ICGN
International Corporate Governance Network

The Council of Experts for the Follow-up of Japan's Stewardship Code and Japan's Corporate Governance Code

27 November 2018

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

I have pleasure in sending you ICGN comments on the items noted in the Agenda for the next Council Meeting which will take place on 27th November 2018. Regretfully, I will not be able to join you in person on this occasion and hope that the comments presented in this letter can serve as a contribution to the Council's discussion.

From the outset I wish to express ICGN's compliments to the FSA and the Council on the great strides that are being undertaken to help enhance dialogue between companies and investors, ultimately to achieve long term corporate value and sustainable growth.

This statement will address:

1. Importance of independent directors
2. Board responsibility for corporate governance disclosures
3. Role of independent board committees
4. Quality of investor stewardship disclosures
5. Rationale for cross-shareholdings
6. Corporate disclosure: capital allocation and cost of capital
7. Actions to improve gender diversity and board quality

1. Importance of independent directors

ICGN welcomes the increase of companies in Japan with two or more independent directors from 21.5% in 2014 to 91.3% in 2018. We are particularly pleased to note that the companies with more than one third of directors have increased from 6% to 34% during the same period. However, we respectfully suggest that this momentum is expedited to ensure that all publicly listed corporate boards in Japan benefit from a significant element that is fully independent. It may be advantageous to refer to a specific time period within which it is expected that the one-third target is achieved, for example by 2021.

In our past correspondence with the Council we have advocated that companies in Japan should strive for one-third independent directors or have a minimum of three as it would then be possible to have fully independent board committees – noting that our standard for widely held companies is for there to be a majority of independent directors.

Independent directors play a crucial role in constructively challenging management, free from external influence. They can help offset the domination of decision-making by any single individual such as the Chairman and or the CEO and generate healthy debate around a company's vision, mission and strategy. We also stress the importance of Independent Directors having the requisite business skill and knowledge of the sector(s) of operations to help generate this healthy debate. The value of independent directors will only be fully realised when the board is appropriately diverse to allow for a mix of business and industry knowledge and perspectives.

Saffron House 6-10 - Kirby Street - London - EC1N 8TS - UK
VAT No. 927 1665 09 | Registered in England No 6467372
t: +44 (0)207 612 7011
f: +44 (0)207 612 7085
e: secretariat@icgn.org
w: www.icgn.org
@ICGNCorpGov
ICGN

The emerging situation with Nissan is an example of why it is so important that the momentum for reform is progressed as expeditiously as possible. While we could not have anticipated the misconduct of the Chairman and former CEO of Nissan, this example does highlight the very important need for robust independence on corporate boards in Japan and the importance of effective board committees, led by independent directors, such that decisions by executives are subject to robust challenge and debate, and the accuracy of public disclosures is fully tested.

The Nissan example also highlights the need to emphasise that the board itself is collectively responsible for promoting the success of the company. This is a shared responsibility among all board members and decision-making should not be concentrated into any single individual such as the CEO.

ICGN encourages regulatory authorities in Japan to strengthen awareness of independence criteria by introducing a definition in Japan's Corporate Governance Code. We acknowledge that there is a definition of 'independence' in TSE Listing Rules however inclusion in the Code would provide further clarity to boards in their independent director appointment processes. In particular, we recommend disclosure on factors that could impact independence including, cross shareholding partners, major client relationships and family ties. This would also provide an opportunity to set guidance for board skills and expertise.

ICGN encourages the introduction of high quality training for independent directors in Japan to help build an understanding of what their role entails, particularly in relation to monitoring management and public disclosures. This would help ensure objective decision-making in response to business issues and in alignment with the company's vision, mission and strategy. We also stress the importance of financial literacy to ensure that independent directors are able to challenge management on issues such as capital efficiency, the use of cross shareholdings and CEO remuneration.

2. Board responsibility for corporate governance disclosures

We opine on the meeting agenda item related to efforts to improve corporate disclosures under point 6 below. However, given the Nissan experience, it is important to articulate clearly that global investors expect that corporate boards will oversee timely and high quality company disclosures – not only relating to financial statements – but also public disclosure around strategic and operational performance, corporate governance and material environmental and social factors.

The board is collectively responsible for approving and overseeing corporate disclosures and should affirm that the company's Annual Report and Accounts present a true and fair view of the company's position and prospects. We note that in Japan the board is responsible for oversight and approval of the annual accounts and securities report (Yuho). However, ICGN strongly advocates that the corporate boards in Japan should also accept responsibility and approve the Annual Report and other relevant disclosures such as the Annual Remuneration Report and relevant Nomination Committee disclosures.

This will help mitigate failures such as the Nissan example and bring Japan's corporate disclosure regime more in line with international best practice. Board oversight and approval of the Annual Report and other relevant disclosures is imperative to ensure that investors are able to take into account information which assists in assessing the company's financial performance, risk profile, business model, strategy and long term prospects. Investors themselves will expect that board directors understand their responsibilities for keeping the market appropriately informed.

3. Role of independent board committees

The Nissan example highlights the vital role that effective Remuneration Committees should play in mitigating financial misconduct and overseeing the level of CEO remuneration which should be properly and fully disclosed. It also emphasises the need for properly constituted Nomination Committees to regularly appraise CEO performance to which remuneration should be linked.

ICGN recommends that more attention is given to the importance of independent committees on corporate boards in Japan and that there is a clear understanding of the role of such committees. We recommend that all publicly listed companies in Japan adopt a Remuneration Committee and Nomination Committee, where appropriate, and that the Terms of Reference of each committee, as well as details on composition and independence, be disclosed.

The Terms of Reference for the Remuneration Committee should include details on procedures for:

- Setting the company's remuneration policy as well as disclosure of the policy itself;
- Monitoring and evaluating performance of the CEO and senior management, and designing and implementing short-term and long-term incentives for them;
- Ensuring that conflicts of interest among committee members are identified and avoided;
- Appointing independent remuneration consultants; and
- Maintaining appropriate communication with shareholders on the subject of remuneration.

The Terms of Reference for the Nomination Committee should make clear that the responsibilities for the committee are as follows:

- regularly assessing the composition of the board taking into account independence criteria and the Diversity Policy;
- developing a skills matrix describing desired board composition aligned with the company's strategic objectives;
- leading the process for nominating board candidates for shareholder approval;
- ensuring that conflicts of interest among committee members are identified and avoided;
- overseeing the process for board evaluation including the appointment of any external consultant;
- entering into dialogue with shareholders regarding board nominations; and
- leading the development, implementation and review of CEO succession planning.

4. Quality of investor stewardship disclosures

It is encouraging to note that 237 investors have become signatories of the Japan Stewardship Code. Investors are responsible for protecting and enhancing the risk adjusted financial return of the assets they manage on behalf of beneficiaries or clients. This requires engagement with companies to help mitigate risk on the one hand, while identifying opportunities to help improve long-term performance on the other.

The Revised European Shareholder Rights Directive requires investors annually to disclose information on their equity investment strategy and how this contributes to the medium and long-term performance of their assets. Most national stewardship codes call for disclosure of policies around conflicts of interest, voting and company engagement.

While most investors comply with these disclosure obligations, the quality of the information is extremely variable. ICGN has just undertaken a review of stewardship disclosures published by our Members as part of analysis for the ICGN Global Stewardship Awards taking place in December this year. The awards celebrate innovation and excellence in stewardship disclosures by asset owners and their managers.

We found that while there are some good examples, most if not all would benefit from improvements. Many policies were too short, generic or out of date and failed to provide evidence of what they are actually doing in terms of stewardship. To help address this ICGN will soon publish best practice guidance in terms of disclosure for policies relating to conflicts of interest, voting, monitoring and engagement.

This issue was raised by the UK Financial Reporting Council two years ago when they introduced a system to rate the quality of Stewardship Code Signatories into three bands. Investors listed under Tier One, are recognised as having provided good quality descriptions of their approach to conflicts of interest, engagement and resourcing. Such investors also provide good explanations for any departure from the principles of the code. Tier Two investors have published statements which are more standardised with less transparency and weaker explanations for code deviations. Tier Three was for those investors which showed no appetite for delivering on their undertakings, and these signatories have now been removed, as has the Tier.

The distinction between the tiers in the UK has created an incentive for investors to improve their disclosures and has also provided asset owners and other stakeholder with more transparency. In this regard, this system may be suitable for emulation in Japan to aid better disclosure around voting results and stewardship policies.

5. Rationale for cross-shareholdings

ICGN has made a number of submissions to the Council on the subject of cross-shareholdings and we submitted a response to the FSA's Disclosure Working Group consultation in May 2018 on the topic. The practice remains an area of concern for ICGN Members, particularly to the extent that cross-shareholdings and capital management more broadly, are viewed to affect investor returns on capital employed, as well as insulating management from full external challenge.

The strategic intent of cross-shareholdings is a critical consideration, and many overseas investors in Japanese companies are not supportive of cross-holdings that have the effect of reducing returns on capital below a company's cost of capital without a clear strategic logic.

ICGN welcomes efforts undertaken by the FSA and TSE to help reduce cross-shareholdings in Japan, such as amendments to the Corporate Governance Code as well as new Guidance on Investor and Company Engagement in 2018. However we note that many companies only provide boilerplate explanations on the purpose of the cross-shareholdings and disclosures often lack a clear strategic rationale. In this regard ICGN supports further revision to mandatory disclosure regulations in Japan to ensure more detailed disclosure of cross-shareholding information in the annual securities report.

6. Corporate disclosures: capital allocation and cost of capital

It is encouraging to observe that returns on capital for Japanese companies are improving, but on a comparative basis the profitability of Japanese companies still lags peers in North American and European markets. To some extent this reflects differing business philosophies and approaches to capital allocation.

The tendency for Japanese companies to have very conservative capital management practices in terms of how debt and equity risk capital are deployed can contrast with more aggressive forms of capital allocation in Western economies that exacerbate financial risks

Saffron House 6-10 - Kirby Street - London - EC1N 8TS - UK
VAT No. 927 1665 09 | Registered in England No 6467372
t: +44 (0)207 612 7011
f: +44 (0)207 612 7085
e: secretariat@icgn.org
w: www.icgn.org
@ICGNCorpGov
ICGN

for companies and providers of risk capital, both debt and equity. From an investor perspective the challenge in all markets is to encourage capital allocation practices that establish a sustainable foundation for company value creation while meeting the needs of both debt and equity investors.

A fundamental starting point in this debate should be a company's ability to achieve a positive return on its risk-adjusted weighted average cost of capital. This requires, in the first instance, the company's ability to understand and measure its cost of capital, and then to manage the company so that it can adequately generate an "economic profit" – a term for meeting and exceeding its cost of capital. In many ways this is a more meaningful investor expectation that asking companies to generate "alpha", a term of art that means achieving an excess return to the market. Companies have little direct control over their share price or alpha generation—that depends on market forces. But they should have the ability to develop capital structures and corporate strategies in such a way as to achieve positive economic profits.

In the specific case of Japan this means that companies should review their balance sheets, 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. This means having an appropriate, but not excessive, amount of cash or other liquid assets, as well as an appropriate balance of debt and equity capital to achieve an acceptable equilibrium of financial stability and returns for investors. It also provides a foundation for company capital allocation decisions relating to how company cash flows are allocated between capital spending, dividends, share buybacks, executive remuneration and investments non-strategic assets that may not be core to the company's own business or sector. This latter consideration again raises the question of cross-shareholdings in other companies.

From this, we believe that corporate reporting and disclosure is an important way for investors to better understand Japanese companies' approach to capital allocation and cross-shareholdings. Companies should be specific about the strategic purposes of the holdings. We also believe that the company and its investors would benefit from the company disclosing its own weighted average cost of capital which can help to identify situations when cross-shareholdings might contribute to diluting returns on capital, particularly if the company is not meeting its cost of capital.

We would encourage the FSA to consider more detailed disclosure requirements in this area for companies in their annual reports and other disclosures that help investment decision making. In particular we would support improvement of corporate disclosure reflecting discussions on capital cost, shareholders return, growth strategy and cash usage. This should include 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. It would also imply a clear explanation of why the proposed dividend is set at the appropriate level, and what the ongoing dividend policy will be.

ICGN encourages Japanese companies to disclose their own policies towards capital management and allocation for the benefit of providers of debt and equity capital, and believe that such disclosures would provide an excellent foundation for investor engagement with Japanese companies. This is where investor stewardship fits in, and it is our hope that more robust disclosures of this nature can contribute positively to management's own understanding of its own capital management and investors' ability to provide constructive inputs to company management of their own expectations relating to the company's financial performance and sustainability.

7. Actions to improve gender diversity and board quality

Board quality is dependent on board diversity. Diverse Boards and management teams are less prone to 'group think' and more likely to embrace new approaches to meet future company threats and opportunities. This allows for better business decision-making which ultimately leads to better financial returns and long term value creation.

A Board's approach to diversity should be described in a publicly disclosed 'Diversity Policy' including measurable targets and a time period over which such targets will be achieved. If a company has chosen not have such a policy, it should explain why it reached the conclusion that such a policy was not appropriate for it, and identify any risks or benefits associated with the decision not to have such a policy.

It is helpful for Boards to disclose a skills matrix aligned with the company's long term strategic needs to aid board succession planning. This should be complemented with information on gender and ethnicity, supported by individual biographical information. In 2017, 16% of US S&P500 companies disclosed a board matrix showing how individual director skills connect to the company's strategy and risk profile according to data from EY.

Boards should set targets over a 3-5 year time horizon and report on progress in meeting the targets by identifying the specific proportions of women in the company both at a board and senior management level. Disclosure around any obstacles that companies face in achieving targets is useful. This sheds light on any industry-specific impediments to achieving diverse corporate leadership which may need to be dealt with by policy makers.

Lengthy director tenure can be problematic in some markets and a major barrier to board quality. Board service should be contingent on individual director performance and annual re-election premised on satisfactory evaluations of his or her contribution to the board. This process would allow for long-standing directors to step down, thus unlocking vacancies to enable appropriate board diversity to improve board quality.

An effective review of board evaluation and regular refreshment should be led by the Nomination Committee. A board evaluation conducted by an external consultant once every three years can help inform candidates of strategic relevance to the company. The role of Nomination Committees includes the development of diversity criteria, engagement of search firms and the consideration of candidates on the basis of their experience and skills (i.e. not to tick a quota box). A report from the nomination committee explaining how they considered the representation of women in director selection and board evaluation is useful. The report should include the skills matrix and the committee itself should include female directors to lead by example!

To conclude, I would like to congratulate the leadership of the Council once again on the progress that is being made in Japan in terms of corporate governance and investor stewardship reform. I hope to see many Council colleagues at the ICGN Annual Conference hosted by the Tokyo Stock Exchange at the New Otani Hotel next year which will take place between 16th – 18th July 2019.

I wish you a successful Council Meeting in November and respectfully submit this letter for your kind consideration.

Yours faithfully,

Kerrie Waring
Chief Executive Officer, ICGN