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# Mizuho Economic Outlook & Analysis

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July 24, 2019

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## *Revision of the Companies Act aimed at improving corporate governance*

*The revised law is expected to be enacted next year at the earliest,  
its effectiveness is being required*

### < Summary >

- ◆ The scheduled revision of the Companies Act will make it mandatory for companies to elect outside directors and to enhance the disclosure of directors' compensation. The revised bill is expected to be submitted to the extraordinary Diet session this fall, with the revised law enacted next year at the earliest.
- ◆ Although the latest revision is aimed at further strengthening corporate governance, it also includes existing provisions already in practice by companies, such as the appointment of outside directors.
- ◆ To truly enhance corporate governance, it is important not only to take formal measures in accordance with the revised law, but also to implement substantial measures to ensure its effectiveness, ultimately improving the transparency of company management and corporate value on a sustainable basis.

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## 1. Background to the Companies Act revision

The bill to revise the Companies Act,<sup>1</sup> including such provisions as obligating the appointment of outside directors, is expected to be submitted to the extraordinary Diet session during the fall, with the bill enacted in 2020 at the earliest if approved. The latest revision will be the second following the one in 2014 (enacted in 2015).

The Companies Act was originally established in 2005 (enacted in 2006), spun off from the Commercial Code and integrating various related laws that included the Limited Liability Companies Act. The Act eliminated complications by consolidating various provisions originally included in the different laws and relaxed certain regulations by dropping the minimum capital requirement and simplifying procedures to set up or reorganize companies in reflection of the social and economic circumstances at that time. Furthermore, it established a new stock company system (abolished the limited liability company system)<sup>2</sup> that took into account small and medium-sized companies.

In the period that followed, the Abe administration positioned the enhancement of corporate governance as a pillar of its growth strategy and opted to reorganize legislation related to parent and subsidiary companies, leading to the revision of the Companies Act in 2014 (enacted in 2015) (**Chart 1**).

**Chart 1 Outline of the previous Companies Act revision (2014)**

Item	Outline
Revision to enhance corporate governance	<ul style="list-style-type: none"><li>• Establishment of companies with an audit and supervisory committee system</li><li>• (If no outside director is appointed) Obligation to explain the reason at the annual shareholders' meeting</li><li>• Establishment of stricter requirements of outside directors</li></ul>
Revision to reorganize regulations related to parent and subsidiary companies	<ul style="list-style-type: none"><li>• Establishment of a multiplex shareholders' lawsuit system (note)</li><li>• Enhancement of the injunction system against corporate reorganization</li><li>• Establishment of measures to protect creditors from damage in a company split</li></ul>

Note: When a subsidiary is a wholly-owned company (when a parent company holds 100% of the stock issued by a subsidiary), shareholders who hold more than 1/100 share of the stock issued by the parent company may, in principle, bring a shareholders' lawsuit against the directors, etc. of the subsidiary company.

Source: Made by MHRI based upon the Ministry of Justice, *Revision of the Companies Act (enacted on May 1, 2015)*.

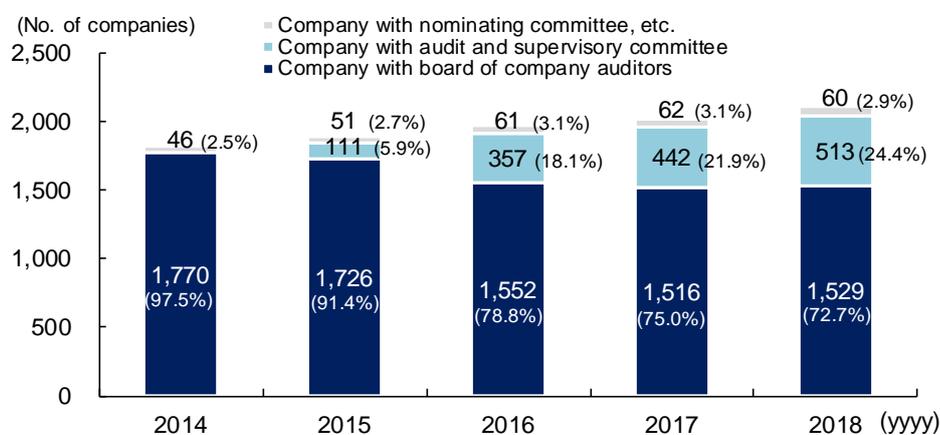
1 The Ministry of Justice, "Outline of the Draft for a Revised Companies Act (Corporate Governance-related Provisions)" (January 16, 2019).

2 In the past, the Limited Liability Companies Act was applied to relatively small companies, but according to the Ministry of Economy, Trade and Industry, the naming of "limited liability company" was prejudicial to these companies. For this reason, limited liability company and stock company were integrated under the newly enacted Companies Act by relaxing various restrictions, including the minimum capital requirement and the number of directors and employees.

The most important features of the revision were (a) it required listed companies without outside directors to explain the reason why at the annual shareholders' meeting, and (b) it established companies with an audit and supervisory committee system as a vehicle to take advantage of the outside directors' functions. It should be noted that as of August 2018, 24.4% of all firms listed in the Tokyo Stock Exchange First Section had adopted the audit and supervisory committee system, showing that the system is penetrating the corporate world at a steady pace (**Chart 2**).

This time's revision also mainly targets the enhancement of corporate governance, just as the previous revision did. Although corporate governance tends to focus on "defensive" measures, such as preventing company scandals, the improvement of corporate value on a sustainable basis ("proactive" measures), including raising productivity, is also an important theme of corporate governance. For this reason, the revision will not only cover the stipulation of rules on corporate management by directors, but will also deal with the system of shareholders' meetings that play a vital role in dialogue with shareholders (**Chart 3**).

**Chart 2: Number of companies with an audit and supervisory committee  
(companies listed in the Tokyo Stock Exchange First Section)**



Note: Data is compiled by the Japan Association of Corporate Directors by using the Tokyo Stock Exchange corporate governance information service. It collects data on August 1 each year. Figures in ( ) represent the share.

Source: Made by MHRI based upon the Japan Association of Corporate Directors, *Corporate Governance Survey of Listed Companies* (August 1, 2018).

**Chart 3 Outline of the latest Companies Act revision**

Item	Outline
Revision of regulations on directors, etc.	<ul style="list-style-type: none"> <li>• Obligation for listed companies to appoint outside directors</li> <li>• Delegation of execution of operations to outside directors</li> <li>• Stipulation of the policy to determine directors' compensation</li> <li>• Clarification of matters to be resolved when own stock and share options become directors' compensation</li> <li>• Enhancement of the disclosure of directors' compensation</li> <li>• Legislation of indemnity agreements and insurance agreements for directors (liability insurance for directors, etc.)</li> </ul>
Revision of regulations on shareholders' meetings	<ul style="list-style-type: none"> <li>• Provision of proxy materials by electronic means such as the internet</li> <li>• Adequate restrictions on the number and content of agenda items that can be proposed by shareholders</li> </ul>
Others	<ul style="list-style-type: none"> <li>• Establishment of a bond administrative assistant system (note 1) and stock delivery system (note 2), among others</li> </ul>

Notes: 1. A company issuing bonds must establish, in principle, a bond administrator, but companies often use an exception clause to forego its establishment. The bond administrative assistant system will be established to mitigate the confusion that arose when such bonds went into default, and the system will allow firms to establish a bond administrative assistant to whom firms can entrust the bond administrative assistance operation.

2. When stock company A ("Company A") wants to make stock company B ("Company B") its subsidiary, this system enables Company A to obtain the stock of Company B in exchange for the stock of Company A. Hence Company A needs no cash but can make its own stock as consideration to acquire Company B.

Source: Made by MHRI based upon the Ministry of Justice, *Outline of the Draft for a Revised Companies Act (Corporate Governance Related Provisions)* (Decided on January 16, 2019).

## 2. Features of the latest revision and its background

### (1) Obligation to appoint outside directors

The latest revision aims at obliging listed companies<sup>3</sup> to appoint outside directors. This provision is targeted at further enhancing corporate governance through inspection and supervision from outside the firms. On the other hand, 97.7%<sup>4</sup> of all companies listed in the Tokyo Stock Exchange have already appointed outside directors, primarily because corporate governance reform was one of the pillars of the growth strategy advocated by the Abe administration in 2014, and the Companies Act revision in the same year and the application of the corporate governance code<sup>5</sup> in 2015 (**Chart 4**) prompted firms to comply with the revised rules. This code requires two or more independent outside directors, but while the code itself is a soft law with no legal binding force, it was included as part of the securities listing regulations of the Tokyo Stock Exchange. With its inclusion, the importance of outside directors has become widely

<sup>3</sup> The definition provided in the "Outline of the Draft for a Revised Companies Act (Corporate Governance Related Provisions)" is "a company with a board of company auditors (limited to public companies and large companies) that is required to submit a securities report to the prime minister with respect to shares that the company issues pursuant to the provisions of Article 24(1) of the Financial Instruments and Exchange Act."

<sup>4</sup> Tokyo Stock Exchange, "Status of Election of Outside Directors at Companies Listed in the Tokyo Stock Exchange and the Trend of [Reasons Why the Election of Outside Directors Is Not Appropriate]" (August 1, 2018).

<sup>5</sup> For details of the Corporate Governance Code, refer to "Corporate Governance Reform Entering the Second Stage," (Mizuho Research Institute "Mizuho Report" [May 29, 2019]) in Japanese only.

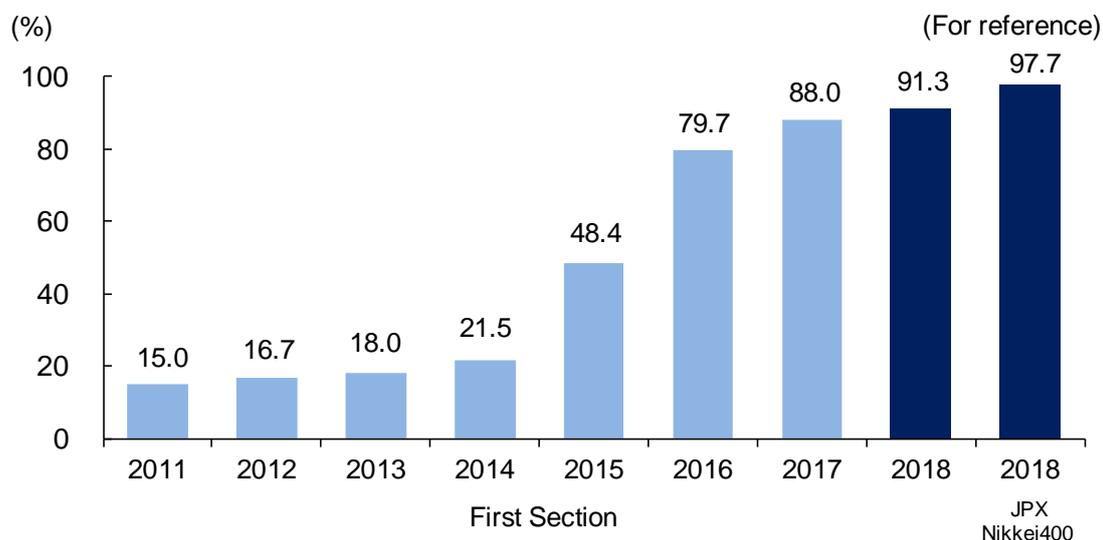
recognized in society and propelled firms to appoint outside directors. As a result, over 90% of all firms listed in the Tokyo Stock Exchange First Section now fulfill this provision (**Chart 5**).

**Chart 4 Salient features of the Corporate Governance Code**

Item	Specific features
Shareholders' rights and equality	<ul style="list-style-type: none"> <li>Ensures the rights of shareholders effectively (including early dispatch of the notice of convocation)</li> <li>Discloses the company's policy on cross shareholdings, and stipulates and discloses the standards to exercise voting rights</li> </ul>
Stakeholders other than shareholders	<ul style="list-style-type: none"> <li>Responds appropriately to issues concerning sustainability</li> <li>Ensures the diversity of human resources by such means as promoting female workers</li> </ul>
Disclosure	<ul style="list-style-type: none"> <li>Provides highly useful information for users in addition to disclosure based on legislation</li> </ul>
Board of directors	<ul style="list-style-type: none"> <li>Utilizes independent outside directors (appointing two or more outside directors)</li> </ul>
Dialogue with shareholders	<ul style="list-style-type: none"> <li>Conducts constructive dialogue with shareholders from the perspective of contributing to sustainable growth</li> </ul>

Source: Made by MHRl based upon the agenda and handouts of the first meeting of the Council of Experts Concerning the Follow-up of Japan's Stewardship Code and Japan's Corporate Governance Code (September 24, 2015).

**Chart 5 Ratio of companies appointing two or more independent outside directors (companies listed in the Tokyo Stock Exchange First Section)**



Source: Tokyo Stock Exchange, *Status of the election of independent outside directors, establishment of committees, and disclosure of advisers or counselors at companies listed in the Tokyo Stock Exchange* (July 31, 2018).

The mandatory requirement to elect outside directors stipulated by the latest Companies Act follows the trend of reinforcing corporate governance, but clarification of the provision as a hard law can be viewed as a remarkable change. While outside directors are required to supervise the company's management from a third-party position, recent corporate scandals have revealed many cases where outside directors were not provided sufficient information, where the opinions of outside directors were ignored, and where the election of outside directors was instructed by executive managers. Needless to say, it is more important to ensure effective management control by enabling outside directors to play their roles properly, and the actions that companies take in the future will be worthy of scrutiny.

Also, from the perspective of utilizing outside directors, when a conflict of interest arises between the company and its directors, and where shareholders' interest may be impaired as a result of other directors executing operations, the company may entrust the execution of related operations to outside directors by obtaining approval at the board of directors' meeting. While the current Companies Act provides that outside directors no longer fulfill the conditions of outsider directors when they engage in executing the company's operations (Article 2(15) of the Companies Act), the revised Act provides that the external nature of outside directors will not be lost in the above case. For example, we can think of a management buyout where a conflict of interest arises between the company's shareholders and directors who are the buyers, with the outside directors stepping in as a measure to secure transaction fairness through their outside activities, such as negotiating from a position independent from the operation execution body. Even though outside directors executing company operations to avoid conflicts of interest falls in line with the purpose of the Companies Act, it can also be interpreted that directors engaged such operations do not fall under the criteria of outside directors,<sup>6</sup> and thus the criteria will be clarified in the upcoming revision.<sup>7</sup>

## **(2) Improvement in transparency of directors' compensation**

The current Companies Act provides for stock companies other than those with a nominating committee to determine the compensation of its directors by resolution at the shareholders' meeting (Article 361(1) of the Companies Act). But in practice, companies may decide only on the maximum amount of total compensation to be paid to all directors, with allocation to the respective directors set within the maximum limit

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<sup>6</sup> The Ministry of Justice, "Supplementary Explanation on the Interim Draft for a Revised Companies Act (Corporate Governance Related Provisions)" (February 14, 2018).

<sup>7</sup> According to the "Outline of the Draft for a Revised Companies Act (Corporate Governance-related Provisions)," the same provision shall be established for a company with a nominating committee, etc. when a conflict of interest arises between the company and its executive officers.

entrusted to the board of directors. In other words, if the maximum amount of total compensation is decided by resolution at the shareholders' meeting, it can be interpreted that the resolution is no longer necessary as long as the maximum amount of total compensation remains unchanged. The application of the directors' compensation rule in the Companies Act has therefore been pointed out as less strict.<sup>8</sup>

In the latest revision, even listed companies with a board of auditors, etc.<sup>3</sup> and companies with an audit and supervisory committee are required to stipulate their policy on how they determine the amount of directors' compensation. More specifically, the revision asks for more in-depth provisions concerning the ratio of compensation for each director by type of compensation, the presence of performance-based compensation, the policy on how to determine the content of performance-based compensation, and such policies are subject to disclosure. Meanwhile, the provision on the disclosure of individual director's compensation, which was under consideration, has been dropped.

Other than these, the revision includes (1) a provision that when a company grants its directors' compensation in a form other than cash such as company stocks, the details shall be resolved at the shareholders' meeting, (2) a special provision concerning stocks and share options as directors' compensation, and (3) greater disclosure of directors' compensation.

In addition, under the circumstances where company operations have become highly complicated, provisions concerning indemnity and insurance contracts (liability insurance for directors<sup>9</sup>) with a view to preventing directors from excessively avoiding risks have been established, and cases where such actions would be tolerated will be clarified in the revised act.

The revision envisages not only ensuring the transparency of directors' compensation but also granting appropriate incentives to directors, so we can regard the revision as a positive development for company management.

### **(3) Raising the importance of shareholder meetings and promoting digitalization**

As part of governance reform, the Stewardship Code<sup>10</sup> was established in 2014 and is considered closely connected with the Corporate Governance Code. The Stewardship Code defines the action principles of institutional investors, and particularly aims at improving corporate value in the mid- to long-term through engagement (dialogue with

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<sup>8</sup> The Legislative Council of the Ministry of Justice, the first meeting of the subcommittee on the Companies Act system (corporate governance-related matters), "Items to be studied when examining regulations concerning corporate governance" (April 26, 2017).

<sup>9</sup> A contract between a company, or policyholder, and an insurance company, or insurer, and is insurance which provides coverage for damage of an insured person (e.g., a director) when such damage is claimed against the insured person during the insurance period as a result of the execution of operations by the director.

<sup>10</sup> For details of the Stewardship Code, refer to "Corporate Governance Reform Entering the Second Stage" (Mizuho Research Institute "Mizuho Report" [May 29, 2019]) in Japanese only.

purpose) between investors (asset management institutions, asset owners, etc.) and companies. With the establishment of this code, shareholders' meetings have become ever more important.

In order to respond quickly to trend of digitalization, the Companies Act will enable companies to revise the Articles of Incorporation so that they can provide proxy materials of shareholders' meetings electronically via the internet. At the same time, the provision of materials by electronic means has become compulsory for listed companies. Although providing proxy materials electronically has been allowed thus far, only a limited number of companies have actually done so because it requires the permission of individual shareholders.<sup>8</sup> As the provision of electronic documents spreads going forward thanks to the Act's revision, convenience for both companies and shareholders is expected to improve.

Also, although the date to provide written documents is set at two weeks before a shareholders' meeting, it will be set at three weeks before the shareholders' meeting when provided electronically, giving shareholders an extra week. Since shareholders' meetings tend to be concentrated during a certain period in Japan, this change is seen as one that takes the convenience of shareholders into consideration.

On the other hand, recent shareholders' meetings have seen many instances where shareholders propose agenda items to intentionally trouble the management team, or where one shareholder puts forth too many proposals, which are actions considered an abuse of the shareholders' proposal rights. Hence, this time's revision has incorporated provisions that restrict the number of agenda items one shareholder can propose and the inadequate contents of the agenda items.

### **3. Situation in Europe and the United States in relation to the main revision items**

In this section, we want to confirm the details of the Companies Act, and look at the regulations in various European countries and the United States in comparison with the main details of the revision this time (**Chart 6**). In the US and UK, more than half of company directors are required to be outside directors, and as for directors' compensation in the US, the law requires the disclosure of the details and amount of compensation in the past three years for the CEO, CFO and the three most highly paid executive officers compensation, along with an explanation of the details of their compensation packages (for other directors, the law requires disclosure of compensation for the past one year). Likewise, in the UK, the details and amount of compensation for all directors in the past two years are subject to disclosure.

**Chart 6: Outline of company legislation in Europe and the United States (related to items covered by the latest revision of Japan's Companies Act)**

Item	United States	United Kingdom	Germany
Appointment of outside directors	Over half the directors must be outside directors at listed companies (New York Stock Exchange Listing Regulations).	More than half of directors must be independent outside directors at listed companies (Corporate Governance Code [note 3] applied to companies listed in main markets).	Boards of directors have a dual board system. In companies of a certain size, half the supervisory board members must be shareholder representatives selected from outside the firms, and the remaining half must be employee representatives selected from within the firms (Stock Corporation Act, Co-determination Act).
Disclosure of directors' compensation	Companies must explain the details and calculation method by component of the compensation packages paid in the past three years to the CEO, CFO and the three most highly paid executive officers compensation, and also disclose the details of compensation paid to all directors in the past one year (SEC Rule).	Listed companies must explain the details and calculation method by component of the compensation packages paid to all directors, and disclose the details of compensation paid in the past two years (Companies Act).	Listed companies must disclose the compensation paid to each executive member individually depending on fixed or varied type (Management Board Members' Compensation Disclosure Act) (note 5).
Timing to provide proxy materials (note 1)	More than 40 calendar days prior to the shareholders' meeting (Code of Federal Regulations) (note 2).	More than 21 calendar days prior to the shareholders' meeting (Companies Act) (note 4).	After the date when the letter of convocation is sent (Stock Corporation Act) (note 6).

- Notes: 1. The table above is based on each country's legislation investigated by KPMG AZSA LLC (survey entrusted by the Ministry of Economy, Trade and Industry, *Research on how dialogue between companies and investors and disclosure can create corporate value on a sustainable basis*).
2. This rule applies when listed companies select directors engaged in management; it also applies when the method of sending proxy materials, etc. is limited to sending a notice on the internet availability of proxy materials.
3. The London Stock Exchange consists of the Main market where large companies are listed and the AIM market where smaller growing companies are listed. The main market has several layers including Premium and Standard.
4. This applies in the case of public companies.
5. In a shareholders' meeting, if more than 3/4 of shareholders resolve not to disclose the compensation of individual management board members based on the Commercial Act, companies may choose (as an exception) not to disclose the compensation for a maximum of five years.
6. The convocation notice must be made public more than 30 days prior to the shareholders' meeting. The letter of convocation must be sent to certain shareholders separately.

Source: Made by MHRI based upon the Financial Services Agency, *Financial System Council, Secretariat's Explanatory Materials of the first Disclosure Working Group* (December 11, 2017); the Ministry of Economy, Trade and Industry, *Report Materials of the Study Group Concerning Promotion of Digitalization, etc. of the Shareholders' Meeting Process* (April 21, 2016); and the survey entrusted by the Ministry of Economy, Trade and Industry, *Investigation of Corporate Governance Practices Concerning Functional Improvement of Boards of Directors* (Deloitte Touche Tohmatsu LLC) (March 2017).

Meanwhile, Germany adopts a different structure of a dual board system (members of the supervisory board are selected and dismissed in shareholders' meetings, while management board members are selected and dismissed by the supervisory board). In companies of a certain size, half of the supervisory board members must be shareholder representatives selected from outside the firms, and the remaining half must be employee representatives selected within the firms, enabling employees to participate in company management as main actors of governance. Furthermore, in principle, the law requires the disclosure of compensation for each executive officer.

Unlike Japan, European countries and the US have worked on reforming corporate governance mainly with a view to preventing excessive risk-taking by management teams, so the treatment of outside directors and directors' compensation requirements is stricter. But as each country carries a different background and employs different board structures and different levels of compensation, we cannot easily compare their merits.

On the other hand, since investors from all around the world, including in Europe and the United States, participate in the Japanese stock market, and given that the Japanese corporate governance scheme follows the system adopted in the UK, Japan's Companies Act and related regulations as well as their level of requirements are naturally subject to comparison with European nations and the United States. Hence, the Companies Act of Japan is expected to be comparable to the systems and levels seen in European countries and the United States in the future.

#### **4. Future outlook and company requirements**

The bill to revise the Companies Act was approved in the Legislative Council of the Ministry of Justice in February this year and has already been proposed to the Minister of Justice. Although it was expected to be a subject for discussion in this year's ordinary Diet session, Japan's government postponed its submission.<sup>11</sup> The revised bill is now targeted for submission to the extraordinary session of the Diet this fall, and the revised act is expected to be enacted in 2020 at the earliest.

This latest revision of the Companies Act falls in line with the Japanese government's and the Tokyo Stock Exchange's initiatives to change the framework to reinforce corporate governance thus far, and the revision should also be within the expectations of companies. As for the actions to be taken by companies, the impact of the provision to obligate the appointment of outside directors is viewed as limited since many companies already comply with this regulation. But we hold that firms will be required to upgrade their company management even further looking ahead to the future by examining the

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<sup>11</sup> The Nikkei, "Companies Act and Other Important Bills Postponed – Will Business Be Affected?" (February 7, 2019).

global standards mostly adopted by European nations and the US, in addition to revisions to the law envisaged in the near future.

In terms of enhancing the disclosure of directors' compensation, a survey of companies listed in the Tokyo Stock Exchange revealed that "less than 70% of the firms set a concrete calculation method (provision standard) for management's compensation, and of those firms, 70% share the (information on) provision standards with outside directors,"<sup>12</sup> suggesting that many companies will be compelled to take new action. Some companies have already clarified and disclosed their management's compensation<sup>13</sup> based on the Corporate Governance Code revised in 2018. Going forward, the details of disclosure will most likely attract greater attention of stakeholders, and companies will have to respond substantially to the disclosure requirements beyond a simple formality. We hope that such developments will lead to enhanced mid- to long-term corporate value by improving transparency in corporate management and providing appropriate incentives to corporate managers.

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12 Taken from the Ministry of Economy, Trade and Industry's survey of companies listed in the Tokyo Stock Exchange First and Second sections indicated in the "Follow-up of the CGS Guidelines" (CGS Study Group [the second period], the third secretariat's materials) (February 22, 2018) compiled by the same ministry.

13 The Nikkei, "Compensation and Stocks Held Subject to Detailed Disclosure – Mounting Pressure to Adopt External Oversight Changes Shareholders' Meetings (1)" (June 11, 2019).