



ICGN

International Corporate Governance Network

26th Council of Experts (“Council”)
Follow-up of Japan’s Stewardship Code and Japan’s Corporate Governance Code

31st March 2021

Dear Fellow Council Members,

ICGN Response to Revision Draft of Japan’s Corporate Governance Code and the Guidelines for Investor and Company Engagement

On behalf of the ICGN, I am pleased to submit our comment on the Draft Revision of Japan’s Corporate Governance Code (“the Code”) and the Guidelines for Investor and Company Engagement (“the Guidelines”).

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 membership includes institutional investors and business leaders who have a shared interest - and thus a shared responsibility - to preserve and enhance long-term corporate value, contributing to economic growth, social prosperity, security, and a healthy environment.

ICGN’s mission supports this shared responsibility, as advocated in the ICGN Global Governance Principlesⁱ which are subject to review this year as part of a three-year cycle. Our commentary draws on some of the potential changes to ICGN’s own Principles subject to ICGN Member approval on 2nd September 2021, and we have provided some examples in this letter (highlighted as underlined text).

We welcome the approach by FSA to convene an Expert Council to deliberate on revisions to the Japan Corporate Governance Code and the Guidelines for Investor and Company Engagement. Both documents serve to help promote long-term corporate value and sustainable economic growth by fostering high standards of corporate governance and encouraging more constructive engagement between companies and investors.

ICGN has participated in every meeting of the Council since the start of this review process and presented letters representing the global investor perspective on priority issues as summarized below:

- COVID 19 impact on corporate governanceⁱⁱ
- Board leadership, diversity, independence, appointments, evaluationⁱⁱⁱ
- AGM format, securities report timing, disclosure of voting results^{iv}
- Capital efficiency, cross-shareholdings and group governance^v
- Sustainability, climate change, social inequality, company and investor dialogue^{vi}
- Risk oversight, audit and key governance priorities for JPX Prime Market^{vii}

We are pleased that many of ICGN’s recommendations have been taken into account in the revisions to the Code and Guidelines. We also note that some of our recommendations have not been included and this letter serves to clarify the areas where we believe further revisions to the Code and Guidelines would be helpful in the future.

1. Draft Revisions to the Corporate Governance Code

General Principle 1.4: Cross shareholdings

The current principle focuses on the need for there to be a policy for cross-shareholdings and the board's role in assessing individual cross-shareholdings. This Principle could be strengthened to require companies to provide:

- Disclosure around the nature of the cross-shareholding, for example if it is a parent company, subsidiary, or supplier.
- Disclosure around the 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.
- 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.
- Disclosure of a time period over which non-strategic cross-shareholdings will be reduced or eliminated.

General Principle 2: Stakeholders

ICGN welcomes the enhanced explanation in the Notes to the General Principles around the importance of sustainability referenced in supplementary principles 3.1.3 and 4.2.2. ICGN's own Global Governance Principles have also been updated in this regard as indicated below:

ICGN Guidance 1.1 Board responsibility

The board is accountable to shareholders and relevant stakeholders for preserving and enhancing sustainable value over the long-term in alignment with a company's purpose. In fulfilling their role effectively, board members are responsible for:

c) understanding the perspectives of relevant stakeholders and disclosing how their interests are taken into account to foster positive relations;

e) accountability for the governance of sustainability ensuring the integration of human capital (particularly the workforce) and natural capital management in strategy, risk and innovation;

Supplementary Principle 2.4.1: Diversity

ICGN welcomes the addition of Supplementary Principle 2.4.1 to recommend the disclosure of a policy on diversity. We recommend that there is also reference to a period over which diversity goals are achieved. Additionally, this Principle should stipulate the importance of there being annual reporting against the policy including an explanation of how the diversity policy aligns with the company purpose, strategy and succession planning for the board and workforce.

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 appreciate that, in addition to diversity, companies should foster equality and inclusivity to ensure fair and equitable treatment of opportunities across the workforce. We refer you to ICGN's draft Principle on diversity by way of example:

ICGN Guidance 3.1: Diversity

Boards, and the workforce, should comprise a diverse group of individuals to ensure equitable 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 periods 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.

We also welcome reference under Supplementary Principle 2.4.1 to the importance of linking human resources strategies 'to enhancing corporate value.' There is growing consensus amongst investors around how companies should measure human capital management and what should be disclosed.

ICGN encourages companies to provide better disclosure around human capital policies, practices and performance as part of a longer-term strategy for value creation. Disclosure should be tailored to the company's specific human capital management strategy and include information on topics like:

- Investment in training
- Lost-time injury and fatality rates
- Pay ratios (across highest, median and lowest quartiles)
- Turnover (voluntary and involuntary, internal hire rate)
- Compensation and incentive plans
- Workforce demographics (full time, part time, agency)
- Workforce engagement, union representation, work-life initiatives
- Gender, ethnic and racial diversity across different workforce levels particularly in relation to recruitment, retention and promotion

Disclosure should also be supplemented with key performance indicators (KPIs) covering relevant policies and their outcomes. This should include measurable goals and a period over which KPIs are achieved.

Such disclosure should be made in the annual securities report (Yuho) where the information is material to corporate strategy and corporate management, as well as in other voluntary corporate disclosure materials more extensively.

Supplementary Principle 3.1.3: Full disclosure

ICGN welcomes reference to sustainability reporting under Supplementary Principle 3.1.3. We refer you to ICGN's draft principle in this regard which clarifies that sustainability reporting extends to all intangible drivers that impact company performance and long-term value creation, such as human capital and natural capital – as well as financial capital.

ICGN Guidance 7.4: Sustainability reporting

The Board should provide 'sustainability' reporting to reflect the complexities inherent in a contemporary business by blending financial, human and natural capital considerations in the context of a company's current and future strategic direction. Sustainability reporting should support and enhance the information in the financial statements and help investors to form an assessment of the company's long-term strategy and prospects.

ICGN welcomes reference to climate related reporting under Supplementary Principle 3.1.3 and we refer you to the new draft recommendation in the ICGN Principles as follows:

ICGN Guidance: 7.5 Climate related disclosure

The board should assess the impact of climate change on the company's business model and how it will be adapted to meet the needs of a net zero economy as part of a long-term strategy. This includes setting and disclosing targets to reduce carbon emissions and a period for achievement. Disclosure around these actions would help investors understand the resilience of companies facing climate change risks and to assess progress towards achieving net zero targets.

Such information should be disclosed in the annual securities report (Yuho) where the information is material to corporate strategy and corporate management, as well as in other voluntary corporate disclosure materials more extensively.

Principle 4.8: Independent directors

We welcome the increased requirement for companies that will be listed on new Prime Market to appoint at least one-third of the board to be independent directors. This has increased from the previous requirement of just two independent directors, which is retained for the Standard and Growth Market.

However, ICGN maintains that ALL listed (standard and growth markets) companies should comprise at least one-third of the board to be comprised of independent directors, and at least a majority of independent directors should be required for Prime Market listed companies which reflects higher governance standards.

Supplementary Principle 4.8.3

ICGN welcomes reference to the importance of companies with a controlling shareholder to appoint at least one-third independent directors who are independent of the controlling shareholder) to the board and for Prime Market companies this requirement increasing to a majority of independent directors.

A majority of independent directors is particularly important in the context of listed subsidiaries 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.

In the future, we suggest that the Code should reference the importance of there being a transparent and rigorous appointment process for independent directors under the responsibility of a Nomination Committee, comprised of a majority of independent directors. In this regard, we refer you to ICGN Guidance 3.4:

ICGN Guidance 3.4: 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 board independence and refreshment aligned with the company's long-term strategy, succession planning and diversity policy.

Supplementary Principle 4.10.1: Committees

ICGN recommends that corporate boards should establish independent committees to deliberate on issues such as audit, executive and non-executive director remuneration and director nomination. We welcome the new supplementary principle which references the need for companies to disclose the duties and membership of such committees.

ICGN advocates that the Audit Committee and Remuneration Committees both be comprised of wholly independent directors, while the Nomination Committee should be majority independent. All committees should be chaired by an independent director.

Supplementary Principle 4.11.3: Board evaluation

We recommend that this Principle be expanded to clarify that it is good practice for the board to be periodically (preferably every three years) evaluated by an external consultant. The Principle should also refer to the importance of board committees to be subject to annual evaluation. This review of performance would result in long-standing directors to step down, thus unlocking vacancies to enable appropriate board diversity, independence and succession planning.

Supplementary Principle 5.2.1: Disclosure of business strategies

We welcome the new supplementary principle to require companies to *'clearly present the basic policy regarding the business portfolio decided by the board and the status of the review of such portfolio.'*

We recommend that this principle make clear that the board should disclose a clear policy on the company's approach to capital allocation as a foundation for long-term value creation and that the board review the business portfolio annually. 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.

2. Guidelines on Investor and Company Engagement Revision Draft

We understand that the Guidelines are intended to help facilitate dialogue between companies and investors on issues of relevance to preserving and enhancing long-term corporate value and we offer the following recommendations regarding the latest proposed revisions:

Guideline 3.8: Appointment of independent directors

We welcome the inclusion of reference under 3.8 of the Guidelines regarding a question around whether the Chair of the Board is independent however we believe this reference could be strengthened in the future.

ICGN advocates that 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.

Guideline 4-1-1: Voting results

ICGN welcomes the reference to encourage companies to demonstrate their accountability to shareholders by providing clarity around how shareholder concerns are addressed, particularly when there is a significant vote (i.e., 20% or higher) against a particular resolution. We recommend that this principle be strengthened to require disclosures of

measures undertaken to address investor concerns within six months after the shareholder meeting.

Guideline 4-1-3: Publication of securities report and date of AGM

ICGN appreciates the reference to the publication of the annual securities reports to be made prior to the annual general meeting to enhance constructive dialogue between investors and companies in the Guidelines. This should also be mentioned in the Code, specifically in the Supplementary Principle 3.1.2 in addition to the disclosure in English by the Prime Market companies.

Guideline 4-1-4: Shareholder interaction

When holding a hybrid or virtual-only AGM, we strongly encourage companies to ensure interactivity with shareholders and to replicate as best as possible the in-person AGM experience. Companies should allow shareholders the opportunity to submit questions/ make statements in advance of the shareholder meeting date and during the meeting proceedings.

Thank you for this opportunity to provide commentary for the Council meeting. We applaud the efforts of the Council, and the FSA particularly, in continuing to reform corporate governance policies and practices in Japan and we recognize the latest revision to the Code and the Guidelines as positive steps forward. 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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ⁱ ICGN Global Governance Principles

ⁱⁱ 20th October 2020, ICGN Statement to the 20th Council of Experts for the Follow-up of Japan's Stewardship Code and Corporate Governance Code

ⁱⁱⁱ 18th November 2020, ICGN Statement to the 21st Council of Experts for the Follow-up of Japan's Stewardship Code and Corporate Governance Code

^{iv} 8th December 2020, ICGN Statement to the 22nd Council of Experts for the Follow-up of Japan's Stewardship Code and Corporate Governance Code

^v 26th January 2021, ICGN Statement to the 23rd Council of Experts for the Follow-up of Japan's Stewardship Code and Corporate Governance Code

^{vi} 15th February 2021, ICGN Statement to the 24th Council of Experts for the Follow-up of Japan's Stewardship Code and Corporate Governance Code

^{vii} 9th March 2021, ICGN Statement to the 25th Council of Experts for the Follow-up of Japan's Stewardship Code and Corporate Governance Code