

# Japan Exchange Regulation publishes principles to prevent corporate scandals

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## Introduction

In response to the significant corporate scandals that have come to light in recent years, Japanese authorities and regulators have been working to improve compliance awareness within corporate Japan.

The Japan Exchange Regulation (JPX-R) is a subsidiary of the Japan Exchange Group, Inc and a regulatory body empowered under the Financial Instruments and Exchange Act to, among other things, conduct listing examinations, compliance reviews, market surveillance and broker-dealer inspections of companies listed on the Tokyo and Osaka stock exchanges. The JPX-R has published certain guidelines to share its views on compliance and risk management, such as its Principles for Responding to Corporate Scandals of February 2016. More recently, on March 30 2018, it published its Principles for Preventing Corporate Scandals (the prevention principles).

While the prevention principles do not have the force of law behind them and do not constitute formal obligations for those entities subject to JPX-R oversight, they do provide valuable insight into the views of the JPX-R and, by extension, other Japanese regulators. The principles represent a useful set of guidelines to better understand how Japanese market participants are expected to manage their compliance function. Companies active in Japan are advised to consider the principles carefully and assess whether their compliance measures are appropriate.

## Prevention principles

### ***Principle 1: gain thorough understanding of actual situation***

This principle highlights the importance of proactively seeking to recognise, in terms of structure and actual operations, the effectiveness of a company's compliance programme. It provides as follows:

- Management should have a clear understanding of the status of all compliance procedures and matters within the entity, across all functions and levels, in order to review existing practices and proactively identify and resolve potential issues.
- Compliance functions are encouraged to regularly review and assess their compliance procedures in the context of broader societal views of compliance and ethical conduct (eg, their communication with and the treatment of customers, business partners and stakeholders) and update such procedures as necessary.
- Compliance functions should facilitate the open exchange of information, including compliance-related concerns, within all levels of the organisation to ensure that their procedures are current and effective and that their concerns can be properly and promptly addressed.

### ***Principle 2: fulfil responsibilities with sense of mission***

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This principle highlights the importance of ensuring that an entity's compliance function is appropriately empowered and supported by management. Under this principle, management should:

- take an active role in promoting the importance of compliance and its commitment thereto within the organisation;
- actively support compliance initiatives, including ensuring fulsome investigations of potential issues, and avoid delivering inconsistent messages in its promotion of compliance objectives, such as by setting unreasonable business objectives; and
- empower the compliance function, including its various audit and supervisory bodies and committees, to carry out its responsibilities in a fulsome and active manner, including from a corporate authorisation and structural perspective.

***Principle 3: encourage two-way communication***

This principle highlights the importance of open and reciprocal reporting lines within companies as an important deterrent against compliance issues. Under this principle, management should:

- promote open communication within the organisation by actively engaging with the workforce on relevant issues and encouraging the workforce to promptly raise issues as they arise; and
- ensure that middle management is properly trained and empowered due to their importance in developing effective two-way communication within an organisation, given their dual role of:
  - conveying the importance of compliance to the workforce; and
  - sharing with management potential issues or concerns identified by the workforce.

***Principle 4: detect non-compliance early and respond swiftly***

This principle acknowledges that while it may be impossible to completely eliminate the risk of compliance issues from arising, if compliance issues are promptly identified and addressed, the negative impact can be controlled. Under this principle, management should:

- be aware of, and vigilant against, the risk of compliance violations at all times and instill such attitude of awareness throughout the company;
- regularly review and enhance its compliance function in order to develop a virtuous cycle of continuous compliance improvement; and
- ensure that compliance messaging and objectives are clear and defined.

***Principle 5: execute consistent business management throughout entire corporate group***

This principle highlights the importance of implementing a consistent approach to compliance across an organisation and its affiliates, providing as follows:

- Given the potential knock-on effect that a corporate scandal may have on an organisation and its affiliates, management should ensure that a consistent approach to compliance policies and procedures is implemented across the corporate group.
- Management should avoid using a one-size-fits-all approach in implementing its compliance policies and procedures across the organisation and its corporate group. Management is encouraged to consider and assess, in each instance, the particular situation so that appropriate compliance policies and procedures, which address the respective underlying compliance risks in a consistent manner, can be implemented.
- Management is advised that particular care should be given in assessing the compliance functions of acquired entities and ensuring a consistent and appropriate culture of compliance is instilled therein.

***Principle 6: be accountable in view of relevant supply chain***

Similar to Principle 5, this principle posits that companies should be aware of their compliance-related obligations to potentially extend over their business partners, suppliers and entire supply chain. It provides as follows:

- Management should carefully consider the role of the company and its position in the

respective market by assessing potential compliance risks and the scope of the market when developing the entity's compliance policies and procedures.

- Management should impress upon the entity's subcontractors and business partners the importance of compliance and take reasonable steps to ensure such parties satisfy their obligations in an appropriate manner, including the use of contractual provisions.

## **Comment**

The prevention principles are a timely reminder of the continued emphasis being placed on compliance by Japanese regulators. They stress the importance of an effective and appropriate compliance regime and allocate significant responsibility for the establishment of such on companies themselves. Companies are expected to actively engage in their respective compliance functions and implement policies and procedures that are appropriate based on the relevant facts and circumstances. From a Japanese compliance perspective, the prevention principles are a warning signal to companies that simply rely on historical norms or apply blanket compliance policies across an entire organisation, without regard to the actual facts, is inappropriate and may not constitute an effective approach to compliance. This suggests that Japanese regulators may be transitioning to a more risk-based approach to compliance, which will place a greater burden on companies to carry out their compliance functions in a vigilant and proactive manner. Compliance remains a significant concern in Japan and all companies operating in Japan, regardless of whether they are under the JPX-R's oversight, should review and consider the guidance set out in the prevention principles.

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