

The Revised Corporate Governance Code to Promote Growth Investments

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I . Introduction

Since the Cabinet’s approval of the “Japan Revitalization Strategy” in June 2013, Japan’s corporate governance reform has been a cornerstone of Japan’s growth strategy. The value created by companies is expected to serve as a source of wealth for the Japanese economy, driving job creation, wage growth, and the expansion of investment returns.

Japan’s Corporate Governance Code (the “Code”) does not solely emphasize “defensive governance” that can lead to a narrow focus on preventing misconduct or undue risk aversion. Instead, it primarily seeks to foster healthy entrepreneurship, achieve sustainable growth and increase corporate value over the mid- to long-term. The Code aims for “growth-oriented governance” to bolster companies’ “value creation capacity” by ensuring transparent and fair decision-making and promoting decisive decision making. Ten years since the Code took effect in 2015, the importance of such a mindset has not diminished and it remains relevant.

To achieve sustainable growth and remain resilient in a continuously changing business environment, companies need to set a path for growth toward corporate goals and to appropriately allocate business resources including growth investments and business portfolio reviews, taking into account their growth stages. How business resources are allocated is a matter of a company’s business judgement. Given that appropriate collaboration with shareholders and stakeholders is crucial for sustainable growth and mid-to long-term corporate value creation, companies are expected to execute growth investments that increase corporate value over the mid-to long-term, rather than focusing exclusively on short-term shareholder returns.

While corporate governance reform has made steady progress, an emphasis on substance over form in the corporate governance reform initiatives of both companies and investors has been pointed out. To encourage companies to focus on substantive initiatives toward value creation over the mid-to long-term— starting from appropriately allocating business resources such as growth investments—the revised Code (proposed) refined the content of the Principles subject to the “comply or explain” approach to capture their core essence. Furthermore, a new “Interpretive Guidance” has been introduced to provide a more specific context, aim and background, supporting substantive implementation of each Principle. The revised Code aims to prioritize

“substance over form,” restoring the original spirit of the principle-based approach when the Code was formulated. Accordingly, companies are expected to apply each Principle in a manner consistent with the aim and spirit of the Principle based on their specific situation. It is desirable that companies comply or explain in light of the aim and spirit of each Principle, providing tailored explanations for their initiatives regardless of whether a company complies or does not comply with a Principle.

II. Revised Code

Below are some key points regarding the proposed revisions to the Code.

1. Promoting Growth Investments

The revised Code explicitly defines the board’s roles and responsibilities concerning growth investment initiatives as follows.

- (i) Setting a path for growth toward corporate goals.
- (ii) Explaining specific measures that will be taken to achieve growth such as growth investments (capital expenditure, R&D, human capital, and intangible assets, including intellectual properties) and review of their business portfolio.
- (iii) Persistently reviewing whether the allocation of business resources is appropriate in light of the disclosed business strategy and business plan created with the aim of achieving growth.

With respect to (ii) above, for example, one option is to explain the approach to capital allocation through specific disclosures. It is essential for companies to explain the allocation of business resources—including human resources, goods, and capital—in a manner consistent with the aim and spirit of each Principle, reflecting the company’s specific situation.

When allocating business resources, it is also necessary to consider resource allocation strategies that balance various investments and shareholder return, taking into account profitability and the cost of capital, as well as other factors, such as the growth stage and opportunity costs. The revised Code promotes a persistent review of appropriate business allocation—for example, effective utilization of financial assets such as cash and real assets to investments. However, maintaining cash holdings and these assets should not be categorically rejected. It should be noted that as long as companies can demonstrate a necessity and rationale, maintaining an appropriate level of cash can be considered as one approach to business resource allocation.

2. Enhancement of the Board

As a fiduciary entrusted by shareholders, the board should act in the interests of the company and the common interests of its shareholders. It should set the broad direction of corporate strategy and provide effective oversight management and directors from an independent and objective standpoint, particularly in matters such as the appointment and dismissal of the CEO and situations involving conflicts of interest.

To ensure that the board can fulfil these responsibilities effectively, enhancing the effectiveness of the board remains important. The Code reclassified the Principles to focus on the core responsibilities of the board, while moving parts relating to specific implementation examples to the Interpretative Guidance with relevant additions.

The ratio of independent directors on the board is increasing, and the environment is improving for them to effectively fulfill their primary roles and responsibilities in monitoring functions. To specifically strengthen the effectiveness of independent directors, the Code emphasizes their roles, responsibilities, expertise, composition, and independence. Furthermore, it promotes the enhancement of secretariat functions (such as a corporate secretary) that has a critical role of supporting directors including the board chair as well as independent directors and other board members.

It has been pointed out that while ensuring the expertise of independent directors is crucial, companies listed on the Prime Market and competing globally should eventually ensure that the majority of their directors are independent directors, given the board's role of effectively monitoring management and directors from an independent and objective standpoint.

Furthermore, while the ideal state of the board changes depending on the situations surrounding the company, it has been pointed out that: (i) appointing an independent director as the chair can enhance board effectiveness under certain circumstances, and (ii) strengthening the internal audit function, including its coordination with directors, is vital when transitioning from a company with a *kansayaku* board to a company with a supervisory committee or a company with three committees (nomination, audit, and remuneration).

3. Disclosure of Annual Securities Report Before General Shareholder Meeting

Given that annual securities reports contain useful and reliable information for decision making by investors, the revised Code (proposed) states that the submission of annual securities reports before general shareholder meetings is a key measure to ensure the appropriate exercise of rights by shareholders at general shareholder meetings.

The Interpretative Guidance complements the Principle by stating that it is best to submit annual securities reports at least three weeks before general shareholders meetings, and companies should consider such measures as moving back the dates of general shareholder meetings. The Financial Services Agency acknowledges the

operational burden and difficulty of submitting annual securities reports three weeks or more before the date of general shareholder meetings, given common practices under the existing laws. The Financial Services Agency will coordinate in tandem with the Ministry of Justice to consider the legal framework. This includes the consolidation of annual securities reports and business reports, the unification of audits required under the Companies Act and the Financial Instruments and Exchange Act as discussed by the Legislative Council, and the optimization of disclosure items in annual securities reports.

III. Application of the revised Code

Companies are expected to submit Corporate Governance Reports disclosing the items prescribed under the revised Code by July 2027 at the latest. The Tokyo Stock Exchange will further define the specific details regarding the submission deadline.

While the Code primarily targets companies listed on the Tokyo Stock Exchange, it is desirable that other stock exchanges reference the Code and consider appropriate measures for each market, taking into account their unique market characteristics.