

18 June 2010 (No. of pages: 10)

Disclosure of Executive Compensation

Japanese report: 13 Apr 10

Legal and Tax Research Dept
Jun Yokoyama

Summary

- On 31 March 2010, the Financial Services Agency (FSA) announced amendments to its “Cabinet Office Ordinance on Disclosure of Corporate Affairs.” These included revised regulations regarding disclosure of executive compensation.
- The FSA now requires listed firms to disclose the following: (1) a breakdown of total compensation by payment type for each executive earning Y100 million or more during the relevant fiscal year, (2) total remuneration for each category of executive (e.g., internal director, internal statutory auditor, executive officer, and external director), and (3) company-wide policies for determining executive compensation.
- These revised regulations will apply to securities reports for the fiscal year ending on 31 March 2010 and beyond (i.e., from FY09 for companies which close their books in March).

*This report updates our 17 February 2010 report on the proposed revisions to the Cabinet Office Ordinance (Japanese only).

Table of Contents

1. Amendments to Cabinet Office Ordinance on Disclosure of Corporate Affairs
2. Overview of Executive Compensation Disclosure
3. Companies Required to Disclose Executive Compensation
4. Compensation Disclosure for Individuals Designated as Executives
 - (1) Definition of “Executives”
 - (2) Definition of “Compensation”
 - (3) Content of disclosure
 - (4) Case Studies
 - (i) Compensation for Post-Retirement Consulting Services
 - (ii) Treatment of Employee Lump-Sum Retirement Benefits for Directors
 - (iii) Treatment of Lump-Sum Retirement Benefits for Directors
 - (iv) Stock Options
5. Disclosure of Compensation by Executive Category
6. Disclosure of Material Employee Compensation for Internal Executives
7. Disclosure of Policies for Deciding Executive Compensation
8. Timing of Implementation

1. Amendments to Cabinet Office Ordinance on Disclosure of Corporate Affairs

On 31 March, 2010, The Financial Services Agency announced amendments to its “Cabinet Office Ordinance on Disclosure of Corporate Affairs” (*Naikaku Furei*, 12; amendments noted as *Kaisei Furei* hereafter)¹. The content covers a lot of ground, but the corporate governance section includes the following items:

- (1) Disclosure of cross-shareholdings
- (2) Disclosure of executive compensation
- (3) Disclosure of voting results
- (4) Disclosure of corporate governance structure

These topics were addressed in the Financial System Council’s report, “Financial System Council’s Study Group on the Internationalization of Japanese Financial and Capital Markets: Toward Stronger Corporate Governance of Publicly Listed Companies”² (here after, Study Group Report; issued on 17 June 2009) but not applied in 2009.

This report examines the second topic, disclosure of executive compensation³. In this report, “companies” refers to listed Japanese firms which file securities reports. The revisions cover disclosure documents, including securities registration statements.

2. Overview of Executive Compensation Disclosure

Companies are required to include the following information regarding executive compensation in the corporate governance section of their securities registration statements and securities reports:

- 1) Disclosure of total compensation and a breakdown by payment type (salary, bonuses, stock options, retirement benefits, etc.) for executives earning Y100 million or more
- 2) Disclosure of total compensation and breakdown by executive category (internal director, internal statutory auditor, executive officer, and external director)
- 3) Disclosure of company’s methods and/or policies for determining executive compensation figures

To summarize, companies must disclose: (1) compensation for each executive, (2) a breakdown by payment type, and (3) details regarding its decision-making process.

These points were developed based on the following statement in the aforementioned Study Group Report.

¹ Issued on 31 March 2010 (Special Edition No. 67). Please refer to <http://www.fsa.go.jp/news/21/sonota/20100331-8.html> (Japanese only).

² Please refer to http://www.fsa.go.jp/singi/singi_kinyu/tosin/20090617.html (Japanese only), as well as our 29 June 2009 report, Kinyushin Study Group Hokoku 1 (Daisansha Wariate nado). Available in Japanese only.

³ Please refer to our 1 April 2010 report, Kabushiki no Hoyu Jokyo Kaiji (Iwayuru Mochiai Kaiji). Available in Japanese only.

“Executive compensation is regarded as one of the important pieces of information for shareholders and investors from the perspective of management incentive structures. Furthermore, it has been said that excessive remuneration and stock options provide incentives to the management to focus too much on the short-term, and in this regard it is important to strengthen the accountability regarding how executive compensation is determined. Therefore, companies should disclose their existing executive remuneration policies, and also improve disclosures of pay, with a breakdown according to the type of incentives provided to executives, including stock options.”

The following are key amendments to/clarifications of the FSA’s “Proposal of Cabinet Office Ordinance on Disclosure of Corporate Affairs”⁴ released on 12 February 2010 (19 Feb in English). The FSA has done the following:

- Noted that only listed companies are subject to the disclosure requirements (more details in Section 3 of this report)
- Clarified that companies do not need to restate compensation figures contained in previous securities reports (Section 4-2)
- Specified compensation categories which must be disclosed for individual executives (4-2)
- Specified executive categories for which compensation must be disclosed (internal directors, internal statutory auditors, executive officers, external directors; 5)
- Clarified that companies must disclose their standards for determining compensation on the date they file their securities reports (6)

3. Companies Required to Disclose Executive Compensation

Companies which issue the following securities must disclose executive compensation under the corporate governance section of their securities reports (Rule 57-a regarding preparation of Form 2, *Kaiji Furei*; Financial Instruments and Exchange Law, Article 24.1, clauses 1, 2). These securities exclude “specified marketable securities,” which are defined as securities for which regular filings of securities reports are not required (investment trust beneficiary certificates, investment fund securities, etc.).

- (1) Securities listed on an exchange (excluding certain types of listed securities*)
- (2) OTC securities (excluding those with liquidity similar to certain types of securities*)

*Refers to securities trading only in a market for professional investors (Tokyo AIM), based on the Financial Instruments & Exchange Law, Article 2.33.

In other words, only listed companies need to disclose (detailed) executive compensation. This probably reflects the fact that recommendations by the aforementioned Study Group were specifically for listed firms⁵.

⁴ On FSA’s website, <http://www.fsa.go.jp/news/21/sonota/20100212-2.html>.

⁵ Companies which file securities reports but are not listed should continue to disclose executive compensation in clear and concrete terms, as in the past (i.e., for internal and external directors).

4. Compensation Disclosure for Individuals Designated as Executives

The revised Ordinance goes beyond the scope of the Study Group Report when it discusses disclosure of individual compensation levels for people designated as executives (Rule 57-a(d) regarding preparation of Form 2, *Kaiji Furei*).

(1) Definition of “Executives”

Companies are required to disclose compensation figures for individuals classified as executives during the relevant fiscal year. This means the following (“compensation” defined in Section 4, 2):

Directors, statutory auditors, executive officers, and other executives at companies which submit securities reports (including executives who resigned up to and including the last day of the most recent fiscal year)

Disclosure may be limited to executives who earned total compensation of Y100 million or more* during the relevant fiscal year

*If a director/statutory auditors also is a director/statutory auditors at a major consolidated subsidiary, his/her “total compensation” should include amount received from the subsidiary.

In essence, companies are required to disclose the compensation of executives who earned Y100 million or more⁶ during the fiscal year. Disclosure seems optional for executives who received less than that amount.

Listed firms must disclose compensation for executives classified as internal directors, statutory auditors, and executive officers. Companies with an auditor-based corporate governance structure (i.e., a board of auditors which supervises execution of duties by directors) may have voluntarily established a role entitled “executive officer,” but the official definition may differ from that of an executive officer under the committee-based system. Auditor-based companies are not required to disclose remuneration for “executive officers” (*Kinyucho no Kangaekata*, 98)⁷.

Companies which file securities reports must disclose remuneration for their own executives. Executives of a subsidiary generally are outside the scope of the requirement, unless they also serve as an executive at the parent company.

The FSA requires firms to include compensation information for executives who resigned up to and including the last day of the most recent fiscal year. This means that companies need to disclose figures for all individuals who received payment for executive services which they performed during the fiscal year in question, even if they were no longer serving that function by the end of the fiscal year⁸ (*Kinyucho no Kangaekata*, 82).

“Compensation” refers to remuneration for employees acting as executives during a specific fiscal year. Thus, companies must also disclose compensation for services which were rendered during the year but paid for after an executive’s resignation date. However, companies do not need to disclose remuneration for post-retirement consulting services, in principle (Section 3-1).

⁶ The FSA drew upon examples of CEO compensation in the US to set the lower limit at Y100 million (*Kinyucho no Kangaekata*, 69).

⁷ Please refer to <http://www.fsa.go.jp/news/21/sonota/20100331-8/00.pdf> (Japanese only).

⁸ Given the timing of implementation, this refers to executives who served in the fiscal year ending on 31 March 2010 or the most recent fiscal year (*Kinyucho no Kangaekata*, 82)..

(2) Definition of “Compensation”

Executive compensation is defined as follows:

Remuneration, bonuses, and other types of compensation paid for executive services rendered by individuals employed by the firm. Payment must be related to work performed during the most recent fiscal year and either received or expected to be received within the most recent fiscal year. This does not include compensation contained in securities reports filed for any fiscal year prior to the most recent one.

This definition is similar to the wording found in Article 361 of Japan’s Company Law. We believe it can be understood to include a wide-ranging types of compensation received for executive positions⁹ (*Kinyucho no Kangaekata*, 84, 107, 113). Fringe benefits probably also should be disclosed as part of the executive’s compensation package.

As noted, compensation which must be disclosed does not include any remuneration contained in securities reports related to prior fiscal years. In other words, the FSA has clarified that companies do not need to restate compensation figures that were listed in previous securities reports.

In summary, compensation disclosed in securities reports must be related to work done in the most recent fiscal year and either received or expected to be received within the most recent fiscal year. For example, if compensation for work performed in fiscal year X were deferred until fiscal year X+1, the company would need to decide whether or not to disclose that compensation in its securities report for fiscal year X and X+1.

If the firm had recorded the above compensation in its securities report for fiscal year X, it would not need to record it in the fiscal year X+1 report. This means that the amount disclosed in fiscal year X probably would be subtracted from the sum used to determine whether or not an executive received at least ¥100 million in fiscal year X+1 (*Kinyucho no Kangaekata*, 82).

(3) Content of Disclosure

Companies are required to disclose the following information regarding executive compensation:

Name of executive
Division
Total remuneration
Breakdown by payment type

If an executive also serves as an executive at a major consolidated subsidiary, compensation received from the subsidiary must be included in the amount of total remuneration received from the listed company.

In other words, listed companies must disclose compensation received from both the parent and the consolidated subsidiary, if an employee served as an executive

⁹Aizawa, Tetsu; Hadama, Masami; Koriya, Daisuke: “Ronten Kaisetsu Shin Kaishaho” [Commentaries on Issues in the New Corporate Code]. Tokyo: Shojihomu, 2006, p. 313...

for both during the fiscal year in question. The amount disclosed must be broken down by source (i.e., parent and subsidiary).

However, the FSA indicates that companies do not need to disclose compensation from consolidated subsidiaries if the information is deemed to have little import for investors (e.g., if aggregate remuneration received for serving as executive of number of small subsidiaries is minimal compared to amount received for acting as executive for parent firm). Accordingly, total compensation received from several minor subsidiaries does not count as remuneration from a major subsidiary (*Kinyucho no Kangaekata*, 78).

Companies are required to disclose not only total compensation received by each executive, but a breakdown by category, namely:

Base pay, stock options, bonuses, retirement benefits, and other

The FSA does not specify how each category should be subdivided, but at minimum, companies must disclose the above four categories of compensation.

(4) Case Studies

In its official response to questions brought forward during public comment periods, the FSA offered several specific examples of possible cases of corporate compensation requiring disclosure and an interpretation of how these should be handled. We summarize the major cases below.

(i) Compensation for Post-Retirement Consulting Services

The new regulations require disclosure only for direct remuneration for employees performing executive services. Therefore, compensation for post-retirement consulting services does not, in principle, need to be disclosed (*Kinyucho no Kangaekata*, 80).

Comment Summary:

A director or statutory auditor of Company A retires before the end of the fiscal year. Does compensation he/she received for consulting services (either general or tax/legal-related in nature) subsequently performed for Company A need to be disclosed, assuming those services were not performed in his/her capacity as an executive?

FSA's View:

No disclosure is necessary. Essentially, compensation received by an individual for consulting services is not considered part of his/her compensation for services performed as an executive.

(ii) Treatment of Employee Lump-Sum Retirement Benefits for Directors

As with Case (1), a director/statutory auditor's lump-sum retirement benefit payments received for his/her period of service as an employee do not, in principle, need to be disclosed (*Kinyucho no Kangaegata*,81).

Comment Summary:

Company A does not pay lump-sum retirement benefits to directors (i.e., strictly for their service as directors), but it does pay lump-sum benefits to directors based on their years of service as company employees. In this case, would Company A need to include retirement benefits accrued for years prior to an individual's appointment as director when disclosing his/her executive compensation (assuming he/she retired within the most recent fiscal year)?

FSA's View:

The firm would not need to disclose this lump-sum retirement payment as executive compensation. Remuneration which is not tied to an individual's services rendered as a director does not qualify as compensation requiring disclosure (as outlined in *Kaiji Furei*, 57 a [d]).

However, if internal executives receive what can be considered a material level of compensation for their services as employees, then the company must disclose the total amount, the number of executives receiving such an amount, and a breakdown by payment type.

(iii) Treatment of Lump-Sum Retirement Benefits for Directors

Companies typically provision for directors' lump-sum retirement payments during their years of service and then pay out these benefits upon retirement. This raises questions regarding whether these retirement payments should be disclosed when companies book provisions or when they actually pay them out.

The FSA's view is that, in principle, if companies disclose executive lump-sum retirement payments when provisions are booked, then there is no need for a second disclosure when payments are made (*Kinyucho no Kangaekata*, 86).

FSA's View:For example, if a company books additions to provisions for directors' retirement bonuses in accordance with accounting principles within the most recent fiscal year, it can basically be assumed that these provisions qualify as director compensation for that year. If a company has disclosed these provisions in its securities reports, then there is no need for additional disclosure when the bonuses are paid out in the future.

We think the same understanding can be applied as in the question of whether or not an executive's annual compensation totaled Y100 million or more. The FSA states that additions to provisions must be disclosed in securities reports for the relevant fiscal year. Thus, a company might decide to disclose its provisions for lump-sum retirement benefits as an aggregate amount, without breaking it down into individual components, because provisions totaled less than Y100 million that accounting period. If so, the company would need to disclose its lump-sum retirement benefit payments the year that it distributed them to individual executives. We believe these payments would then need to be counted as part of each executive's total compensation that year. As noted, the FSA requires compensation to be disclosed if it reached the threshold of Y100 million during the relevant fiscal year.

For example, consider the example of a director who serves for five years, receiving total compensation of Y40 million per year. Separately, the company records annual provisions for lump-sum retirement benefit payments of Y20 million, which the director will receive in a lump sum (Y100 million) upon retirement. In this case, the director's total compensation for years one through four equals Y60 million (Y40 million + Y20 million), which would not need to be

disclosed on an individual basis. However, if the firm did not disclose provisions for lump-sum retirement payment for the first four years, then the director's Y100 million lump-sum retirement pay theoretically should be counted as part of the remuneration that might need to be disclosed on an individual basis. In this case, his/her compensation would reach Y140 million (Y40 million + Y100 million lump-sum retirement payment) in the fifth year, which would likely require a separate, individual disclosure.

In principle, provisions for directors' lump-sum retirement payments booked before the regulations were enacted do not need to be disclosed (*Kinyucho no Kangaekata*, 85).

FSA's View: ...Anticipated remuneration for fiscal years ending before 31 March 2010 (e.g., additions to provisions for lump-sum retirement payments booked according to accounting principles in FY08) does not need to be disclosed in securities reports for fiscal years ending on or after 31 March 2010.

(iv) Stock Options

Stock options are considered part of remuneration which may need to be disclosed. This raises questions as to how stock options should be valued when calculating the amount of total compensation.

In principle, the FSA recognizes the recorded expense of stock options (not only their total value but also the value of prorated portions) as compensation related to the most recent fiscal year (*Kinyucho no Kangaekata*, 89).

FSA's View: ...Based on trends reflecting current accounting principles and corporate law, additions to provisions for lump-sum retirement payments and expenses associated with stock options basically can be considered part of an executive's compensation for the most recent fiscal year.

5. Disclosure of Compensation by Executive Category

Earlier regulations also required listed companies to disclose executive remuneration in their securities reports, but only divided into two categories, internal director and external director (*Kaijifuirei 2.57*).

The revised regulations categorize executives into four classes:

Directors (excl. external directors)
Statutory auditors (excl. external auditors)
Executive officers
External directors/auditors

Companies with an auditor-based corporate governance structure would likely disclose information for the following three executive classes: "internal directors," "internal auditors," and "external directors/auditors," while companies with a committee-based system would likely use "directors," "external directors," and "executive officers."

Companies are required to disclose the following information for each executive class:

<p>Total compensation Total compensation by payment type Number of executives*</p>
--

* Number of executives who received compensation which must be disclosed (*Kinyucho no Kangaekata*, 99).

The payment types are the same as in Part 4, Section (3).

6. Disclosure of Material Employee Compensation for Internal Executives

If internal executives receive what is considered material levels of compensation for their services as employees, then the company must disclose the total amount of their remuneration, the number of executives receiving it, and a breakdown by payment type.

The FSA has the following view on whether or not employee compensation can be considered material (*Kinyucho no Kangaekata*, 97):

<p>Compensation received by a director who is employed by the firm is considered material if investors could not accurately assess that individual's contribution to the firm as an internal director based only on the amount disclosed for his/her services as a director (shortened from previous description in text)</p>

7. Disclosure of Policies for Deciding Executive Compensation

The Company Act states that if they have policies on the amount of individual compensation for each director and/or for determining such figures, firms with a committee-based corporate governance structure must disclose and outline their policy and the policy-making process in their financial reports.

This stipulation applies only to companies with a committee-based system. Many Japanese companies have auditor-based systems; these and other firms are not required to disclose this information.

The amendments require all listed companies to disclose the following on the date they file their securities reports, whether or not they have a committee-based system:

<p>(1) Information regarding policies for determining executive compensation, if such policies exist (2) If no such policies exist, companies should specify that</p>
--

In other words, all listed companies which have policies for setting executive compensation levels must disclose them on the day they issue securities reports, whether they have a committee- or an auditor-based corporate governance structure (*Kinyucho no Kangaekata*, 112).

When disclosing their policies for determining executive compensation, companies must basically state the content of the policy, not simply provide guidelines for their decisions. The FSA indicates that companies with extensive policies should

explain them in concrete, easy-to-understand terms (*Kinyucho no Kangaekata*, 104). Thus, companies with complicated policies probably should disclose them in a somewhat simplified form so that investors can understand the key points, if including the entire policy could make it difficult to comprehend.

The FSA's view is that items such as the following can be categorized as a policy for determining executive compensation and thus should be disclosed:

- Factors taken into account when deciding basic compensation for the president and other executives, as well as additions to/deductions from that amount, based on company-wide rules for executive remuneration (*Kinyucho no Kangaekata*, 96)
- Policies for deciding how to allocate total compensation among executives (*Ibid.*, 111)
- Internally-decided standards for executive benefits (*Ibid.*, 115)

8. Timing of Implementation

The amendments to the Cabinet Office Ordinance on Disclosure of Corporate Affairs take effect from 31 March 2010 (Revised Supplementary Provision 2, 1).

Listed companies are required to disclose the new information regarding executive compensation in their securities reports from the fiscal year ending on 31 March 2010 (FY09 for companies which close their books in March).