

Secretariat's Explanatory Material

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1. Background of the Establishment of this Council of Experts (1)

(“Japan Revitalization Strategy” Revised in 2014)

Japan Revitalization Strategy Revised in 2014 (abridged)

Approved at a Cabinet meeting on June 24, 2014

II. Key Policy Measures in the Revised Strategy

1. Restoring Japan’s Earning Power

(1) Companies to change

(Enhancing corporate governance)

What should be done to increase Japanese companies' earning power, in other words, medium to long-term profitability and productivity and to pass the fruits of such increase on to the people (households) evenly? First, it is important to strengthen the mechanism to enhance corporate governance and reform corporate managers' mindset so that they will make proactive business decisions to win in global competition for the purpose of attaining targets including globally-compatible level in return on equity. Particularly, companies that have achieved the highest earnings in several years should be encouraged to proactively use their earnings for new capital investment, bold business realignment, mergers and acquisitions, and other deals, instead of accumulating internal reserves.

In response to last year's Growth Strategy, investors and companies have launched efforts to deepen their talks towards sustainably improving profitability and capital efficiency and enhancing corporate governance through the creation of a Japanese-version Stewardship Code, revision of the Companies Act to impose accountability on companies having no outside directors, and discussions on desirable investment of public and quasi-public funds. Under such circumstances, institutional investors have offered to participate in the Stewardship Code one after another. Companies have introduced outside directors one after another. Early this year, the JPX Nikkei Index 400 was launched as a new stock index covering companies that have higher profitability and are highly attractive for investors. Positive developments towards improving "earning power" are gaining momentum.

1. Background of the Establishment of this Council of Experts (2)

(“Japan Revitalization Strategy” Revised in 2014)

The time has come to further advance the environment for companies' demonstration of corporate governance and implement specific measures to improve companies' “earning power”. Based on the efforts so far, companies must link their proactive utilization of outside directors to the evolution of their business strategies, specify what values they would create in the long term and how they would enhance their earning capacity to win in global competition, and activate their communication with investors.

[Omitted]

Such series of initiatives will allow corporate earnings to expand further, bringing about a true virtuous cycle where the fruits of the breakaway from deflation will be returned finally to the people through various channels including increases in employment opportunities, wages and dividends.

IV. Major Policy Measures in the Revised Strategy

1. Restoring Japan's Earning Power

(1) Companies to Change

① Enhancing corporate governance

○Drafting the Corporate Governance Code

The Tokyo Stock Exchange will draft the Corporate Governance Code to encourage companies' initiatives to attain sustainable growth. Publicly listed companies are asked either to comply with the principles or explain why they are not complied with.

[Drafting in time for the season of general shareholders' meetings next year]

1. Background of the Establishment of this Council of Experts (3)

(“Japan Revitalization Strategy” Revised in 2014)

(II) Three Action Plans

1) Industry Revitalization Plan

1. Accelerating Structural Reform Program (Vitalizing industries)

(3) Specific New Measures to be Taken

As a result of initiatives conducted so far, companies are increasing moves to start how businesses and take steps to enhance profitability and productivity. From now on, in order to further encourage such moves, the government will further strengthen measures using new approaches.

i) Enhancing Corporate Governance, Promoting the Supply of Risk Money and Improving the Investment Chain

In order to increase corporate profits through improvement of productivity and ensure that the increased profits lead to increase of wages, reinvestment and the return of profits to shareholders, it is important – primarily for global companies – to achieve sustainable increases in corporate value by cost of capital and enhancing corporate governance.

[Omitted]

It is important to strengthen the favorable economic cycle by returning the benefits of economic growth achieved through these initiatives throughout the economy via the expansion of employment opportunities, wage increases, and increases in capital expenditures and distribution of dividends.

To that end, the following measures will be implemented.

1. Background of the Establishment of this Council of Experts (4)

(“Japan Revitalization Strategy” Revised in 2014)

1. Drafting the Corporate Governance Code, etc.

Corporate governance is the system which supports companies making timely entrepreneurial decisions with transparency and integrity and with due regards to the views of shareholders as well as customers, employees, local communities and other stakeholders. Principles outlining key elements of good governance should help companies’ initiatives towards sustainable growth of their corporate values and would thereby contribute to the prosperity of the companies themselves, investors and, ultimately, the whole economy.

The “Corporate Governance Code” will be drafted, specifying the principles of corporate governance to be applied by listed companies. The Code will be drafted by referring to, among other rules, the Tokyo Stock Exchange’s existing rules and guidelines regarding corporate governance, and the OECD Principles of Corporate Governance. The Code will, while reflecting the circumstances of Japanese companies, aim to attain international reputation. To that end, a council of experts of which the Tokyo Stock Exchange and the Financial Services Agency will jointly act as a secretariat, will aim to prepare key elements of the Code by around this autumn so that the Tokyo Stock Exchange can newly draft the Code in time for the season of general shareholders’ meetings in (June,) 2015. Effectiveness of the new Code shall be ensured through “comply or explain” approach. The listing rules of Tokyo Stock Exchange will require listed companies to either comply with the principles contained in the Code or explain the reason why they did not comply with such principles.

1. Background of the Establishment of this Council of Experts (5)

(“Japan Revival Vision” by Liberal Democratic Party of Japan, Japan Economic Revival Headquarters)

Liberal Democratic Party of Japan, Japan Economic Revival Headquarters, “Japan Revival Vision” (abridged)

Released on May 23, 2014

● Formulation of a Corporate Governance Code

In February this year, as proposed in the government’s “Japan Revitalization Strategy – Japan Is Back” (of June 14, 2013), a “Japan Stewardship Code” was introduced in order to clarify the fiduciary duty of institutional investors in their relationship with the companies in which they invest, and there has been consequent improvement in the behavior of company management and institutional investors, through improved communications. That said, European countries such as the UK, France, and Germany have formulated “Corporate Governance Codes” which set forth concrete best practices for corporate governance and unified disclosure of them, on the basis of comply-or-explain rules.

We propose that in a similar manner, Japan too should formulate a Corporate Governance Code, which would (a) require strict adherence to comply-or-explain rules, and (b) set forth concrete methods of sound corporate governance for listed Japanese companies, including introduction of independent directors, securing transparency in setting compensation and methods for nominating directors and appointing other top personnel, separation of execution and oversight functions, and practices for top management development and training.

In more concrete terms, there should first be created an expert committee with broad representation, supported by a joint secretariat from the FSA and the Tokyo Stock Exchange (TSE), which would compile by this autumn basic concepts for the Corporate Governance Code, based on best practices and OECD principles. Next, the TSE should formulate a concrete Corporate Governance Code in time for the general shareholders meeting season next year. The FSA should request the TSE to specify clearly the comply-or-explain rule in the listing regulations of the TSE.

The effectiveness of corporate governance will be enhanced by (a) clarification of the status of executive officers, and the duties of loyalty that they owe, none of which are prescribed by law; (b) requiring balance among directors from various viewpoints, such as experience, independence, and knowledge; and (c) disclosure of methods of corporate governance and explanation thereof by management. In addition, there is a need to build systems to enhance information flow within firms, such as an internal whistleblower system that feeds into both outside directors and statutory auditors.

1. Background of the Establishment of this Council of Experts (6)

(“Japan Revival Vision” by Liberal Democratic Party of Japan, Japan Economic Revival Headquarters)

- The Corporate Governance Code Might Include the Following

- ① Independent Outside Directors

For example, the TSE listing regulations might include best efforts at appointment of independent outside directors in the code of best practices, which requires firms to disclose the reasons why they believe it not appropriate for them to fulfill the requirements, if that is the case.

(Code Proposal)

- The issuers of listed equities must secure two or more independent directors on the Board of Directors.
- When two or more independent directors are not secured for the Board of Directors, at the scheduled general shareholders meeting of the said company, the firm must explain the reasons why it is not appropriate to have two or more independent directors on the Board.

- ② Shareholder Voice

Corporate governance is basically a method to govern the relationship between stockholders and managers, and heretofore most discussion has concentrated on governance of managers. However, in order to strengthen the effectiveness of governance, it is necessary to spur stockholders to perform their roles as well. That is, the awareness of institutional investors of their role as stockholders must be enhanced, and there is a need to encourage institutional investors to speak out in favor of improvement of corporate earnings. On this point, there is no fundamental difference between the position of institutional investors and listed companies, which owe a fiduciary duty toward the stockholders of their company.

(Code Proposal)

- In order for firms to raise firm value sustainably, and to promote growth of the firm, stockholders should responsibly exercise their rights. Specifically, in exercising voting rights, stockholders should:
 - Examine thoroughly the suitability and independence of candidates for directorships, in order to secure directors who can perform their functions;
 - Make decisions from a high-level, balanced perspective, from the viewpoint of raising the medium and long-term growth of the firm, through investments to raise productivity and return profits to shareholders.
 - Disclose adequate information for these purposes, in the case of issuers of listed equities.

1. Background of the Establishment of this Council of Experts (7)

(“Japan Revival Vision” by Liberal Democratic Party of Japan, Japan Economic Revival Headquarters)

- In particular, institutional investors must accept the principles of fiduciary responsibility (in the “Japan Stewardship Code”), the purpose of which is to promote the medium and long-term growth of companies through active consultation with firm management, and must disclose their share voting policies and vote results.

③ Stock Crossholding

Under Cabinet Office rules, when firms hold listed equities with voting rights as “policy stockholdings” (i.e. for purposes other than pure investment), for holdings listed on the balance sheet that exceed 1% of equity capital, there is a requirement to disclose: (a) the number of shares; (b) the amount on the balance sheet; and (c) the concrete reason for holding. However, this requirement is only a disclosure requirement.

In addition to this disclosure requirement, the following rules might be put into effect, for the purpose of clarifying compliance, and adding accountability concerning the reasons why the equities are held.

(Code Proposal)

- Crossholding of equities for “policy” reasons inevitably creates obstacles to effective governance, due to latent conflicts of interest concerning profit-seeking, return of profits to shareholders, and the interests of general stockholders. Hence, unless there is a rational reason, such policy stockholdings should be drastically reduced.
- When “policy stock” is held, the rationale for that holding must be explained in addition to the specific policy goal (e.g. in cases where there is a need for capital injections to raise the value of a company needing DIP finance, or new investments by banks for restructuring borrowers which are in danger of bankruptcy, or conversion of debt into equity).

2. Outline of the OECD Principles of Corporate Governance (Revised in 2004)

○ **The Rights of Shareholders and key Ownership Functions**

Protection of the rights of shareholders

Facilitation of the exercise of shareholders' rights

○ **The Equitable Treatment of Shareholders**

Ensuring the equitable treatment of all shareholders (including minority and foreign shareholders)

Effective redress for violations of shareholders' rights

○ **The Role of Stakeholders in Corporate Governance**

Respect of the rights of stakeholders other than shareholders

Encouragement of active co-operation between corporations and stakeholders

○ **Disclosure and Transparency**

Ensuring that timely and accurate disclosure is made on all material matters* regarding the corporation

*Financial situation, performance, ownership, foreseeable risk factors, etc.

○ **The Responsibilities of the Board**

Strategic guidance of the company

Effective monitoring of management

Accountability to the company and the shareholders

3. Corporate Governance Codes of Other Countries (1)

(Prescriptive Frameworks on Corporate Governance)

		Japan	UK	Germany	France	US
Principle-based and "Comply or Explain" style corporate governance codes		—	○	○	○	Rule-based CG approach (SOX Act, SEC Regulations, Listing rules)
	Regulations that require "Comply or Explain"	—*	Listing Rules	Stock Corporation Act	Commercial Code	
Ref.	Stewardship Code	○	○	—	—	—

*Under the Revised Companies Act of June 2014, a "Comply or Explain" approach has been taken that requires listed companies, etc. that do not have outside directors to "explain the reason why it is not suitable for their company to have outside directors."

In addition to the above, the countries listed to the right have also introduced principle-based and "Comply or Explain" style corporate governance codes.

Italy, Spain, the Netherlands, Belgium, Sweden, Denmark, Finland, Australia, New Zealand, Thailand, Malaysia, Singapore, Hong Kong, etc.

3. Corporate Governance Codes of Other Countries (2)

(Overview)

		UK	Germany	France	US
Name		The UK Corporate Governance Code	German Corporate Governance Code (KODEX)	Corporate Governance Code of Listed Corporations	—
		Established in 1998 (name changed in 2010)	Established in 2002	Established in 2008	—
Establishing Body	Parent Organization	Financial Reporting Council (FRC) *Independent self-regulatory body	Ministry of Justice	Association française des entreprises privées (AFEP) Mouvement des Entreprises de France (MEDEF)	—
	Committee established by the parent organization	Hampel Committee	Cromme Commission	Working Parties of AFEP and MEDEF	—

3. Corporate Governance Codes of Other Countries (3)

(Background of Code Formulation in the UK)

○ Cadbury Report (1992)

In 1991, the Financial Reporting Council (FRC), the London Stock Exchange, and the accounting profession established the Committee on the Financial Aspects of Corporate Governance primarily to discuss corporate accounting reports and accountability issues.

Chaired by Sir Adrian Cadbury (former chairman of Cadbury Schweppes), the committee issued its report in 1992, making recommendations regarding **the efficacy and reporting functions of boards of directors, and the role of external auditors.**

○ Greenbury Report (1995)

In 1995, triggered by the increasing concerns about the high executive pay in privatized utility companies, the Confederation of British Industry (CBI), under the direction of the government, established a Study Group on Directors' Remuneration.

Chaired by Sir Richard Greenbury (Chairman, Marks & Spencer), the committee compiled its report in 1995, with **recommendations on the establishment of remuneration committee comprised of Non-Executive Directors and the disclosure on the remuneration.**

3. Corporate Governance Codes of Other Countries (4)

(Background of Code Formulation in the UK)

○ Hampel Report (1998)

Following the request of the Cadbury Committee to establish a successor committee, the FRC, with support from the London Stock Exchange and the CBI, etc., established the Committee on Corporate Governance in 1995.

Chaired by Sir Ronald Hampel (Chairman, Imperial Chemical Industries (ICI)), the committee issued a report in 1998 in which it **formulated a wide range of principles related to corporate governance overall, including boards of directors, external auditors, and institutional investors.**

○ The Combined Code (1998)

In 1998, following the recommendation of the Hampel Committee, the London Stock Exchange combined the norms and principles presented in the previous three reports, the Cadbury Report, the Greenbury Report, and the Hampel Report, and **formulated the Combined Code* intended to serve as best practices in corporate governance in the UK.**

*Incorporated in the London Stock Exchange Listing Rules

○ Corporate Governance Code (2010)

In 2009, based on the Walker Review commissioned by the Chancellor of the Exchequer in response to the global financial crisis, the FRC disassembled and reconfigured the Combined Code to formulate the UK Stewardship Code, which applies to relationship between institutional investors and investee companies, as well as the Corporate Governance Code, which is related to discipline of companies' side.

3. Corporate Governance Codes of Other Countries (5)

(Background of Code Formulation in Germany)

○ Baums Report (2001)

In response to the internationalization of stock trading, in 2000, German Chancellor Gerhard Schroeder established a government committee on the modernization of corporate governance and the Stock Corporation Act.

Chaired by Professor Baums of the University of Frankfurt, the committee issued its report in 2001, **recommending the establishment of a corporate governance code, etc.**

○ KODEX (German Corporate Governance Code) (2002)

In 2001, based on the recommendations of the Baums Report, the Ministry of Justice established a government committee to draw up a corporate governance code that listed companies should comply with.

Chaired by Dr. Gerhard Cromme (Chairman of the Supervisory Board of ThyssenKrupp), the committee **published the KODEX** in 2002. KODEX contains comprehensive standards regarding shareholders' meeting, supervisory board and management board, transparency (information disclosure), annual reports, and account auditing.

3. Corporate Governance Codes of Other Countries (6)

(Background of Code Formulation in France)

○ Viénot Reports (I in 1995, II in 1999)

(1) Viénot I Report

Chaired by Marc Viénot (Chairman, Societe Generale) and comprised of other business leaders, the committee published the Viénot Report in 1995, primarily containing **recommendations regarding the functions and operation of boards of directors.**

(2) Viénot II Report

In 1999, following the request by the Viénot I Report for review after three years, the second version of the report was compiled, **adding new recommendations.***

*These included separation of the offices of chairman of the Board of Directors and chief executive officer, disclosure of the compensation granted to executive officers, and other issues related to the Board of Directors.

○ Bouton Report (2002)

In 2002, a committee chaired by Daniel Bouton (Chairman and Chief Executive Officer, Societe Generale) compiled and published a new report. It made **stricter recommendations than those in the Viénot Reports regarding the Board of Directors** and added **new recommendations regarding the independence of auditors and the financial information, etc.**

○ AFEP - MEDEF Code (2008)

In 2008, the AFEP (Association Française des Entreprises Privées) and the MEDEF (Mouvement des Entreprises de France), which had contributed to the creation of the Viénot and Bouton Reports, **created a code that integrated the recommendations of all three reports.**

3. Corporate Governance Codes of Other Countries (7)

(Comparison of Each Country's Code and the OECD Principles)

	OECD	UK	Germany	France	(For reference) TSE Corporate Governance Principles for Listed Companies
Key Headings	Preamble	Preface	1. Forward	Preamble	Introduction
	<p>I. Ensuring the Basis for an Effective Corporate Governance Framework</p> <hr/> <p>II. The Rights of Shareholders and Key Ownership Functions</p> <p>III. The Equitable Treatment of Shareholders</p> <p>IV. The Role of Stakeholders in Corporate Governance</p> <p>V. Disclosure and Transparency</p> <p>VI. The Responsibilities of the Board</p>	<p>A. Leadership</p> <p>B. Effectiveness</p> <p>C. Accountability</p> <p>D. Remuneration</p> <p>E. Relations with shareholders</p>	<p>2. Shareholders and the General Meeting</p> <p>3. Cooperation between Management Board and Supervisory Board</p> <p>4. Management Board</p> <p>5. Supervisory Board</p> <p>6. Transparency</p> <p>7. Reporting and Audit of the Annual Financial Statements</p>	<p>1. The Board of Directors: A Collegial Body</p> <p>2. The Board of Directors and the Market</p> <p>3. Separation of the Offices of Chairman of the Board of Directors and Chief Executive Officer</p> <p>4. The Board of Directors and Strategy</p> <p>5. The Board of Directors and the General Meeting of Shareholders</p> <p>6. Membership of the Board of Directors: Guiding Principles</p> <p>7. Representation of Employees</p> <p>8. Minority Shareholders</p> <p>9. Independent Directors</p> <p>10. Evaluation of the Board of Directors</p> <p>11. Meetings of the Board and of the Committees</p> <p>12. Directors' Access to Information</p> <p>13. Directors' Training</p> <p>14. Duration of Directors' Terms of Office</p> <p>15. Committees of the Board</p> <p>16. The Audit Committee</p> <p>17. The Committee in Charge of Appointments or Nominations</p> <p>18. The Committee in Charge of Compensation</p> <p>19. Number of Directorships for Executive and Non-Executive Directors</p> <p>20. Ethical Rules for Directors</p> <p>21. Directors' Compensation</p> <p>22. Termination of Employment in Case of Appointment as Executive Director</p> <p>23. Compensation of Executive Directors</p> <p>24. Information on Executive Directors' Compensation and the Policy of Awarding Share Options and Performance Shares</p> <p>25. Implementation of the Recommendations</p>	<p>1. Rights of shareholders</p> <p>2. Equal treatment of shareholders</p> <p>3. Relationship with stakeholders in corporate governance</p> <p>4. Disclosure and transparency</p> <p>5. Responsibilities of Directors, Auditors or Board of Company Auditors, and other relevant group(s)</p>

Reference 1: Principles of Corporate Governance for Listed Companies (Revised in December 2009)

1. Rights of shareholders

Respect of shareholders' basic rights

Due consideration to the infringement of rights of existing shareholders

2. Equal treatment of shareholders

Development and improvement of a system to prohibit transactions with conflict of interest

Enhanced disclosure of transactions with potential conflict of interest

Prohibition of special benefits provided to specified shareholders

3. Relationship with stakeholders in corporate governance

Cultivation of a corporate culture and development of internal systems respecting the positions of stakeholders

Development of internal systems for timely and accurate disclosure to stakeholders of material information

4. Disclosure and transparency

Enhanced disclosure of qualitative information that deepens the understanding of the management conditions of companies

Securing opportunities for investors to access information equally and easily

Development and improvement of internal systems to secure the accuracy and promptness of disclosure

5. Responsibilities of Board of Directors, Auditors or Board of Company Auditors, and other relevant group(s)

Monitoring of the management by the Board of Directors and Auditors or Board of Company Auditors and other relevant group(s)

Motivation for the management to maximize corporate value

Development and improvement of a mutual monitoring system by directors

Reference 2: Principles for Responsible Institutional Investors (Japan's Stewardship Code)

Background

○ Following the publication of **Japan Revitalization Strategy** (June 2013), the **Council of Experts** established by the Financial Services Agency (FSA) held meetings. Based on public comments from both within Japan and abroad, it finalized **Principles for Responsible Institutional Investors (Japan's Stewardship Code)** in February 2014.

Framework

- The Code allows each institutional investor to apply the Code in a manner suited to its own specific conditions and situations (as in the UK code).
- Expects each institutional investors to decide whether to accept the Code or not.
The FSA will publish the list of signatories(updated every three months), and thereby encourage more institutional investors to accept the Code.

[Status of Acceptance]

The first list was published on June 10, 2014. 127 institutional investors have signed up to the Code.

- Adopts a “**principles-based approach**” instead of a “rule-based approach”.
- Adopts the “**comply or explain**” (comply with the principles or explain why they are not complied with) approach as opposed to mandatory requirements like laws/regulations.

Principles

Institutional investors should:

1. disclose a clear **stewardship policy**,
2. properly manage **conflicts of interest**,
3. **monitor** investee companies,
4. arrive at an understanding in common with investee companies and solve problems through **engagement**,
5. have a clear **voting policy** and disclose voting activity,
6. **report** to clients/beneficiaries, and
7. have **skills & resources necessary for engagement**.

<<Key Features of the Japan's Code>>

- To ensure that the Code would be well balanced based on the actual business conditions in Japan:
 - It emphasizes the importance of improving and fostering the investee companies' corporate value, capital efficiency and “**sustainable growth**” from medium- to long-term perspective.
 - It promotes “**constructive engagement**” between institutional investors and investee companies.

List of references related to the International Codes (Section 3)

- *International Comparison of Corporate Governance* (Bunshindo), 2000, by Toshio Kikuchi and Mitsuhiro Hirata (Author and Editor)
- *Corporate Governance in the UK* (Hakuto Shobo), 2000, co-translated by Shinji Hatta and Takashi Hashimoto.
- *Corporate Governance and Accountability* (Shoji Homu), 2008, by Takaya Seki
- *Deutsche Corporate Governance* (Chuo Keizaisha) 2013, Nobuchika Kaido.