

Corporate Governance Reform in Japan

Japan Corporate Governance Forum
with ACGA



金融庁

Financial Services Agency, the Japanese Government

May 25, 2023

Summary of discussions at the previous meeting (27th meeting on 16 May 2022) (1)

- ❑ At the previous meeting of “Council of Experts Concerning the Follow-Up of Japan’s Stewardship Code and Japan’s Corporate Governance Code” (hereinafter the “Council”), as part of the interim review after the re-revision of the Corporate Governance Code, the Financial Services Agency (JFSA) organized empirical research and conducted interviews with companies, and discussions were held based on the results.
- ❑ While some respondents supported the direction and effectiveness of corporate governance reforms, others pointed out issues relating to management, the quality of directors, the quality and scope of engagement, and the legal system.

Interim review: (1) reviewed empirical research on corporate governance, and (2) interviewed 16 listed companies about their corporate governance-related initiatives and reactions to them.

1

Overview of empirical research

- Not a lot of empirical research covering the period after the implementation of corporate governance reform in Japan has been conducted as yet, and the results are varied. Therefore, **their effect on corporate performance remains to be seen.**

Outside directors: A relatively large amount of Pre-reform research indicated that appointment of outside directors boosts market valuation. On the other hand, much Post-reform research indicated that there was no significant relationship with corporate value

Committee: Establishment of nomination committee and remuneration committee will improve ROA

Capital policy: Reduction of surplus cash by companies with poor capital efficiency boosts market valuation

Cross-shareholding: The profit margin is lower at companies with more cross-shareholdings and the profit margin will improve upon their sale. Unwinding cross-shareholdings contributes to increased share repurchases and dividends, but does not contribute to increased R&D, investment in tangible assets, or M&A.

Dialogue: Engagement with institutional investors leads to better governance and higher share prices.

Shareholders: The high ratio of active investors improves R&D performance in the manufacturing industry, and the high ratio of institutional / foreign investors leads to higher productivity (ROA) and market evaluation.

2

Overview of interviews with companies

- Many companies have commented that "enhanced deliberations by the board have had a positive impact on corporate management" and "useful suggestions for management have been obtained from dialogue with investors," suggesting that **the direction and effectiveness of reform are widely supported.**
- On the other hand, there were concerns that the Corporate Governance Code's **demands on the details of corporate management may lead to formalistic responses by companies, resulting in counter-productive reforms.**
- It was noted that a higher quality dialogue should be promoted by addressing the following issues:
 - **Voting rights are exercised and advised in a mere box-ticking manner** by institutional investors and proxy advisors
 - **Lack of opportunities for dialogue**, particularly at medium-sized and smaller companies
 - **Difficulty in identifying beneficial shareholders**

Summary of discussions at the previous meeting (27th meeting on 16 May 2022) (2)

Discussions: The main opinions expressed in the discussions among experts based on the interim review are as follows:

Evaluation of Corporate Governance Reforms

- The reforms have **improved the formal governance** of listed companies, and many companies share **the view that it is important to enhance the supervisory function of the board** in order to improve corporate value.
- Dialogue between companies and institutional investors is **gradually moving toward the larger goal of making the investment chain work**.

Responses to formal compliance by companies with the Corporate Governance Code

- There should be a shared recognition that **“comply” and “politely explain” are of equal value**.
- With the “principle-based approach” not firmly established, **further branching of the Code should not be implemented, or the need for further enhancement of the Code is not large**.

Management issues

- **It is necessary to ensure that an awareness of cost of capital takes root in companies**.
- **Human capital costs and R&D costs** should be linked to corporate value, such as the company’s purpose, and communicated with investors to **make the value visible**.

Improving the quality of directors, exercising the functions of the board of directors, and the role of execution

- **The biggest obstacle to the substantiation of reform is the quality of those who carry it out (independent directors and executive officers)**.
- **The mission of the President and CEO is to discuss and share the management vision at the board, and once a vision has been put together, explain it to investors, employees and the unions**.

Issues related to engagement between companies and investors

- The issue for institutional investors is **the risk of deterioration in the quality and quantity of engagement** in corporate governance, and this issue should be focused on.
- Shareholders, investors and related parties should aim to **improve the effectiveness of the Stewardship Code** by enhancing corporate value through constructive dialogues with companies, instead of making judgements in a mere box-ticking manner.

Institutional issues

- The definitions of **“joint holder”** and **“act of making important suggestions”** under the large shareholding reporting system **should be clarified**.
- **It is desirable for a company and other shareholders to identify the beneficial shareholders without difficulty, so that the management can access institutional investors and other shareholders can take more appropriate action**.

Issues and expected initiatives in reforms

Japan Corporate Governance Forum

- ❑ To accelerate and strengthen corporate governance reforms, JFSA established the Japan Corporate Governance Forum (hereinafter the “JCGF”) to hear a wide range of opinions from stakeholders, including overseas investors.
- ❑ In JCGF, while some praised the improvements in corporate governance, the following issues were pointed out: (1) management issues, such as encouraging management with an awareness of profit-making and growth based on the cost of capital and promoting initiatives relating to sustainability, including human capital; (2) issues related to the effectiveness of independent directors; and (3) issues related to dialogues between companies and investors.

Prime Minister Kishida’s Remarks at the New York Stock Exchange (NYSE) September 22, 2022

JCGF event history

One very important policy is corporate governance reform. [...] We will accelerate and further strengthen corporate governance reforms in Japan, such as **establishing a forum in the near future to hear from investors from around the world.**

- 1st Forum held on Tuesday, September 27, 2022, with Asian Corporate Governance Association
- 2nd Forum held on Monday, October 3, 2022, with International Corporate Governance Network
- 3rd Forum held on Thursday, January 12, 2023, with U.S. investors, etc.

Main opinions in JCGF

General

- **Corporate governance reform, including corporate mindset, has begun to make substantial progress. Although there are still some issues, we look forward to further progress.**

Issues related to management and effectiveness of independent directors

- **The importance of capital efficiency is being recognized, but it is not recognized by all companies.** Issues include accumulation of cash, low ROE, and a large number of companies with PBR below 1.
- **Board diversity, including gender perspective, and disclosure on human capital** are needed.
- **Effectiveness of independent directors, such as strengthening the roles of the nomination / remuneration committee and ensuring the independence of the board** are needed.

Issues related to dialogue between companies and investors

- Fiduciary responsibilities in index investment have not been fully fulfilled, and it is necessary to improve the treatment of investment personnel.
- It is necessary to **enhance disclosure**, such as submission of Annual Securities Reports prior to general shareholders meetings.
- It would be useful to **enhance English disclosure and make visible companies with good corporate governance.**
- It is **necessary to review the legal system** from the perspective of promoting and substantiating engagement and protecting minority shareholders.
- **There are concerns that listed subsidiaries may harm the interests of minority shareholders** and that there is **a large number of cross-shareholdings.**

Main opinions in the Japan Corporate Governance Forum (1)

Evaluation of corporate governance reforms

- Several years after the formulation of both codes, at long last, substantial progress has begun on corporate governance reforms, including corporate awareness, and we are confident that Japan's governance reforms will continue.
- Improving corporate governance does not mean immediate improvement in business performance. It is necessary to take a long-term view. There is no doubt that it is moving in a good direction.
- While we are aware of improvements in corporate governance in Japanese companies, the pace of progress is slow in some areas.

Issues for mid - to long-term enhancement of corporate value

Raising awareness of cost of capital

- Although awareness of the importance of improving ROE and capital efficiency is increasing, this is not always the case.
- Factors such as capital efficiency, growth potential, and ROE are very important for investors to include in their portfolios.
- Accumulation of cash is a major issue, and investing cash contributes to the Japanese capital market and economy.
- Companies with extremely low ROE or PBR below 1 have been able to continue their business without any penalty.

Initiatives on sustainability issues, including human capital

- Increased disclosure of human capital is a recent trend, and training employees to improve their skills, disclosure of investment in employees, and targets for the percentage of female directors are particularly important.
- The biggest expectation for the Japanese economy going forward is wage increases, which in turn would raise the target investment yield and the cost of capital for Japanese stocks, leading to higher ROE.
- Improving gender diversity of company boards is a pressing issue.
- It is important to increase the number of foreign directors in addition to female directors.

Effectiveness of independent directors

- The percentage of companies with independent directors accounting for the majority on their boards falls far short of global standards.
- While the number of independent directors is increasing, there is also a tendency for them to be sent by the companies they own shares in.
- Directors are obligated to the company, and outside directors working for the CEO are not eligible.
- The lack of human resources to serve as directors is an issue, and it is not desirable for the same person to serve concurrently as an outside director at several companies.
- A major problem is that there is no institutional requirement to separate the CEO from the Chair of the board.
- It is important for independent directors to serve as chairs of committees and to bring external opinions to committees.
- In order to strengthen the roles and responsibilities of nomination/remuneration committees, it is necessary to improve transparency to investors.

Main opinions in the Japan Corporate Governance Forum (2)

Investor initiative

- Fiduciary responsibility in index investment has not been sufficiently fulfilled.
- Low salaries hinder the development of investment personnel. Treatment as investment personnel should be improved.

Enhancement of disclosure

- In order to further provide information to investors, Annual Securities Reports should be submitted 30 days before the general shareholders meeting.
- The timing of general shareholders meetings is concentrated over two to three weeks, making it impossible to exercise voting rights based on analysis of the company and due consideration.
- Some companies do not want to meet investors, and top management in particular is not easily accessible.

Promoting dialogue with global investors

- Visualizing companies with outstanding corporate governance practices is useful for improving investor confidence and incentivizing companies.
- English disclosure should be further expanded.

Legal and institutional issues

- The scope of "act of making important suggestions" and "joint holders" under the large shareholdings reporting system is still unclear, and it is necessary to further clarify the interpretation of it in order to promote and substantiate collaborative engagement.
- A partial takeover bid would be too coercing for minority shareholders. If a takeover bid system similar to that in Europe is introduced, the benefits for minority shareholders would be great.

Market environment issues

- It is questionable that a listed subsidiary is justified in terms of the market for minority shareholders and investors. There are cases where the parent company is not aware that it is harming the interests of minority shareholders of the subsidiary.
- Cross-shareholdings remain a problem, and even in cases involving business tie-ups, which are often justified on the grounds of economic benefits, there is a lack of transparency in corporate governance.
- In order to determine the success of corporate governance reforms, it is important to create a market environment that facilitates M&As. In a market environment that is prone to M&A pressure, management will pay more attention to ROIC, and there will be pressure to unwind cross-shareholdings.

Survey on Stewardship Activities (1)

- ❑ In order to promote more effective implementation of stewardship activities, JFSA commissioned Mizuho Research & Technologies to conduct a survey of actual stewardship activities by institutional investors, analyze issues, and make recommendations based on these results. From January to March 2023, the survey, in the form of a questionnaire survey of 136 institutional investors and an interview survey of 16 companies, was conducted.
- ❑ As a result of the survey, the following issues were pointed out: (1) Lack of resources (human resources and time) for engagement, (2) Insufficient behavioral changes and attitudes at investee companies, (3) Room for improvement in process development (PDCA cycle), (4) Lack of incentives to allocate costs and budgets to activities. In addition, the individual efforts of each asset manager to address these issues were aggregated.

Issues pointed out as a result of the survey

- | | |
|--|--|
| 1
Lack of resources (human resources and time) for engagement | <ul style="list-style-type: none">● There is a shortage of human resources with the necessary skills and capabilities to conduct effective stewardship activities at each asset management firm and in the industry as a whole.● In cases where it is difficult to secure and develop sufficient human resources in-house, it is expected that external knowledge will be utilized through collaboration with other asset managers, including collaborative engagement. However, the interpretation of "joint holders" under the large shareholding reporting rule is unclear, and the burden of the collaboration is concentrated in some asset managers, so resources may not be sufficiently supplemented through the collaboration.● As a result of the selection of companies for engagement, small and medium-sized companies tend to be excluded. |
| 2
Insufficient behavioral changes and attitudes at investee companies | <ul style="list-style-type: none">● Engagement (dialogue) and exercise of voting rights by asset managers may be perceived by companies as formalistic and may not lead to behavioral changes because companies are not convinced by them.● There is a possibility that in-depth engagement has not been conducted because the interpretation of "act of making important suggestions" is unclear under the large shareholding reporting rule. |
| 3
Room for improvement in process development (PDCA cycle) | <ul style="list-style-type: none">● Asset owners may not have sufficient evaluation and monitoring resources. |
| 4
Lack of incentives to allocate costs and budgets to activities | <ul style="list-style-type: none">● Stewardship activities by asset managers may not be appropriately reflected in the selection and compensation of asset managers. |

Survey on Stewardship Activities (2)

- Based on the results of the survey, the following recommendations were made: (1) in order to promote more substantial stewardship activities (i) wide-ranging collaborative efforts among asset managers, (ii) efforts between asset managers and asset owners, (iii) wide-ranging collaborative efforts among asset owners should be promoted; and (2) administrative authorities should appropriately follow up on these efforts so that all concerned parties can work together to improve the effective implementation of stewardship activities.

Initiatives to Resolve Issues

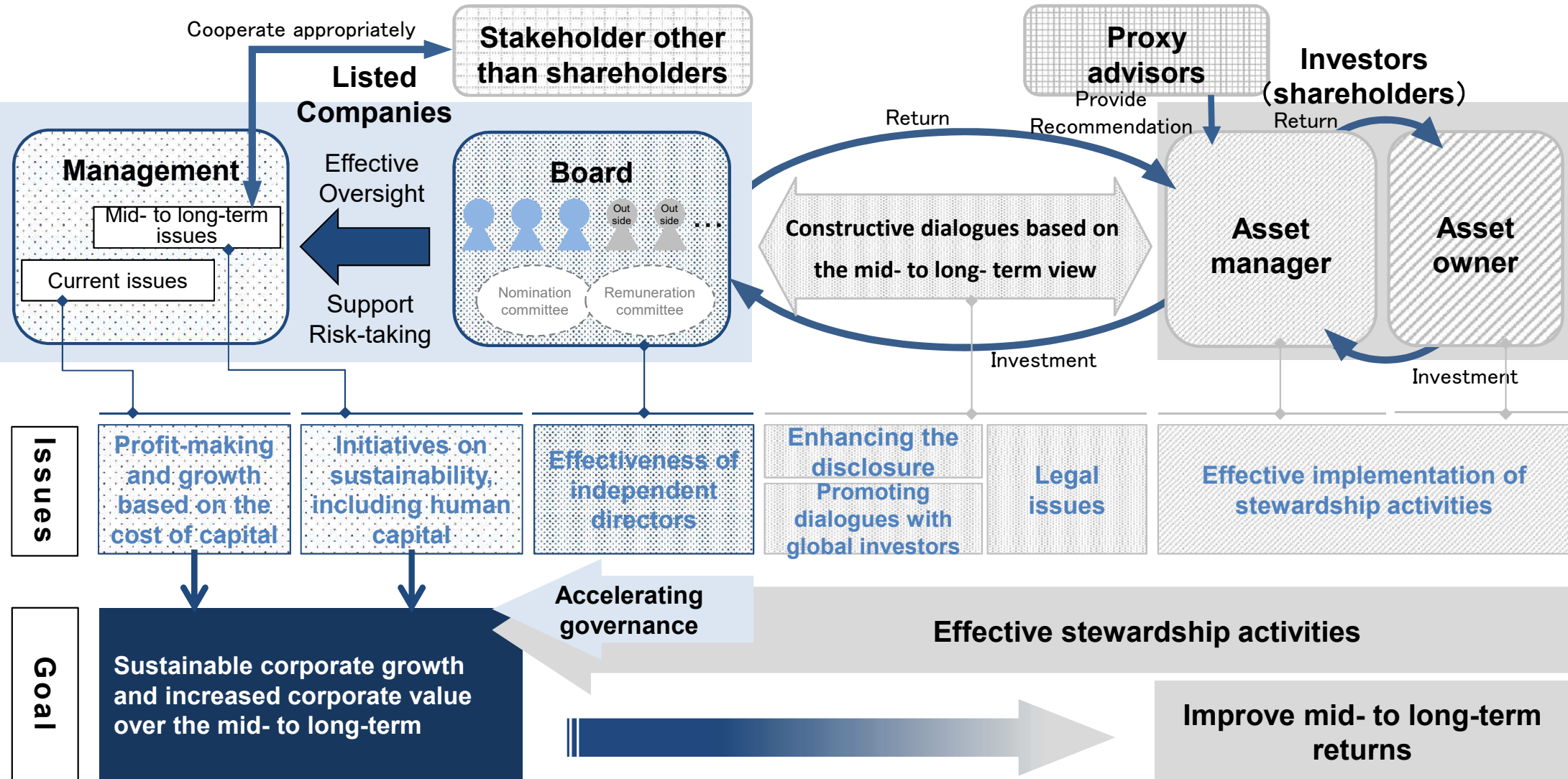
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| <p>1</p> <p>Wide-ranging collaborative efforts among asset managers</p> | <ul style="list-style-type: none"> Based on the self-assessment of each asset manager's individual issues, it is worth considering the establishment of a forum in which asset managers can widely cooperate to exchange views on the appropriateness of the issues recognized by each asset manager and the effectiveness of efforts to resolve them, and to examine specific measures. As an issue for the whole asset management industry, an appropriate framework should be established to avoid a situation in which some asset managers are forced to bear an excessive burden in terms of collaboration with other asset managers, including collaborative engagements. It is also expected that the asset management industry as a whole will cooperate in efforts to attract new talent. |
| <p>2</p> <p>Efforts between asset managers and asset owners</p> | <ul style="list-style-type: none"> Asset managers should report to asset owners on their own issues and efforts to resolve them, as well as appropriately reflecting evaluations received from asset owners in future efforts. Asset owners should appropriately evaluate the appropriateness of the asset manager's recognition of issues and the effectiveness of efforts to resolve them based on the above reports, and appropriately monitor future efforts. It is also expected that the results of evaluation and monitoring will be reflected in the selection of the asset manager and the setting of compensation. |
| <p>3</p> <p>Wide-ranging collaborative efforts among asset owners</p> | <ul style="list-style-type: none"> It is important for asset owners to have sufficient knowledge and operational resources for assessment and monitoring. In cases where it is difficult for each asset owner to secure sufficient knowledge and operational resources independently, it is worth considering taking measures such as evaluating and monitoring asset managers in collaboration with asset owners who have sufficient knowledge and operational resources as needed. |
| <p>4</p> <p>Follow-up by the administrative authorities</p> | <ul style="list-style-type: none"> The administrative authorities should appropriately follow up on the effectiveness of each of the above initiatives and, if necessary, take further measures to promote them. Regarding the ambiguity of the interpretation of "joint holders" and "important suggestions" under the large shareholding reporting rule, efforts should be made to resolve the issues. At the same time, the transparency of beneficial shareholders should be improved so that companies that are not subject to engagement by asset managers can themselves ask for dialogue with asset managers. |

Issues for corporate governance reforms

- ❑ In order to realize sustainable corporate growth and increased corporate value over the mid- to long-term through corporate governance reforms, it is vital for management, the board, investors, and various other stakeholders to cooperate appropriately.
- ❑ The following is a diagram of cooperation among stakeholders and a summary of issues pointed out in the previous meeting of the Council, JCGF, and the survey of institutional investors.

Corporate Governance Code

Stewardship Code



Action Program

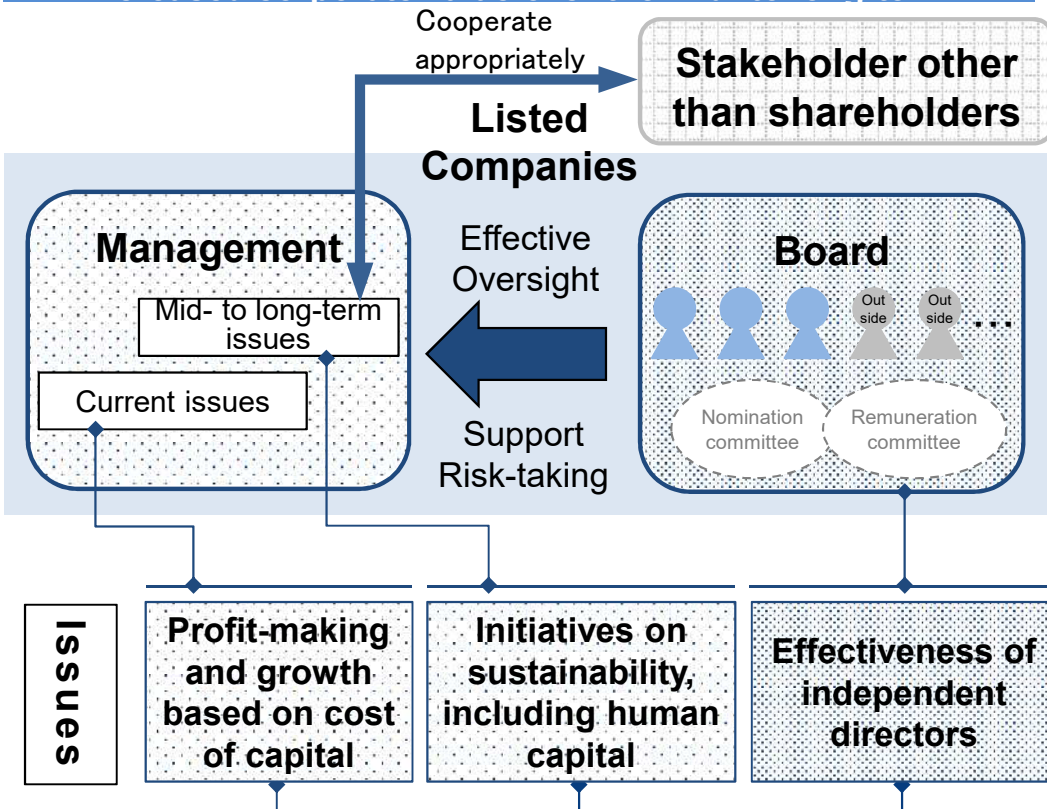
- The Council published recommendations regarding "Action Program" as of April 26. The Council will review the implementation status from time to time and consider whether additional measures are needed.

Action Program for Accelerating Corporate Governance Reform: From Form to Substance

Approach to future initiative

- It is vital to move the focus of reform from form to substance in resolving the issues. To this end, it is necessary to create an environment that promotes self-motivated changes in the mindsets of companies and investors, as well as to make the dialogues between companies and investors more productive and more effective.
- It is appropriate to examine the timing of the revision of each Code in a timely manner based on the status of progress from the viewpoint of the effective implementation of corporate governance reform, not necessarily following the review cycle in the past years.

1. Issues for seeking sustainable corporate growth and increased corporate value over the mid- to long-term



Specific measures

A) Encouraging the management with an awareness of profit-making and growth

Encourage the management with an awareness of profit-making and growth based on the cost of capital (such as the proper allocation of management resources toward risk-taking, including a business portfolio review and investments in human capital, intellectual properties and R&D)

B) Encouraging the management with an awareness of sustainability issues

Encourage companies to take actions on sustainability through publication of companies' good disclosure practices. Consider measures to improve the diversity of the board and core human resources, such as increasing the percentage of female executives (target of 30% or more by 2030).

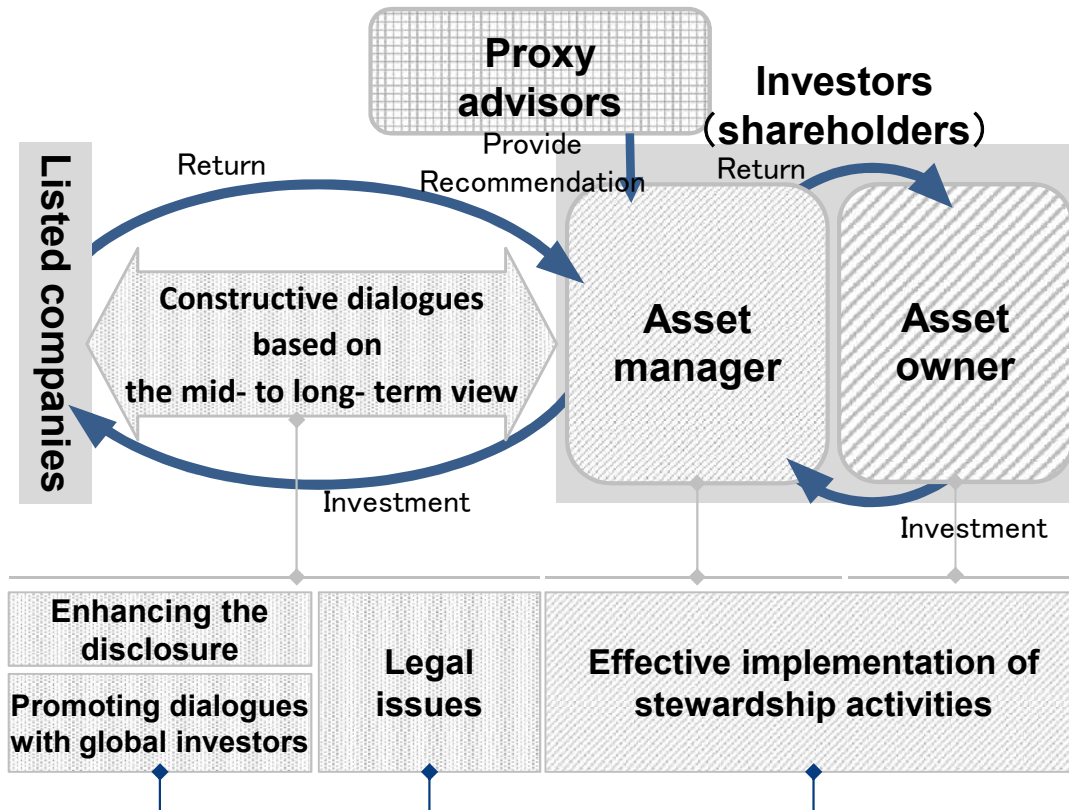
C) Improving the effectiveness of independent directors

Promote further improvement of the effectiveness of independent directors through compilation and publication of the actual status and examples of a board, nomination committee and remuneration committee, and educational activities to promote understanding of the roles expected of independent directors

Action Program (cont.)

Action Program for Accelerating Corporate Governance Reform: From Form to Substance

2. Issues related to dialogue between companies and investors



Specific measures

A) Effective implementation of stewardship activities

Promote the efforts of asset managers and asset owners to deal with the issues relating to the stewardship activities (including allocating sufficient resources, providing incentives for stewardship activities, establishing governance structures of asset owners).

B) Enhancing the disclosure as a basis for dialogue

Request to disclose the status of dialogues and make clear sufficient and insufficient cases of "Explain".
Consider measures to provide investors with the information they need prior to the general shareholder meeting and to promote timely disclosure of corporate information.

C) Promoting dialogues with global investors

Promote dialogues between companies and global investors by "visualizing" companies that willingly and actively respond to the expectations of global investors and further expand the coverage of English disclosure.

D) Resolving legal issues

Consider clarification of "act of making important suggestions" and "joint holders" under the large shareholding reporting rule, transparency of beneficial shareholders, and how to protect minority shareholders in the case of a partial takeover bid.

E) Resolving market environment issues

Consider the disclosure and corporate governance issues with regard to quasi-controlled listed companies, follow up on the progress of reduction of cross-shareholdings and consider whether further measures are called for.



Thank you for your attention.

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