of the impact (eg, is it an isolated incident or widespread? Is the conduct in question historical or is it ongoing?). If the company has decided to disclose, priority should be given to prompt reporting and the company should endeavour to sincerely apologise and provide accurate explanations as necessary.
- Companies that are developing their businesses globally should be aware of the impact of document discovery during litigation in common law legal systems. Employees may need to be educated about which communications are protected by legal professional privilege. When making a decision about whether to publish an investigation report, or a summary of findings from the report, senior management must weigh up and balance between restoring accountability and stakeholder trust and the risk that information contained in the report may be used against the company in a class action or group litigation, particularly in the United States.
- In investigations into alleged serious misconduct, the role of independent non-executive directors may be important. The GGS Guidelines state that independent non-executive directors should play a leading role in the selection of the investigation system (eg, should the legal or compliance department conduct the internal investigation? Should the company establish a committee

comprised solely of independent non-executive directors to oversee an investigation conducted by outside counsel? Should the company establish an arm's-length third-party committee comprised of academics, accounts or lawyers?).
- In order to confirm the accuracy of the facts and the feasibility and effectiveness of the proposed remedial measures, management must communicate with the investigation committee while being careful not to hinder or inappropriately influence the investigation.
- A subsidiary's board should be primarily responsible for compliance and regulatory issues which occur at the subsidiary; however, parent companies are expected to take the lead in formulating remedial measures to prevent recurrence at a group-wide level.

Nomination and compensation of subsidiaries' management

Parent companies have the right to decide the composition and compensation of a subsidiary's senior management team provided that they are a controlling shareholder. The GGS Guidelines stipulate that decision making by the parent should be exercised to further the integrated management of the group and maximise shareholder value. In this regard, the GGS Guidelines state that the appointment and compensation of the senior management of major wholly owned subsidiaries should be included in the scope of deliberations by the board of directors and highlight the following measures:

- develop plans for successors to group management, including effective use of subsidiary management posts;
- develop plans to harmonise personnel-related information to facilitate the identification and training of personnel throughout the entire group;
- establish a unified compensation policy based on the corporate philosophy and management strategy of the entire group; and
- disclose basic information in relation to the group's compensation policy.

These initiatives are expected to strengthen the sense of unity among the directors and employees of a parent and its subsidiaries as a group, maximise group synergies and facilitate communication.

Governance of listed subsidiaries

For listed subsidiaries, special consideration is required since there is a risk of conflicts of interest between the parent, which is the controlling shareholder, and other shareholders. As a general consideration, the GGS Guidelines highlight that parents should keep under review whether it is optimal for a listed subsidiary to maintain its public listing from the perspective of improving the corporate value of the group and improving capital efficiency.

Comment

Group design and business management

The GGS Guidelines state that group design needs to find the appropriate balance between centralisation and decentralisation. Recent high-profile compliance failures at group companies in Japan have been partially caused by reductions in the resources of parents' legal and compliance functions and the decentralisation of decision-making authority with an emphasis on speeding up decision making and reducing costs, resulting in inadequate supervision and management of subsidiaries. This highlights the importance of establishing a system to appropriately manage and supervise subsidiaries when designing a group structure. The challenge in doing this is maintaining both effective governance and operational flexibility. Continuous monitoring of the structure is necessary to ensure that the right balance is being struck.

The specific initiatives for business portfolio management in the GGS Guidelines were not part of the CGS Guidelines published in 2017. There is an increasing recognition that inadequate business portfolio management can lead to the institutionalisation of low-growth and low-profit businesses. This, in turn, may create compliance risks, such as inappropriate pressure on officers and employees in these underperforming divisions, which can result in a short-term pursuit of profitability at the expense of compliance considerations.

Internal controls

The GGS Guidelines recommend the implementation of the three lines of defence model. In Japan, although listed companies usually have legal, compliance and internal audit divisions that work with and oversee business divisions, in some cases, the relationship between the second and third lines and the business divisions can be dysfunctional. Some companies have historically underinvested in the functions that support and monitor the business units and, consequently, there can sometimes be a lack of talent in these areas. Therefore, to help mitigate legal and compliance risk that may arise in the business divisions, it is crucial to:

- formally implement the three lines of defence model;
- widely communicate its importance to the success of the company as a whole;
- ensure adequate resources for the second and third lines; and
- undertake periodic reviews to ensure that the lines are functioning effectively.

Crisis management

The GGS Guidelines leave open the possibility that a board of directors may wish to establish a third-party committee at arm's length to conduct an investigation. While a report produced by such a committee may be protected by legal professional privilege outside Japan if the committee is comprised at least partially of lawyers, the successful assertion of privilege by the company over any report produced is not guaranteed, particularly if large parts of the report are published. Therefore, commissioning this kind of report can create new risks for a company in any follow-on civil litigation, particularly as reports prepared by committees operating at arm's length sometimes contain fundamental inaccuracies since the testing of evidence and conclusions are typically not as robust as the process undertaken by outside counsel who have day-to-day contact with a company.

For further information on this topic please contact John Lane or Yu Yuasa at Nagashima Ohno & Tsunematsu by telephone (+81 3 6889 7000) or email (john_lane@noandt.com or yu_yuasa@noandt.com). The Nagashima Ohno & Tsunematsu website can be accessed at www.noandt.com.

Endnotes

(1) Further information is available here.

(2) Further information is available here.

(3) CGS Guidelines, p 2.

Akiko Inoue assisted in the preparation of this article.

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