Provisional translation

Material 3

Summary of comments by overseas institutional investors on the issues for deepening corporate governance reform

December 21, 2017

Financial Services Agency

This Material summarizes major comments based on consultation with overseas investors who invest in Japanese equity on the issues for deepening Corporate Governance Reform in Japan.

＜Outline of Inquiry of Comments＞
Period ：September, 2017 through November, 2017
Respondent institutions：17 institutions

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1. Management Decisions in Response to Changes in the Management Environment (1)

Points

- ☐ Japanese companies' recognition of the cost of capital is still, on average, very low. Companies should generate a return on capital greater than the cost of capital. Whilst ROE measure is important, ROIC and other benchmarks are also important.
- ☐ Too many Japanese companies are unfocused conglomerates. A company should focus on those areas that add value for customers, employees and shareholders.

Comments

- Recognition of the cost of capital is still, on average, very low. There are some companies that are still raising equity when they have net cash on the balance sheet, which demonstrates a complete disregard for the cost of capital, and specifically the cost of equity. 〔Indus Capital, US asset manager/UK asset manager〕
- We applaud those companies that have disclosed ROE targets, and would encourage other companies to make similar steps. 〔UK asset manager〕
- Whilst ROE measure is important, return on invested capital or a return on tangible net asset value, is a more appropriate basis to estimate return when the business is funded by both debt and equity. Companies should generate a return on capital greater than the weighted average cost of capital. 〔University Superannuation Scheme, UK pension fund〕
- ROE does not give a complete picture of capital efficiency. We would note that any single-metric policy regarding a company's capital efficiency may take too narrow an approach. We believe that the most effective way to promote good governance practices is by taking a holistic approach that weighs multiple considerations and metrics on a case-by-case basis. 〔US asset manager〕

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1. Management Decisions in Response to Changes in the Management Environment (2)

Comments

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- Whilst we would be supportive of more information on the ROE, ROA and ROIC numbers, more importantly is how the board uses this information in their decision-making and oversight. It is essential the board is financially literate and has the ability to identify when capital is not used efficiently. 〔Legal & General, UK asset manager〕
- Too many Japanese companies are bloated and unfocused conglomerates. A company should focus on those areas that add value for customers; through this it will create worthwhile jobs for employees, and it will also create profits for shareholders. It is rarely possible to create value for all 3 of these stakeholders without focusing on areas where the company has genuine areas of difference and competitive advantage. 〔Aberdeen, UK asset manager〕
- We do believe that the explanation of the management's awareness, understanding and clear strategy should be explained better (disclosure). This includes strategy on organic growth versus through M&A, etc. 〔PGGM, Dutch asset manager〕

2. Investment Strategy/Financial Management

Points

- ☐ Companies should utilize available assets effectively and invest in capital expenditure, R&D and human resources for the sustainable growth.

Comments

- We are looking for companies to achieve long-term sustainable growth. In order to achieve this we expect balance sheets to be actively managed, ensuring available assets are effectively utilized.〔Baillie Gifford, UK asset manager〕
- It is important to use the funds so the company has enough funds for the long-term growth, and after that pay dividend at a decent level.〔AP4, Swedish pension fund〕
- We are always keen to see companies maintain sufficient resources to invest for the future. However, appropriate levels of capital expenditure, R&D and human resource spending will vary on a case-by-case basis. We consider it inefficient for companies to have balance sheets that carry cash well in excess of that required for ongoing operations, investing for growth, other resourcing and maintaining a cash buffer for any unexpected business/economic conditions.〔UK asset manager〕
- Generally speaking, too many companies are still hoarding cash or reducing net debt too much. We strongly encourage investment in core businesses (capex/R&D) so long as the rate of return is clearly higher than the cost of capital, but this is not always the case and too few companies are able to explain this concept to investors.〔Indus Capital, US asset manager〕
- Companies should not hold cash, but should invest in new fields in order to increase returns exceeding capital cost.〔CalSTRS, US pension fund〕
- One area that we believe could be improved is the disclosure to shareholders on the use of current cash balances and future retained earnings.〔British Columbia Investment Management, Canadian asset manager〕

3. Appointment/Dismissal of CEO and Fulfillment of Responsibilities of Board of Directors, etc. (1)

Points

- ☐ Appointment of CEO shall be through a forward planning and transparent process in light of the company's strategy requirements. An independent nomination committee is critical to lead the board decision-making on appointment/dismissal of CEO and succession planning.
- ☐ The board with necessary skills and diversity should make strategic decisions, reviewed by board evaluation. For this purpose, independent outside directors should fulfill their responsibilities effectively.

Comments

- On the issue of CEO succession planning, we are simply in favor of forward planning, meritocracy and a clear and transparent process. 〔UK asset manager〕
- When developing a CEO succession plan, companies can explain why a candidate meets the criteria the board sets for itself in light of the company's (future) strategy requirements. 〔PGGM, Dutch asset manager〕
- A nomination committee is critical to lead the board decision-making on board and management success, appointment and dismissal. It is essential the nomination committee comprise a majority of independent directors. No executive directors should sit on the nomination committee, especially the CEO. A robust nomination process for the appointment of the CEO and executive directors provides assurance to shareholders that the best possible person is leading the company who has the ability to deliver long-term value. 〔Legal & General, UK asset manager〕
- We are encouraged by the strong improvement in the number of external directors, and committee-style oversight structures now on Japanese boards, but do have some concerns about the effectiveness of these changes. It is all still a work in progress. 〔Indus Capital, US asset manager〕
- We believe that it is still crucial to get a proper understanding in Japan of the role of non-executives. Adding non-executive directors should be done in order to foster greater healthy debate and discussion in the boardroom so that corporate performance will be enhanced over time. 〔Aberdeen, UK asset manager〕

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3. Appointment/Dismissal of CEO and Fulfillment of Responsibilities of Board of Directors, etc. (2)

Comments

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- A robust nominations process will typically involve matrix style disclosure of the competencies of the board, and an understanding of the skills that may be required of a formal process for identifying.〔Canadian pension fund〕
- We would like to encourage the appointment of outside directors with relevant experience in finance, accounting and law and to improve diversity.〔UK asset manager〕
- The transition of boards from day-to-day managers to long-term strategic decision makers is underway but continued development is to be encouraged. Board evaluations should assist with this development.〔Baillie Gifford, UK asset manager〕
- We believe there is a need for a greater number of companies to implement performance-linked compensation which will help align management with shareholders.〔UK asset manager〕
- Former CEOs have remained within the confidence of the board; however this may not always lead to a positive outcome.〔Baillie Gifford, UK asset manager〕
- We strongly advocate that the corporate governance code's minimum independence threshold to be increased to one-third. 〔Legal & General〕
- With respect to definition of independent directors, allowing companies latitude to define independence is resulting in numerous people with direct or indirect business relationships with companies, either currently or in the recent past, being called "independent".〔ACGA, Institutional investor organization〕
- It is also important to have the role of CEO and Chairman as separate persons.〔AP4, Swedish pension fund〕

4. Cross-shareholdings (1)

Points

- ☐ Cross-shareholdings shall be reduced as much as possible. It is dead money on corporate balance sheets, resulting in weaker corporate accountability to shareholders and holding back performance of the market as a whole.
- ☐ The companies who hold cross-shares should explain the business benefits (in a financial sense) in the form of a cost/benefit analysis, and disclose targets to reduce them over a specified period of time.

Comments

- Should be reduced and eliminated as much as possible. It is dead money on corporate balance sheets and holds back performance of the market as a whole. 〔Aberdeen, UK asset manager〕
- Cross shareholdings should not be prolonged in most situations. Cross shareholdings need to be adequately disclosed. 〔Canadian pension fund〕
- We would like to see targets to reduce cross shareholdings over a specified period of time together with an explanation around the business benefits (in a financial sense) in the form of a cost/benefit analysis. Also, we would like to see disclosure of cross shareholdings, not only in the Japan Securities Report, but also on the company's website in English. 〔British Columbia Investment Management, Canadian asset manager〕
- We contend that cross shareholdings can result in weaker corporate accountability to shareholders. Where companies have a cross shareholding in order to maintain a business relationship they are likely to support management at shareholder meetings rather than use their vote to promote reform within the investee companies. 〔UK asset manager〕

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4. Cross-shareholdings (2)

Comments

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- The rationale for the cross shareholding should be adequately explained and justified, particularly in light of the comment above regarding capital allocation. Does the cross-shareholding generate returns above the companies cost of capital? If the answer is no, the capital should probably be returned to investors. We are concerned about “creeping control” or, where a company that USS may hold a minority position.〔University Superannuation Scheme, UK pension fund〕
- Greater disclosure by banks, insurance companies and listed companies generally on why they hold certain shares is important. Companies should disclose how companies vote their shares at other company AGMs.〔ACGA, Institutional investor organization〕
- We have urged companies to provide disclosure and rationale of cross-shareholdings.〔CalPERS, US pension fund〕
- For untangling cross-shareholding, there could be sticks such as stricter disclosure on such holdings, i.e. on voting results and reasons, or making any business transactions with the cross held companies subject to approval from the non-cross-held independent shareholders.〔APG, Dutch pension fund〕
- We would encourage those who have cross shareholdings to adopt robust and transparent conflict of interest policy to ensure that stewardship is being exercised in an effective way.〔UK asset manager〕

5. Asset Owners (1)

Points

- Corporate pension funds should become signatories of the Japanese Stewardship Code, and the board directors of the parent companies should support stewardship activities of their corporate pension funds.
- Corporate pension funds should appoint members of the board with significant expertise on investment management.
- The corporate pension funds should be operated in the best interest of its members and beneficiaries, and should diverge from the commercial interests of the parent companies.

Comments

- Japanese corporate pension funds should become significant signatories of the Japanese Stewardship Code. We believe the boards of the parent companies have a duty to urge their pension funds to seriously care and contribute not only to their beneficiaries' long-term investment returns but also to the long-term sustainable growth of investee companies. The company board should collaborate with the board of trustees to make its fund a committed participant in investment.〔Hermes, UK asset manager〕
- Lack of willingness of corporate pension funds in stewardship activities may be the issue here. Expectations placed on asset owners under the revised stewardship code should improve this.〔Baillie Gifford, UK asset manager〕
- The board at corporate pension funds need to be carefully configured and significant expertise should be required for the members of the board at corporate pension funds.〔Canadian pension fund〕
- We would expect the corporate pension fund to operate in the best interests of its members and beneficiaries, and should those interests diverge from the commercial interests of the parent company.〔University Superannuation Scheme, UK pension fund〕

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5. Asset Owners (2)

Comments

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- There are a number of barriers to better involvement of asset owners, including:

- Conflicts of interests

We would encourage a review of the strength of “Chinese walls” between pension funds and their corporate sponsor; and asset managers and their parent company.

- Resource

Pension funds are less resourced than asset managers, but they have a large influence and impact on the market and behavior of asset management firms. Pension funds therefore need to have the knowledge of how to assess good stewardship in order to hold their asset managers accountable. We suggest guidance to this effect would be a helpful addition. 〔Legal & General, UK asset manager〕