7 May 2021

Tokyo Stock Exchange
Listing Department
2-1 Nihombashi Kabutocho
Chuo-ku
Tokyo 103-8224
Japan

By email: jojo-kikaku@jpx.co.jp

To Whom it May Concern,

Revision of the Japan Corporate Governance Code

We are writing in response to the revised draft of the Japan Corporate Governance Code (the "Code") issued by the Tokyo Stock Exchange (TSE) for public comment on 6 April 2021 and Guidelines for Investor and Company Engagement (the "Guidelines"), issued by the Financial Services Agency (FSA) for public comment on 7 April 2021.

General comments

We welcome this second revision of the Code, first published in 2015 and amended in 2018, and appreciate that regulatory authorities in Japan have continued to review the document at regular three-year intervals. There are many new aspects to the Code that we welcome, as outlined below. There are also some high-level questions that we believe remain to be addressed and specific areas of the current Code that have been largely overlooked in this latest revision. We elaborate on all these points below.

Positive additions

We note the enhanced emphasis on **sustainability** in several areas of the Code and the Guidelines:

- Principle 2 promotes positive and proactive responses to sustainability issues.
- Principle 3.1.3 references the Taskforce for Climate-related Financial Disclosures (TCFD) as companies assess the impact of climate change-related risks and earning opportunities.
- Principle 4.2.2 calls on firms to develop a basic policy on sustainability initiatives.
- Guideline 1.3 asks whether a committee on sustainability under the board or management has been established.

These additions are welcome because they put greater emphasis on climate risk reporting and encourage boards to consider how to adapt to sustainability challenges and the changing external environment. As we argue in our new CG Watch 2020 report, titled "Future Promise: Aligning governance and ESG in Asia" and to be published on 20 May

ASIAN CORPORATE GOVERNANCE ASSOCIATION
Room 1801, 18th Floor, Wilson House, 19-27 Wyndham Street, Central, Hong Kong Tel 852 2160 1788 Fax 852 2147 3818

2021, many CG codes around the region are still relatively silent on how boards should address climate change and other sustainability issues.

Board diversity figures prominently in certain proposed revisions:

- Principle 2.4.1 asks companies to present diversity policies and goals, as well as the status of implementation on promoting women, foreign nationals and mid-career hires to middle managerial positions.
- Principle 4.11 adds work experience and age to board diversity considerations.
- Principle 4.11.1 encourages identifying gaps in skills and utilising a "skills matrix", as well as including independent directors with management experience.
- Guideline 3.6 adds work experience and age to its question on diversity considerations.

These principles encourage companies to think about diversity more broadly and in a more structured way. Utilising a skills matrix and appointing independent directors with business experience should enhance board quality and decision-making.

We firmly support proposed revisions that promote enhanced **internal audit** procedures and coordination with Kansayaku:

- Principle 4.13.3 asks companies to establish a system in which the internal audit department reports directly to the board and the Kansayaku.
- Guideline 3.11 asks whether the Kansayaku engages in discussions with the external auditor during the review process of key audit matters.

In our view, internal audit has not received sufficient focus in governance discussions in Japan in the past, despite the prevalence of accounting frauds. Clarifying reporting lines for internal audit should help to improve this critical function.

We are pleased to see an emphasis on higher standards in terms of **group governance**:

- Principle 4 includes an additional introductory paragraph stating that: "Controlling shareholders should respect the common interests of the company and its shareholders and should not treat minority shareholders unfairly, and accordingly, companies with a controlling shareholder are required to develop a governance system to protect the interest of minority shareholders."
- Principle 4.8.3 asks companies with a controlling shareholder to either:
    - Appoint at least one-third directors who are independent of the controlling shareholder (a majority for Prime Market constituents from April 2022); or
    - Establish a special independent committee to deliberate and review material transactions or actions that conflict with minority shareholder interests.

The governance problems of parent-child listings have become increasingly apparent in Japan in recent years. The new revisions should help to balance the scales in favour of

ASIAN CORPORATE GOVERNANCE ASSOCIATION
Room 1801, 18th Floor, Wilson House, 19-27 Wyndham Street, Central, Hong Kong Tel 852 2160 1788 Fax 852 2147 3818

minority shareholders; however we would note that much more needs to be done in this area to create a truly fair system for all shareholders.

We also note the greater attention paid to **board independence** in the revisions:

- Principle 4.8 calls for companies listed on the Prime Market to appoint one-third independent directors, and for those on other markets to appoint two.
- This principle also opens the way for Prime constituents to appoint a majority of independent directors (or at least one-third for those on other markets) depending on consideration of a number of factors.
- Principle 4.10.1 suggests the majority of remuneration and nomination committee members for Prime Market constituents be independent and that a policy on independence for these boards be disclosed.
- Guideline 3.8 asks whether the board ensures effective supervision of management, including appointing independent directors as chair when necessary.

These provisions should help to facilitate the continued development of a more independent mindset on the boards of larger companies in Japan. We believe, however, that the standards for Prime Market companies should be higher, as we argue below under "Specific issues".

Overall, the new measures outlined above should enhance the quality of corporate governance in Japan over time. But they do not answer all the challenges facing regulators, investors and listed companies. A number of pressing high-level questions need to be addressed as part of the reform process.

High-level questions

We focus on three questions that we consider important at this stage of Japan's CG reform process.

1. <u>Disclosure – where and when?</u>

The draft revisions do not specify where and when disclosures to comply with the Code are to be made. Although most issuers include them in their annual CG Report as required by TSE listing rules, the timing of such reports is less than ideal—they are usually published after the annual general meeting, typically held in late June—hence cannot inform voting at the AGM. The template format, moreover, lends itself to "boilerplate" (ie, formulaic) reporting with limited narrative explanation.

A better option would be to include this content in the Annual Securities Filing (*Yukashokenhokokusho*) as this is one of the most referenced documents among investors. This report is considerably longer than the CG Report and would allow for greater elaboration on CG practices by companies. It could also help to place a company's governance development in a firmer business and financial context. Unfortunately, this report also comes out after the AGM, hence cannot inform voting either. Instead, investors

ASIAN CORPORATE GOVERNANCE ASSOCIATION
Room 1801, 18th Floor, Wilson House, 19-27 Wyndham Street, Central, Hong Kong Tel 852 2160 1788 Fax 852 2147 3818

have to rely on the Business Report, a requirement under company law, and AGM proxy materials provided before the AGM for incomplete corporate governance information.

There is no simple solution to this problem under the current corporate disclosure regime in Japan. Reporting is governed by the Companies Act, the Financial Instruments & Exchange Act, and the TSE Listing Rules and there appears to be no move to simplify the framework to lower costs for issuers and make life easier for investors. The reporting regime is further complicated by the conventionally short AGM window of just three months in Japan, which puts considerable pressure on companies, auditors, and investors to get reporting, auditing, AGMs and voting over and done with as quickly as possible.

We note that the introduction to the CG Code and Guideline revisions encourages firms to disclose information early and we recognise that many companies are moving in this direction. Of the 25 Japanese issuers (15 large and 10 mid-sized) reviewed by ACGA for our new CG Watch 2020 report, the majority produce their CG Reports in Japanese and English either on the day of, or a few days after, their AGM. To be utilised properly by investors, however, these reports need to come out at least two to three weeks before the annual meeting.

While it is possible to imagine different short-term workarounds, the most sustainable long-term solution would involve consolidating all three reports into one published before the AGM. This is common practice in all developed and most developing markets and, indeed, Korea recently pushed large companies to release their "business report" (the annual securities report that is the equivalent of the Yuho) before AGMs. Such a reform in Japan should be combined with a longer period for AGMs.

2. "Comply or explain" vs mandatory requirements

The introduction to the revisions to the Code and Guidelines states that it is important for firms listed on the Prime Market to advance efforts toward a higher level of corporate governance. This highlights the expectation that Prime Market constituents will have demonstrated a higher level of corporate governance achievement than other firms.

There are a number of areas in the Code where the language implies that a certain standard must be met for a firm to be included as a Prime constituent, for example in revisions regarding independent directors: "Companies listed on the Prime Market should therefore appoint at least one-third of their directors as independent directors (two directors if listed on other markets)" and "Companies that have a controlling shareholder should … appoint at least one third of their directors (the majority of directors if listed on the Prime Market) as independent directors".

Such passages could be interpreted as optional because the Code follows a "comply or explain" approach, even though the expectation is that they will be treated as mandatory requirements. To reduce confusion, any specific principle in the Code that firms are

ASIAN CORPORATE GOVERNANCE ASSOCIATION
Room 1801, 18th Floor, Wilson House, 19-27 Wyndham Street, Central, Hong Kong Tel 852 2160 1788 Fax 852 2147 3818

expected to follow should also be incorporated into the TSE listing rules. Including mandatory requirements in the listing rules will eliminate any possible misunderstandings.

This approach has become common practice in many Asia-Pacific markets over the past two decades, with a clear overlap between the listing rules and parts of the local CG code. Hong Kong Exchanges and Clearing (HKEX) for example mandates audit and remuneration committees for all listed companies—and is proposing the same soon for nomination committees. HKEX listing rules set out the basic requirements on committee formation and composition, which for audit committees include: all members must be "non-executive directors"; the committee must have at least three members; a majority of members must be independent directors (INEDs); at least one INED must have relevant accounting or financial management expertise; and the chair must be an INED. The CG Code then elaborates in more detail how the committee should function, what its terms of reference should cover, and how it should assess the independence of the external auditor. The Code therefore provides practical guidance to companies and complements the rules.

3. The three board governance options

We note that the draft revisions in the Code firm up the language around voluntary nomination and remuneration committees by removing the adjectives "advisory" and "optional", and delete a footnote explaining they are not legally required for Kansayaku board or Audit and Supervisory Committee companies. Also, a majority of members of each committee should be independent directors if a company is listed on the future Prime Market, which will be implemented from April 2022.

These are welcome developments and indirectly touch upon a fundamental question in Japanese corporate governance: should the country's three board governance options be merged into one? We would support such a move because it would simplify the current system, which we feel is more complicated than it needs to be, and would allow for increased effectiveness and fuller development of board committees, including a much stronger audit committee structure and a proper legal basis for nomination and remuneration committees.

Specific issues

Despite the many positive changes, we note some omissions and weaknesses in the draft revisions. Since the Code serves as a best-practice document that enumerates a set of aspirational goals for the market, one question is whether it is fit for purpose given Japan's stage of governance development, its status as a major securities market for international investors, and in light of the needs of domestic pensioners and savers. We feel that the Code could be more ambitious. For example:

Independent directors – outdated standards

While we appreciate the attention paid to board independence, setting a basic standard for only one third independent directors for Prime constituents is quite outdated. This

ASIAN CORPORATE GOVERNANCE ASSOCIATION
Room 1801, 18th Floor, Wilson House, 19-27 Wyndham Street, Central, Hong Kong Tel 852 2160 1788 Fax 852 2147 3818

standard became the norm in several Asian markets some time ago and has since been surpassed by India, Korea, Malaysia and Singapore, all of which mandate that for certain types of companies, such as large issuers or those with a non-independent chairman, at least half the board or a majority must be independent directors. For one-third independence to still be the standard for the best-performing segment of the stock market in an advanced economy like Japan means the market is well behind the curve on corporate governance.

English disclosure

The code advises Prime Market constituents to provide necessary information in English. Indeed, many of the best firms already do this. We suggest phasing in English-language requirements to cover more kinds of disclosure and more listed companies, an approach that is being adopted in Taiwan. Under that system, beginning in 2020, listed companies with more than a 30% foreign shareholding or more than NT$10 billion (¥39 billion) in paid-in capital have been required under the listing rules to publish detailed shareholder meeting agendas (called “handbooks”) and supplementary information, annual reports and annual financial statements in English. From 2021, this has been extended to firms with more than NT$2 billion in paid-in capital and from 2023 it will apply to all listed companies. (For more information, please see: https://cgc.twse.com.tw/pressReleases/promoteNewsArticleEn/4003.)

Japan could consider a similar approach. For the sake of clarity, our recommendation would be to extend this beyond Prime Market companies and apply it initially to any issuer with a foreign shareholding ratio of 30% or more.

Sustainability governance

The introduction to the revision mentions that companies should consider and promote sustainability initiatives, including developing an oversight system such as a committee on sustainability and engagement with stakeholders, and also that responses on sustainability issues should be substantive rather than formulaic. We agree with the spirit of this statement and appreciate that Guideline 1.3 asks whether a committee on sustainability under the board or management has been established. However, we note that this has not carried over into concrete requirements for firms within the Code itself. Some of the principles call for positive and proactive responses to sustainability issues and basic policies on sustainability initiatives, but requirements for board governance and accountability on sustainability issues are not fully developed.

We recommend that the Code clearly emphasise the principle of board involvement and accountability for ESG reporting as well as sustainability strategy and governance. As the primary corporate governance guidance, the CG Code should take the lead here and be fully aligned with any other government ESG policy documents. The CG Code should lay down the basic principles of board oversight of ESG reporting and the minimum standards expected of companies in terms of board structure and skills on sustainability issues. In

ASIAN CORPORATE GOVERNANCE ASSOCIATION
Room 1801, 18th Floor, Wilson House, 19-27 Wyndham Street, Central, Hong Kong Tel 852 2160 1788 Fax 852 2147 3818

addition, we suggest adding references to other standards beyond TCFD, for example those established by the Sustainability Accounting Standards Board (SASB), the Global Reporting Initiative (GRI), CDP (formerly the Carbon Disclosure Project) and the Climate Disclosure Standards Board (CDSB).

AGM attendance – options for institutional investors
We were saddened to see that one of our long-standing concerns was not addressed in revisions under Principle 1.2 on shareholder rights. This relates to the right of shareholders to attend general shareholder meetings in their own name. Because many institutional investors hold shares via so-called "street names", they do not appear on company registers as shareholders and thus may not be allowed to participate fully in shareholder meetings. While Japanese companies are generally becoming more flexible regarding meeting attendance, it is still the case that some large issuers only allow foreign shareholders to attend AGMs as observers—and often in a separate room, watching proceedings on video! Absent an amendment to the Companies Act, the Code could encourage companies to let such shareholders attend the real AGM and ask questions.

Capital efficiency and cross-shareholdings
The revisions to the CG Code leave these two important and related areas largely untouched. While we observe that some companies have improved their shareholder returns by increasing their dividend payout ratios, their management should formulate coherent financial strategies that create positive economic value (that is to generate returns greater than the cost of capital). Robust financial strategies include not merely ad hoc buybacks and raised dividends, but also disposal of low-return businesses and assets, including cross-shareholdings.

While the code revision adds a supplementary principle (5.2.1) on the need for companies to present a clear policy on their portfolio of assets, and the status of their review of such assets, we believe this part of the Code could have been addressed in a much more robust manner. For example, companies could be required to explain how their capital allocation and management policy has contributed, or not, to a tangible improvement in corporate value over the medium to long-term. This includes cross-shareholdings but includes the broader issues noted above.

Definitions – common terms not defined
We note that there are several terms used throughout the Code and Guidelines that are not clearly defined, for example "sustainability", "value", "mid-term" and "long-term". We would suggest including a full definition, especially of "sustainability", and an explanation why this is considered to be desirable. Doing so would provide some guidance to firms on how to comply.

ASIAN CORPORATE GOVERNANCE ASSOCIATION
Room 1801, 18th Floor, Wilson House, 19-27 Wyndham Street, Central, Hong Kong Tel 852 2160 1788 Fax 852 2147 3818

We would be pleased to discuss any of the points in our letter further with you.

Yours sincerely,

Jamie Allen
Secretary General

*Neesha Wolf, ACGA Research Director – Taiwan and Supporting Research Director – Japan, contributed to this letter.

ASIAN CORPORATE GOVERNANCE ASSOCIATION
Room 1801, 18th Floor, Wilson House, 19-27 Wyndham Street, Central, Hong Kong Tel 852 2160 1788 Fax 852 2147 3818