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Research Analyst

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Mr. Motoyuki Yufu
Director, Corporate Accounting and Disclosure Division
Financial Services Agency, Japanese Government
3-2-1 Kasumigaseki
Chiyoda-ku, Tokyo
100-8967, Japan

By email and post

Dear Yufu-san,

ACGA Preliminary Comments on Japan CG Code

Thank you for the opportunity to provide preliminary comments on the Japan Corporate Governance Code being drafted by the Financial Services Agency (FSA) and the Tokyo Stock Exchange (TSE).

The Asian Corporate Governance Association (ACGA) is a not-for-profit association chartered under the laws of Hong Kong. The association is dedicated to assisting companies and markets across Asia in their effort to improve corporate governance practices. In our educational outreach, we are guided by a practical, long-term approach. ACGA's operations are supported by a membership base of institutional investors, such as public pension funds and fund managers, as well as listed Asian companies, law and accounting firms, and universities. ACGA today has more than 100 corporate members, two thirds of which are institutional investors with around US\$18 trillion in assets under management globally. They are also significant investors in the Japan market.

ACGA would like to offer the following suggestions regarding the scope and content of the proposed Japan CG Code:

1. "Comply or explain"

The basic objective of a corporate governance "code of best practice" is to outline commonly agreed governance principles and practices that listed companies should strive to achieve. If they cannot meet such standards, or choose not to do so, they should explain their reasoning in sufficient detail so that a thoughtful and well-informed shareholder understands the explanation and considers it meaningful. The shareholder may not agree with the company's decision, but he or she should consider the explanation adequate in length and credible. Simple "boilerplate" explanations are generic, inadequate and lack credibility.

We recommend that due consideration be given in the Code as to how to encourage Japanese companies to give meaningful descriptions of their governance practices. This is much harder than it might appear. In our experience, many companies find it easier to comply than to explain, while some interpret “comply or explain” as putting the emphasis on compliance, which inevitably leads to box-ticking. Companies should be encouraged to follow the spirit of “comply or explain” and appreciate they have a choice. If they choose not to comply, shareholders are entitled to a sensible explanation. (It is worth noting that in Australia the phrase used is “If not, why not?”, which might be a clearer formula for some companies to bear in mind.)

2. The Code should be more than a set of principles

While corporate governance codes lay down agreed principles and aspirational practices for companies to follow, we believe that some degree of specific guidance is necessary to help companies implement them. In our experience, companies welcome such practical advice, as this helps them to know what benchmarks they should follow.

A simple example: The regional and global best practice for releasing final annual general meeting (AGM) agendas and all supporting documents used to be 28 calendar days before the meeting. This is now “good” practice, while “best” practice today is five to six weeks before the AGM. Such information provides companies with a useful benchmark to aim for, whereas a principle stating, for example, that ‘AGM agendas should be published as early as possible’, is much less meaningful.

Other areas where developed country CG Codes set down useful guidance include, among many other things:

- Preparation for and management of board meetings, including necessary follow-up and communication between meetings;
- Dealing with conflicts of interest facing directors;
- The proper role and responsibilities of directors;
- Communication between the chairman and independent directors;
- The management of the audit committee and other board committees;
- The management of the annual general meeting, how to count votes, publication of results and independent scrutiny of vote counting;
- Effective communication with shareholders.

We are conscious, however, that CG Codes should not become excessively prescriptive. Nor are we advocating an overly long document that tries to answer every possible question. It is a matter of finding the right balance in the content and updating it as necessary over time.

3. Addressing local issues

Some national corporate governance codes in Asia and elsewhere have largely been designed to import global standards in order to build credibility with international investors. While achieving international parity in critical areas is certainly important, and helps to enhance cross-border investment, the better codes attempt to address local governance challenges and opportunities directly. In Japan, for example, such issues could include:

- The strategic and competitive reasons why increasing numbers of large Japanese companies are voluntarily appointing “outside directors”;
- The similarities and differences between outside and independent directors;
- What “independence” means in the Japanese board context;
- The value of board diversity to business decision-making and strategy development at this current stage of Japan’s economic development;
- The role of the Kansayaku Board and how it differs from the globally accepted Audit Committee standard;
- The continuing influence of banks in the governance of some companies;
- Disclosure of any unique ownership and control structures that may influence the control of the company, such as ongoing cross-holdings or direct equity holdings;
- The impact of family ownership on listed-company governance.

We believe that the more a CG Code addresses significant local as well as international issues, the more relevance it will have for both local issuers and their shareholders and other stakeholders.

4. Company-investor dialogue

We believe the Code will play a constructive role in promoting a more productive and positive dialogue between companies and shareholders in the coming years. While much progress has been made in this area in recent years, the Code could assist in strengthening this trend by encouraging companies to:

- Release full and final AGM agendas, and business reports, at least 28 days before the meeting (see above);
- Publish company reports, meeting notices, announcements and corporate governance reports in English;
- Make senior executives and even directors available for meetings with international investors who wish to discuss CG and ESG issues. Global investors are increasingly seeking “board level” dialogue, in particular direct discussions with outside/independent directors as well as the chairman or CEO.

Companies that are open to meeting their shareholders are typically regarded more highly and gain greater market trust. The opposite is also true.

5. Same standards for large and small listed companies

We strongly disagree with the argument that governance standards should vary depending on company size (usually defined in market cap terms). While it may seem fair and reasonable to allow small listed companies more time to adopt new governance best practices, or be allowed to ignore certain provisions of a Code, we believe that this approach will create “moral hazard” for both regulators and listed companies. Small companies may feel justified, or even incentivised, in having lower governance standards, while regulators will likely encourage the poor governance they are seeking to avoid. Given the volatility of markets, it is extremely hard to draw a clean dividing line between large and small companies that applies in all market conditions. And large companies may feel aggrieved that many riskier, smaller firms are allowed to follow lower standards.

We also believe that small companies do not necessarily benefit from lower governance standards, except in the very short term (ie, saving on certain costs). As listed companies, they should be required to meet minimum standards and, in our view, such an investment will ultimately pay off. Allowing them to delay or avoid this process will likely impede their governance development—which in turn could harm their corporate and brand development over the long term.

Lastly, different standards are unnecessary: the “comply or explain” concept already allows companies wide flexibility in what they choose to implement and over what timeframe.

6. Role of the board

The board should have a comprehensive understanding of its role. The board is a steward of shareholders’ capital and is accountable to them. Each company faces particular challenges and opportunities, which the board needs to understand and respond to. A board should possess independent perspectives and a balanced range of skill and competence that meets the specific and changing needs of the company, and gives it the authority and knowledge to challenge strategy constructively and understand risk. The board should ensure that management operates the company in line with the corporate strategy as well as the direction communicated to shareholders.

7. Proportion of independent directors

In line with our 2008 *White Paper on Corporate Governance in Japan*, we recommend that the minimum number of independent directors be set at three or one third. Companies with more complex business operations, hence more complex board committee structures, may need a higher number or percentage of independent directors. Smaller companies may find that one third of the board is sufficient. Companies should be encouraged to think this issue through for themselves and explain their reasoning for following the minimum or a larger number. They should also be encouraged to see board composition as a dynamic process that will likely change as their business grows.

8. Director training

The Code should strongly encourage director training. Having formulated its outside/independent director policies later than most jurisdictions around the world, Japan has a golden opportunity to ensure it puts in place the right ecosystem to allow director competence to flourish.

Director training is regarded as essential in all developed markets today, yet it is often voluntary and there is no agreement as to what minimum governance, business, financial or communication skills a director should possess. Japan could potentially take a lead by setting new standards in this area and could require all directors—inside and outside, executive and independent—to undergo such training and achieve a minimum level of acceptable knowledge.

9. Board evaluation

The Code should strongly encourage regular board evaluation. The purpose of evaluation is to strengthen the contribution of the board to the success of the company. Effective boards undergo regular self-assessment at least once every two to three years, if not annually, and they accept that replacing ineffective board members is sometimes necessary if they are to assume proper accountability for their decisions. The board could design its own assessment process or seek external assistance.

10. Improved narrative reporting

As noted in point 1 above, corporate disclosure that is formulaic and not meaningful is of little value to shareholders and other interested parties. It is critical that the CG Code encourages companies to produce meaningful “non-financial” narrative reporting on corporate governance and ESG matters. This process will only become more important as Japanese companies adopt the Integrated Reporting <IR> standard and as the new Stewardship Code takes effect. We also note that the recent Ito Review is driving in the same direction.

Finally, we would like to note that the format and location of corporate reporting under the CG Code will be important. Listed companies in Japan produce financial and non-financial information in several different documents (securities reports, business reports for the AGM, corporate governance reports on the stock exchange website, and some publish “annual reports” as well). It would certainly enhance efficiency, readability and comparability if the CG Code required publication of “comply or explain” reports in a common document and in English.

Thank you for your attention. We would be pleased to discuss any topic above in further detail.

Yours truly,

A handwritten signature in blue ink, appearing to read 'JA Allen', is written over a light blue circular stamp.

Jamie Allen

Secretary General