ICGN Policy Priorities: Japan

As discussed at the ICGN Annual Conference, hosted by the Tokyo Stock Exchange, taking place between 16-18 July 2019.

Background

The ICGN is a global authority on high standards of corporate governance and investor stewardship policies and practices with members led by investors responsible for assets under management in excess of US$ 34 trillion, based in over 45 countries. ICGN's policy positions are guided by the ICGN Global Governance Principles and the ICGN Global Stewardship Principles which inform regulatory developments around the world and guide investors in their voting and investment decisions.

Every year, ICGN's Policy Priorities are reviewed in consultation with ICGN Policy Committees and are broadly defined as:

- Promoting long-term investment perspectives and sustainable value creation
- Making successful investor stewardship a reality
- Building effective boards amidst the changing boundaries of governance
- Protecting minority shareholder rights; and
- Seeking transparency through robust reporting, audit and metrics

This year, for the first time, ICGN has published Policy Priorities at a market-level to help inform the discussion at the ICGN Annual Conference which will be held in Tokyo between 16-18 July. ICGN acknowledges the governance, stewardship, reporting and audit reforms that have taken place in Japan and which are on-going. The policy priorities presented in this paper serve to help inform Japanese regulators, companies and other stakeholders on continued priorities for reform from a global investor perspective.

ICGN acknowledges that there are wider issues of relevance that may not be referred to in this paper. For purposes of brevity, ICGN has identified five Policy Priorities that we understand to be of concern to global investors at the current time. It is expected that Policy Priorities at a market level will be published every year as relevant to the country hosting the ICGN Annual Conference.

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1. Corporate reporting

ICGN welcomes the reforms proposed in the Report of the Disclosure Working Group convened by the Financial Services Agency which includes recommendations to enhance financial and narrative information and the reliability and timeliness of corporate reporting. Other matters of concern to ICGN members include:

- **AGM Clustering**: While the issue of AGM concentration in Japan has improved since the 1990s, many companies maintain a March fiscal year end with subsequent meetings in June. This clustering of AGM's, often within a few days in the lats week of June, causes difficulties for investors to allocate appropriate time to read annual reports and make voting decisions.
- **AGM notifications:** Notices are issued on average 19 days in advance of the meeting taking place in Japan – compared to international best practice of 30 days.
- **Timing of Securities Report:** The Securities Report (Yuho) is published post AGM despite the fact that it 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.
- **English language**: As of May 2019, 40% of companies issued English AGM Notices this year and the Securities Report is often not published in English, despite companies wishing to attract overseas capital.

Recommendation: 1) AGM Notices and the Securities Report should be issued at least 30 days in advance of the AGM; (2) Companies should move their respective record dates from March to April to the allow AGMs to be held in July; and (3) Companies listed in TSE section 1 should make both English translated Securities Report and Notice of AGM

2. Board independence

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. ICGN welcomes that over 90% of 1st Section JPX listed companies now have two or more independent directors and 33% of companies have one-third. ICGN encourages further progress towards a majority of independent directors on Japanese boards, or at least one-third.

ICGN Members comment that it is difficult to determine the extent to which a director is independent in Japan. Further clarity around the definition of independence in the JPX Listing Rules might be helpful in this regard, for example around issues such as 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 candidate can be considered independent.

Often in Japan board directors are promoted from within the company and this has become a symbol of career progression. Furthermore, is no reference to how independent directors are nominated and appointed in Japan's Corporate Governance Code and the process is therefore often opaque. More disclosure around the process would be helpful along with the rationale for director selection.

Recommendation: (1) Listed company boards should comprise one-third independent directors, or preferably a majority of independent directors particularly in subsidiary companies. (2) Enhance the definition regarding the factors which impact a directors' independence in the TSE Listing Rules, aligned with international best practice. (3) Companies should disclose clear procedures and disclosure around the rationale for individual director appointments including how their experience aligns with company strategy and any factors affecting their independence.

3. Board evaluation and nomination committees

ICGN advocates that board evaluation (collectively, individually and for the Chairman) should take place annually by the board itself and periodically (e.g. every three years) by an external evaluator. A 'skills matrix' which maps the experience of the current board with the company's long-term strategic needs can be a helpful tool to aid the board evaluation process.

The board evaluation should be led by a Nomination Committee comprised of independent chair and a majority of independent directors. Outcomes from the board evaluation can help to inform the types of candidates of strategic relevance to the company

Recommendation: (1) All listed companies (not just those with a three-committee structure) should establish a Nomination Committee comprised of independent chair and a majority of independent directors. (2) Listed company boards should be subject to periodic external board evaluation and director tenure should be contingent on individual performance and annual re-election premised on satisfactory evaluations of his or her contribution to the board. (3) Board evaluation disclosure should include the process for board evaluation and any material issues of relevance arising from the conclusions.

4. Executive pay and remuneration committees

ICGN welcomes improvement to regulations for corporate disclosure on executive pay in January this year and also welcome reference in Japan's Corporate Governance Code under principle 4.2.1 regarding the board's role to determine executive remuneration through 'objective and transparent procedures.' We understand that 46% of 1st section JPX listed companies have a Remuneration Committee – up from 13% in 2015. The Committee should be responsible for establishing clear remuneration policies and reports which are aligned with the company's long-term strategic objectives and executive key performance indicators and progress towards achieving such indicators.

Regarding remuneration related disclosure, the board should disclose who is responsible for setting executive pay, the process for remuneration setting, rationale for individual levels and how it fits within the overall context of the company's human resource strategy. We note that the current rule in Japan only requires disclosure of individual remuneration above YEN 100 million (£700,000) which may create an artificial ceiling on pay levels.

Recommendation: (1) Listed companies to establish a Remuneration Committee comprised of independent chair and a majority of independent directors. (2) The rule requiring disclosure of individual remuneration in excess of YEN 100 million should be abolished. (3) A new rule to require disclosure of CEO and senior executive pay on an individual basis and annually should be introduced. The disclosure should include the proportions of fixed pay, bonus and long-term incentives. This extends to non-cash items such as director and officer insurance, pension provisions, fringe benefits and terms of severance packages if any.

5. Capital efficiency and cross-shareholdings

ICGN notes that progress has been made since the minimum target of 8% return on equity (RoE) was introduced in the Ito Review in 2014 to a median of 11.5%. Whilst setting profitability targets are important, the rationale for targets and what progress is being made towards achieving them as part of a longer-term capital allocation strategy is of more interest to investors. For example, this includes information in relation to acquiring new businesses, making large capital investments, discontinuing existing businesses and research and development expenditure. ICGN members are likely to vote against management if RoE is less than expected over a prolonged period and not expected to improve.

Regarding cross-shareholdings, ICGN welcomed the revisions to Japan's Corporate Governance Code last year 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. However, we understand that cross-shareholdings are still high in companies as a proportion of overall shares with voting rights, despite the progress that has been made in Japan's banking sector. It is important that Issuer Companies do not prevent companies in receipt of cross-share-holding to sell through tactics employed to threaten trading relationships. Cross shareholdings impede shareholder rights and business relationships are prioritized over proper corporate governance practices at the expense of asset efficiency.

Recommendation: (1) Japanese companies should improve disclosure to shareholders on the company's capital policy which would highlight the Board's risk appetite and understanding of the company's cost of capital. (2) Companies should disclose a target to reduce their cross shareholdings over a specified period including their policies; and the nature of the cross-shareholding, for example if they are a parent company, subsidiary, supplier.

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