29th Council of Experts
Follow-up of Japan's Stewardship Code and Japan's Corporate Governance Code

18th April 2024

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 taking place on 18th April 2024.

Led by investors responsible for assets under management of $77 trillion, ICGN is a global authority on the highest standards of corporate governance and investor stewardship. These standards are defined in ICGN's Global Governance Principles and Global Stewardship Principles. As such, our commentary is based on these standards, together with ICGN's Japan Governance Recommendations.

ICGN applauds the Financial Services Agency (FSA) 'Action Program for Accelerating Corporate Governance Reform' and initiatives undertaken by the Tokyo Stock Exchange (TSE), among others. As a result, global investor confidence in Japan as an attractive financial centre is high, as evidenced in today's strong stock market performance.

Going forward, we agree with the FSA's approach to focus on substantive – not formulaic – market reform. In doing so we welcome the suggestions put forth by the FSA regarding future initiatives related to the following areas as described in Council materials:

1. General observations on the application of corporate governance principles.
2. Effective implementation of stewardship activities.
3. Improving the effectiveness of the board.
4. Encouraging management with an awareness of profit-making and growth.
5. Enhancing the quality of disclosure and promoting dialogue with global investors.
6. Resolving market environment issues: cross-shareholdings.
7. Encouraging management with an awareness of sustainability issues, particularly diversity.

1. General observations on the application of corporate governance principles.

For corporate governance to be effective in any market there must be constructive dialogue between companies and their shareholders in their mutual pursuit of long-term corporate value creation. Typically, this dialogue concerns a company's approach to governance, resilience, sustainability related risks and opportunities, and management's performance against strategic objectives.

A Corporate Governance Code can facilitate this dialogue by setting high standards of practice, notwithstanding that, on occasion, there may need to be deviation to certain code principles. In such cases, the concept of 'comply or explain' is useful allowing companies to explain their rationale in the event that a company deviates from a code principle or needs additional time to comply. This approach allows for flexible application of the code in accordance with the individual circumstances of the company. In this regard ICGN encourage companies to provide meaningful explanations for code deviations and the rationale for the alternative approach.

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."*

2. Effective implementation of stewardship activities.

ICGN appreciate the FSA's efforts to address potential legislative obstacles to facilitate effective stewardship including dialogue between investors and companies in Japan. In this regard, we welcome revisions to the Financial Instruments & Exchange Act and the definition of "Joint holders." This may help provide clarity for investors around their ability to act collaboratively with other investors without being considered a 'concert party' when engaging with companies. In this regard, it may be helpful for the FSA to publish guidance on what constitutes acceptable engagement subjects to ensure investors do not unknowingly breach rules regarding collective holding thresholds above which would trigger onerous reporting requirements.

We understand that the FSA is considering how to encourage greater coordination by investors in terms of their company engagements and exercise of share voting. In this regard, we refer you to the following relevant guidelines in ICGN's Global Stewardship Principles which are currently under review (noting underlined text represents new language).

> 2.2 Integration
> Stewardship, as a fundamental aspect of an investor's fiduciary duty, should be understood and promoted by senior executives of the organisation. Investors should disclose how their stewardship policies are implemented through robust processes and integrated across the organisation (e.g., stewardship and investment portfolio management teams) to ensure a consistent approach to effective stewardship responsibilities, objectives, and outcomes.
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> 3.5 Company engagement
> Investors should engage with companies in a constructive manner to preserve and create long-term corporate value. Engagement objectives should be clarified to companies in an agenda submitted in advance of the meeting. Investor concerns or proposals should be evidence-based and include <u>peer examples where available</u>. Following the meeting, investors may wish to correspond with the company reiterating their expectations on the issues discussed and monitor how such issues are addressed over time.
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> 3.6 Engagement responsibilities

Investors should disclose who is responsible for leading company engagements and clarify which company representatives they expect to meet with and why. Where an investor is a controlling shareholder, they should consider engaging with minority shareholders to seek mutually aligned engagement objectives where possible. Engagement may also extend to key stakeholders of the company.

4.2 Voting guidelines
Investors should disclose, and regularly review, their voting guidelines, aligned with their investment beliefs, business model and strategy. Guidelines should clarify how voting is prioritised (e.g., issues of general importance to beneficiaries and clients, or specific issues relevant to individual companies), or differs depending on jurisdiction, investment mandate or asset type and should be reviewed periodically.

4.3 Voting process
Investors should disclose how their voting process ensures informed and independent voting decisions, applying due care, diligence, and judgement in the interests of beneficiaries and clients. Disclosure should clarify who is responsible for the vote decisions, including if this differs depending on the nature of the resolution, geography, or scale of holdings, and how any in-house conflicts of interest are identified and addressed.

4.4 Voting rationale
Investors should disclose the rationale for voting decisions, particularly when votes on company (or shareholder) resolutions were cast against or abstained, or if a vote was cast inconsistent with the investor's voting policy. The decision should be communicated to companies, preferably before annual general meetings, and there should be constructive dialogue thereafter in pursuance of engagement objectives and effective outcomes.

3. Improving the effectiveness of the board.

ICGN supports the FSA's objective to improve the effectiveness of boards and committees, and the quality of independent directors more generally. We agree with FSA's observation that there appears to be a lack of clear understanding of the role of independent directors and the market may benefit from enhanced educational provisions.

Independence
We are pleased that (95%) Prime Market companies now have one third or more independent directors on the Board. Ideally, companies - whether in the standard or growth market - should have a majority of independent directors, particularly for companies with controlling shareholders.

Independent directors provide independent judgement, outside experience and objectivity to board decision-making and thus provide a valuable, impartial perspective to corporate decision-making, and are well placed to represent the interests of minority shareholders.

We encourage Japanese companies to demonstrate practical usage of independent directors. For example (1) the chair should regularly hold meetings with independent directors without executive directors present; (2) independent directors should meet at least annually, without the chair present, to appraise the chair's performance or as appropriate; (3) independent directors should scrutinise performance of management and hold them to account against agreed KPIs; and (4) utilize independent directors on key committees, such as Audit, Compensation and Nomination.

We also encourage corporate directors to undertake governance training to help build an understanding of what their role entails, particularly in relation to strategy, monitoring management and corporate reporting.

Leadership

ICGN advocates that the roles of the Chairperson and CEO be separated 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 Chairperson 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. Additionally, we encourage that the responsibilities of the Chairperson and CEO should be clearly described and publicly disclosed.

Board appointments

Independent director appointments be subject to a formal and transparent procedure based on relevant and objective selection criteria led by the Nomination Committee, comprised of a majority of independent directors. Individuals should demonstrate competency for the role of director and be subject to director training to ensure periodic refreshment of knowledge. The rationale for all director appointments (executive and independent) be disclosed including how their experience relates to a Skills Matrix with indicators that are clearly defined as aligned with the company purpose, long-term strategy, succession plan, Diversity Policy and any factors affecting their independence.

Board evaluation

ICGN recommends that companies undertake a formal and rigorous review of the performance of the board (as a collective body, including kansayaku boards), committees and individual directors prior to being proposed for annual re-election. The board should periodically (preferably every three years) engage an independent external consultant to undertake such evaluations. Nomination Committees should lead an annual internal evaluation and be responsible for appointing an independent consultant to conduct an external evaluation at appropriate intervals (e.g., once every three years).

Board evaluation should be conducted to review composition as appropriate for the needs of the company. In this regard, we encourage companies to develop and disclose a skills matrix of board composition to identify how key skills, experience and knowledge are aligned with the company's long-term strategic needs, diversity policy and succession planning.

The process for board evaluation and decision-making should be clearly disclosed and, as far as reasonably possible, information around the discussion topics, the conclusions (including any material issues arising from the evaluation) and actions taken forward.

4. Encouraging management with an awareness of profit-making and growth.

ICGN welcomes the FSA's focus on encouraging management to have a greater awareness of corporate profitability and growth, based on the cost of capital. Many ICGN members are using the new data provided by the TSE's recent requirement for companies to enhance capital allocation disclosure.

Board oversight

The board should oversee a company's capital allocation policy aligned with long-term strategy and explain its rationale to shareholders. For example, in relation to acquiring new businesses, large capital investments, discontinuing businesses and R&D expenditure. We welcomed Japan CG Code requirement for the Board to review the business portfolio annually including business unit return on invested capital and cost of capital. If a return in excess of the cost of capital cannot be achieved in a reasonable period, the Board should show a plan for exit.

Cross shareholdings
We are encouraged by the decline in cross-shareholdings and some companies are disclosing numerical reduction targets and timelines. However, while Japan's Corporate Governance Code clarifies that there are cases where cross-shareholdings can be rational, disclosure is often vague (for example, "to smooth business relations") and investors want clearer linkage regarding how such holdings impact a company's returns on capital.

More generally we encourage corporate boards to disclose a plan to reduce cross-shareholdings over a specified period and progress towards achieving a specified target. This includes the nature of cross-shareholdings, e.g., parent company, subsidiary, or supplier.

5. Enhancing the quality of disclosure and promoting dialogue with global investors.

ICGN welcomes ongoing efforts led by the FSA to enhance the content, format, timeliness and publication of corporate governance and sustainability related information. Going forward we recommend increased attention on English language disclosure and the timing of the publication of the securities report.

English-language disclosure
ICGN welcomes the TSE's recent requirement for Prime Market companies to publish simultaneously in English and Japanese statutory disclosures. Over time, we encourage application to non-statutory disclosures and to a broader scope of companies.

Timing of publication of the Securities Report
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. The Yuho should therefore be published pre-AGM, not post. Companies listed in TSE prime market should make both English translated Securities Report and Notice of AGM.

6. Resolving market environment issues: cross-shareholdings.

ICGN welcomed previous revisions to Japan's Corporate Governance 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.

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 of Japan Corporate Governance Code should be strengthened to require companies to provide:

- clarification around the nature of the cross-shareholding, for example if they are a subsidiary company or supplier.
- a firm rationale for the cross-shareholdings.
- a description of how cross-shareholdings will be reduced or eliminated over a specified time-period.

7. Encouraging management with an awareness of sustainability issues, particularly diversity.

ICGN welcome the Japan Sustainability Standards Board's efforts to develop national corporate sustainability reporting standards, functionally aligned with the ISSB's global baseline. ICGN particularly welcomes the mandatory requirement for reporting on human capital, IP, and diversity in the Yuho.

We support the Government's target for at least one female board director by 2025 and 30% of female directors, auditors, or executives by 2030. Corporate boards, and the workforce, should comprise a genuinely diverse group of individuals to ensure effective, equitable and inclusive decision-making in alignment with the company's purpose, succession plan and long-term strategy.

We encourage companies to describe their approach to this in a Diversity Policy specifying measurable, time-bound targets, aligned with a company's purpose, values, and long-term strategy. Nomination Committees should oversee a company's approach to diversity and hold the CEO to account – linked to KPIs - for ensuring a diverse executive pipeline.

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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