



ICGN

International Corporate Governance Network

25th Council of Experts
Follow-up of Japan's Stewardship Code and Japan's Corporate Governance Code

9th March 2021

Dear Fellow Council Members,

ICGN Statement to the Council of Experts for the Follow-up of Japan's Stewardship Code and Japan's Corporate Governance Code (the "Council")

I have pleasure in sending you ICGN's comments on the items noted in the Agenda for the next Council Meeting which will take place on 9th March 2021 (see annex 1 for translation to Japanese).

Led by investors responsible for assets under management of USD\$54 trillion, ICGN is a leading authority on global standards of corporate governance and investor stewardship. Our Members are primarily institutional investors such as public pension funds and their asset managers and thus are committed to promoting sustainable value through the long-term success of companies on behalf of the investing public. Our commentary is drawn from the ICGN Global Governance Principles which is subject to review this year as part of a periodic review process.

Japan is an important market for ICGN Members, where over 30% of the market capitalisation of the Tokyo Stock Exchange is held by overseas investors. ICGN has engaged in regulatory dialogue in Japan for over two decades and we have convened global conferences in Tokyo attracting hundreds of governance professionals from around the world. Our Japan Policy Priorities (2019) highlight key issues for dialogue between ICGN Members and Japan based stakeholders, along with our most recent submissions to the Council.

This letter addresses the subjects of:

1. Risk oversight
2. Ensuring confidence in audits
3. Key governance standards for Prime Market listed companies
4. Other matters

1. Risk oversight

Principle 5 of the ICGN Global Governance Principles states that *'the board should proactively assess and publicly disclose the company's key risks and approve the company's approach to internal controls and risk management and mitigation on a regular basis or with any significant business change and satisfy itself that the approach is functioning effectively.'*

The board should adopt a comprehensive approach to the oversight of risk which should be enterprise-wide and include threats to the company's business model, performance, solvency, liquidity and reputation. Risk oversight should extend beyond financial capital to include human capital and natural capital and in particular, systemic risks identified in the United Nations Sustainable Development Goals.

The board should ensure that risk is appropriately reflected in the company's strategy and capital allocation. Risk should be managed in a rational, appropriately independent, dynamic and forward-looking way. The board should annually assess the company's key risks, the potential probability and impacts of such risks, and any mitigating actions and procedures. The board should also ensure that the company has robust and effective risk management and internal control systems which should address all key risks.

The board should lead by example and foster an effective risk culture that encourages openness and constructive challenge of judgements and assumptions. This entails recognising the nature of the wide spectrum of risks a particular company may face and classifying these in terms of frequency, low or high levels of severity and a recognition of the human element in risk. The company's culture with regard to risk and the process by which issues are escalated and de-escalated within the company should be evaluated periodically.

2. Ensuring confidence in audits

We are pleased to share references from the ICGN Global Governance Principles in relation to the subject of ensuring confidence in audits. Principle 8 describes investor expectations around how to ensure confidence in audit and assets that the board should establish rigorous, independent and effective internal and external audit procedures, to ensure the quality and integrity of corporate reporting. This principle is supported by the following guidance points:

2.1 Internal audit

The board should oversee the establishment and maintenance of an effective system of internal control to properly manage risk which should be measured against internationally accepted standards of internal audit and tested periodically for its adequacy. Where an internal audit function has not been established, full reasons for this should be disclosed in the annual report, as well as an explanation of how adequate assurance of the effectiveness of the system of internal controls has been obtained.

More generally, internal audit is an important component in building trust and assurance in the governance, risk management and internal control systems of a company. Internal audit officers should have an understanding of audit standards and practices. They should also have diplomacy to be able to traverse between management and the board (or the audit committee) and ensure the audit committee understands and can take advantage of the important role of internal audit.

2.2 External audit

The board should establish formal procedures to ensure an effective and independent external audit of the company's financial statements to provide assurance to shareholders and relevant stakeholders around a company's financial position, performance and prospects.

The board should publish a report from the external auditor in the annual report which provides an independent and objective opinion as to whether the accounts give a true and fair view of the company's financial position and prospects.

2.3 Audit Committee

The board should establish an audit committee comprised entirely of independent non-executive directors. At least one member of the audit committee should have recent and relevant financial expertise and all audit committee members should be financially literate,

including a basic understanding of accounting. The terms of reference for the committee should be disclosed and include:

- a) monitoring the integrity of the accounts, financial statements and any formal announcements relating to the company's financial performance, and reviewing significant financial reporting judgements contained in them;
- b) maintaining oversight of key accounting policies and accounting judgements in accordance with generally accepted international accounting standards, and disclosing such policies in the notes to the company's accounts;
- c) reviewing the company's risk management approach, system of internal financial controls, other internal control functions, and the effectiveness of the internal audit function;
- d) agreeing the minimum scope of the audit as prescribed by applicable law and any further assurance that the company needs;
- e) annually assessing the quality and effectiveness of the audit and ensuring independence of the external auditor including in relation to the provision of non-audit services and related fees;
- f) recommending to the board the appointment, reappointment and, if necessary, the removal of the external auditor and audit fees. Non-audit fees should normally be less than the audit fee and, if not, there should be a clear explanation as to why it was necessary for the auditor to provide these services and how the independence and objectivity of the audit was assured;
- g) approving the terms of reference for the audit engagement and ensuring that contracts do not contain specific limits to external auditor liability to the company for consequential damages or require the company to use alternative dispute resolution;
- h) engaging with the external auditor without management present to discuss any risks or other concerns that were significant to the audit process, including any significant questions or disputes regarding accounting practices or internal controls;
- i) overseeing the interaction between management and the external auditor, including reviewing the management letter provided by the external auditors and overseeing management's response; and
- j) reporting on the committee work in the annual report and engaging with shareholders either directly or via the board.

2.4 Board accountability to shareholders

At the annual general meeting, shareholders should approve a recommendation from the board regarding the appointment / reappointment and remuneration of the external auditor. The board should explain the work of the Audit Committee in the annual report and engage with shareholders either directly or via the board on any significant issues arising from the audit relating to the financial statements and they were addressed; and more generally the board should report to shareholders on the effectiveness of the audit process including audit tender, auditor tenure, independence, fees, and the provision of any non-audit services.

3. Key governance standards for Prime Market listed companies

The creation of the Prime Market listing category offers an opportunity for the best governed Japanese companies to differentiate themselves. In terms of recommendations on which corporate governance principles should be prioritised in the standards for the newly created Prime Market, we reiterate some of the recommendations previously submitted to the committee. We have suggested dozens of recommendations over the course of the year and for brevity we have refined this to the following 10 priorities:

3.1 Independence levels

The board should comprise a majority of independent non-executive directors, particularly for Prime Market listed companies. This majority threshold is important in Japan due to the higher number of listed subsidiary companies compared to other markets. According to data from Ministry for Economic Trade and Industry (METI), subsidiaries account for around 11% of all listed companies in Japan, compared to less than 1% of companies the US and UK, or between 3-4% in France and Germany. A majority of independent directors is particularly important in the context of listed subsidiaries (including those in the Standard and Growth Market) to act as a check on the presence of a controlling owner (i.e. the holding company shareholder) to ensure minority shareholder rights are upheld, particularly relating to major decisions which may impact the nature of their investment in the company.

3.2 Independent leadership

There should be a clear division of responsibilities between the role of the chair of the board and the CEO to avoid unfettered powers of decision-making in any one individual. The Board should be chaired by an independent director who should be independent on the date of appointment. Should the role of the Chair and CEO be combined, the board should explain the reasons why this is in the best interests of the company in the annual report and keep the structure under review. The responsibilities of the chair, CEO, lead independent director and committee chairs should be clearly described and publicly disclosed.

3.3 Lead independent director

The Board should appoint a Lead Independent Director (LID) even when the company chair is independent. The LID provides shareholders, relevant stakeholders and directors with a valuable channel of communication particularly when they might wish to discuss concerns relating to the chair or significant shareholders in the case of controlled companies.

3.4 Diversity

Boards, and the workforce, should comprise a diverse group of individuals to ensure effective and inclusive decision-making in alignment with the company's purpose and key stakeholders. This includes individuals from different genders, ethnicities (in jurisdictions where it applies), nationalities, social and economic backgrounds, and personal attributes. Boards should disclose and report against the company's policy on diversity which should include measurable targets and period for achievement. The report should include an explanation of how the diversity policy aligns with the company strategy and succession planning for the board and workforce.

3.5 Board appointments

There should be a formal approach to the appointment of board directors based on relevant and objective selection criteria, led by the Nomination Committee, to ensure appropriate

refreshment aligned with the company's long-term strategy, succession planning and diversity policy.

3.6 Capital allocation

The board should disclose a clear policy on the company's approach to capital allocation as a foundation for long-term value creation. The policy should clarify how a sustainable balance of capital allocation is achieved among different and competing company, shareholder, creditor and stakeholder interests, while maintaining a sufficient level of capitalization and liquidity to cushion against foreseeable risks. ICGN welcomes the proposals by the METI for an annual, data-led review of a company's business portfolio by the board. This involves identifying business unit return on invested capital (RoIC) and cost of capital: if a return in excess of the cost cannot be achieved in a reasonable and justified time period, the board should show a plan for exit.

3.7 Timing of the securities report

The Securities Report (Yuho) and the Notice of AGM should be published pre-AGM (not post) and be translated in English. The Securities Report (Yuho) includes valuable information for investors around the business model, corporate strategy, audited financial results, Key Audit Matters and other corporate governance related information such as cross-shareholdings.

3.8 Information consolidation

Accessing corporate governance related information in Japan can be difficult given the dispersed nature of governance-related reporting with various elements required under different authorities, e.g., the Securities Law and Companies Act. Consolidating the information into the Securities Report (Yuho) could help investors assess any explanations for deviations to Corporate Governance Code compliance and make considered judgements on voting. This could be further enhanced through digitalisation of corporate governance related information with separate XBRL tags to make analysis more efficient.

3.9 Cross shareholding disclosure

While disclosure around cross-shareholdings in Japan has improved, we observe that many companies in Japan 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 not sufficient. ICGN suggests that Principle 1-4-1 of Japan Corporate Governance Code should be strengthened to require companies to provide:

- clarification around the nature of the cross-shareholding, for example if it is a parent company, subsidiary, or supplier.
- a firm rationale for the cross-shareholdings - notably, companies should not obfuscate cross-shareholdings by recognising them in the pure investment category, which would also increase the weight in the revised TOPIX index - where the purpose of cross-shareholding is changed to pure investment, the shares should normally be sold in one year.
- a description of how non-strategic cross-shareholdings will be reduced or eliminated over a specified time-period.

- disclosure of the top 60 cross-shareholdings by value as well as the total number, not only in the Annual Securities Report to be published before the AGM, but also on the company's website in English.

3.10 Takeover rule reform

While the subject of takeovers is a matter of hard law and not necessarily considered relevant for inclusion in the Japan Corporate Governance Code, we recommend that the Financial Instruments and Exchange Law regarding public takeovers in Japan be reviewed to ensure appropriate minority shareholder protections. This is particularly relevant to shareholder rights plans ('poison pills') or other structures that act as anti-takeover mechanisms. ICGN strongly advocates that only non-conflicted shareholders should be entitled to vote on such plans. Plans should be time limited and put periodically to shareholders for re-approval.

Conclusion

To conclude, we believe it critically important for boards to enter into constructive dialogue with shareholders and relevant stakeholders for the mutual pursuit of long-term corporate value creation as mentioned in Supplementary Principle 1.3 of the ICGN Global Governance Principles:

"The board, particularly the chair, lead independent director and committee chairs, should constructively engage with shareholders, creditors and relevant stakeholders for meaningful dialogue. Such dialogue should encompass all matters of material relevance to a company's governance, strategy, innovation, risk management and performance as well as environmental and social policies and practices. "

Additionally, ICGN encourages companies to demonstrate their accountability to shareholders by providing clarity around how shareholder concerns are addressed, particularly when there is a significant vote against a particular resolution. If a board-endorsed resolution has been opposed by a significant proportion of votes (e.g. 20% or more), the company should explain subsequently what actions were taken to understand and respond to the concerns that led shareholders to vote against the board's recommendation within six months after the shareholder meeting. We recommend that Supplementary Principle 1.1.1. of Japan's Corporate Governance Code reflect this practice.

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

Yours faithfully,



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