



ICGN

International Corporate Governance Network

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Planning and Coordination Bureau (Secretariat of the Follow-up Council)
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To the Follow Up Council:

Re: Opinion Statement No. 2 of the Council of Experts Concerning the Follow-up of Japan's Stewardship Code and Japan's Corporate Governance Code: "Corporate Boards Seeking Sustainable Corporate Growth and Increased Corporate Value over the Mid-to-Long Term"

The International Corporate Governance Network (ICGN) is an investor-led organization of governance professionals with members including institutional investors responsible for assets under management in excess of US\$ 26 trillion.¹ Our mission is to inspire and promote effective standards of corporate governance to advance efficient markets and economies world-wide. As such we, as an organization of members with significant investments in Japanese companies, welcome the opportunity to share our comments in respect to the process of further improving the corporate governance of listed companies in the Japanese financial markets.

ICGN has actively supported Japan's efforts to establish both its Stewardship Code and Corporate Governance Code, and we congratulate in particular the Financial Services Agency (FSA) and the Tokyo Stock Exchange (TSE) for the hard work and positive results that have been achieved thus far. ICGN has contributed to various consultations relating to these developments, which we hope have been helpful. Most recently we followed up with the FSA in November 2015 to express our support for the establishment of the "Council of Experts Concerning the Follow-up of Japan's Stewardship Code and Japan's Corporate Governance Code" (the "Follow-up Council"). We are therefore pleased to receive the Opinion Statement No. 2 issued this past February demonstrating the Follow-up Council's assessment of progress to dates.

We are particularly encouraged to see the significant progress being made by many Japanese companies in implementing the Corporate Governance Code, and we

¹ For more information about ICGN, please visit www.icgn.org.

believe this will also be welcomed by the international investor community. We agree that the issue of board effectiveness is critical, and believe that sensible issues are being focused upon: appointing and dismissing the CEO, board composition, board operations and board evaluations. There is really nothing in the report that we would disagree with, but in the spirit of providing constructive feedback we offer a few further comments:

Appointment/dismissal of the CEO. We agree that this one of the most fundamental responsibilities of the board, and that a CEO plays a critical role in influencing the fate of a company – either positively or negatively. We draw attention to the language in the first paragraph in discussing this topic. It states that “the CEO’s ability determines the fate of the company”; while the phrasing in Japanese might read differently, the way this is expressed in English may place undue emphasis on the CEO as compared with other company executives. We are wary about the potential for creating a “star” culture relating to CEOs, which can sometimes result in negative consequences. So while we agree with your focus on the board’s role in appointment and dismissals—and the critical role of the CEO—we also encourage the role not to be characterized in terms of overdependence on one individual.

Independent directors: We were pleased to read about the progress relating to board independence. This has been a standing theme throughout ICGN’s feedback to the FSA. As we have noted in previous communications, ICGN was pleased to see the new Japan Corporate Governance Code take a positive step forward in terms of encouraging two independent directors. While this is a promising start, we also noted that ICGN strongly believes in an absolute minimum of three independent directors on boards. With this minimum of independent directors it would be possible to have board committees that completely exist of independent directors. Article 3.1 of the ICGN Corporate Governance Principles states that “the board of directors should comprise a majority of non-executive directors, the majority of whom are independent, noting that practice may legitimately vary from this standard in controlled companies where a critical mass of the board is preferred to be independent”. Against this international basis of comparison ICGN believes the board of Japanese companies should strive for at least a minimum of one-third of independent directors and it is positive to learn that over 10% of companies in the TSE first section have adopted three independent directors. So we believe that good progress has been made in Japan, and that this journey continues.

Audit Committee: The Toshiba case remains a visible reminder, both within Japan and internationally, that there is still a need for further strengthening of auditor function within both listed companies and the Japanese corporate governance structure. ICGN believes a dual- reporting relationship to both executive management and the board of directors is an important mechanism to reduce opportunities of accounting fraud.

We have noted in the past that for many Japanese companies with company auditors (Kansayaku), the Kansayaku are not members of the board of directors and cannot participate in the resolutions reached by this board. The Kansayaku therefore can be in a weak position to intervene in the decisions made by the board of directors. So

we support greater focus on establishing independent audit committees as part of the board, and would like to support your specific observation in Section 2 (4) of the Opinion Statement that an independent director should serve in the role of the audit committee chairman. Of all the important roles to play on a board ICGN believes that audit committee chair is one committee in particular where independence is an important criterion for membership.

The chairman of the audit committee plays a critical governance role in the checks and balances and risk controls functions of a company, particularly with regard to preventing or investigating causes of fraud. The role of the independent audit committee chairman continues to grow in focus in Western markets where audit committees are a standard governance feature and where audit reporting is becoming more detailed. As Japan's own governance framework evolves, this may be a useful role to consider in the context of Japanese corporate governance.

Audit process. We would also like to raise two issues about the audit process, which we also raised with you in our letter this past November. Firstly, with regard to the role of internal audit, we would like to re-emphasise the point made in our earlier letter about establishing a "double reporting" of the internal audit function to both executive management and to the company board. We believe this is important in terms of ensuring the independence and objectivity of the internal audit function. Secondly, with regard to external audit, we understand that the FSA is reviewing the possibility to establish a code of standards for extended audit reporting, as exists in some other markets. ICGN encourages this trend, and we believe in particular that improved audit reporting to investors can help to sharpen the quality and relevance of shareholder engagement.

Board composition: We agree with your focus on board composition with a view to ensure that the board has the "necessary qualifications and diversity as well as independence and objectivity. And while we agree with what was said, we also would like to comment on what may have been possibly missing. Specifically, in the discussion of board diversity we observe that gender diversity was not mentioned. It is our view at ICGN that gender diversity is an important, and growing, area of focus in many markets around the world. It speaks not only to better board effectiveness and fairness of opportunity but also addressing the type of skills gap mentioned in Section 2 (1). Many jurisdictions are placing greater emphasis on achieving gender balance to help create more opportunities to develop executive talent and better boards, and we encourage Japan to explore this area further in the context of its own company cultures. We refer you specifically to ICGN's Guidance Statement on Gender Diversity², and would also alert you to an updated guidance statement on board diversity that ICGN will publish after member approval at its AGM in June 2016.

Thank you for the opportunity to provide comments to the Follow-Up Council. We wish the Council fruitful and prosperous ongoing deliberations. Should you wish to

² See http://icgn.flpbks.com/icgn_gender-diversity_2015/#p=1

discuss our comments further, please contact George Dallas, ICGN's Policy Director,
by email at george.dallas@icgn.org

Yours faithfully,

Erik Breen
Chairman, ICGN Board

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