



ICGN

International Corporate Governance Network

23rd Council of Experts

Follow-up of Japan's Stewardship Code and Japan's Corporate Governance Code

26th January 2021

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 which will take place on 26th January 2021 (see annex 1 for translation to Japanese). 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.

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 - in promoting the success of companies to preserve and enhance long-term value, contributing to strong economies and healthy societies.

ICGN's mission supports this shared responsibility, as advocated in the ICGN Global Stewardship Principles and the ICGN Global Governance Principles, the latter of which is currently subject to Member consultation as part of a three-year review cycle. Our comments forthwith are guided by ICGN Principles and largely written from the perspective of the global institutional investor community and our Japan Policy Priorities, published in July 2019 (see annex 2).

Our comments refer to the core items on Council's meeting agenda being:

1. Capital efficiency;
2. Cross-shareholdings; and
3. Group governance.

1. Capital efficiency

1.1 Global competitiveness and capital allocation approach

Returns on capital for Japanese companies are improving but, on a comparative basis, profitability still lags peers in North American and European markets. 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 for companies and providers of risk capital.

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.

1.2 Board awareness

Oversight of capital allocation, and the capital allocation policy, is a key responsibility of a corporate board, so it is important that directors understand the cost of capital and therefore the shareholder returns on capital that are required. Board directors should be financially literate and able to accurately assess the company's cost of capital. They should understand the company's capital allocation policy which guides how cash flows are allocated between capital spending, dividends, share buybacks, executive remuneration and so on.

ICGN welcomes the proposals by the Ministry for Economic Trade and Industry for an annual, data-led review of a company's business portfolio by the board. 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.

More generally, boards should be able to competently engage with shareholders on things like 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.

1.3 Dividends

Boards should be able to explain why the proposed dividend is set at the appropriate level, and what the ongoing dividend policy will be. More generally, we recommend that companies should cease referencing dividends to a 30-40% pay-out ratio as it is an unhelpful benchmark which can lead to increased cash hoarding (i.e., 60-70% retained earnings) without any justification.

This practice encourages speculative ambition to expand by mergers / acquisitions or increases in capital expenditure without showing any discipline around the return on invested capital. Instead, dividends should be set by determining the use of free cash flow in the context of the balance sheet: in principle, all free cash flow (i.e., operating cash flow minus capital spending) should be returned through dividends and buybacks.

1.4 Operating cash flow and resilience

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 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 done in the context of the cost of capital. We note that the COVID crisis has required companies around the world to conserve cash to build further resilience. This is appropriate but, in order to overcome COVID related challenges, companies must also use cash reserves to invest in things like human resource, intellectual property, technology, research and innovation.

1.5 Capital allocation policies and non-core assets

A clear capital allocation policy can help ensure that management is not irrationally using cash (such as rebuilding new office buildings etc) and instead employ cash in activities which are aligned with the company's purpose and strategic objectives to generate long-term value. A clear capital allocation policy 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.

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.

2. 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.

ICGN recognises that most corporate shareholdings 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.

2.1 Investor concerns

As ICGN has expressed at previous Council meetings, overseas investors remain concerned about the practice of cross-shareholdings in Japan for the reasons highlighted below:

- One of the purposes of cross-shareholdings is to help preserve managements' positions as directors. Using shareholders' assets for such a purpose is highly inappropriate.
- Obstruction to fair competition whereby companies are expected to do business with those with whom they have relationships, instead of those who can offer the best quality products or services at the most competitive price.
- Unreasonable restraint of trade using shareholdings to prevent the investee companies from trading with competitors or refusing to trade with those without shareholding relationships is unreasonable.
- Unequal treatment of shareholders whereby companies which hold shares of other companies for strategic purposes may receive benefits for their business, while other shareholders, including institutional and retail investors, do not.
- Obstruction to board independence whereby many Japanese companies have appointed non-executive directors who represent their cross-shareholding partners and designated them as 'independent'. This may impede effective managerial challenge and objective board decision-making.
- As cross-shareholdings are accounted for as a part of equity capital, the return on equity will experience undue fluctuations as a result of market price movement of the

cross-shareholdings. During periods of extreme stock-market drawdowns, the declining value of cross-shareholdings can potentially hit the PL as an extraordinary loss (or mark down).

- Weaken management discipline because such shareholders will unconditionally support management decisions (often referred to as “stable shareholders”.)

2.2 Disclosure

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 1-4-1 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 parent company, subsidiary, or supplier.
- a firm 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.
- a description of how cross-shareholdings will be reduced or eliminated over a specified time-period.
- 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.

Governance of Company Groups

3.1 Independent Directors and fiduciary duties

Generally, ICGN advocates that, as an international standard, corporate boards should comprise a majority of independent directors. In Japan, we advocate that there should be a majority of independent directors on companies listed on the prime market and at least one-third independent directors on other segments. For listed subsidiary companies, there should be a majority of independent directors serving on the board to mitigate infringements to minority shareholder interests.

Independent directors serving on the boards of subsidiary companies owe their fiduciary duty to that company. Subsidiary companies are separate legal entities from their Holding (Parent) company and, as such, the duties of directors serving on subsidiary company boards are owed to the subsidiary, not to the Holding company. There should also be a clear statement describing the primary duty of care of directors serving on the Subsidiary Company board.

This has the potential to create tensions between the Holding Company appointed directors and independent directors when taking decisions in the best interests of the Subsidiary. This tension might be resolved by applying the following broad principles, as described in a recent ICGN Viewpoint entitled ‘Duties of Boards in Company Groups’:

- Clear policy regarding the nomination and appointment process of independent directors and the influence that the Holding Company has over this process.
- Comprehensive disclosure of group structures, including the identity of all group companies and all forms of common controlling interests and cross-holdings.
- *Ex ante* transparency about the role of the company within the group.
- Accurate measurement and disclosure of costs associated with decisions taken in consideration of group interests.
- Clear explanation of compensation, transparency and board independence.
- Disclosed policy on allocation of business opportunities.
- Procedures for managing conflicts of interest.

More generally, boards of companies in groups be as explicit as possible about the benefits and potential costs of being part of the group, and that their boards measure the costs and benefits of actions motivated by group concerns, providing shareholders with as precise as possible an accounting.

Independent directors, possibly as part of an audit committee and risk oversight process, should monitor how the Holding Company interacts with the Subsidiary Company and effectively challenge the Holding Company if they believe that the Holding Company is acting against the interests of minority shareholders.

3.2 Internal control

The Holding Company should develop a comprehensive ‘Governance Framework’ applied throughout the group which should include robust internal control and risk management procedures. More generally, high standards of corporate governance practices should be communicated through clear policies on matters such as bribery and corruption, whistleblowing, share dealing and data protection. Such policies should be regularly reviewed to ensure effectiveness.

3.3 Communication

There should be clear communication regarding the overall strategic direction of the group, as set by the Holding Company, and how this relates and aligns with the purpose and performance of subsidiary entities. The purpose of Subsidiary Companies should therefore be clearly defined along with how they contribute to the overall strategic direction of the group. This should include how they engage with minority shareholders and key stakeholders.

3.4 Conflicts of interest

The ICGN Global Governance Principles note that “if a director has an interest in a matter under consideration by the board, then the director should promptly declare such an interest and be precluded from voting on this subject or exerting influence.”

Conflicts of interest should be carefully managed, particularly with directors that are common to both the Holding Company and the Subsidiary Company. Information flows within the

group should be governed by clear disclosure policies, particularly where information is sensitive.

3.5 Minority shareholder rights in subsidiary companies

Minority shareholder rights (and the equitable treatment of shareholders holding the same class of share) must be protected where there is the presence of a controlling shareholder on the subsidiary board – i.e., the Holding Company shareholder.

Minority shareholders must be able to effectively exercise their right to vote on major decisions which may change the nature of their investment in a company. These rights should be clearly defined in the company's constitutional documents such as the articles of incorporation.

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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Annex 2: ICGN Policy Priorities: Japan *With Summary Japanese Translation*

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

ICGN Policy Priorities: Japan

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 last 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 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.

ICGN 重点方針（日本）＜要約版＞

ICGN（International Corporate Governance Network）はグローバルの機関投資家を主体とする組織（事務局：英国ロンドン）であり、効率的な市場と持続的な経済の促進に向け、実効的なコーポレートガバナンスの構築と投資家のスチュワードシップの醸成を目的としています。1995年に設立され、会員の運用資産合計金額は34兆米ドル（国別では45か国以上）、主要なグローバルの年金基金と大手運用会社が加盟しています。

ICGNでは、毎年、グローバルベースの「重点方針」の策定・見直しを行っていますが、今回、東京で開催されたICGN年次総会（7/16-18）の議論をより実りあるものとするため、国・地域別の「重点方針（日本）」をはじめて策定しました。今後とも、ICGN年次総会が開催される国・地域において（国・地域別の）重点方針を策定する予定です。

なお、本資料は“ICGN Policy Priorities”の日本語訳（要約版）となります。原文は、以下のリンクをご活用ください。

プレス資料

https://www.icgn.org/sites/default/files/2_AGREED_Policy%20Priorities_Japan.pdf 原文
https://www.icgn.org/sites/default/files/ICGN%20Policy%20Positions_Japan.pdf

ICGN 重点方針：日本＞ 重点方針は、以下の 5 項目から構成されます。

1. 企業報告 上場企業は、株主総会の少なくとも 30 日前までに株主総会の招集通知と有価証券報告書を発行すべきである。(3 月決算の場合) 株主総会の基準日を 3 月から 4 月に変更し、株主総会の 7 月開催を可能とすべきである。東証 1 部上場企業は、英文の有価証券報告書と株主総会の招集通知を作成すべきである。
2. 取締役会の独立性 取締役会の構成において、1/3 以上、望ましくは過半数以上(上場子会社のような場合)の独立社外取締役が設置されるべきである。国際的なベストプラクティスを参考に東証の独立性基準をより充実すべきである。また、取締役選任に関する透明性のあるプロセスの開示とともに、個々の取締役が企業戦略に沿った形で適切に選任されているか等の取締役選任に関する根拠や独立性において問題がないか、といった事項も開示されるべきである。
3. 取締役会評価と指名委員会 上場企業は、議長と構成員の過半数を独立社外取締役とする指名委員会を設置すべきである。定期的に、外部評価者も入れた取締役会評価を行うべきであり、取締役就任期間(再任)については、個々の取締役の活動と取締役会に対する貢献への十分な評価に基づき決められるべきである。取締役会評価の開示には、評価プロセスとともに、評価の結果として認識された重要な事項も含まれるべきである。
4. 役員報酬と報酬委員会 上場企業は、議長と構成員の過半数を独立社外取締役とする報酬委員会を設置すべきである。役員報酬の開示においては、1 億円以上の制限を撤廃し、CEO や経営陣の報酬の個別開示が毎年実施される仕組みの導入が行われるべきである。また、固定報酬・ボーナス・長期インセンティブは区分された形で開示され、開示内容となる報酬の対象には、役員保険、年金、退職金などの非金銭的な報酬も含まれるべきである。
5. 資本効率と政策保有株 「資本政策」についての株主への説明内容は改善されるべきである。また、その策定にあたっては、リスクや資本コストについての取締役会の認識を反映すべきである。上場企業は、政策保有株削減に関する方針の策定とともに、削減目標(期限を決めた上で)と政策保有株継続保有の理由の詳細な開示を行うべきである。

2019 年 7 月

以上