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Amendment to the Companies Act - Director Compensation

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An amendment to the Companies Act (the "**Amended Companies Act**") was enacted on December 4, 2019, and most of the amendment, including the revisions regarding director compensation, came into effect on March 1, 2021. This memorandum outlines the revisions introduced regarding director compensation and the actions companies should take accordingly.

I. Outline of the Amendment

Japanese companies have been well known for having director compensation structures that set forth a far lower performance-based portion than those in U.S. and European companies. Given this situation, companies in Japan have been encouraged to reform such structures to increase directors' incentives (especially for executive directors) towards achieving sustainable increases in enterprise value. Moreover, the conventional practice regarding director compensation has been focused on preventing self-determination of the maximum aggregate amount of such compensation for all directors (except for companies with nomination committees etc.). Under such practice, while the maximum aggregate amount of compensation for all directors has been resolved at the general shareholders meeting, the decision on the amount for each director has been delegated to the board of directors, and typically the board of directors further has delegated the decision to the representative director. As a result, in Japan, it has been a typical practice for the representative director to determine the specific amount of compensation for each director (including himself or herself) within the maximum aggregate amount. Further, this practice has been criticized for lack of transparency due to a lack of public disclosure for the policy for the determination of each director's compensation. To tackle these issues, since 2015, a series of reforms have been implemented, including the adoption and revisions of the Corporate Governance Code, amendments to tax laws, and revisions of the Financial Services Agency's disclosure rules. The amendment subject to this

article follows such effort at the Companies Act level, which is a fundamental hard law, aiming to facilitate implementation of the performance-based portion of director compensation, improve the transparency of the decision-making process for director compensation, and thereby strengthen corporate governance.

In relation to director compensation, the Amended Companies Act implements the following four main points:

1. Resolution of the Policy for Determining Each Director's Compensation

The Amended Companies Act **obliges the board of directors of the following companies ("Listed Companies, Etc.") to decide (or resolve) the policy regarding the determination of compensation etc. for the individual directors** in order to improve the transparency of the process for determining director compensation (Article 361, Paragraph 7 of the Amended Companies Act) (companies with nominating committees etc. has already been subject to such obligation, and the Amended Companies Act expands the scope of the subject companies). Such obligation does not apply to companies which specifically stipulate the details of compensation for each director in their Articles of Incorporation or resolve the same at their shareholders meeting. In addition, directors who submitted to a shareholders meeting proposals to prescribe for or amend the compensation, whether it is a monetary compensation in fixed amount or not, must explain the reasons why such compensation is reasonable at such shareholders meeting (Article 361, Paragraph 4 of the Amended Companies Act).

- ✓ Company with Board of Auditors (limited to companies that are both a "Public Company" (Note 1) and a "Large Company" (Note 2)) that are required to submit annual securities reports to the Prime Minister with respect to its issued shares pursuant to Article 24, Paragraph 1 of the Financial Instruments and Exchange Act; or
- ✓ Company with Audit and Supervisory Committee

2. Clarification of Shareholders Meeting Resolution Matters regarding Shares and Stock Options as Director Compensation

Under the pre-amendment laws, matters to be resolved at the shareholders meeting or set forth in the Articles of Incorporation for payment of non-monetary compensation (including direct issuance of shares or stock options as director compensation) were only stipulated as "specific details thereof," and it was unclear as to what extent of specification was required. Accordingly, instead of the direct

issuance of shares or stock options as director compensation, a common practice for companies was to grant monetary compensation claim to directors, where the directors will use this claim as payment fund such as a contribution in kind (i.e., indirect issuance of shares or stock options) and receive shares or stock options from the company (Note 3). In this case, however, because the company is granting monetary claims to the directors, the number and other details of the shares or stock options to be issued were not required to be determined by the Articles of Incorporation or shareholders meeting, despite this substantially being issuance of shares or stock option, under the pre-amendment laws.

For similar purposes as explained in Section I.1. above, the Amended Companies Act has clarified that **companies contemplating issuing company shares to their directors as compensation (whether direct or indirect issuance of shares) must stipulate certain matters regarding the shares in their Articles of Incorporation or resolve the same at their shareholders meeting** (Article 361, Paragraph 1, Item 3 of the Amended Companies Act; Article 98-2 of the Enforcement Regulations of the Amended Companies Act). Such certain matters include (i) the maximum number of the shares; (ii) restrictions on the transfer of such shares by directors until the occurrence of certain trigger events, and the details of such events if applicable; and (iii) redemption of such shares without consideration upon the occurrence of certain trigger events and the details of such events if applicable. Similarly, **companies contemplating issuing stock options to their directors as compensation (whether direct or indirect issuance of stock options) must stipulate certain matters including the maximum number of the stock options** as well (Article 361, Paragraph 1, Item 4 of the Amended Companies Act; Article 98-3 of the Enforcement Regulations of the Amended Companies Act).

3. Special Provisions for Shares and Stock Options as Director Compensation

Under the pre-amendment laws, the issuance of shares always required the payment of contribution, so a technical solution was followed involving first granting a monetary compensation claim to the directors and then having such claim paid-in as a contribution in kind. Similarly, since under the pre-amendment laws, the exercise of stock options always required payment of contribution, the exercise price was typically set at JPY 1 per subject share to be issued.

The Amended Companies Act, aiming to enable legitimate and facilitated implementation of performance driven director compensation, **allows “Listed Companies” (Note 4) to issue shares for the purpose of director compensation without requiring the payment of any contribution in exchange for the issuance** (Article 202-2, Paragraphs 1 and 2 of the Amended Companies Act,

etc.), and for the same purpose **allows Listed Companies to issue stock options, as director compensation, or in exchange for payment with director compensation, without requiring the payment of any contribution in exchange for the exercise of the stock options** (Article 236, Paragraph 3 of the Amended Companies Act, etc.).

4. **Enhanced Disclosure through Business Report**

The aforementioned matters regarding director compensation in a Public Company will be subject to disclosure through business reports (Article 119, Item 2 and Article 121, Items 4 to 6-3 of the Enforcement Regulations of the Amended Companies Act).

II. **Actions Required**

In accordance with these amendments, relevant companies are required to take the following actions.

1. **Resolve to Implement the Policy for Determining Each Director's Compensation**

As explained in Section I.1. above, **the board of directors of Listed Companies, Etc. must decide (or resolve) the policy regarding determination of the compensation, etc. for the individual directors** in principle (Article 361, Paragraph 7 of the Amended Companies Act). Therefore, Listed Companies, Etc. having not implemented the policy shall, after the effective date of the amendment (March 1, 2021), **promptly resolve to implement such policy. If Listed Companies, Etc. decide on the specific compensation of each director either without implementing or in violation of such policy, such decision will be regarded as illegal and invalid** (Note 5).

The details of the policy that needs to be resolved are as shown below (Article 98-5 of the Enforcement Regulations of the Amended Companies Act):

(a) **(For performance-based compensation -- other than non-monetary compensation (together with indirect issuance of shares or stock options, "Non-Monetary Compensation, etc.") Policy regarding determination of the amount or calculation method of the compensation for each individual director;**

(b) **(For performance-based compensation) Policy regarding determination of the performance indicators, and the amount or calculation method of the performance-based**

compensation;

(c) (For Non-Monetary Compensation, etc.) Policy regarding determination of the type of compensation, and the amount or quantity or calculation method;

(d) Policy regarding determination of the ratio of each type of compensation listed in Items (a), (b) and (c) above among the total compensation amount for each individual director;

(e) Policy regarding determination of the timing and conditions for paying the compensation;

(f) (If the determination of the details of the compensation for each individual director is to be subdelegated to a director or another third party, the following matters regarding the third party subdelegate:

- Name, or position or responsibility
- Details of the subdelegated authority
- If any measures will be implemented to ensure appropriate exercise of the subdelegated authority, then such details;

(g) Method to determine the details of compensation for each individual director (other than the matters listed above); and

(h) In addition to the matters listed above, other important matters regarding determination of the details of compensation for each individual director

2. Review the Necessity of Re-resolving Shares and Stock Options as Director Compensation.

As described in Section 1.2. above, with respect to shares and stock options as director compensation, the matters to be resolved at the shareholders meeting or set forth in the Articles of Incorporation, including the maximum number of shares or stock options, have been clarified. Therefore, **companies with shares or stock options as director compensation shall consider whether all matters required to be resolved are covered, and if not, shall re-resolve the uncovered matters at the shareholders meeting.**

3. Compliance Regarding the Business Report

In relation with Section I.4. above, according to the Ordinance of the Ministry of Justice, the primary matters to be reported in the Business Report are as follows (Article 119, Item 2 and Article 121, Items 4 to 6-3 of the Enforcement Regulations of the Amended Companies Act):

- (a) Total amount of compensation per respective group of directors, accounting advisors, auditors and executive officers (the respective total amount of performance-based compensation; non-monetary compensation and other types of compensation, as applicable) and the number of individuals per group**
- (b) (For performance-based compensation, if any) The following matters:**
- **Details of the performance indicators, and reason for selecting such performance indicators**
 - **Method of calculating the amount or quantity of the performance-based compensation, etc.**
 - **Experience regarding the use of such performance indicators**
- (c) (For non-monetary compensation, etc.) Details of the non-monetary compensation, etc.**
- (d) Following matters concerning the Articles of Incorporation or the shareholders meeting resolution regarding compensation for the company's directors or officers:**
- **The day when the relevant provision of the Articles of Incorporation was implemented or the day of the shareholders meeting resolution**
 - **Outline of the content thereof**
 - **Number of applicable directors or officers**
- (e) If the policy regarding the method to determine the details of the compensation for each individual director is implemented, then the following matters:**
- **Method of deciding the policy**
 - **Outline of the policy**
 - **The reason why the board of directors (or the compensation committee if the company is a company with nominating committees etc.) judged that the details of the compensation for each individual director for the relevant fiscal year are in accordance with the implemented policy**
- (f) If the company implements policies other than the policy referred to in (e) above, the**

method for determining the policy and the outline of the policy

(g) If a director or another third party subdelegated by the board of directors to decide the compensation for individual directors has decided the same, such fact and the following matters regarding the third party subdelegate:

- **Name, position and responsibility**
- **Details of the subdelegated authority**
- **Reason for subdelegating the authority to the person**
- **If any measures have been implemented to ensure appropriate exercise of the subdelegated authority, then such details**

Among the Public Companies which owe this disclosure obligation through the business report, most listed companies should have already disclosed many of the above items in their annual securities reports, in accordance with the Cabinet Office Ordinance to partially amend the Cabinet Office Ordinance on Disclosure of Corporate Affairs, etc. (Cabinet Office Ordinance No. 3 of 2019). Therefore, this amendment should not have any significant impact on the disclosure practices of listed companies (however, please be careful because the information required to be disclosed in the business report and the annual securities report do not completely coincide). On the other hand, among the Public Companies, unlisted companies which does not owe the obligation to disclose annual security reports may be significantly impacted (Note 6).

Based on the transitional measures under the Amended Companies Act, companies whose accounting period ends on or before February 2021 will be entitled to a one-year grace period before being required to disclose the additional information pursuant to the amendment.

4. Compliance Regarding the Annual Securities Report

In the “Compensation, etc. of directors or officers” section of the annual securities report, listed companies are required to disclose **the details of the policy regarding determination of the directors’ and officers’ compensation amount or the calculation method and its determination method** as of the date of submission of the annual securities report (or, if no policy is implemented, then a statement to that effect) (Note 7).

Accordingly, **given that listed companies are required to disclose in their annual securities report the policy regarding determination of the amount of compensation etc. for each individual director** as explained in Section I.1. above, **if a listed company resolves a policy that**

alters the previous policy, such alteration shall be disclosed.

5. Compliance Regarding the Corporate Governance Report etc.

From prior to effectuation of the Amended Companies Act, for companies listed on the First or Second Section of the Tokyo Stock Exchange, the Corporate Governance Code (revised as of June 1, 2018, and the same applies to the revision as of June 11, 2021) have encouraged the disclosure of the **"Policy and Procedure for the Board of Directors' Determination of the Compensation for Management Executives and Directors"** (Corporate Governance Code Principle 3-1(iii)) through materials such as the Corporate Governance Report.

Therefore, if such listed companies resolve a policy pursuant to Section I.1. above that alters the previous policy, the relevant description of the Corporate Governance Report or another material where the previous policy was disclosed shall be updated.

Note 1: "Public Company" means a company with no transfer restrictions on all or part of its issued shares.

Note 2: "Large Company" means a company whose stated capital is JPY 500 million yen or more or whose total liabilities are JPY 20 billion yen or more on its balance sheet as of the end of the most recent fiscal year.

Note 3: Prior to the enforcement of the Amended Companies Act, when granting stock compensation to directors, companies first granted a monetary compensation claim, then had such claim paid-in as a contribution in kind and issued the shares. Similarly, when granting stock options, under certain structures, companies first granted a monetary compensation claim, then had such claim set-off against the obligation to pay-in at the issuance and issued the stock options. Under the Amended Companies Act it is possible to continue to apply these methods, and in such circumstances it has been clarified that certain matters must be prescribed regarding the shares or stock options to be issued in exchange for paying-in or setting-off the monetary compensation claims (Article 361, Paragraph 1, Item 5 of the Amended Companies Act; Article 98-4 of the Enforcement Regulations of the Amended Companies Act).

Note 4: "Listed Companies" here means stock companies that issues shares listed on a financial instruments exchange as prescribed in Article 2, Paragraph 16 of the Financial Instruments and Exchange Act.

Note 5: Toshikazu Takebayashi, "Q&A Amended Companies Act of 2019" at page 78 (Shojihomu, 2020).

Note 6: Hiroaki Takagi et al., "Amendment Regarding Director Compensation, etc." (Jyunkan Shojihomu Vol. 2232) at

Note 7: Please see precautionary statement (57) of Form 2 of the Cabinet Office Ordinance on Disclosure of Corporate Affairs, etc., and precautionary statement (38) of Form 3 thereof.

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