



ICGN

International Corporate Governance Network

27th Council of Experts (“Council”)
Follow-up of Japan’s Stewardship Code and Japan’s Corporate Governance Code

16 May 2022

Dear Fellow Council Members,

ICGN Response to Interim Review Following the 2021 Revision of the Corporate Governance Code

On behalf of the International Corporate Governance Network (ICGN)¹, I am pleased to join the 27th Council of Experts (“27th Council”): Follow-up of Japan’s Stewardship Code and Japan’s Corporate Governance Code to represent ICGN’s perspective on the Council’s deliberations. We understand that the primary purpose of the 27th meeting of the Council is to consider:

- Challenges for sustainable growth with specific focus on board independence, capital allocation and cross shareholdings; and
- Dialogue between companies and investors with specific focus on collective engagement, transparency, and the comply-or-explain system.

Led by investors responsible for assets under management of around \$70 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.

This shared responsibility is advocated in the ICGN Global Governance Principles² (“ICGN GGP”) and the ICGN Global Stewardship Principles (“ICGN GSP”)³ which form the basis of ICGN’s work programme around the world. The ICGN GGP is referred to by many members in their voting policies and company engagements. Both the ICGN GGP and the ICGN GSP are also used by regulators as an international benchmark in the development of national policies.

Relevant to Japan, ICGN also published a Statement of Japan Corporate Governance Priorities⁴ in 2019 (“ICGN 2019 Statement”) which recommend priority areas of governance improvement from the perspective of global investors, noting around 30% of shares issued by companies listed on the Tokyo Stock Exchange are held by overseas investors.

ICGN welcomes the revisions to the Japan Corporate Governance Code (“the Code”) undertaken last year. We believe that the new recommendations will further 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.

¹ <https://www.icgn.org/about>

² <https://www.icgn.org/sites/default/files/2022-04/ICGN%20Global%20Governance%20Principles%202021.pdf>

³ https://www.icgn.org/sites/default/files/2021-06/ICGN%20Global%20Stewardship%20Principles%202020_1.pdf

⁴ <https://www.icgn.org/sites/default/files/2022-05/ICGN%20Policy%20Priorities%20Japan.pdf>

We encourage continued momentum for active corporate governance reform initiatives in Japan under the Kishida Administration. This is aligned with international acceptance, developed over two 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. This requires corporate boards, management, and investors alike to focus not only on financial capital underpinning corporate success but also on sustainability related factors such as human capital and natural capital.

Going forward, we encourage JPX listed companies to adopt the Code principles into practice and disclose evidence to that effect on a comply or explain basis to shareholders and key stakeholders. To help facilitate an understanding by companies on areas of particular interest to global investors, in this letter ICGN has considered progress achieved since the Code came into effect. We have also reviewed the degree to which the corporate governance priorities outlined in ICGN's 2019 Statement appear to have been addressed. This statement to the Council therefore focuses on potential areas for continued improvement as well as celebrating progress to date.

1. Quantity of Independent directors

We welcome the positive trend of more than 80% of companies listed on the JPX Prime Market to have at least one third of independent directors. Going forward, we recommend that:

- A timeframe be imposed for all Prime Market listed companies to abide by the Code requirements for one-third independent directors – for example by January 2023.
- More ambition be pursued so that all Prime Market Listed companies embrace a majority of the Board to be comprised of independent directors within a reasonable timeframe – for example by January 2025; and
- All listed companies whether in the standard or growth market to comprise at least one-third independent directors.
- The definition of independence in the JPX Listing Rules be enhanced to facilitate better disclosure around cross-shareholdings, major client and supplier relationships, business relationships, the provision of consultancy services and family ties. There should also be clarity around how long any conflicts should be absent before a board candidate can be considered independent without conflicts of interest and ties to other board members and the boards on which they serve.

2. Quality of Independent Directors

Independent Directors are relied upon by investors to bring their industry knowledge and experience to the Board to assess the quality of managerial decisions, for example relating to strategic investments in fixed assets, acquisitions, research and development and human resources. We acknowledge that disclosure has improved since the Code was updated last year and recommend going forward that:

- Disclosure continues to 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 align 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.
- Disclosure around board evaluation be improved include the process for board evaluation and any material issues of relevance arising from the conclusions. More generally, the conduct of regular reviews of board / director performance may help facilitate improved board diversity, independence, and succession planning as resultant vacancies arise over time.

3. Diversity, equity and inclusion

ICGN welcomes enhanced corporate disclosure in Japan around board and workforce diversity. We emphasise that 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 companies should foster equity and inclusivity 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. This is data that companies will already likely collate and disclosure should be made in the corporate governance section of the annual report or on a company's website.

4. Committee adoption

We welcome the positive trend of around 80% of companies listed on the JPX Prime Market to have established nomination and compensation committees. Going forward we recommend that:

- All Prime Market listed companies adopt a three-committee system as an optimal governance structure with Audit and Remuneration Committees comprised fully of independent directors and the Nomination Committee being comprised of a majority of independent directors.

5. Capital allocation

ICGN appreciates that companies around the world currently face a myriad of systemic risks associated with climate change, the Covid pandemic, Russia's war against Ukraine, global supply chain dissolution, energy shortages and more. We understand that it is prudent for companies to take a conservative approach to capital allocation in these challenging times to manage efficiencies, mitigate risk, and ensure resilience. However, compared to European and North American markets, JPX listed companies take a markedly risk adverse approach to capital allocation as evidenced in the continual build-up on retained earnings and cash deposits. This suggests the need for a greater awareness of Japanese companies to consider their economic profitability, and more specifically their economic returns on capital.

Boards should regularly review the company's balance sheet and how cash positions, debt and equity can be blended prudently to achieve both acceptable returns for investors, while maintaining a sufficient level of capitalisation and liquidity to provide a cushion against foreseeable systematic and unsystematic risks. "Cash" in this context includes not only cash and other liquid assets but all securities (with the exception of subsidiaries) and real estate for leasing. ICGN regards such assets as "cash" because, much like actual cash, the returns are below the economic cost of capital.

Boards should ensure that companies maintain an appropriate, but not excessive, amount of cash or other liquid assets - justifying cash holdings together with allocation of cash flows should be executed in the context of the cost of capital. Despite these challenging times, in order to continue to create long-term value, companies must also use cash reserves for investment in human resources, intellectual property, technology, research, innovation and more.

Furthermore, a clear capital allocation policy can help ensure that management is not irrationally using cash (such as rebuilding new office buildings etc.) and instead employing cash in activities which are aligned with the company's purpose and strategic objectives to generate long-term value. This will also highlight any investments in non-strategic assets that may not be core to the company's own business or sector, and which may suffer from low profitability (below the cost of capital) and be value destructive.

More generally, the oversight of a company's capital allocation policy is a key board responsibility and guides management on how cash flows are distributed between capital spending, dividends, share buybacks, executive remuneration and so on. It is therefore important that board directors are financially literate and understand the cost of capital and expected shareholder returns.

Going forward, we recommend:

- Improved disclosure around the rationale for capital allocation decisions as part of a longer-term capital allocation strategy. For example, this includes information in

relation to acquiring new businesses, making large capital investments, discontinuing existing businesses and research and development expenditure.

- Improved disclosure around the rationale for holding non-core assets - whether they are in property or business units or investment securities - should be clearly explained by the board. If the rationale is insufficient, such assets should be sold and proceeds returned to shareholders or used to invest in value enhancing activities.
- Enhanced disclosure on a company's risk adjusted cost of capital (both debt and equity) relative to its returns on capital. This will help investors and boards to better understand a company's economic profitability.
- Enhanced willingness of directors on corporate boards in Japan to competently engage with shareholders on capital cost, shareholders return, growth strategy and cash usage. This includes specific disclosures of the company's calculation of its own cost of debt and equity capital, and how this relates to the company's long-term value creation, including its use of cash, debt, and equity.
- Improved disclosure around the rationale for the dividend policy and improvement around the rationale for the pay-out ratio, often determined around 30-40% and at odds of much higher pay-out ratios in other markets. Dividend policies which are overly conservative can lead to increased cash hoarding (i.e., 60-70% retained earnings) without any reasonable justification.
- Enhanced disclosure of plans related to capital allocation to address systemic risks that could harm sustainable value creation over time. Reporting to shareholders and stakeholders on these risks serves the company and its investors, and shows the board is approaching capital allocation as a business strategy.

6. Cross shareholdings

ICGN welcomed the revisions to the 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 particularly in the banking sector, 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 insufficient and going forward 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.
- 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 - where the purpose of cross-shareholding is changed to pure investment, the shares should be sold in one year.

- How cross-shareholdings will be reduced or eliminated over a specified time-period.
- 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.

7. Corporate governance disclosure

More generally, we emphasise that 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.

Crucially we recommend that the Securities Report (Yuho) is published before the Annual General Meeting to ensure that investors have access to the information required to determine voting decisions. This included information around the corporate business model, corporate strategy, audited financial results, Key Audit Matters and cross-shareholdings.

Going forward we recommend that:

- AGM Notices and the Securities Report are published at least 30 days in advance of the AGM.
- Companies move their respective record dates from March to April to allow AGMs to be held in July and avoid the current challenge of AGM clustering in June.
- JPX Prime Market listed companies provide English translation for both the Securities Report and Notice of AGM.

8. Sustainability disclosure

In 2021 several important developments took place in the harmonisation of sustainability reporting standards - the establishment of the International Sustainability Standards Board, a cooperation agreement between the European Financial Reporting Advisory Group and the Global Reporting Initiative, the continued development of the Sustainability Standards Board of Japan, and national efforts to expedite reporting aligned with the Taskforce for Climate Related Financial Disclosures, including in the Japan Code.

ICGN welcomes all of these initiatives as we work towards the achievement of high-quality global sustainability reporting standards across borders, alongside standards on financial statements. This will enable better investment decision-making through consistent, comparable, and verifiable disclosure across sectors, markets, and industries.

In the case of Japan, we recommend that sustainability information 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.

9. Collective engagement

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 held in 2019, 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.

10. Enhancing dialogue between companies and investors

As noted at the start of this letter, 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 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.

Enhanced dialogue requires that companies develop clear plans for outreach, with a focus on a constructive dialogue with investors, to facilitate collective engagement, provide more transparency, and fully participate in the comply-or-explain system.

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,

A handwritten signature in black ink, appearing to read 'Kerrie Waring', written in a cursive style.

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