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Mr. Motoyuki Yufu
Director, Corporate Accounting and Disclosure Division
Financial Services Agency, Japanese Government
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By email and post

Dear Mr. Yufu,

ACGA Comments on Exposure Draft of Japan CG Code

Thank you for the opportunity to provide comments on the exposure draft of the Japan Corporate Governance Code 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 welcomes and supports the exposure draft of the Japan Corporate Governance Code, and we commend it for being progressive, practical and business friendly. The draft covers many of the essential areas that other corporate governance codes globally and regionally have sought to address. It highlights the importance of the role of investors and shareholders as "important partners for companies", and we believe it will be helpful in promoting mid- to long-term investing in Japan. The requirement for the board to establish "an environment where appropriate risk-taking by the senior management is supported" is refreshing.

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We welcome also the clear references in the exposure draft to foreign shareholders, the requirements for an electronic voting infrastructure or platform, and English translations of notices convening general shareholder meeting and other disclosures, all of which will be most useful to global investors.

We would like to take this opportunity to offer some further suggestions regarding the scope and content of the exposure draft:

1. "Comply or explain"

The exposure draft adopts the "comply or explain" approach that has become firmly established in jurisdictions such as the United Kingdom, Australia and other developed markets in Asia and around the world. While there is an emphasis on best practice, there is also flexibility for "particular circumstances of individual companies" (as stated in Paragraph 12 of the exposure draft). Australia uses the phrase "if not, why not", whereas the Dutch Code and the South African Code take a slightly different approach with "apply or explain", with more emphasis on compliance than pure disclosure.

The United Kingdom celebrated the 20th anniversary of its Corporate Governance Code in 2012 and hence has more than 20 years of experience in the implementation of the "comply or explain" principle. This experience may be of valuable reference to Japanese companies, as there is a link between the effectiveness of a corporate governance code and a stewardship code, which Japan implemented last year and now has 175 domestic and foreign signatories (as of December 2014).

On "comply or explain", the 2013 Annual Review of the UK Corporate Governance and Stewardship Codes acknowledges the high levels of compliance with the UK Corporate Governance Code, yet criticises UK listed companies for "[struggling] to articulate clearly why they have chosen to deviate". Hong Kong has had a similar experience–despite expanding the Hong Kong CG Code in 2012 with a preamble on what "comply or explain" means, the Hong Kong Stock Exchange sent a reminder to Hong Kong listed companies in 2014 that they need to do a better job in this area, as many Hong Kong companies also fail to explain properly and in a company specific manner. Other "comply or explain" markets face similar challenges.

Japan, therefore, has both a unique opportunity and a challenge ahead on the implementation of its new CG Code. On the one hand, "box ticking" should be discouraged and companies must not confuse superficial compliance with good corporate governance. On the other, as the exposure draft explains in Paragraph 12, offering shallow explanations using boilerplate expressions would be inconsistent with the spirit of "comply or explain".

The experience of other markets shows that the implementation and evolution of "comply or explain" will take time to develop. The FSA may wish to make particular effort to guide and assist Japanese listed companies to come to grips with good disclosure through organising training and workshops. Inviting regulators and listed issuers from the United Kingdom and other markets to share their implementation experiences may be helpful. Best practice disclosure guides published by governance organisations like the Canadian Coalition for Good Governance also provide useful

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references and concrete examples of how a corporate governance code is applied, which Japanese issuers could adopt or adapt according to particular Japanese culture and norms.

2. Differentiated application of the CG Code

In Paragraph 13 of the exposure draft, it is proposed that the CG Code applies equally to the TSE First and Second Sections (ie, the main markets), while flexibility may be allowed for other markets. We appreciate this approach and understand that consideration may need to be given to the size and characteristics of firms listed in smaller company markets and to their challenges in implementing the Code.

However, we believe that the Code should establish minimum governance standards for the whole market, and given there is inherent flexibility in the concept of "comply or explain"(which allows companies to choose what they comply with and over what timeframe) there is no need in our view to dispense entirely with the applicability of the Code's principles to these companies. Unequal application of the standards could create a moral hazard, and we believe that requiring them to adhere to higher governance standards would benefit them more in the long-term than allowing them to follow lower standards. Indeed, initial public offerings that list with higher governance standards generally pose less risk for investors and are more highly valued by the market. We look forward to further discussions with the TSE on the appropriateness of dispensations to be given to companies in other markets.

3. Avoiding a boilerplate standard framework

Paragraph 15 of the exposure draft states that companies should disclose and explain the reasons for non-compliance with the Code in a "standardised framework", and the TSE will offer clarification for handling this matter. We look forward to guidance from the TSE on this point, but would reiterate the importance of avoiding boilerplate disclosure or box-ticking as explained above.

One straightforward and unambiguous approach, as adopted in the United Kingdom listing rules, is to require disclosure on all items in the Code through a "corporate governance report". That is to say, companies must explicitly state how they have complied with each key component of the Code or explain why not. This creates a structured approach that will hopefully give investors clarity and sufficient information to form a view on the governance standards of the companies.

We also recommend that companies be encouraged to provide a statement on their long-term corporate governance policy or strategy, including their approach to balancing "comply or explain", and to disclose any other matters not covered by the Code yet which they deem important to their governance. For example, investors would find it helpful if boards reported regularly on how they are carrying out their responsibilities under the Code in practical terms. Illustrations of such reporting could include: (i) the board's role in selecting and overseeing auditors; and (ii) disclosure of not only board procedures for deciding related-party transactions (Principle 1.7)—an essential element of protection of minority shareholders—but also an explanation of why such transactions are in the interest of the company and its minority shareholders.

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An alternative approach, which we would not recommend, is to allow companies complete flexibility as to how they report their compliance or deviation from the Code. This could result in unstructured and probably simplistic reports that provide limited meaningful information to investors. It could also result in companies using different publication mechanisms for delivering this information (eg, the existing CG reports provided on the TSE website; annual securities reports required under FSA regulations; annual business reports presented to AGMs; or the pictorial annual reports that some companies prepare for their shareholders).

For the sake of clarification: when we referred in our letter of November 25, 2014 to the desirability of incorporating this disclosure in a "common document", we meant in the same type of report for each company. While the existing TSE corporate governance reports may seem the most logical place for this disclosure, most of these are in Japanese only and continue to be somewhat disconnected from the more established annual securities reports and AGM business reports. The latter documents would, in our view, be a more effective and convenient place for disclosure of Code compliance. Any such disclosure should also be made available in English on each company's website.

Lastly, while the exposure draft refers to a "standardised framework" for disclosure, it is not clear whether listed companies will be required to disclose their compliance with all aspects of the Code or only some. We recommend that this be made clearer in the section entitled "Implementation of the Code" (paragraphs 13-15). For the reasons given above, we recommend complete not partial disclosure.

4. Pushing back deadlines of AGMs

On appropriate measures to ensure the exercise of shareholder rights at general meetings, we would invite the FSA to consider supporting an effective four-month period for AGMs rather than delaying the provision of annual audited financial statements, as referred to in Supplementary Principle 1.2.3. It is worth noting that Japan and Korea are the only two markets in Asia with tight AGM deadlines. Most other markets range from four months (Singapore, Thailand) to six months (China, Hong Kong and Taiwan).

As we understand, there is no hard company law regulation in Japan mandating a three-month deadline for AGMs. However, it is common practice for companies to set their record date (or "base date") for determining voting eligibility according to their fiscal year-end, which means they must hold their AGM within three months. Our members support the idea of setting a later record date, such as the end of April for companies with March fiscal year-ends, which would allow the AGM season to run until the end of July (hence, a four-month period). We should emphasise, however, that we are not calling for any change in the rule requiring companies to submit their annual audited securities report within three months, as investors are entitled and accustomed to receive timely financial information.

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5. Appointment of independent directors

Principle 4.8 of the exposure draft provides for two approaches: listed companies should appoint a minimum of two independent directors or, if their size and business complexity is greater, they are encouraged to have at least one-third of the board as independent directors. We fully support the direction of this principle. As we stated in our White Paper of 2008 and Statement on Corporate Governance Reform in Japan in 2009, we recommend that listed companies introduce an independent element in their boards and that they allow their boards to play more of a strategic oversight role (rather than a more managerial, operational role). In this regard, the quality of the individuals chosen as independent directors—their character, expertise, business experience and broader understanding of the interests of all stakeholders, including shareholders—is critical.

For practical and organisational reasons, however, we believe that companies will generally need at least three or one-third independent directors if they are to gain tangible value from their participation, and if they are to meet the requirements of Principle 4.3 that states that boards should carry out "effective oversight of directors and management from an independent and objective standpoint". While the final number depends on many factors, including the complexity of the company's business, how many board committees they have, and so on, larger or more complicated companies may find over time that they need a higher number of independent directors. Indeed, for the above reasons, the trend in most developed markets is towards having a majority of independent directors on boards.

Companies should do their best to lend all necessary support to their independent directors so that they can play an effective role. To further enhance the effectiveness of the independent directors, we support the appointment of a lead independent director, as envisaged under Supplementary Principle 4.8.2 of the exposure draft. We also recommend the TSE review the present criteria on independence (Principle 4.9) and undertake appropriate reviews on its interpretation by companies, as necessary.

Meanwhile, with regard to board diversity in Principle 2.4, the word "personnel" appears to limit the principle to employees. We suggest that this principle explicitly refer to boards as well, by stating "diversity of personnel and boards", and that diversity should also explicitly include the promotion of global talent and not just gender diversity.

6. Board committees

We further commend General Principle 4 of the exposure draft for covering the key responsibilities of the board and touching upon important best practices such as the proper management of board meetings, director and *Kansayaku* training, and requiring the board to evaluate its own performance and composition.

One broad topic that we believe is lacking in the exposure draft, however, is the area of board committees. While Principle 4.10 touches upon the use of "optional advisory committees" to enhance the function of boards, much greater focus could have been put on the purpose and effective functioning of key committees for audit, nomination and remuneration. We recommend that this be included in the next version of the

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Code, with the additional stipulation that every board committee should at least have one independent director, preferably as chairman.

We also recommend that the optional advisory committees envisaged by the Code be composed of all or a majority of independent directors, otherwise their value as an advisory entity to the executive/inside directors is likely to be significantly diminished. Moreover, since it is envisaged that independent directors will play an important role on these committees—which many listed companies in Japan already have—it may be more logical to include Supplementary Principle 4.10.1 under the supplementary principles to Principle 4.8.

As a final comment, we note that the FSA envisages the Code will be reviewed and possibly revised in future. It would be helpful if the timeframe and process for undertaking this work is outlined in the Code, eg, two years after implementation of the Code in June 2017. The FSA may also wish to explore conducting a disclosure review within a year to determine if company reporting is in line with the Code.

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

Yours truly,

Jamie

Jamie Allen
Secretary General

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