Provisional translation

Improving the Effectiveness of the Revised Corporate Governance Code

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Sub-Committee on Capital Markets

Committee on Financial and Capital Markets

Keidanren

Keidanren has previously given its views on the Corporate Governance Code (hereinafter "Governance Code"), both when the Code was initially formulated, and twice again during the process of subsequent revisions, with a view to building effective corporate governance in Japan. By managing their businesses in a way that continually accepts new challenges while accurately assessing risk, companies can make an important contribution to achieving the UN Sustainable Development Goals (SDGs) and finding solutions to other social issues, as well as strengthening their competitiveness and improving mid- to long-term corporate value. Corporate governance of this kind is therefore not only essential to the companies themselves but will also help to bring sustainable growth to the Japanese economy.

In the view we made public on the occasion of the revisions to the Governance Code[1], we recognized that the proposed changes were aimed at social development and increasing corporate value by promoting corporate initiatives on sustainability and diversity in human resources, and assessed them as concurring with the "sustainable capitalism" approach endorsed by Keidanren.

At the same time, we believe that each company should proactively establish its own corporate governance in line with the company's purpose. We accordingly argued that

[1] Keidanren's View on Draft Revision of Japan's Corporate Governance Code (May 7, 2021), https://www.keidanren.or.jp/en/policy/2021/043.html

it was key to make a further shift from “formality” to “substance” in the way that corporate governance was handled and in the dialogue between investors and companies. With this in mind, we called for: (1) Thorough application of the “principles-based approach” and “comply-or-explain approach”, (2) Verification of effects of code revisions on increases in corporate value, (3) Follow-up on implementation and operation of the revised code.

The Council of Experts Concerning the Follow-up of Japan’s Stewardship Code and Japan’s Corporate Governance Code (“Follow-up Council”) held discussions to review the effects of governance reforms. As input to the discussions, Keidanren would like to present its findings on how companies have responded to revisions of the Governance Code to date, note several problems in the way the Code has been implemented, and give our views on the measures we would like to see in the future from government, companies, investors, and other market players. The content of these views is outlined below.

I. Issues within companies regarding the operation of the Governance Code

(1) The significance of governance reforms

The objectives of governance reforms are twofold: from the perspective of companies, to secure sustainable growth by rebuilding management systems and, from the perspective of investors and stakeholders both at home and abroad, to improve the effectiveness of investments and their ongoing relationships with the companies they invest in. Even before the formulation and revision of the Governance Code, Japanese companies were already taking steps to reform and improve management systems on their own initiative. For example, many companies started to reduce the number of board members, appointed outside directors, and introduced an executive officer [*shikkoyakuin*] system in the early 2000s, as global competition became more intense[2].

The background and motivations for these reforms were various. Objectives included making management philosophy more widely known through the company, developing the organization and systems necessary to achieve business strategies, responding to a scandal, or breaking out of a crisis in the business environment.

Throughout this process of reform, sincere efforts and ingenuity has been used to ensure that the reforms are effective. For example, providing detailed materials and explanations to outside directors about the company's strategy and business helps to make discussions at board meetings livelier and more meaningful, but these efforts are often difficult for investors and others outside the company to see and understand.

In addition, ongoing conscious promotion of these reforms by senior management helps to increase awareness within companies, and contributes to achieving effective operation of the Code.

(1) The Significance of the Governance Code

Although companies were already working to improve the effectiveness of their management on their own initiative, the establishment of the Governance Code in Japan reinforced these efforts and encouraged companies in their efforts to achieve sustainable improvements in corporate value. Specifically, it provided an opportunity for companies to introduce new initiatives in governance reform, support and reinforcement for

[2] According to a "Report on the Results of the Third Survey on Corporate Governance," published by the Tokyo Stock Exchange on January 27, 2003 (carried out on the 2,103 listed Japanese companies, responses were received from 1,363 companies), in response to a multiple-choice question about the current state of concrete measures to strengthen the function of boards of directors, the most popular responses were: "reduction in the number of directors" (36.2%), "introduction of an executive officer [*shikkoyakuin*] system " (34.2%), and "appointment of outside directors" (28.5%). In other words, companies were already implementing measures to improve corporate governance since the early 2000s.

existing initiatives, and a useful guideline for companies to review and improve their own efforts.

In addition, it contributes to awareness and understanding within companies of the hopes and expectations of investors and other stakeholders.

(2) Issues with the Governance Code

(i) Is it contributing to sustainable growth?

The Governance Code in Japan was formulated from the perspective of achieving improvements to mid- to long-term profitability and productivity, and aimed to build a framework that would encourage aggressive management decisions, animal spirits, and entrepreneurship[3]. However, some companies say that they do not feel the Governance Code has had any real impact, particularly in the economic climate of recent years[4].

Company results and share prices are primarily the result of management efforts. Further ingenuity is necessary to ensure that the measures that companies take in line with the provisions of the Governance Code have a real effect in terms of improving corporate value and growth over the mid- to long-term.

(ii) Is the Code encouraging a tendency among companies and investors to value

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[3] Excerpt from "Japan Revitalization Strategy," Revised in 2014 (approved by Cabinet June 24, 2014).
On what is necessary to increase the earning power of Japanese companies, by improving medium to long-term profitability and productivity: "First, it is important to strengthen the mechanism to enhance corporate governance and reform corporate managers' mindset so that they will make proactive business decisions to win in global competition for the purpose of attaining targets including globally-compatible level in return on equity." Since "principles outlining key elements of good governance should help companies' initiatives towards sustainable growth of their corporate values and would thereby contribute to the prosperity of the companies themselves, investors and, ultimately, the whole economy," the "Corporate Governance Code will be drafted, specifying the principles of corporate governance to be applied by listed companies."

[4] According to the "Report of the 7th Survey of Listed Companies Regarding Institutional Investors' Stewardship Activities" carried out by the Government Pension Investment Fund (GPIF), dated May 12, 2022, a combined total of more than 70% of firms answered either "They do not appear to use the reports effectively" (4.2%) or "They show no significant changes" (66.3%).

formality over substance?

Companies comment that responding to the increasingly detailed provisions in the revised Governance Code has increased the burden on them, and that it is hard to understand the need for some of the provisions. There is sometimes a mismatch between the managerial system that companies think is appropriate and the requirements demanded by the Governance Code; some companies feel that this gets in the way of their execution of corporate strategy.

The Governance Code adopts a principles-based approach, and asks companies to make their own decisions on what measures are appropriate for them, considering the intent and principles of the Code. It should therefore not be the case that either of the “comply” or “explain” options is considered preferable to the other. In fact, however, in many cases both companies and investors clearly feel that “Comply” is the only correct or acceptable option[5]. Some companies say that if they do not comply with some detail of the Code, there is a tendency for investors to evaluate the company negatively for this reason, in a rather mechanical and formulistic, “box-ticking” manner.

There is a tendency for Japanese companies, under the understanding that to comply with the Code is the only acceptable approach, to carry out quite careful and detailed deliberations in order to implement the provisions of the Code in a meaningful way, and this tends to take time. This is another contributing factor that means it is often difficult for companies to be appropriately evaluated by investors and others for their efforts in this regard, since investors’ evaluations tend to be template-based and formulaic.

[5] According to the “2017 Survey on Corporate Governance” published by METI, carried out on 2,569 firms listed on the 1st and 2nd sections of the TSE, in response to a question on responses to the Corporate Governance Code, the most popular answer, was: “Our plan is to choose the ‘comply’ rather than the ‘explain’ option as much as possible” (50%).

Numerous issues have also emerged to achieving richer and more substantial dialogue between companies and investors. While the significance of such dialogue is generally perceived positively, we hear concerns from companies that investors often fail to set aside sufficient time and opportunities for dialogue. Some companies comment that investors tend to follow automatically the advice of proxy advisory firms, but that engagement between companies and proxy advisory firms is extremely difficult.

Some investors still make formulaic decisions (including standards for exercise of voting rights) based simply on whether the company is in compliance with the provisions of the Governance Code. Companies say that investors' concerns tend to be focused on the short term and are often performance-centric. In some cases, investors lack a proper understanding of information that has already been made publicly available by the companies with which they are engaged in dialogue. [6]

(iii) Is the Code neutral with regard to the choice of organizational structure?

It was not part of the intention of the Governance Code to determine the quality of a company's corporate governance based on that company's choice of organizational structure under the Companies Act (i.e. Company with Kansayaku Board, Company with Supervisory Committee, or Company with Three Committees (Nomination, Audit and Remuneration)) [7].

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[6] In a FY2021 survey on measures to improve corporate value carried out by the Life Insurance Association of Japan, the most popular response (with 49.6%) to a question about the issues that companies felt in dialogues with investors was that "dialogues tend to be based exclusively on short-term perspectives and subjects." Similarly, in the "Report of the 6th Survey of Listed Companies Regarding Institutional Investors' Stewardship Activities" (May 12, 2021) published by the GPIF, some listed companies that had dialogues with funds and other investors felt that some funds or investors were not worthwhile to have dialogue with. The most commonly cited reason, given by 69.2%, was that "Their suggestions to the company are purely based on the pursuit of the fund's profit and short-term gains" On looked-for improvements from institutional investors as a whole, there were multiple comments hoping for dialogue with medium- to long-term purposes rather than concentrating on short-term issues, and a wish that investors would not simply repeat the same questions in each quarter.

[7] The "notes" section for General Principle 4 in the Corporate Governance Code says: "Companies may choose one

Many companies choose to be Company with a Kansayaku Board, because they continue to value the benefits of a system that combines the authority and functions of auditors with the external perspective of outside directors. Meanwhile, other companies that choose the structure of Company with Supervisory Committee say their reason for this choice is that they value discussions that incorporate the entire board of directors, with a diverse range of members, rather than discussions involving only a small number of committee members. Companies that prioritize the separation of the execution and supervision functions and want to emphasize the separation of powers between each committee choose the format of Company with Three Committees (Nomination, Audit and Remuneration). In all cases, in addition to the organizational structures laid down in the Companies Act, companies make changes and modifications to how these structures operate in accordance with their business and the composition of their boards of directors, by voluntarily establishing additional committees and other means, as they work to achieve effective management through an organizational structure that suits their own needs.

II Measures aimed at improving the operation of the Governance Code

Considering the current situation and the issues outlined above, we make three suggestions below, as measures aimed at improving the operation of the Governance Code and as points to be addressed at the Follow-up Council.

(1) Continued follow-up and verification with companies regarding the implementation

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of three main forms of organizational structure under the Companies Act: Company with Kansayaku Board, Company with Three Committees (Nomination, Audit and Remuneration), or Company with Supervisory Committee. (. . .) Irrespective of which form of organizational structure is adopted, what is important is that the various institutions within the company effectively and fully execute their responsibilities through creativity and ingenuity.”

of the Governance Code

The Governance Code is principles-based and thus based on the premise that companies have a certain amount of discretion to implement the Code flexibly in accordance with their own circumstances. On the other hand, implementation of the Governance Code in its latest revised form has only just begun, and the effect of these latest measures is yet to be seen. There is a need for continued verification and confirmation of the significance and effect of the provisions in the Code, and issues that may emerge.

(2) Ensuring effective implementation of the Stewardship Code

If the increasing detail of the Governance Code means that shareholders and investors come to rely on a simple assessment of whether a company is in compliance or not (through a formulaic, check-the-box approach) when evaluating companies they invest in, this will have a major negative effect. We hope that companies and investors will work through constructive dialogue to ensure that the Code and its implementation contribute to solving social issues and improving corporate value.
In order to achieve richer, more meaningful dialogue between companies and investors, from the perspective of securing effective operation that will help to promote growth, we hope to see discussions and proposals in the Follow-up Council for improving the effectiveness of the Stewardship Code.

At the same time, proxy advisory firms, ESG rating agencies, and data providers are having an increasing role and influence on the way in which investors evaluate companies. Accordingly, in discussions improving the effectiveness of the Stewardship Code, important points to be considered include how to ensure the quality of the services provided by these institutions and how to make their evaluations transparent, and steps to put systems in place to make this possible.

(3) Shared awareness and understanding among government, companies, investors, and other market players

It is not desirable for the Governance Code to become merely detailed provisions that are too dependent on formality. The effectiveness of companies’ measures will depend on whether the Code can be used in a way that suits the needs of individual companies. There are also problems with a lack of adequate dialogue with investors and issues with understanding on the investors’ side. Addressing these points will be an important part of ensuring that the Stewardship Code is operated and implemented in an appropriate way. Accordingly, it is vital that the government, companies, investors, and other market players share the common understanding with regard to the following points in the process of operating the Governance Code and Stewardship Code.

- One of the characteristics of Japan’s approach is that the Governance Code is regarded as part of growth strategy. The effectiveness of the measures that a company takes in respect of the Code should not be evaluated simply by whether the company is formally in compliance with the provisions of the Code, but based on whether the measures contribute to the mid- to long-term growth of the company.
- The Governance Code adopts a principles-based approach, and the choice between the two options of “Comply” and “Explain” should have an equivalent value, provided the latter is accompanied with a detailed explanation based on the company’s strategy. In particular, Japanese companies tend to view the principles of the Code as the only acceptable option, and there is a tendency for companies to aim to comply with the provisions. There is a need for further efforts to promote an awareness that the Code is not designed to encourage companies to formalistically choose the Comply option. Steps should be taken to improve the ability of companies

to communicate their choices and to encourage a better understanding on the part of investors. This should include sharing good examples of companies that have chosen the “Explain” option.

Conclusion

The key to achieving the “sustainable capitalism” endorsed by Keidanren will be the realization of the Society 5.0 for SDGs concept, which looks to link the solution of social issues through innovation to economic development and growth. Supporting companies that make bold efforts to innovate is also an urgent matter, considering the ongoing economic climate of low growth and stagnation in Japan. Encouraging this kind of ambitious undertaking is another reason why it is important to consider how to effectively achieve the Governance Code’s objective of spurring growth.

To ensure the effectiveness of the revised Governance Code and that it leads to sustainable growth, it will be vital for the government, companies, investors, and other market players to continue their efforts to improve the way the Code is operated and to work together toward richer, more meaningful dialogue.