

April 24, 2019

Recommended Directions for Further Promotion of Corporate Governance Reform

The Council of Experts Concerning the Follow-up of Japan's Stewardship Code
and Japan's Corporate Governance Code
Opinion Statement No. 4

I. Introduction

In order to further deepen corporate governance reform from “form” to “substance,” the Stewardship Code was amended in May 2017 and the Corporate Governance Code was amended in June 2018. We are currently seeing steady reform progress, with a large number of institutional investors having started to disclose AGM voting results for investee companies on an individual agenda item basis, and with companies with two or more independent directors now constituting over 90% of listed companies.

Since November 2018, in order to enhance the effectiveness of corporate governance reform the Council has reviewed how institutional investors and companies have addressed the two Codes since their revisions. The Council has also received input on the importance for companies, in their exchanges of opinion with overseas investors, to clearly embody a corporate purpose that is integrally linked to their pursuit of profitability, and to understand their responsibility to help their employees navigate retirement, the importance of conducting dialogue with investors from a long-term perspective, and their responsibility to meet investor expectations.

At the same time, the Council members pointed out as ongoing issues for corporates that:

- Nomination committees or remuneration committees do not necessarily fulfill their functions due to imbalances in the composition of committee members, and independent directors with appropriate qualities are not necessarily chosen;
- There are cases of cross-shareholdings in corporate pension accounts being excessively high;
- Companies do not necessarily explain the activities of the board and the results of board evaluations with specificity or via information disclosure.

The Council members also pointed out as ongoing issues for investors that:

- Dialogue with investee companies remains formalistic and does not contribute to enhancement of mid- to long-term corporate value;
- There are cases of institutional investors, while demanding more extensive disclosure from companies, not being pro-active in fulfilling their own disclosure responsibilities;
- Understanding of compliance to the Code is formalistic due to the lack of an

appreciation of the principle of “comply or explain.”

In preparation for the next revision of the Stewardship Code and to further promote the effectiveness of corporate governance reform, this Opinion Statement offers recommended directions on issues to review.

II. Stewardship

In order to enhance the effectiveness of corporate governance reform, increasing the quality of dialogue between investors and companies is important. Further promotion of disclosure on stewardship activities by asset managers is appropriate both to fulfill asset managers’ accountability to asset owners and to promote constructive dialogue with companies to deepen mutual understanding.

Because service providers such as proxy advisors and investment consultants may exercise significant influence over the quality of stewardship activities by asset managers and asset owners, it is important to work towards service providers’ advice and support serving to enhance the functioning of the overall investment chain.

From this perspective, it is important to accelerate the review of key issues, including the following topics. The issues of collective engagement and the escalation of engagement at investee companies have also been raised at Council meetings and will also continue to be reviewed.

1. Asset Managers

Asset managers are increasingly disclosing their stewardship activities, with over 100 asset managers starting to disclose AGM voting results for investee companies on an individual agenda item basis and/or publishing stewardship activity reports. On the other hand, since the number of asset managers who disclose the underlying reasons for their voting decisions is limited to just 20, and the quality of asset managers’ stewardship activity reports varies considerably, it has been pointed out that asset managers should not only disclose their voting results, but also improve their disclosure on stewardship activities with companies previous to asset managers’ voting decisions. Furthermore, it has been pointed out that strengthening the corporate governance of asset managers, including conflict of interest management, continues to be an important issue.

In order to fulfill their accountability to asset owners as well as deepen mutual understanding with companies via constructive dialogue, it is important to encourage asset managers to improve the disclosure of not only the reasons for their voting decisions, but also their stewardship activities with companies, their results, and self-evaluation of their stewardship activities.

When asset managers engage with companies on sustainability issues, including ESG factors, asset managers are expected to promote dialogue that is consistent with their investment strategies and that leads to the sustainable growth of companies and their mid- to long-term increases in corporate value.

2. Asset Owners, including Corporate Pension Funds

In order to support the functioning of the investment chain in which asset owners are located closest to final beneficiaries, the role of asset owners is critically important to encourage and monitor the asset managers who are the direct dialogue counterparts to companies.

With this perspective in mind, the revision of the Corporate Governance Code in 2018 added a principle to urge companies to take measures to support the human resources and operational practices of corporate pension funds. However, the number of corporate pension funds that have signed the Stewardship Code remains limited. It has been pointed out that the backdrop to this limited participation is that the benefits and responsibilities of stewardship activities expected of corporate pension funds are not well understood.

It is thus important to promote measures to support the stewardship activities of corporate pension funds in collaboration with the business sector and other stakeholders.

3. Service Providers

(1) Proxy Advisors

Although the responsibilities of proxy advisors were defined in the 2017 revision of the Stewardship Code, it has been pointed out that the procedures for developing voting recommendations are not yet sufficiently transparent. In addition, proxy advisors may not have sufficient human and operational resources necessary for making substantive evaluations of companies' specific circumstances, including AGM director election proposals.

Given that proxy advisors are widely used by asset managers amidst expanding passive investment management, it is important that proxy advisors provide recommendations based on correct information with respect to individual companies to asset managers in order to support voting which serves the sustainable growth of companies.

From this perspective, proxy advisors are expected to secure sufficient and appropriate human resources and organizational structures, disclose their processes (including the resources and organization) for developing voting recommendations, and directly and proactively engage with companies as necessary.

It is important that asset managers also provide explanations and information on their usage of proxy advisors, such as the names of proxy advisors, their processes to confirm the advice of proxy advisors, and how specifically they use the proxy advisors' advice.

(2) Investment Consultants

Market data suggest that approximately 30% of Japanese corporate pension funds have advisory contracts with investment consultants. In this context of investment consultants exercising influence with respect to pension funds, it has been pointed out that investment consultants in the process of providing consulting services sometime solicit sales of their own investment products. There is also concern that they do not appropriately evaluate the stewardship activities of asset managers.

It is important to encourage investment consultants to manage conflicts of interest and disclose their activities due to their roles as important actors in support of the stewardship activities of corporate pension funds and to enhance the overall functioning of the investment chain.

III. Corporate Governance

The Council will continue to review measures taken by companies based on the revised Corporate Governance Code, such as companies managing their businesses with a recognition of their cost of capital, cross-shareholdings, and board effectiveness, along with reviewing the following issues.

1. Ensuring Confidence in Audits

“Defensive governance” is indispensable to realizing the sustainable growth of companies and their mid- to long-term increases in corporate value. Ensuring confidence in audits through “triple auditing” (internal audits, *kansayaku* audits, and external auditor-led audits) is an extremely important prerequisite to this defensive governance.

It has been pointed out that the internal audit department is under the control and supervision of the CEO in most companies, and that the oversight function of this department has not been fully performed in cases where senior management has been involved in dishonest practices.

It is important to promote the establishment of processes where the internal audit department reports to organizations which are independent from management, such as the Board of Directors, Audit Committees, the *kansayaku* Board, etc., so that internal audit works effectively and with independence.

Starting with this internal audit issue, the Council will review measures for ensuring confidence in audits in order to secure effective corporate governance, while taking into account companies’ specific institutional structures and characteristics.

2. Group Governance

With respect to Japanese corporate group management, it has been pointed out that the appropriate allocation of management resources and the risk management of subsidiaries may not be being carried out sufficiently, and that the independence of the Board of Directors may need to be strengthened, because listed subsidiaries with a controlling shareholder (so-called “listed subsidiaries”) have the risk of conflicts of interest between the controlling shareholder and general shareholders.

Discussions with respect to group governance, including discussions on governance of listed subsidiaries, should include better explanations by parent companies as to why they have listed subsidiaries. They should also involve establishing stricter governance of these listed subsidiaries, such as increasing the proportion of directors independent from a controlling shareholder, keeping in mind the review of the Tokyo Stock Exchange’s independent director criteria.

Based on these discussions, the Council will continue to review further group governance from the standpoint of protecting general shareholders.

IV. Closing Remarks

In order to enhance the effectiveness of corporate governance reform – and amidst expectations of the enhancement of corporate disclosure on cross-shareholdings, etc. due to the recent revision of the Cabinet Office Ordinance on corporate disclosure – it is critically important that asset managers and service providers engage in dialogue with companies based on deeper understanding of the companies, and that asset owners proactively encourage and monitor asset managers with respect to their stewardship activities. The Council looks forward to the further deepening of discussions to realize companies’ mid- to long-term increases in corporate value through constructive dialogue between investors and companies, with a view to further revision of the Stewardship Code, which is scheduled to occur about once every three years.

In addition, corporate governance is closely connected to equity market structure. It is necessary for the Council to discuss further promotion of corporate governance reform based on trends in equity market structure, taking into consideration the clarification of the nature of each equity market and the corporate governance structure appropriate to each market.