Appendix

Detailed Comments on the exposure draft of Japan's Corporate Governance Code (the Code)

1 THE COMPLY-OR-EXPLAIN MODEL

As noted in paragraph 12 on page 4 of the Code, the comply-or-explain model may not well known in Japan. Our experience in other markets where comply-or-explain model corporate governance codes have been implemented is that the model has been advantageous for many reasons. It is our opinion that the model:

- allows for market-based solutions for corporate governance to develop without the need for regulatory intervention;
- is sufficiently flexible to allow for special circumstances at company level to be taken into account as companies are encouraged to explain rather than required to comply;
- fosters dialogue; and
- supports long-term changes to corporate governance principles.

The success of a comply-or-explain corporate governance model is determined by: (i) how transparent companies are in terms of the corporate governance choices they make and (ii) how investors receive and interpret the disclosed information. To guide and help Japanese companies implement the Code and to minimize the use of generic or boiler-plate expressions, we recommend the Code elaborate more on the comply-or-explain principle. The Code should provide a benchmark for what constitutes a satisfactory explanation. An explanation should, for example, set the background, provide a clear rationale for action taken by the company, describe any mitigating actions, explain if a deviation from a particular provision is temporary, and indicate – if a deviation is temporary - when the company expects to conform to the provision.

UNIVERSAL APPLICABILITY

The Code includes the possibility of differentiated application of Code principles (paragraph 13 on page 6). We understand why the need for differentiation has been included, however the comply-or-explain model allows individual companies to apply the Code principles in accordance with their particular situation and we do not see a need for further differentiation. We do not believe that characteristics such as size, maturity or ownership concentration should be a determining factor when assessing the level of transparency required from companies. All companies should be capable of clearly explaining their governance model. It is likely that exemptions or special rules would be difficult to define, and could result in lower disclosure standards.

2 THE ROLE AND RESPONSIBILITIES OF THE BOARD

OVERSIGHT

We recognise the emphasis the Code puts on boards' responsibility to carry out independent, objective and effective oversight of management (Section 4).

The majority of Japanese companies have a *kansayaku* board governance model. This structure is unique to Japan, specifically with regard to the dominance of management on the board of directors

and the oversight role given to *kansayaku* boards. *Kansayaku* boards have a compliance focused oversight function and audit the performance of directors and management. The Code encourages *kansayaku* and the *kansayaku* board not to define their role too narrowly, but this corporate governance model does not support an statutory independent oversight function, as touched upon in principle 4.4.

We believe the Code should explicitly emphasise and explain what the independent supervision and monitoring role of the board of directors entails, regardless of the form of corporate governance model of the individual company. The board of directors should have a comprehensive understanding of its role. The directors represent shareholder interests and should be accountable to shareholders.

A board should include directors with an independent perspective and a balanced range of skills and competences that meet the specific and changing needs of the company. The composition of the board should give it the authority and knowledge to challenge strategy constructively and understand risk. The board should ensure that management operates the company in line with the corporate strategy as well as the direction communicated to shareholders. The appointment of the CEO and the succession plan process is the responsibility of the board.

RESPONSIBILITY FOR RISK MANAGEMENT

We support the view that the board has the responsibility for setting the risk framework, as expressed in principle 4.2. We believe the Code should go further by stating the board should proactively oversee risk management and ensure that the company has sound internal control and systems for risk management that are appropriate in relation to the company's activities. The board should review and approve the approach to risk management regularly and satisfy itself that the approach is functioning effectively. The board should adopt a comprehensive approach to risk, including all material aspects of risk such as financial, strategic, operational, environmental, and social risks.

BOARD EVALUATION AND THE NOMINATION AND ELECTION PROCESS

We are supportive of the Code's encouragement for companies to disclose information on board policies and procedures for the nomination of directors and *kansayaku* candidates (principle 3.1). The expectation of the Code is that the board will be balanced in terms of knowledge and experience in order to fulfil its roles and responsibilities (principle 4.11). More detailed disclosure on the individual candidate, his/her background, qualifications and core competencies, and rationale for nomination would support this expectation. Factors which may affect independence, including relationships with controlling shareholders, length of tenure, board and committee meeting attendance, and shareholdings in the company should also be disclosed.

3 SHAREHOLDER RIGHTS

FUNDAMENTAL SHAREHOLDER RIGHTS

Section 1 of the Code is focused on securing the rights and equal treatment of shareholders and encourages companies to take appropriate measures to fully secure shareholder rights. We believe the Code should be strengthened by the inclusion of specific references to fundamental shareholders' rights, such as the right to be sufficiently informed about and vote on fundamental issues. Such issues include the election and removal of board members, amendments to governing documents of the company, approval of material and extraordinary transactions such as mergers and acquisitions, and the authorisation of additional shares. Further, the board should be mindful of the dilution of existing shareholders and provide full explanations where pre-emption rights are not

offered. Shareholder rights plans ('poison pills') or other structures that act as anti-takeover mechanisms should be avoided. Any such structures should be put to a shareholder vote where only non-conflicted shareholders are entitled to vote. Plans should be time limited and put periodically to shareholders for re-approval.

RELATED PARTY TRANSACTIONS

We are pleased to see the Code focus on the responsibility of the board to establish appropriate procedures for related party transactions (principle 1.7). We stress the importance of full disclosure of all material related party transactions and the terms of such transactions to the market. The Code should go a step further and propose a precise definition of related parties. Such a definition should cover a wide range of ownership and business interests, including companies in the same group where any of the companies involved have minority shareholders.

The board should disclose the process for reviewing and monitoring related party transactions and the thresholds established for approval and disclosure. We believe the Code should encourage companies to establish a committee of independent directors to review significant related party transactions to determine whether they are in the best interests of the company and, if so, to determine what terms are fair and reasonable. Such a committee would align with the expectations in principle 4.7 of independent directors monitoring conflicts of interest between the company and the management or controlling shareholders.

The Code would be strengthened by advocating and setting thresholds for shareholder approval or independent third-party pricing verification of material related party transactions. Material transactions should be approved by shareholders or be verified by an independent third-party before consummation. For shareholder approvals, it is important that shareholders get sufficiently detailed information to understand potentially conflicting interests. For third-party verifications, the principle could specify the necessary requirements for the third-party assessment to be truly independent and relying on relevant data.

ANTI-TAKEOVER MEASURES

The Code establishes the responsibility of the board to examine anti-takeover measures and to provide sufficient explanation to shareholders (principle 1.5). We recommend that the Code encourage companies to avoid shareholder rights plans ('poison pills') or other structures that act as anti-takeover mechanisms. Any such structures should be put to a shareholder vote where only non-conflicted shareholders are entitled to vote.

4 DISCLOSURE AND TRANSPARENCY

SHAREHOLDER COMMUNICATION

We support the Code's encouraging companies to provide information beyond that required by law, with regard to both financial and non-financial information, as described in principle 3. We suggest that the Code also state that the board of directors has the responsibility for the entirety of the company's market communication. The board of directors has a choice as to how transparently and consistently the company informs shareholders. As presentation and explanation to the capital markets is a key responsibility of management, the board must assume responsibility for the way the company communicates.

A strong disclosure regime that promotes real transparency is central to shareholders' ability to understand corporate strategy and to exercise ownership rights on an informed basis. Our experience in countries with large and active equity markets shows that disclosure can be a powerful

tool for influencing the behaviour of companies and for protecting investors. A strong disclosure regime can help to attract capital and maintain confidence in the capital markets.

Principle 3.1.2 encourages companies to make disclosure in English. This principle should be strengthened by advising companies, within reasonable limits, to pursue full, real-time disclosure in English of all market relevant information. Having the same information available at the same time and with the same level of accuracy is a precondition for equal treatment of shareholders.

We support that the position shareholder dialogue is important is reflected in several principles, mainly in Section 5, but also in various principles in the other Sections of the Code. It would be useful if the Code also encourages all directors to make themselves - but not necessarily to the same extent - available for shareholder communication and that the board of directors must find a way to relate to shareholders.

TRANSPARENCY ON STRUCTURE AND HOLDINGS

We consider it very positive that the Code (principle 1.4) establishes the responsibility of the board to disclose any cross-shareholdings, including history and rationale behind the company's holdings in other companies. We believe this principle should also explicitly include disclosure of the shareholder structure of the company itself, detailing, when relevant, other companies' holdings in the company, structure of the group of companies the company is part of, intra-group relations, other major shareholders, and any shareholders with special voting rights. The disclosure should explain the type of relationship with the various shareholders.

SHAREHOLDER MEETINGS

We agree that an overly lengthy period between the closing of the financial accounts and the date of the general shareholder meeting should be avoided. We recommend that the date for reporting of audited financial results is brought forward so that the general shareholder meeting can also be held earlier to reduce the period in question. To our knowledge, the current market practice among Japanese companies for the release of audited accounts is approximately three months, which is in contrast to many other Asian markets where fully audited reports come out in less than 60 days after closing of the financial accounts.

The Code should encourage companies to shorten the period between the record date and the date of the general shareholder meeting. Companies should also be encouraged to help reduce the current clustering of shareholder meetings and the challenges this presents for shareholders to cast informed votes (especially foreign institutional investors who hold shares in a large number of Japanese companies).

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