Seal the Deal

As the UK hails its historic deal with Japan, changes to the UK-Japan trading relationship will likely require exporters in both countries to navigate differences in corporate governance approaches

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On 11 September, the UK government announced a free trade deal with Japan, its first post-Brexit independent trade pact, tipped to boost trade between the two countries by an estimated £15.2 billion in the short term.

The deal with Asia's largest advanced economy officially took just over three months to conclude, although negotiations have been going on in the background for a number of years, and the full text of the agreement will not be available for scrutiny until October.

Although the deal has been broadly welcomed by the UK business community and appears to largely replicate the existing deal between Japan and the EU, until the complete text is available, it is difficult to assess to what extent the agreement goes beyond the benefits the UK received as an EU member.

Based on the information available in September, the main points of the deal seem to be a commitment to closer trade relations between Japan and the UK; some limited additional preferential treatment for UK goods exporters; reciprocal benefits for UK and Japanese service sectors including unrestricted digital trade and a framework for greater potential access for financial services; greater freedom of movement for workers; and a step towards possible UK accession to the Trans-Pacific Partnership.

According to the UK government, once implemented, the UK-Japan Comprehensive Economic Partnership Agreement will allow UK businesses to benefit from tariff-free trade on 99% of exports to Japan.

The deal promises to create more openings for those looking to expand into Japan, or potentially new market competition which all businesses should be aware of, whether they export or not.

This raises questions about how differences in approaches to corporate governance in Japan and the UK, and the level playing field such governance aims to promote, will affect future trade between the two countries.

The Overview

While Japan is estimated to account for just 2% of British trade, the deal is expected to enhance trade relations between the two countries and provides some security for British and Japanese businesses that their current trading conditions will continue.

However, given that many Japanese businesses have traditionally used Britain as a hub to access the EU market and are keen for this continue unhindered through an EU-UK trade deal, there is still a risk that Japanese exporters will cool their enthusiasm for the UK if it fails to maintain enhanced trade relations with the EU.

> **Standards for corporate governance are important for establishing a level playing field among firms**

Tariff Quotas

The government has said that there will be 'strong tariff reductions' for UK pork and beef exports to Japan, with low tariffs for other British food and drink products such as Stilton cheese, tea extracts and bread mixes and 'more generous market access' for UK malt producers than under the EU-Japan trade deal.

But the UK did not manage to secure new so-called tariff rate quotas, which allow EU farmers to sell a limited quantity of sensitive food products to Japan at lower tariffs. The UK will instead be allowed to use any quota left unfilled by the EU in 10 of 25 products covered by the EU-Japan agreement.

Reduced tariffs on imports of Japanese car and rail parts supplying major investors in the UK like Nissan and Hitachi are touted as supporting British automotive and rail manufacturing sectors, with streamlined regulatory procedures and greater legal certainty for their operations.

One notable advance the agreement makes over the EU-Japan deal is in cumulation and rules of origin. Under the terms of the deal published so far, British exports to Japan of some products containing large amounts of EU or international parts will count as goods originating from the UK.

But this arrangement does not resolve the issue of how British goods containing lots of Japanese parts that the UK wants to sell into the EU will be treated. This will still need to be sorted out in a trade deal with the EU and could prove a sticking point in maximising the economic benefit to the UK from the Japan deal.

The UK-Japan deal also allows the UK to apply for up to 70 geographical indications (GIs) on special products, up from the seven it has under the EU-Japan deal.

Services and Benefits

The deal contains some beneficial provisions for services, including a boost for 'digital trade' through a ban on data localisation, allowing data to flow freely between the two countries – a benefit strongly angled for by Japan's large tech companies.

It also promises to widen market access to Japan for UK financial services firms, including new British fintech companies that have been growing rapidly in the UK, by streamlining the process of applying for licences to operate in Japan.

The deal also allows greater movement of people, and junior employees from firms will be able to travel more easily between the two countries, which is likely to benefit service sector employers.

Future Admission

The deal with Japan is potentially a stepping-stone towards the UK acceding to the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (TPP), an 11-nation trade bloc (including Canada, Australia and Mexico).

If achieved, this could open up significant trading opportunities for UK businesses to markets where they currently have relatively limited access. This is expected to be a complex, multi-year negotiation, however.

Governance Standards

Standards for corporate governance are important for establishing a level playing field among firms and issues can emerge in international deals where there is a wide gulf between the respective jurisdictions' approaches to governance.

There are a number of key similarities between UK and Japanese approaches to corporate governance, however Japan is at a less mature stage of enforcing standards of 'good governance'.

Japan has had its fair share of high-profile corporate scandals and its governance culture has historically been criticised for helping to perpetuate sluggish growth, poor returns on investment, hoarding cash that could have been returned to shareholders and a general lack of transparency, accountability and shareholder responsiveness.

Under the leadership of its former prime minister Shinzo Abe, Japan commenced a concerted attempt to overhaul its regulation of corporate governance in 2014, when it introduced the country's first

stewardship code. This, among other things, required transparency on voting records at fund managers.

The Japanese Financial Services Agency published the final version of its Corporate Governance Code (Japanese Code) in March 2015. This was incorporated via Japan's Companies Act into the Tokyo Stock Exchange's Securities Listing Regulations and entered into force on 1 June 2015.

The code was amended in June 2018 to add new principles, including measures designed to ensure objectivity and transparency in the appointment, dismissal and remuneration of directors.

The Companies Act introduced several reforms, including the introduction of companies with supervisory committees, as an addition to Japan's traditional company models, which involve either corporate auditors or general committees.

A further amendment, proposed in December 2019, includes changes to the rules governing shareholders' meetings (such as provision of online meeting materials for shareholders), directors' incentives and a request to appoint at least two outside directors. This amendment comes into effect by June 2021, with the exception of some provisions relating to shareholder meetings, which are due to come into force by June 2023.

In the UK, the Corporate Governance Code (UK Code) is set by the Financial Reporting Council (FRC), which is responsible for promoting high quality corporate governance and reporting to foster investment.

The FRC's efforts are supported by other institutional initiatives, such as the Institute of Directors' (IOD) Centre for Corporate Governance, which was launched in June 2020 with the aim of improving corporate governance in British boardrooms with a greater focus on sustainability.

The Japanese Code reflects both Organisation for Economic Cooperation and Development (OECD) principles on good corporate governance and elements of the UK Code – perhaps most notably the latter's 'comply or explain' principle, which requires firms to either adhere to its principles or explain why it would be disproportionate to do so.

Other similarities to the UK Code include the Japanese Code's responsibilities of company boards and the requirement to appoint independent non-executive directors (INEDs) to challenge and inform the board's decisions and provide an outside perspective on key decisions and matters such as executive pay.

Both codes also require companies to have internal risk and control framework processes to ensure companies have appropriate policies and procedures to manage internal risks and strongly encourage regular, honest engagement with stakeholders to ensure accountability of the board and executive management.

One notable difference is that while the UK Code strongly encourages the separation of the roles of chair and CEO of public companies to reduce conflicts of interest and facilitate better oversight of governance aspects by the chairman, this is not a requirement in the Japanese Code.

In fact, one persistent criticism of Japanese governance models is that CEOs continue to have too much leeway within their organisations and effective mechanisms for keeping them in check are still lacking.

Additionally, the UK's unitary board structure typically means that INEDs chair the nomination, audit and remuneration committees. While the structure in Japanese firms may be different, as required by regulation, the UK experience shows that effective challenge from INEDs can only occur where they occupy such key positions.

Unlike the UK, cross-shareholdings (a practice where companies own large chunks of each other's shares) remain a stubborn feature of corporate Japan – although the revised corporate governance code does urge the unwinding of undesirable cross-shareholdings.

Despite some areas of divergence between the UK and Japanese approaches, anecdotal evidence suggests Japan's efforts to overhaul its corporate governance regime are paying off. Companies are voluntarily following disclosure guidelines, gender equality is increasing, and there are more outside directors than before, indicating a change of mind-set as well as regulatory context.

Japan's progress on corporate governance is highly relevant to UK institutional and other investors, who will now be looking more closely at Japanese opportunities following the announcement of the UK-Japan trade deal.

While Japan's corporate governance framework is still generally considered to be more rigid than the UK's, it seems that the country is working to become more flexible and raise standards (and returns) in the process.

In particular, it appears to be prioritising greater C-suite accountability and responsiveness to shareholders.

A closer connection with the UK's corporate culture may accelerate this shift and UK companies may also learn some valuable lessons from their Japanese counterparts.

Trade Relations

The COVID-19 pandemic has increased scrutiny on corporate governance in many jurisdictions, with pressure mounting on businesses to demonstrate high ethical standards and transparency throughout their business, supply chains and partnerships.

This is something UK businesses and investors will need to bear in mind when evaluating opportunities in Japan, given the differences in corporate governance standards.

For Japan's part, as noted above, the attitude of Japanese exporters used to using the UK as a hub for accessing EU markets may be tested if the UK fails to secure a solid trade deal with the EU.

On top of this, Tokyo will likely be deeply uncomfortable if London flouts treaty commitments to its European partners, as it has threatened to do via provisions in its new Internal Market Bill. n