



December 17, 2015

Secretariat of the Follow-up Council
Corporate Accounting and Disclosure Division
Planning and Coordination Bureau
Financial Services Agency, Japanese Government
3-2-1 Kasumigaseki
Chiyoda-ku, Tokyo
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By email and post

Dear Sir,

ACGA Feedback on the Japan Stewardship and CG Codes

Thank you for the opportunity to comment on the issues to be discussed and reviewed by the newly created “Council of Experts Concerning the Follow-up of Japan’s Stewardship Code and Japan’s Corporate Governance Code”.

The Asian Corporate Governance Association (ACGA) is a not-for-profit association chartered under the laws of Hong Kong and dedicated to assisting companies and markets across Asia in their effort to improve corporate governance practices. ACGA today has more than 100 corporate members, more than two-thirds of which are institutional investors with around US\$24 trillion in assets under management globally. They are also significant investors in the Japanese market.

ACGA welcomed the release of the Japan Stewardship Code and Japan Corporate Governance Code. Both are important documents that should serve as clear benchmarks for the conduct of Japanese listed companies and their shareholders. We strongly support the main contents and objectives of the two Codes which, if implemented fully and faithfully, will improve the governance of listed companies and help attract mid- to long-term investment into Japan. They will, moreover, help to address the problem of low productivity and returns, which in turn contributes to slow economic growth. In this regard, we would like to praise the establishment of the Follow-up Council to monitor the implementation of the two Codes and to promote further corporate governance improvement.

It is our view that market participants need some time to study and understand the intended impact of both Codes in their original form before any amendments or additions are considered. In particular, listed companies and investors must be allowed to internalise the spirit of the best-practice principles in the two Codes, as opposed to feeling pressured to adhere to them for the sake of compliance. This does not mean, however, that companies and investors should approach implementing the guidance in the two Codes slowly. A sense of urgency is also needed to improve corporate value, profitability and long-term economic growth.

We would like to make some detailed comments regarding the key issues to be taken up in the Follow-up Council's meetings in the coming months. While some of these points have been conveyed to Japanese regulators in our previous submissions, we believe they are worth repeating or elaborating on here.

Comments relevant to both the CG and Stewardship Codes:

1. "Comply or explain"

A key feature of the two Codes is the adoption of the "comply or explain" approach that has become established in jurisdictions such as the United Kingdom, Australia and other developed markets in Asia and around the world. Australia uses the phrase "if not, why not", whereas the Dutch and South African codes take a slightly different approach with "apply or explain", with more emphasis on compliance than pure disclosure.

"Comply or explain" is more challenging than it may first appear. The 2013 Annual Review of the UK Corporate Governance and Stewardship Codes acknowledged high levels of compliance with the UK Corporate Governance Code, yet criticised 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 Corporate Governance Code in 2012 with a preamble on what "comply or explain" means, the Hong Kong Stock Exchange felt compelled two years later to remind listed companies to do a better job in this area. Many firms had failed to explain their governance policies and practices in a sufficiently company-specific manner. Other jurisdictions using "comply or explain" have faced similar challenges.

Experience shows that the implementation and evolution of "comply or explain" can take a long time to develop, but there are opportunities to accelerate this transition. The Follow-up Council may wish to consider how to guide and assist Japanese listed companies and domestic institutional investors to understand and implement good disclosure. For example, the Council could advise the FSA to do the following:

- Encourage or require companies to undertake training and workshops organised by specialist providers;
- Invite regulators from the United Kingdom and other markets to share their implementation experiences;
- Develop a guide for companies drawing on good disclosure practices in Japan and, where relevant, other developed markets; and
- Investigate potential legal impediments to collective efforts by investors wishing to promote long-term stewardship.

One assumption in the "comply or explain" model that may not be immediately apparent to market participants in Japan is that "comply" does not simply mean 'do what the Code says and state this as fact'. Investors are also looking for an explanation as to how a company is implementing the Code's provisions and what have been the results of this action. "Comply or explain" would more accurately, if less elegantly, be written as "comply and explain; or do not comply and explain". The onus is therefore on the company to think through its governance policies and practices, and then explain this rationale to shareholders. This is the *quid pro quo* for using soft law (guidance) rather than hard law (legislation): companies are given the flexibility to choose, but are also expected to take responsibility for their actions. This is not an exercise in merely following the letter of the law.

2. Avoiding boilerplate disclosure

We would like to reiterate the importance of avoiding boilerplate disclosure or box-ticking. That is to say, companies and institutional investors must state in their own words—not legalistic or formulaic language—how they have complied with each key component of the Codes or explain in meaningful detail why not. A large amount of corporate reporting on company governance in all markets today contains little information useful for investors, with the same boilerplate phrases and paragraphs repeated year after year. The key test should be whether the information provided to shareholders assists them in developing a deeper understanding of a company’s governance and, ideally, how it is improving. By definition, such information should be current, material and specific to the company.

We recommend that companies be encouraged to provide a statement on their long-term corporate governance policy or strategy. Indeed, some Japanese companies, such as Mizuho Financial Group, OMRON Corporation and Sompo Japan Nipponkoa Group, are already doing so. They have produced corporate governance “Guidelines” or “Policies” that outline in some detail their basic policy regarding corporate governance, reasons for choosing their current board system, the role of their board of directors, and so on. We recommend that the Follow-up Council urge other companies to do the same and to write these documents in “plain” and original, not legalistic, language. Nor should they simply copy another company’s policy. Such statements should also disclose any other matters not covered by the CG Code, yet which companies deem important to their governance.

3. Disclosure in English

A key disclosure-related issue requiring special mention is translation into English. Timely translation is critical for companies that need to communicate with foreign shareholders, and to allow those shareholders to participate actively in the Japanese market. Without translation, foreign shareholders will not be able to meet their obligations under the Stewardship Code, nor will they have equal access to the same information as domestic shareholders.

4. Stewardship dialogue with companies

The spirit of the Stewardship Code is meant to encourage positive and constructive engagement between institutional investors and companies to discuss long-term business issues and strategies. That said, it also calls for institutional investors to “work to solve problems” through constructive engagement. It will be interesting to understand how the FSA intends to encourage or enforce investor compliance with the Code, especially in cases where engagement might be expected but appears not to have taken place, such as a major governance or accounting scandal. Will it be sufficient for a few leading investors to engage directly with the company and for the majority to do very little? And what form of disclosure will be expected of investors in such cases to avoid the boilerplate problem?

Unlike the extended debate on appropriate governance structures and practices of listed companies, less attention has been devoted so far to the organisational implications for institutional investors of their stewardship responsibilities. There needs to be more discussion on this in due course, including the issue of conflict of interest and how this affects responsible investment. Moreover, just as listed companies should provide a statement on their long-term corporate governance policy or strategy, we recommend that institutional investors be encouraged to do the same.

The following points pertain only to the CG Code:

5. Strategic role of the board

As we stated in our *White Paper on Corporate Governance in Japan*¹ of 2008 and *Statement on Corporate Governance Reform in Japan*² in 2009, we recommend that listed companies introduce a material level of independence into their boards and that they allow their boards to play more of a strategic oversight role, rather than a managerial, operational one.

Indeed, much progress has been made in this area in recent years. The corporate governance Guideline/Policy documents mentioned above emphasise a distinction between the supervisory function of the board of directors and the execution function of management. And in its recent *2015 Proxy Season Review: Japan*, the proxy advisory firm Institutional Shareholder Services (ISS) notes how some companies have been reducing the number of board meetings held each year from more than 50 to only 20. As ISS says of Yamada Denki:

“The reduction of the number of board meetings held, combined with the appointment of outside directors, implies that the company has started to change its stance toward the role and function of the board. The fact that the board had met more than 50 times a year over the years implies that the board in fact had served as a management body, where day-to-day business decisions are discussed, rather than as a supervisory organ.”³

We recommend that the Follow-up Council discuss how the strategic role of the board can be further embedded in Japan.

6. Independent directors

While Japanese companies have made significant progress in introducing outside directors, and many of them are reasonably independent of management, we would urge another look at the definition of “independence”. As it stands, Japan lacks a complete definition that promotes fully independent directors—that is, people who are not only independent of management and any controlling shareholder, but also free of conflicts of interest with no significant prior business relationships, including ties with affiliated companies.

For practical and organisational reasons, we also believe that companies will generally need at least three independent directors and a minimum one-third board independence if they are to gain tangible value from their participation. 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.

At the same time, such directors should also be people with relevant business experience who can promote the success of a company and contribute to discussion of strategy, financial management and improved stakeholder/shareholder relations, among other things. Institutional shareholders are increasingly looking at the quality of independent directors, not merely the quantity.

¹ http://www.acga-asia.org/public/files/Japan%20WP_%20May2008.pdf

² http://www.acga-asia.org/public/files/ACGA_Japan_Statement_2009_Dec15_English.pdf

³ Institutional Shareholder Services, *2015 Proxy Season Review: Japan*, p11.

Companies should lend all necessary support to their independent directors so that they can play an effective role, including providing proper administrative support, training opportunities and visits to company facilities. To further enhance the effectiveness of independent directors, we support the appointment of a “lead independent director”, who should have a specific mandate to reach out to shareholders and consult them on the company’s performance and strategic direction. Meanwhile, with regard to board diversity, we suggest that diversity should explicitly include the promotion of global talent and not just gender diversity.

7. Board evaluation

To encourage board effectiveness and enhance shareholder understanding of this critical component of a company’s governance, we recommend that the board as a whole be evaluated on its performance on a regular basis (for example, once a year). Companies should be required to disclose their process for undertaking such evaluations and whether it is a self-evaluation or carried out by an independent, specialist consultant.

One tool for developing an effective board is the “skills-set matrix”, which outlines the range of talent and expertise among directors and links this to the company’s strategic and operational needs. But an important caveat: such matrices must contain sufficiently detailed information about each directors’ business experience and knowledge, not simply generic or boilerplate words and phrases.

8. Board committees

One broad topic that we believe is underdeveloped in the CG Code is the area of board committees. Much greater focus could have been put on the purpose and effective functioning of key committees for Nomination, Audit and Remuneration, as well as their independent composition and leadership.

We recommend that the Follow-up Council discuss the role of board committees in some depth. As we noted in our 2013 paper titled, *The Roles and Functions of Kansayaku Boards Compared to Audit Committees*⁴, a first step towards creating effective board committees in Japan would be to create a deep pool of knowledgeable, capable and experienced independent directors. Second, firms without an independent nomination committee, including most of those with traditional *kansayaku* boards, should be encouraged to create one for the selection and nomination of both directors—including the President/CEO—and *kansayaku*. Thirdly, with a sufficient cadre of independent directors and a proper nomination process in place, companies should consider forming a genuinely independent and authoritative audit committee and other relevant board committees. (Note: We also recommended that the company law be amended to ensure that these board committees had a proper legal basis and were not merely advisory in nature, as is the case today in many firms with “hybrid” board structures—that is, a *kansayaku* board alongside a board of directors with a couple of committees on nomination and remuneration.)

We do not intend here to repeat our views, as expressed in detail in the above paper, on the importance of a properly functioning audit committee. Suffice to say, our view is that a well-functioning and independent audit committee with strong powers of supervision over internal controls and financial risk management, with a direct line of communication to the internal audit department, and with the power to monitor and hold external accounting

⁴ http://www.acga-asia.org/public/files/ACGA_Paper_Kansayaku_Audit_Committees_October_2013_English_Final.pdf



auditors to account, is a more effective supervisory mechanism than the *kansayaku* board prevalent in Japan.

There may be a perception among some people in Japan that the Toshiba accounting scandal highlighted the weakness of audit committees in ensuring strong internal controls and proper accounting systems. We would argue that what happened at Toshiba reflected, in addition to a corrupted leadership culture, certain inherent weaknesses in the “three committee system” in Japan. For example, the audit committee that had been set up at Toshiba had no accounting experts as members and was chaired by a company insider. To its credit, Toshiba is now putting in place a more robust and independent audit committee system, with stronger supervision of internal controls, greater administrative and informational support from management, and a direct line of reporting from the internal audit department.

A related issue here is that of the new Audit and Supervisory Committee board structure, which Japan adopted as part of its update of the Companies Act in 2014. We understand that more than 200 listed Japanese companies have adopted the new structure in order to strengthen their governance. We continue to have our doubts about this structure, however, and will return to it at a later date.

9. Other issues

Two further we would like to mention briefly are the recent case of the Toyota AA shares and the status of cross-shareholdings. We have concerns that the AA share model, by treating existing equity holders unfairly and effectively undermining “one share, one vote”, would increase long-term investment risk in Japan if it became widely adopted. Such a trend is clearly not in line with the spirit or letter of the CG or Stewardship Codes, nor with the government’s stated aim of enhancing corporate value through governance reform.

On cross-shareholdings, we have particular concerns about the systemic risk implications of equity holdings among the large banks. We recognise that the three main bank groups have materially reduced their “equities held for business relationship purposes” since 2003, and are in the process of selling a further 30% of equity holdings over three to five years. However, as the Financial Services Agency notes in a recent document⁵, the three main bank groups in Japan still have a higher rate of shareholdings to equity capital than comparable G-SIFIs in Europe and the US, and remain exposed to stock price fluctuations.

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 positioned above the printed name.

Jamie Allen
Secretary General

⁵ Japan FSA, Supervisory Bureau, *Explanatory Material*, November 24, 2015