20 YEARS | INSPIRING GOOD GOVERNANCE

ICGN
International Corporate Governance Network

26 November 2015

Corporate Accounting and Disclosure Division, Planning and Coordination Bureau,
Financial Services Agency (Secretariat of the Follow-up Council)
Tokyo
Japan

By email: sccgfollowup1@fsa.go.jp

Dear Sir and/or Madam,

Re: Call for comments to further improve the corporate governance of listed companies by the Council of Experts Concerning the Follow-up of Japan's Stewardship Code and Japan's Corporate Governance Code (the "Follow-up Council").

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 organisation 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 is supportive of the recent decision by the Cabinet to revise the Japan Revitalization Strategy, and we also support the adoption of Japan's Stewardship Code, established and released in February 2014 ("JSC"), and Japan's Corporate Governance Code, which entered into force in June 2015 ("JCGC"). We believe this is an important development and sends a positive signal to all market participants in Japan. The positioning of corporate governance as an important part of the FSA's Strategic Directions and Priorities 2015-2016 is also a development we think reinforces this market signal.

Further improvement in Japan's effort toward effective corporate governance standards is a continuous process. Therefore, ICGN supports 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"). It is of utmost importance that the sustainable growth of companies be promoted by both investors and companies. ICGN would like to contribute to this goal by sharing our comments on several aspects of the current standards on Corporate Governance in Japan.

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

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In respect to both the JSC and the JCGC, we have specific views on the following issues:

Independent directors: to avoid any misunderstanding on the independence of directors and their positions on the board, extra criteria might help to establish an internationally accepted level of qualified independent board members. Independent directors are vital to a board's ability to consider multiple viewpoints on board matters. 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, 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". ICGN believes the board of Japanese companies should have at least a minimum of one-third of independent directors. To ensure that independent directors can spend adequate time and capacity in their role, listed companies should offer extra administrative support and executive assistance to independent directors.

Accounting fraud and Audit Committee: The wide visibility, both within Japan and internationally, of the Toshiba case has raised the concerns that there is still a need for further strengthening of auditor function within both listed companies and the Japanese corporate governance structure. For example, at Toshiba the internal audit function was designed to report only to the management, and this structure is adopted across many Japanese companies. ICGN believes a dual- reporting relationship to both executive management and the board of directors—as articulated by the Institute of Internal Auditors (IIA) -- is an important mechanism to reduce opportunities of accounting fraud.

It is critical that internal audit and risk management systems function effectively in these challenging times. A board's audit committee and its board of company auditors (Kansayaku) should seek to hire a skilled, strong and independent external auditor that reports to it and the Board, not management. The recent amendment of the Japanese company law grants also the board of company auditors to hire external auditors. ICGN believes that it is imperative for investors to understand how the board undertakes the selection and tenure of the external auditor, who should have the independence, necessary qualifications and sufficient experience to fulfill their responsibilities. Any misstatements, restatements or concerns in financial records should be responded to by the company, which, in turn, should explain to shareholders how the financial issues have been handled immediately or contained and resolved.

We note that for 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.

In terms of disclosure about activities of external auditors, ICGN believes additional information from auditor report is needed following International Auditing and Assurance Standard Board (IAASB) initiatives. This could lead to improving the quality of external auditors in Japan.

Altogether, internationally focused foreign investors are careful investing in Japanese companies if they do not completely understand the corporate governance structure and the audit, risk and control best practices. The Follow-Up Council should address these issues very clearly and offer guidance how to proceed with implementing and changing new corporate governance structures, especially regarding audit and accounting.

Procedure of proxy voting: overseas investors still have difficulties to meet certain time constraints for instructing and casting their votes. The Japanese proxy season occurs over a short period of time. It is extremely challenging to review proxy ballots with numerous shareholder proposals in a limited amount of time. Information on the background of director candidates may not be available in order to determine whether they are independent candidates. ICGN recognizes the value of shareholder rights, especially voting at the general shareholder meeting. It is imperative that accurate information be received by shareholders in advance of the meeting. The agenda should clearly reflect the content of the meeting, the names and background of directors who have been nominated to serve and all relevant information to allow investors to vote as fully informed owners of the company.

Special class shares: the introduction of shares with differential rights, such as the “Model AA” class shares, might have a negative impact on effective stewardship and exercising shareholder rights. ICGN believes that shareholders deserve to have their issues and concerns heard, which in part, is effectuated through voting their shares equally. ICGN generally does not support differential ownership rights, particularly those that separate economic stake from voting control. Dual class shares and lesser ownership standards for minority shareholders will have a chilling effect on effective dialogue. No matter how many shares might be acquired, a shareholder will always remain in the minority.

Translation of disclosure documents: corporate governance reports required by the Japanese Code are predominantly published in Japanese and updates are only sent to the regulators instead to investors as well. Given the substantial percentage of Japanese equities held by non-Japanese institutional investors, we would find it particularly helpful if all public disclosures including reports based on the corporate governance code and securities report (‘Yuho’) were in English. By doing so, Japanese listed companies and their boards will be in a better position to accommodate the necessary dialogue and stewardship from their growing overseas investor base.

Monitoring report: a clear and comprehensive 'comply or explain' provision will help listed companies and their investors to start a true dialogue to foster good corporate governance. We recommend that a report be generated at regular intervals. We also believe that companies should provide robust and full statements of disclosure and their rationale for situations in which they are not able to comply with one or more of the Principles.

Thank you for the opportunity to provide comments to the Follow-Up Council. This Council and its members face significant challenges improving and strengthening corporate governance standards and practices in Japan. We wish them fruitful and prosperous deliberations. Should you wish to 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

ICGN contacts:

Kerrie Waring, ICGN Executive Director

Carol Drake Nolan and Niels Lemmers, Co- Chairmen ICGN Shareholder Responsibilities Committee

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