(Provisional Reference Translation)

Publication of Principles for Preventing Corporate Scandals

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Japan Exchange Regulation

I. Background

In recent years, a large number of corporate scandals have emerged at listed companies and received frequent media coverage. These scandals have spread across industries, regardless of company size. Some have taken place in recent years, while others had long gone undetected before coming to light. Whichever the case, these scandals not only have a severely negative impact on society but also hurt the reputation of the company, inflict adverse effects on its business performance and stock price, and thereby damage its corporate value. Going beyond the consequences for individual companies, a capital market where high-profile scandals at listed companies are a common occurrence would lose its credibility due to perceptions of insufficient corporate governance.

In February 2016, Japan Exchange Regulation (JPX-R) published the "**Principles for Responding to Corporate Scandals.**" The document provides guidelines on how to address corporate scandals at listed companies, enabling companies to restore confidence quickly and recover corporate value steadily. Now that corporate scandals are no longer uncommon, however, there is an imperative need for listed companies to take effective measures to prevent the occurrence of corporate scandals. Thus, JPX-R has compiled a new set of principles that focus on preventive (ex-ante) measures against corporate scandals in addition to the aforementioned principles on responsive (ex-post) measures. JPX-R hopes that listed companies will attach due importance to these two sets of principles and endeavor to implement effective measures for achieving their intended aims.

The "**Principles for Preventing Corporate Scandals**" ("Preventive Principles") are a set of principles-based guidelines that encourage each listed company to take creative approaches in implementing each principle and to establish effective measures that reflect the company's individual situation. A failure to abide by the Preventive Principles alone will not constitute grounds for imposing adverse actions against the listed company, as long as the company has not committed a breach of the TSE Listing Regulations. Rather, JPX-R expects that the Preventive Principles will be used as a guide for exercising self-discipline. JPX-R also hopes that these principles will be shared with the lawyers and accountants who provide professional advice to listed companies, as well as with company shareholders and investors, thereby encouraging the companies to embody better corporate discipline.

Japan Exchange Regulation (JPX-R), a member of Japan Exchange Group, Inc., is a self-regulatory body under the Financial Instruments and Exchange Act that engages in listing examination, listed company compliance, market surveillance, and broker-dealers inspection for Tokyo Stock Exchange and Osaka Exchange. In accordance with the Listing Regulations, JPX-R has the authority to make judgments on adverse dispositions against listed companies in cases involving direct threats to the fundamental infrastructure of the capital market, such as false statements in Securities Reports, inappropriate disclosure, and violations of the Code of Corporate Conduct. On the other hand, JPX-R is not in a position to exercise direct authority on listed companies with regard to corporate fraud or inappropriate acts committed in the course of their business execution unless these acts constitute a violation of the Listing Regulations. JPX-R believes, however, that it is meaningful to share the intellectual assets that it has acquired through its operations, in the form of principles, for the sake of enhancing the credibility of Japan's capital market.

II. Principles

Principles for Preventing Corporate Scandals
- Protecting Corporate Value -

Listed companies are expected to refer to these principles when implementing measures for preventing corporate scandals (serious improper/inappropriate conduct, etc.) in order to enhance their effectiveness. It is crucial for company management, especially top managers (CEOs), to demonstrate integrity and leadership in addressing this issue.

Principle 1: Gain a thorough understanding of the actual situation

Companies should correctly grasp the current state of their own compliance system in terms of both rules and substance. In doing so, companies should pay attention not only to their compliance with written laws and regulations but also to their sincere, honest responses to stakeholders, including business partners, customers, and employees, and the credibility of their business operations in light of broader social norms. In this context, companies should not take their long-standing in-house customs and industry practices for granted. They should also be keenly aware of the changing social perceptions of the norms over time.

Companies should ensure that its systems for understanding actual conditions function on a continuous, autonomous basis.

Principle 2: Fulfill responsibilities with a sense of mission

Company management should commit to the compliance effort and continually publicize its dedication thereto. In addition, management should set business goals and conduct business in line with the company’s real capabilities and the market situation so as not to induce non-compliance.

Audit bodies and supervisory bodies should always be clearly aware of the importance of their disciplining function and should act proactively based on the necessary and sufficient information and objective analysis and evaluation.

Companies should give due consideration to the appropriate organizational design and the resource allocation to ensure the steady functioning of the above.

Principle 3: Encourage two-way communication

Companies should encourage two-way communication between workforce and management, enabling both parties to share a sense of compliance. In this context, the awareness and behavior of middle management is highly crucial in collecting opinions from workforce and conveying them to top management.

Such enhanced communication will help detect cases of non-compliance at an early stage.

Principle 4: Detect non-compliance early and respond swiftly

Companies should detect cases of non-compliance at an early stage and respond to them swiftly in order to prevent individual cases from developing into serious corporate scandals.

Companies should establish this cycle of early detection, swift response, and subsequent corrective action and embed the process into their corporate culture.

Principle 5: Execute consistent business management throughout the entire corporate group

Companies should execute effective business management throughout the entire corporate group. When building its management structure, companies must pay sufficient attention to the importance of each group company and the potential risks involved in line with its overall structure and characteristics.

Overseas subsidiaries and acquired subsidiaries, in particular, require highly effective management in accordance with their individual characteristics.

Principle 6: Be accountable in view of the relevant supply chain

Companies should be aware of their positions in the relevant supply chains so that they are prepared to fulfill their due responsibilities when a serious problem occurs at their outsourcing contractors, suppliers, or distributors.

III. Detailed explanations

Principle 1: Gain a thorough understanding of the actual situation

Companies should correctly grasp the current state of their own compliance system in terms of both rules and substance. In doing so, companies should pay attention not only to their compliance with written laws and regulations but also to their sincere, honest responses to stakeholders, including business partners, customers, and employees, and the credibility of their business operations in light of broader social norms. In this context, companies should not take their long-standing in-house customs and industry practices for granted. They should also be keenly aware of the changing social perceptions of the norms over time.

Companies should ensure that its systems for understanding actual conditions function on a continuous, autonomous basis.

(Explanations)

1-1 Having an accurate, thorough understanding of compliance status is the first step in preventing scandals. While knowing about the compliance systems, structures, and operations represents a significant part of that awareness, a firm grasp on what the corporate culture embodies and how fully the different levels of the company organization have embraced that identity is also vital to identifying weaknesses and signs of potential scandals. Instead of simply assuming that their existing compliance structures are working well, companies should take a self-critical approach and look at things objectively.

1-2 Compliance goes beyond conforming to written laws, regulations, and rules—it also involves responding to business partners, customers, employees, and other stakeholders in a sincere, honest way and conducting business in accordance with social norms, sound common knowledge, and business ethics on an even broader scope.

Perceptions of prevailing social norms can change over time, however. A company's long-standing customs and familiar industry practices, for example, could fall out of step with social conventions, grow into empty routines, or end up deviating from the changing social mindset. Always aware of those possibilities, companies need to be sensitive to voices from both inside and outside their organizations as they assess compliance.

1-3 Companies should have well-oiled mechanisms for relaying firsthand information from workforce to management via ordinary operational reporting lines. To safeguard against the problems that can come with clogged reporting lines, however, companies also need to establish structures for analyzing and processing internal whistleblowing, external complaints, and input from shareholders and investors as appropriate so that management can maintain access to accurate information should the conventional communication channels break down.

It is important to make sure that these mechanisms for establishing a clear, accurate understanding of the actual situation take root throughout the company organization and continue to function on a continuous, autonomous basis.

1-4 Proactively disclosing information on the company's conditions and measures taken and thereby making use of external disciplining engine is another effective practice.

(Examples of problems that have led to scandals)

- ✓ The company carelessly adhered to outdated practices in violation of internal rules for inspection processes or quality confirmation, thereby letting non-compliance transpire undetected
- ✓ The company regularly allowed and/or forced employees to work illegal levels of overtime and neglected to address harassment disrespecting social norms, which developed into a social issue
- ✓ The company lacked appropriate whistleblowing structures, and whistleblowing was concealed and not properly reported

Principle 2: Fulfill responsibilities with a sense of mission

Company management should commit to the compliance effort and continually publicize its dedication thereto. In addition, management should set business goals and conduct business in line with the company's real capabilities and the market situation so as not to induce non-compliance.

Audit bodies and supervisory bodies should always be clearly aware of the importance of their disciplining function and should act proactively based on the necessary and sufficient information and objective analysis and evaluation.

Companies should give due consideration to the appropriate organizational design and the resource allocation to ensure the steady functioning of the above.

(Explanations)

2-1 Compliance success also depends on verbalizing management's commitment to compliance and implementing various measures to establish a company-wide awareness of that core stance, including consistent, ongoing internal communications.

As part of its commitment to compliance, management should both actively evaluate employees' compliance practices, identify where the responsibility lies (including management) for any non-compliance that comes to light, and respond accordingly. Unrealistic profit targets that overestimate actual capabilities and quality standards, deadlines, and other conditions that ignore the actual situation often induce non-compliance.

2-2 For audit bodies (*Kansayaku*, *Kansayaku* boards, audit committees, supervisory committees, and internal audit divisions) and supervisory bodies (boards of directors, nomination committees, and similar bodies) to function properly and effectively, companies need to collect the necessary and sufficient information, analyze and evaluate the information from an objective standpoint with an eye to social attitudes, and establish a structural framework for facilitating the organizational operations. Companies should also pay close, careful attention to any conflicts of interest with their audit and supervisory organizations by taking steps to prevent what amounts to "self-auditing," among other measures.

Audit and supervisory bodies should proactively seek out factors that could trigger scandals and, if signs of potential non-compliance emerge, address the issues with a sense of mission.

Audit and supervisory bodies also serve a disciplining function that includes not only day-to-day activities but also the processes of appointing and dismissing executives as necessary in view of their individual qualifications and aptitude levels.

(Examples of management-related problems that have led to scandals)

- ✓ Top management set profit goals with short-sighted targets disregarding actual business capabilities and pursued achievement of these targets as the top priority. Personnel were forced into the mindset that they needed to meet targets by any means (including compliance violations), thereby leading to accounting fraud
- ✓ Management (top management or in-the-field management) aggressively set unrealistic deadlines that the production floor simply could not meet, thereby forcing personnel into working conditions prone to quality-related non-compliance

(Examples of audit-related problems that have led to scandals)

- ✓ The company appointed a former chief financial officer (CFO) to oversee audits (to serve as an audit committee member) for an accounting period that he/she was directly involved in, thereby leading to a conflict of interest and endangering audit effectiveness
- ✓ The company adopted a company framework with three committees (nomination, audit and remuneration), but rendered the board of directors, nominating committee, and audit committee, etc., unable to assess and address the qualifications of top-level managers in the appointment/dismissal process and lost the governance functions of these committees

(Examples of organizational design and resource allocation problems that have led to scandals)

- ✓ The company appointed the same individual to oversee both the manufacturing and quality assurance divisions of a given business unit, thereby endangering the effectiveness of the unit's quality assurance function
- ✓ The company failed to secure adequate resources (personnel and systems) to give its quality assurance division what it needed to perform its duties

Principle 3: Encourage two-way communication

Companies should encourage two-way communication between workforce and management, enabling both parties to share a sense of compliance. In this context, the awareness and behavior of middle management is highly crucial in collecting opinions from workforce and conveying them to top management.

Such enhanced communication will help detect cases of non-compliance at an early stage.

(Explanations)

3-1 Solid, two-way communication and a shared awareness of compliance between workforce and management are mutually beneficial, a synergistic pairing that forms a powerful deterrent against scandals.

When working to improve that two-way communication, management should make an active effort to understand issues in the field—embodying an openness to frank comments from workforce in the field—and demonstrate its commitment to acting on that input.

3-2 Middle management, which constitutes the main link between workforce and top management, is responsible for understanding and sharing messages of top management, and enrooting the messages in the field, and consolidating and conveying input from workforce to top management. For this “hub” to function as fully as possible, top management should lay out the roles of middle management in clear, specific terms, positively evaluate middle management, and make sure that middle management understands its roles well.

Good two-way communication helps prevent scandals that could potentially arise out of awareness gaps between workforce and management, including target-settings that ignore the actual situation.

3-3 With effective channels of communication in place, companies benefit from a stronger awareness of compliance in the field, a more active flow of information from employees to management, and early detection of potential problems.

(Examples of problems that have led to scandals)

- ✓ Management unilaterally set profit targets disregarding actual business capabilities and continuously demanded that the workforce meet the goals, which not only demoralized middle management and the workforce but also sapped awareness of responsibilities and compliance across the company organization
- ✓ While management was trying to push through unrealistic production targets and deadlines that ignored the capabilities of the field, the workforce found itself unable to make its voice heard and began to assume that management would never listen to its input
- ✓ Management relied too much on the traditional notion of “(effective) independent field-level operations,” creating a communication barrier between the workforce and management and a corporate culture in which it was impossible to establish a shared awareness of problems and issues. As a result, management overlooked compliance violations at the manufacturing site for many years, thereby aggravating the scandal

Principle 4: Detect non-compliance early and respond swiftly

Companies should detect cases of non-compliance at an early stage and respond to them swiftly in order to prevent individual cases from developing into serious corporate scandals.

Companies should establish this cycle of early detection, swift response, and subsequent corrective action and embed the process into their corporate culture.

(Explanations)

4-1 Every company needs to assume that improprieties could arise at any time; eradicating that potential completely is impossible. The key to preventing scandals from occurring, then, is spotting and eliminating the seeds of improper conduct before they have a chance to grow.

Adhering to Principles 1, 2, and 3, companies should thus strive to detect non-compliance as early as possible and respond swiftly. That initial corrective action then lays the groundwork for business improvements, which companies can shape by extending their investigations whether similar non-compliance or analogous situation exists in other departments, divisions, and group companies, and identifying common root causes.

Making that cycle a self-propelling, continuing element of corporate culture can stop non-compliance from developing into a major scandal. This effort helps deter non-compliance from occurring in the first place.

4-2 When management continuously exhibits an active, demonstrable commitment to compliance and corresponding improvements, compliance takes on a deeper importance throughout the company. Creating systems for evaluating the improvement cycle, too, can have substantial benefits.

4-3 However, compliance activities with no clear objectives and an emphasis on overly formal, hollow rules can reduce the efforts to mere facades of their actual intent and breed “compliance fatigue” in workforce. Companies should thus aim for meaningful, applicable projects, maintaining a focus on key issues.

(Examples of problems that have led to scandals)

- ✓ The company learned of an instance of internal non-compliance from multiple sources, but the department in charge of the investigation judged that there was no problem following only superficial hearings. As a result of the absence of proper corrective action and problem-sharing, the incident was recognized only after being pointed out by external observers, thereby seriously damaging corporate value
- ✓ The company adopted measures in hopes of preventing past scandals from recurring, but the company’s initial response entailed merely perfunctory measures, and personnel regarded such measures as meaningless tasks. Thus, such practice became a mere façade and failed to take root in a self-sustaining manner. As a result, similar scandals occurred again subsequently

Principle 5: Execute consistent business management throughout the entire corporate group

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Overseas subsidiaries and acquired subsidiaries, in particular, require highly effective management in accordance with their individual characteristics.

(Explanations)

5-1 Corporate scandals, whether they occur at the head company or a group company, can have a serious impact on the value of the corporate group. In accordance with the Principles, it is important for companies developing business with a large number of group companies to establish a framework to ensure that their reporting lines (including chains of supervisory command) covering their subsidiaries, affiliates, and other similar organizations function and that supervisory functionality is demonstrated.

Consistent, group-wide compliance policies are vital, even in cases where some group companies have a certain degree of independence in terms of management and operations.

5-2 Companies with overseas subsidiaries and acquired subsidiaries, in particular, need to implement their business management with the following points in mind.

- That the geographical distance between the head company and its overseas subsidiaries/sites can limit the frequency of audits and that numerous factors, including differences in language, culture, accounting standards, and legal structures, can weaken business administration, and other elements.
- That mergers and acquisitions require companies to gather a sufficient base of the necessary information, make sufficient assessments of the necessary management frameworks in advance, and then promptly build and operate effective management frameworks after acquiring their targets.

(Examples of problems that have led to scandals)

- ✓ An overseas subsidiary failed to report a problem to the company due to a lack of clear standards and frameworks for information sharing. As a result, detection of and response to the problem was delayed, which led to serious damage to corporate value
- ✓ The company’s management structure did not properly align with the subsidiaries’ degree of independence for a prolonged period. As a result, the company had insufficient control over an overseas subsidiary and overlooked compliance violations by the subsidiary’s management
- ✓ Despite already knowing about compliance risks pertaining to an acquisition target, the company failed to establish a corresponding management structure after acquiring the subsidiary. As a result, the compliance violation in the acquired business came to light before the company took effective preventive measures, which invited social criticism of the company

Principle 6: Be accountable in view of the relevant supply chain

Companies should be aware of their positions in the relevant supply chains so that they are prepared to fulfill their due responsibilities when a serious problem occurs at their outsourcing contractors, suppliers, or distributors.

(Explanations)

6-1 In today's industrial sphere, consignment, subcontracting, and outsourcing dominate the supply chains for products and services. In light of these trends, it is highly fruitful for companies to be fully aware of their roles across the supply chain—a span that extends all the way to the end customer.

There are now numerous examples of companies losing social credibility and having to shoulder considerable blame due to problems at their outsourcing contractors, suppliers, or distributors. By recognizing and fulfilling their roles as relevant parties within their supply chains and fulfilling their roles accordingly, companies can better mitigate the negative impact that escalating scandals and conflicting responsibility arrangements can have on corporate value.

6-2 It is also important for companies to be clearly aware of their responsibility for supervising their subcontractors and, if necessary, monitor their subcontractors' business performance.

Outsourcing agreements may define the responsibilities of the relevant parties in specific, contractual terms, but it is beneficial for each company involved to look beyond those provisions and understand its position and responsibilities within the entire supply chain under normal circumstances. When an emergency arises, that awareness helps companies act quickly and appropriately in fulfilling its accountability to customers and its other stakeholders.

(Examples of problems that have led to scandals)

- ✓ An information leak occurred because the company had insufficient control over its security authorizations for outsourcing subcontractors, thereby damaging the company's credibility
- ✓ In addition to legal liability for product accidents, the company neglected to manage its supply chain properly, failed to pinpoint the root causes of the incident, and was not accountable. As a result, distrust was fostered among the company's customers and stakeholders, and the company's credibility was damaged
- ✓ The companies operating in a multilayered structure lacked accurate recognition of the business activities of each party (outsourcers, contractors, subcontractors, and sub-subcontractors). As a result, when false data was discovered in a crucial construction process, fact-finding and explanation of the incident was delayed, thereby leading to distrust among stakeholders such as customers and shareholders
- ✓ Due to the company's insufficient awareness of social issues, its brand value suffered when a third-party organization found evidence of oppressive working conditions at one of the company's manufacturing subcontractors abroad