ICGN
International Corporate Governance Network

28th Council of Experts (“Council”)
Financial Services Agency (FSA)
Follow-up Council of Japan's
Stewardship Code and Japan's Corporate Governance Code

19th April 2023

Dear Fellow Council Members,

Re; ICGN Response to the FSA’s Proposed Action Program for Substantiating Corporate Governance Reforms

On behalf of the International Corporate Governance Network (ICGN)[1], I am pleased to submit our response to the FSA’s ‘Proposed Action Program for Substantiating Corporate Governance Reforms’ (“Action Program”).

Established in 1995, ICGN’s purpose is to convene capital market participants to develop, promote and embed high standards of corporate governance and investor stewardship worldwide to preserve and enhance long-term value, contributing to sustainable economies, societies, and the environment. ICGN Members, many of whom are investors responsible for assets of around $70 trillion, are based in over 40 countries - largely in Europe and North America, with growing representation in Asia, particularly Japan.

ICGN’s work programme is guided by the ICGN Global Governance Principles[2] and the ICGN Global Stewardship Principles[3] which are developed in consultation with ICGN Members.The ICGN Global Governance Principles are particularly relevant to the Council’s deliberations as they are referred to by many ICGN Members in their voting policies and company engagements, as well as referenced by regulators as an international benchmark in the development of national policies.

ICGN’s work in Japan is guided by our Statement of Japan Governance Priorities[4] which aligns with the initiatives put forth by the FSA, METI, MOJ, TSE and other regulatory authorities and particularly focus on areas for reform from the perspective of global investors. These areas include strong corporate governance practices, including corporate reporting, board independence, board effectiveness, capital allocation and executive pay disclosure.

It is understood that the agenda for the Council Meeting taking place on 19 April 2023 will focus on areas that might benefit from continued corporate governance reform efforts and are clarified as being:

- Issues for seeking sustainable corporate growth and increased corporate value over the mid-long term.
- Issues related to dialogue between companies and investors.

Additionally, ICGN wishes to address the importance of corporate governance as a key driver to corporate performance and success which is prioritised at the start of our commentary.

[1] www.icgn.org
[2] ICGN Global Governance Principles, 2021
[3] ICGN Global Stewardship Principles, 2020
[4] ICGN Statement of Japan Governance Priorities, 2022

1: Corporate governance as a key driver of corporate success

There appears to be some sentiment expressed in the meeting materials questioning the value of high standards of corporate governance to overall corporate performance. The narrative explains that *"not a lot of empirical research on the effects of these reforms has been conducted yet and an evaluation of the effects of corporate governance reforms on corporate performance has yet to be determined[5]."*

Institutional investors clearly value high standards of corporate governance as demonstrated in their investment approach – both at a national level and at a company level. In practice this valuation is continually assessed through investee company monitoring, voting and engagement activities – otherwise known as stewardship. From ICGN's perspective there can be no doubt that corporate governance directly contributes to corporate performance and the resultant preservation and enhancement of long-term value.

Next month the G7 High-Level Corporate Governance Roundtable will take place in Japan under Japan's G7 Presidency. Again, this demonstrates a high degree of international acceptance, developed over nearly three decades, that effective corporate governance based on the principles of fairness, accountability, responsibility, and transparency directly contribute to successful companies and sustained long-term value creation. The G20-OECD Principles of Corporate Governance[6] and the ICGN Global Governance Principles both serve to guide capital market participants in this regard.

ICGN welcomes the many positive efforts undertaken by the FSA, TSE, METI, MOJ and other regulatory authorities over the last decade including the development of Japan's Corporate Governance Code[7], Japan's Stewardship Code[8], the Guidelines for Investor and Company Engagement[9], among others. Much has been achieved in terms of policy development over a relatively short period of time. ICGN therefore encourages all stakeholders – corporate and investment alike – to accept the importance of policy reforms to strengthen corporate governance and investor stewardship practices in Japan. In particular, we encourage TSE listed companies to expedite their efforts in putting the principles into practice and disclose evidence to that effect on a comply or explain basis to shareholders and key stakeholders.

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

<u>A) Awareness of corporate profitability and growth</u>

ICGN supports the FSA's objectives to encourage companies to 'improve profitability based on an accurate understanding of cost of capital.' We refer to Section 4 of the ICGN Japan Governance Priorities which states that *"Boards should regularly review the company's balance sheet and how cash positions, debt and equity are blended to achieve acceptable returns for shareholders, while maintaining a sufficient level of capitalisation and liquidity to provide a cushion against future risks. Oversight of a company's capital allocation policy is a key board responsibility and directors should be financially literate and understand the company's cost of capital and expected shareholder returns."*

More generally, with regards to capital allocation, ICGN continues to recommend that:

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[5] FSA Meeting Materials: Action Program for Substantiating Corporate Governance Reform
[6] G20-OECD Principles of Corporate Governance (revised edition forthcoming 2023)
[7] Japan's Corporate Governance Code, 11 June 2021
[8] Japan's Stewardship Code, 24 March 2020
[9] Guidelines for Investor and Company Engagement, 11 June 2021

- A clear capital allocation policy be disclosed and reviewed annually by the Board to ensure that cash is employed in activities which are aligned with the company's purpose and strategic objectives.

- The Board review the business portfolio annually including business unit return on invested capital and cost of capital. More generally, economic profitability should be disclosed as evidenced in returns on capital relative to a company's weighted average cost of capital.

- The rationale for holding non-strategic assets that may not be core to the company's own business or sector be clearly disclosed. If the rationale is insufficient and deemed to be value destructive (i.e., suffering from low profitability below the cost of capital), such assets should be sold, and proceeds returned to shareholders or used to invest in value enhancing activities.

- The rationale for shareholder returns be clearly disclosed including why the proposed dividend is set at the appropriate level, and what the ongoing dividend policy will be. Dividends and share buybacks should be set by determining the use of free cash flow in the context of the balance sheet.

B) Promoting initiatives on sustainability, including investment in human capital

ICGN supports the work of the Japan Sustainability Standards Board in their efforts to develop national sustainability-related accounting and reporting frameworks harmonized with global standards. The mandatory introduction of such disclosure requirements will help to facilitate rigorous, consistent, comparable, and verifiable corporate sustainability reporting, backed by regulation and enforcement, and enable the proper assessment and pricing of sustainability related risk, opportunity, and resilience in investee companies. In relation to climate change, this provides a tool for investors assessing progress towards achieving corporate transition plans and carbon neutral investment portfolios as we advance towards a net-zero global economy by 2050.

ICGN welcomes enhanced corporate disclosure in Japan around board and workforce diversity and around initiatives to increase female representation. The concept of diversity extends beyond gender and encompasses a range of factors including different nationalities, ethnicities, professional backgrounds, social and economic origins, and personal attributes. We also encourage companies to ensure fair and equitable treatment of opportunities across the workforce, i.e., creating a culture in which diversity can flourish and people of different backgrounds and views feel valued.

We recommend that companies demonstrate their commitment to board diversity, equity and inclusion (DEI) in clear policies expressing goals, action plans and measurable, time-bound objectives. Corporate boards should annually report against the policy including an explanation of how this aligns with the company's purpose, strategy and succession planning for the board and workforce.

The Nomination Committee should oversee the development, publication, and review of the company's DEI policies. Generally, a company's CEO and senior executives are responsible for implementing the policy who can be held to account with appropriate reference to DEI in key performance indicators. Data that is useful for assessing DEI representation relates to quantitative statistics in senior management levels, new hires, promotions within the company, and evidence of initiatives which create an inclusive environment and support its employees' different requirements.

C) Improving the effectiveness of independent directors

We welcome the positive trend of increased independent directors serving on boards of TSE listed companies. Independent directors play a crucial role in constructively challenging management, free from external influence. By drawing on their personal competencies and experience, they can contribute a diversity of perspectives to generate healthy debate in the boardroom and are well placed to represent the interests of minority shareholders.
We acknowledge that disclosure around the appointment of independent directors and their role on the board has improved since Japan's Corporate Governance Code was updated and further recommend that:

- Disclosure be improved around the procedures and rationale for individual director appointments including how their experience aligns with company strategy and any factors affecting their independence.

- Companies improve the usefulness of disclosing the Skills Matrix by clarifying how the attributes chosen aligns with the company's purpose and long-term strategy.

- Periodic external board evaluation be conducted (e.g., once every three years) and director tenure be contingent on individual performance. This acknowledges that the election/ re-election of directors by shareholders is premised on satisfactory evaluations of his or her contribution to the board. The process for the board evaluation and any material issues of relevance arising from the conclusions should also be clearly disclosed.

We also encourage the promotion of education initiatives for board directors – both executive and independent – to support individuals in becoming more effective in their role. In this regard, ICGN regularly delivers an Excellence in Corporate Governance Programme in Japan twice yearly. The course was developed to provide a global investor perspective on corporate governance practices in Japan and to share international good practices experience.

More generally, companies should disclose their training policies for board directors and report on what actual training occurs over an appropriate period. ICGN also encourages companies in Japan to have a formal process of induction for all new directors so that they are well-informed about the company as soon as possible after their appointment. This includes building an understanding of its strategy, business operations, regulatory obligations, and other fundamental business drivers.

3. Issues related to dialogue between companies and investors.

A) Substantiating stewardship activities

Based on ICGN's seminal Statement of Institutional Investor Responsibilities (2003)[10], the ICGN Global Stewardship Principles set out our recommendations to investors regarding the conduct of their fiduciary responsibilities. We clarify from the outset that investors should be led by robust governance arrangements including with regards to leadership, independent oversight, governance effectiveness, ethics, conflicts of interest, remuneration and capacity.

We draw your attention to Principles 1.3 which states that *'investors should be overseen by boards or other governance structures that act independently and without bias to advance beneficiary or client interests.'* We add that, for asset owners, it is not desirable that the plan sponsor or employer dominate the governing body. Where this is the case, consideration should be given to the representation of individuals accountable to beneficiaries. We also

[10] ICGN Statement of Institutional Shareholder Responsibilities (2003)

refer to the need for asset owners to effectively oversee and monitor asset manager stewardship activities and their consistency with the asset owner's own investment beliefs, policies, and guidelines. Listed companies with their own pension funds also act as asset owners and should also undertake appropriate stewardship at the pension fund level.

In this regard, last year, the ICGN, in partnership with the United Nations (UN) supported Global Investors for Sustainable Development Alliance (GISD), published the ICGN-GISD Model Mandate.[11] The original Model Mandate was published by ICGN in 2012 to provide guidance to asset owners to ensure that their investment strategy and their own fiduciary obligations to beneficiaries are properly reflected in the Investment Management Agreements (IMA), and that they can monitor whether their objectives and interests are being met. It provided a series of example contractual terms which embed governance and stewardship obligations, beyond financial parameters, into IMA terms.

The updated ICGN-Model Mandate provides examples of how investors assess and monitor sustainability related factors in their investment processes. It sets out draft contract clauses with specific references to Sustainable Development Investment, particularly directed towards the achievement of the UN Sustainable Development Goals.

B) Enhancing disclosure as a basis for dialogue

ICGN welcomes FSA initiatives to require companies to enhance dialogue between companies and investors through improved disclosure and a better understanding of how the system of comply-or explain works in practice.

Board directors and institutional investors share a mutual responsibility to preserve and enhance long term corporate value which is facilitated through effective corporate governance and investor stewardship practices. In doing so, corporate boards hold management to account by offering strategic direction, risk oversight, financial discipline, reporting and managerial oversight.

Simultaneously, investors are responsible for holding boards to account, on behalf of their beneficiaries, through the exercise of company monitoring, voting and engagement. It is imperative that's both parties embrace their respective roles and enter into meaningful dialogue in pursuance of these responsibilities.

This dialogue is facilitated through a 'comply or explain' system – usually set out in Stock Exchange Listing Rules or in the law – which requires companies to apply corporate governance principles and practices as described in a national code and to disclose to investors how they have done so.

For the 'comply or explain' system to work effectively, companies should have a good reason to deviate from a particular code recommendation and disclose this to investors. Explanations from companies for the deviations should be meaningful and provide investors with a clear reason for the alternative approach and the impact that this may have.

For investors, the comply or explain system assumes they will make informed use of their shareholder rights and effectively exercise their share-ownership responsibilities in the oversight of corporate governance. Investors are expected to carefully consider deviations to the code explanations and pay due regard to individual company circumstances – i.e., avoid a box ticking approach. They should also provide feedback to companies regarding their

[11] ICGN - GISD Alliance Model Mandate Guidance (2022)

opinion on code deviations which may influence their voting decisions. This premise is described in Principle 3.4 of the ICGN Global Stewardship Principles:

> *"Investors should develop an understanding of the company's corporate governance practices and consider the quality of company reporting against relevant national or international codes, including the explanations given for any deviations from relevant corporate governance codes. Investors should also understand the specific circumstances of the investee company, taking into account the legal environment, cultural norms and ownership characteristics."*

The system of comply or explain is only effective if corporate governance information is accessible to investors in an efficient and transparent manner. In this regard, we repeat ICGN's request to the FSA and other relevant authorities in Japan, to centralise corporate governance disclosure in a single source in the Securities Report (Yuho) and for this information to be available in English.

The Securities Report (Yuho) should be published at least 30 days in advance of the Annual General Meeting to ensure that investors have access to the information required to determine voting decisions. This includes information around the corporate business model, corporate strategy, audited financial results, Key Audit Matters, and cross-shareholdings.

<u>C) Promoting dialogue with global investors</u>

ICGN supports any effort to promote dialogue between Japanese companies with global investors. We acknowledge reference to this in Japan's Corporate Governance Code, Supplementary Principle 5.1.1, which clarifies that *"the senior management, directors including outside directors, and kansayaku, should engage in dialogue with shareholders."* This sentiment is echoed in Principle 1.4 of the ICGN Global Governance Principles:

> *"The board, particularly the chair, lead (or senior) independent director and committee chairs, should constructively engage with shareholders and relevant stakeholders for meaningful dialogue. This infers two-way communication between companies and shareholders and not a unilateral presentation from just one party. Such dialogue should encompass all matters of material relevance to a company's governance, strategy, risk management and performance as well as environmental and social policies and practices."*

ICGN has committed substantial effort into building relationships between domestic Japan based companies and ICGN Members for over two decades. For example, by holding ICGN Conferences in Tokyo or by convening the Annual Virtual Japan Forum, hosted by the Japan Exchange Group and Tokyo Stock Exchange.

ICGN also respects the importance of building institutional relationships and in this regard, we are proud of our friendship with many professional bodies in Japan. From a corporate perspective, we have a Memorandum of Understanding (MoU) with Keidanren which was established in 2019. The MoU provides that each party undertakes to convene our respective members for ongoing dialogue to build mutual understanding around high standards of corporate governance.

<u>D) Resolving legal issues: obstacles to collective engagement</u>

We appreciate FSA examining potential obstacles to collective engagement in Japan. ICGN Members would welcome further clarity around their ability to act collaboratively with other investors without being considered a 'concert party' to improve the governance and sustainability of investee companies in Japan. It would therefore be helpful for the FSA to publish guidance on what constitutes acceptable engagement subjects to ensure they will not breach rules regarding collective holding thresholds above which would trigger onerous reporting requirements.

As suggested by ICGN at previous Council meetings, the publication of guidance such as the list from the European Securities Markets Authority might help to give investors more confidence in being able to engage constructively with Japanese companies. It is a public statement made under the European Takeover Bids Directive (Directive 2004/25/EC) which indicates a list of activities indicating that co-operation by investors will not lead to a conclusion that the shareholders are acting in concert. This includes voting on proposals relating to directors' remuneration, capital and financial policies, the environment or any other matter relating to social responsibility.

<u>E) Resolving market environment issues: cross shareholdings</u>

ICGN welcomed the revisions to Japan's Corporate Governance Code requiring companies to disclose their policies and rationale for cross-shareholdings as well as an annual assessment of the costs and benefits and how that impacts a company's cost of capital. We recognise that most corporate shareholdings in Japan are in the form of holdings in subsidiaries and affiliates. This is distinct from 'strategic equity' holdings, and the relatively smaller proportion of 'cross-shareholdings' – both types of which ICGN recommends should be unwound so that corporate boards in Japan are more accountable to shareholders.

While disclosure around cross-shareholdings in Japan has improved we observe that many companies refer to the purpose for holding cross-shareholdings being to "smooth business relations" or "maintain / expansion of business transactions". We respectfully submit that this kind of rationale is insufficient, and it would be helpful if companies provided more information around the nature of the cross-shareholding, for example if they are a parent company, subsidiary, or supplier; and how cross-shareholdings will be reduced or eliminated over a specified time-period.

To conclude, we congratulate the FSA and other regulatory authorities for the reform efforts in Japan and encourage continued momentum towards international high standards of corporate governance and investor stewardship practices. The path towards excellence is a journey, not a destination – and there is no 'one size fits all' approach. Key to success is to build trust and confidence between companies and investors who share a mutual responsibility to preserve and enhance long term corporate value upon which we all rely.

Thank you for this opportunity to provide commentary for the Council meeting. Should you have any questions or would like to discuss our comments in more detail, please contact me or ICGN's Japan Advisor, Amane Fujimoto (amane.fujimoto@icgn.org).

We hope our comments are helpful and we look forward to the continued deliberations.

Yours faithfully,

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