24th Council of Experts
Follow-up of Japan's Stewardship Code and Japan's Corporate Governance Code

15th February 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 15th February 2021 (see annex 1 for translation to Japanese).

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 Members are primarily institutional investors such as public pension funds and their asset managers and thus are committed to promoting sustainable value through the long-term success of companies on behalf of the investing public. Our commentary is drawn from the ICGN Global Stewardship Principles and the ICGN Global Governance Principles, both of which are written from the perspective of the global institutional investor community.

Japan is an important market for ICGN Members, where over 30% of the market capitalisation of the Tokyo Stock Exchange are held by overseas investors. ICGN has engaged in regulatory dialogue in Japan for over two decades and we have convened global conferences in Tokyo attracting hundreds of governance professionals from around the world. Our Japan Policy Priorities (2019) highlight key issues for dialogue between ICGN Members and Japan based stakeholders, along with our most recent submissions to the Council.

This letter addresses the following items listed on the Council Meeting Agenda:
1. Sustainability and climate change
2. Sustainability and social inequality; and
3. Measures to enhance company and investor dialogue.

1. Sustainability and climate change

1.1 Defining sustainability

ICGN has long advocated that companies and investors share a mutual interest in preserving and enhancing long-term corporate value, ultimately contributing to sustainable economic growth and social prosperity.

In the context of understanding what companies should take into account when considering sustainability, it is useful to reflect on the definition published by the European High-level Expert Group on Sustainable Finance in 2019 as follows: *'sustainability means making economic prosperity long lasting, more socially inclusive and less dependent on exploitation of finite resources and the natural environment'.*

The question of sustainability is particularly poignant within the context of a world facing systemic challenges of the highest magnitude: a global pandemic and climate change. These colossal events both stem from ecological degradation and give rise to a double jeopardy of risks to the future of humanity. They are interlinked and, if we are to create a healthier and more sustainable world, we need to manage these risks simultaneously to reboot the global economy while at the same decarbonizing the planet.

It is against this backdrop that the ICGN Global Governance Principles ("ICGN Principles") have been revised this year, with a greater focus on the responsibility of the board for the governance of sustainability and its integration with company strategy, operations and risk oversight. This means a commitment to legitimate shareholder expectations for returns on capital while maintaining positive relations with key stakeholders, including employees, customers, suppliers, and society more broadly. This requires companies and investors to focus, not only on aspects relating to preserving and building a company's long-term financial capital, but factors impacting human and natural capital too.

There are a wide range of issues which impact an individual company approach to sustainability. For the purposes of the Council Meeting, we will address two systemic risks of high importance to investors and likely to feature prominently as part of their engagements with companies: climate change and social inequality.

1.2 Climate change

There is now global consensus among politicians, regulators, capital market actors and society in general that climate change presents a systemic threat to the future of humanity on a magnitude of importance like no other. It will eclipse the current COVID crisis in terms of testing our ability to quickly react, mitigate and manage the dire effects. It is incumbent on companies and investors to immediately respond to this threat and help ensure that future generations are not unfairly burdened with the negative social, ecological and financial consequences.

Scientists have warned that global carbon emissions have risen by 20% over the past five years with atmospheric temperature increases set to exceed 3°c by 2100 due to our dependence on fossil fuels. The impact of this global warming is evident in sea level rises and more frequent extreme weather events which – helped by deforestation – are having a devasting impact on the world's biodiversity.

In 2006, nearly 200 countries signed the Paris Agreement commitment to a target of limiting global temperature rises to below 2°c by 2100. The Intergovernmental Panel on Climate Change (IPCC) later published a report warning that global warming should be limited to within 1.5°c to avoid catastrophic impacts. The IPCC warned that not enough is being done to avert warming beyond a point of no return – in fact instead of cutting carbon dioxide emissions, world consumption of oil, coal and natural gas is increasing. The UN Global Assessment Report on Biodiversity and Ecosystem Services was equally damning on biodiversity, asserting that around 25% of all species on earth face extinction within decades if we do not expedite the pace of change for a greener, cleaner way of working.

There is now a growing sense of urgency among policy makers, companies, investors and communities that imminent and assertive action is required for this transition. The United Nations Sustainable Development Goals (UN SDGs) were published 2017 and Expert Panels (notably in Europe and Canada) comprised of investors, companies and others have produced helpful tools to progress towards meeting the goals. An example of this is the development of taxonomies to create a shared vocabulary and identify sustainable investment products that mitigate climate change risks. This then helps investors move capital towards companies that contribute to the UN SDGs as part of their investment strategy.

1.3 Net-zero targets

Many Governments, including Japan, have declared net zero targets so that the amount of carbon emissions produced by our economies equals the amount removed from the atmosphere. It is important to achieve this net-zero position by 2050 to stabilize global temperature rises to 1.5°c. ICGN encourages all Governments to establish and disclose a net zero target for their economies, accompanied with an action plan for achievement. This will help incentivise the market – companies and investors – to embrace the risks and opportunities presented by climate change and our transition towards net-zero.

This means weaning our dependence away from fossil fuels and mobilising private capital towards sustainable environmental and social infrastructure. This, in turn, will help optimise the world's finite resources while fueling economic growth. In doing so, companies that commit to transitioning towards net-zero carbon emissions will not only mitigate the negative effects of climate change, but also benefit from opportunities arising from renewable energy, resource efficiency and smart technology.

For this to be achieved, we must galvanise and co-operate on a global scale. By way of example, many ICGN Members are part of the coalition called Climate Action 100+ to ensure 'that the world's largest greenhouse gas emitting companies take necessary action on climate change.' Around half of the 167 companies identified by the coalition have established commitments to reach net zero emissions by 2050 or sooner.

1.4 Board responsibilities

ICGN supports the Climate Action 100+ initiative and others to encourage corporate boards to be responsible and accountable for climate change transition. Boards should be prepared to explain to investors how they embed the effects of climate change in their business models and risk management systems to ensure they are properly identified, measured, monitored and managed.

The revised ICGN Principles also emphasize that the board is responsible for identifying, addressing and reporting on relevant systemic risks to the company, particularly those identified in the UN SDGs. Climate change poses a level of systemic risk which encompasses all markets, all sectors and all industries. These risks are foreseeable and measurable as we experience the effect on our warming planet in real time. Action taken now to mitigate the negative effects of carbon will directly impact the magnitude of risks in the future.

There are many ways in which boards can help equip themselves to effectively respond to climate change risks and opportunities, for example:

- Appointing independent directors who are knowledgeable about sustainability issues;
- Establishing 'sustainability committees', led by independent directors, notwithstanding that the board as a whole is collectively responsible; and
- Enhancing understanding through education around the implications of climate change and how it applies to the role of corporate boards.

1.5 Climate related disclosure

Many ICGN Members encourage companies to align their reporting with the Taskforce for Climate-related Financial Disclosures (TCFD) introduced in 2017 and which requires companies to describe how climate change is reflected in governance, strategy, risk management and risk metrics. More specifically ICGN encourages company boards to:

- Assess the impact of climate change on the company business model and how it will be adapted to meet the needs of a net zero economy as part of a long-term strategy;

- Set and disclose targets to reduce emissions in-line with 1.5°c global warming, including a time period for achievement;

- Develop and disclose a plan for achieving the net-zero target, to be approved by shareholders; and

- Align CEO and executive bonus systems with the plan, to be approved by shareholders.

Disclosure around these actions would help investors understand the resilience of companies facing climate change risks and to assess progress towards achieving net zero targets. This includes transition risk (where companies cannot adapt to the changes in the economy and society) as well as physical risks (e.g., from wildfires, drought and floods) which impact business operations, for example building damage or increased insurance premiums.

Many companies already report voluntarily in alignment with the TCFD framework and some countries, such as New Zealand, have encouraged wider adoption by introducing TCFD as a national mandatory requirement. Since January this year, the UK has required companies listed on the Premium Market of the London Stock Exchange to align their reporting with TCFD, albeit on a comply or explain basis – this is set to become mandatory by 2025. While in Europe TCFD may become mandatory under the Non-financial Reporting Directive.

In Japan, ICGN applauds the work of the TCFD Consortium and encourages companies to disclose TCFD aligned information in the Securities Report (Yuho). As noted in previous ICGN letters to the Council, we emphasise that the Securities Report (Yuho) and the Notice of AGM should be published pre-AGM (not post) and be translated in English.

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. Accessing corporate governance related information in Japan can be difficult given the dispersed nature of governance related reporting with various elements required under different authorities, e.g., Securities Law and Companies Act. Consolidating the information into a single source could help investors assess any explanations for deviations to Corporate Governance Code compliance and make considered judgements on voting. This could be further enhanced through digitalization of corporate governance related information with separate XBRL tags to make analysis more efficient.

1.6 Global consolidation of sustainability standards and frameworks

There are growing calls for TCFD to become a global mandatory requirement for all large companies, possibly integrated within the IFRS accounting framework. More broadly there have been calls for there to be a single, global approach to sustainability reporting given that IFRS and US GAAP provide little insight into non-financial dimensions of risk and return.

Conventional financial reporting primarily describes what has already occurred and financial results at a point in time. Traditional accounting is transaction focused and not well equipped to capture intangible drivers which underpin value creation. This causes a ‘value gap’ between financial accounting measures and the intangible drivers that impact company performance and long-term value creation, such as human capital and natural capital.

More comprehensive ‘sustainability’ reporting would seek to reflect the complexities inherent in a contemporary business and the context of a company’s current and future strategic direction. It would support and enhance the information in the financial statements and help investors to form an assessment of the company’s long-term strategy and prospects.

There are a number of established voluntary ESG reporting standards and frameworks to facilitate consistency and comparability of reporting. ICGN welcomed the recent merger of the Sustainability Accounting Standards Board and the International Integrated Reporting Council. We await with interest the outcome of the consultation by the Trustees of the IFRS Foundation regarding possible global sustainability standards, most notably on climate, and the role that the IFRS Foundation might play. We understand that a definitive proposal will be forthcoming leading to the possible announcement of the establishment of a Sustainability Standards Board at the meeting of the United Nations Climate Change Conference COP26 in November 2021.

1.7 Investor responsibilities

Investors cannot diversify climate change risks out of their investment portfolios given the systemic nature of the threat. Over the past year, there has been renewed vigor among investors to deploy assets into sustainable investments as noted in Larry Fink’s 2021 Letter to CEOs:

“From January through November 2020 investors in mutual funds and ETFs invested $288 billion globally in sustainable assets, a 96% increase over the whole of 2019. I believe that this is the beginning of a long but rapidly accelerating transition – one that will unfold over many years and reshape asset prices of every type. We know that climate risk is investment risk. We also believe the climate transition presents a historic investment opportunity.”

Many investors are committing to net-zero portfolios by 2050 – this relies on the companies within the portfolio to provide adequate disclosure on the same. There are market-led and Government-led initiatives which are driving increased investor disclosures, for example:

- TCFD requires asset owners to disclose how their portfolios are positioned for the transition to net zero carbon emissions so that climate rise stays within 2°c.

- In France, Article 173-VI (2015) of the Law on Energy Transition for Green Growth requires asset owners to disclose their carbon risks and climate policies and how they contribute to net-zero transition objectives.

- In the UK, (2018), pension funds must explain how the trustee takes account financially material factors including those relating to environmental, social and governance (ESG) in company engagement and voting.

ICGN itself is about to embark upon a review of the ICGN Model Mandate (2012) in partnership with the UN Global Investors for Sustainable Development (GISD) Alliance. The Model Mandate provides example terms for asset owners to consider when drafting stewardship obligations in their contracts with investment managers including time horizons, asset manager remuneration and ESG integration.

The review aims to update the Model Mandate to help shift the behaviours of key actors along the investment chain towards a longer term, sustainable perspective, particularly those related to the UN SDGs. This includes recommendations around performance measures and incentives for asset managers that asset owners might include in their mandates. The ICGN and GISD hope to publish the updated Model Mandate ahead of the COP 26 Meeting taking place in Glasgow, UK, in November 2021.

These initiatives are underpinned by a common understanding in many markets today that investor's fiduciary duties extend beyond financial returns and encompass sustainability and governance factors. In 2018, ICGN Members approved new ICGN Guidance on Fiduciary Duties to extend investor duties beyond 'care' and 'loyalty' to address the impact of systemic risk, time horizons and governance as part of stewardship obligations. The following year, the European Commission announced mandatory disclosure by investors around 'the extent to which ESG risks are expected to have an impact on returns.'

At an international level, the ICGN Global Stewardship Principles articulate clear responsibilities for investors around the analysis, monitoring and integration of ESG factors in investment decision-making, voting and investee company engagement. For markets that have yet to embrace this mindset, regulatory clarification that ESG integration does not compromise returns and therefore fiduciary duty would be a significant catalyst for change.

2. Social inequality

2.1 Elevated prioritisation of social factors

The COVID crisis has elevated social issues as a key corporate engagement priority for investors. It has exposed stark social inequalities between young and old, rich and poor, by gender, ethnicity and more and have propagated public mistrust in capitalism like never before. How we 'level up' and 'build back better' are key priorities for companies and investors in every market.

In response, ICGN published a letter to corporate leaders in April 2020 in the spirit of solidarity to provide an agenda for dialogue as we navigate this unprecedented challenge together. This agenda elevates the importance of social factors as a key determinant to a company's long-term financial health and sustainability and respectfully suggests the following broad priorities companies might consider while dealing with the COVID crisis:

- Ensuring employee safety and welfare while meeting short-term liquidity requirements to preserve financial health and solvency;

- Pursuing a long-term view on social responsibility, fairness and sustainable value creation and publicly defining a social purpose;

- Taking a holistic and equitable approach to capital allocation decisions, considering the workforce, stakeholders and providers of capital; and

- Communicating comprehensively with all stakeholders to instil confidence in a company's approach to building resilience into strategy and operations.

2.2 Corporate purpose

Now more than ever, society is questioning the role of corporations in society and legitimacy of their license to operate – this extends to the effectiveness of investors in holding them to account. Companies create prosperity, employment and tax revenues for public good. But companies can also be perpetrators of economic risk, wealth inequality and environmental degradation. This has inspired a movement towards 'stakeholder' capitalism, and statements of 'corporate purpose' to better demonstrate responsibility and accountability to all.

In response, we see organisations such as the US Business Roundtable encouraging their members to publish statements of corporate purpose, while in Europe, the Commission is consulting on how corporate boards should balance shareholder and stakeholder interests and integrate sustainability into strategy using targets aligned with the SDGs. At a global level, the ICGN Principles have been strengthened to clarify:

- that boards should disclose a clear company purpose to justify the company's social license to operate and ensure this is pursued in strategy and operations; and

- that boards should ensure that the corporate culture facilitates constructive stakeholder relations, particularly with company employees, linked to the board's oversight of human capital management.

2.3 Income inequality

In 2015, the United Nations identified rising income inequality as one of the root causes of systemic social and political risk. Last year, in the immediate response to COVID, many companies imposed temporary executive pay cuts and bonus reductions (or even cancellations). This was particularly acute in sectors heavily impacted by the pandemic resulting in staff losses.

This year, investors will scrutinise a company's longer-term response to the COVID crisis and recovery and how that relates to CEO pay and performance. ICGN advocates that remuneration policies should seek an equitable treatment of ordinary staff with that of senior executive management and financial sacrifice appropriately shared.

Revisions to the ICGN Principles this year include strengthened reference to the responsibilities on the Remuneration Committee who should disclose their rationale in relation to the awarding of CEO / executive pay and disclose this in the Annual Remuneration Report. Elements that investors are likely to consider include:

- Fairness and how the level of CEO / executive pay and bonus structure compare with the average company worker and relative to the average median income of the company's place of domicile. This extends to tertiary benefits, e.g., medical insurance;

- Pension benefit consistency across the company so that the structure of CEO and executive pension contributions are aligned across the workforce; and

- Performance metrics that include quantifiable ESG indicators that are material to the company's sustainable value creation. According to ISS data, more companies are using environmental and social metrics to align CEO pay with performance than ever before. Social metrics (e.g., health and safety) are used five times more frequently than environmental metrics (e.g., climate change).

2.4 Human capital management

Many ICGN Members are calling on regulators to require companies to publish better information around how human capital is managed as part of a longer-term strategy for value creation. Last year, ICGN issued a letter to support ICGN Members as part of the Human Capital Management Coalition which called on the United States Securities and Exchange Commission (US SEC) to require companies to disclose information about their human capital policies, practices and performance.

We subsequently welcomed, a change of reporting rules by the US SEC to require companies to report 'material' human capital objectives. This is a helpful first step and we encourage the US SEC and other regulators to continue to require companies to provide more transparency around human capital management, particularly on things like workforce stability, total workforce costs, ethnic/racial diversity across different employee levels and talent management.

Investors want to address these issues with companies, as well as issues relevant to a company's response to the COIVID pandemic where engagement subjects include:

- Ensuring the health and safety of employees, suppliers and customers;
- Keeping staff informed on how the crisis is affecting the business;
- Committing to fair contracts and working conditions;
- Maintaining anti-discrimination policies and practices; and
- Staff training as companies have transitioned their operations to a virtual and socially distanced world.

3. Measures to enhance company and investor dialogue

Effective corporate governance and investor stewardship practices rely on an ecosystem of parties who work together synergistically. All are working towards the premise, as articulated at the start of this letter, that companies and investors share a mutual responsibility to preserve and enhance long-term value, contributing to economic growth and social prosperity.

We applaud the many efforts undertaken by the Japan Financial Services Agency, Japan Exchange Group /Tokyo Stock Exchange, Ministry for Economic Trade and Industry, Ministry of Justice and other regulatory authorities to promote constructive dialogue between companies and investors. ICGN acknowledges the publication of key documents which serve to inform and encourage the continual improvement of corporate governance and investor stewardship policies and practices:

- Japan Corporate Governance Code: Principles for Companies (2018)
- Japan Stewardship Code: Principles for Institutional Investors (2020)
- Guidelines for Investor and Company Engagement (2018)

3.1 Sharing opinion through partnerships

Regulatory authorities have produced codes and guidelines, underpinned by hard law, to be adopted by the market for effective corporate governance and investor stewardship. The path towards corporate governance excellence is a journey, not a destination – and there is no 'one size fits all' approach. There will inevitably be differences of opinion around perceived best practices and key to achieving consensus is constructive and continual dialogue.

It is in this spirit that ICGN welcomes engagement through virtual forums and in-person conferences with organisations representing governance professionals in Japan. One example of this is our continued engagement with Keidanren, a relationship that has flourished since the signing of a Memorandum of Understanding in 2019 to encourage mutual understanding around corporate governance priorities between Japan based companies and overseas institutional investors. We particularly welcomed the recent Keidanren publication 'Promoting Constructive Dialogue between Companies and Investors.'

There are many other bodies that play a key role and serve to educate on core disciplines imperative to the effective functioning of corporate governance. This includes the Japan Institute of Certified Public Accountants, Japan Investor Relations Association, Japan Stewardship Initiative and Japan Association of Corporate Directors. This extends to the myriad of professional advisors from the auditing profession to index providers, all playing a vital part in facilitating effective dialogue around continuous corporate governance improvements.

3.2 Understanding 'comply or explain' in practice

One way in which this dialogue might be enhanced further is through a better understanding of how the Japan Corporate Governance Code and Japan Stewardship Codes relate through the system of 'comply or explain'. The importance of this dialogue is clarified in Principle 1.3 of the ICGN Global Governance Principles:

"The board, particularly the chair, senior independent director and committee chairs, should regularly engage with shareholders, creditors and other stakeholders for meaningful dialogue. Such dialogue should encompass all matters of material relevance to a company's strategic direction, risk management and performance as well as governance, environmental and social policies and practices."

Corporate governance was defined by the Cadbury Committee in 1992 as being "the system by which companies are directed and controlled". This definition clarifies that the board is responsible for 'directing' and governing the company and setting its values (a role distinct from the managerial day-to-day operations), while shareholders are responsible for 'controlling' the company by holding the board to account through investee company monitoring, voting and engagement.

Accountability for high standards of corporate governance is managed through disclosure and dialogue between companies and investors. 'Comply or explain' – usually set out in Stock Exchange Listing Rules or in the law - 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. In Japan, we recommend that this disclosure should be centralised in a single source in the Securities Report (Yuho).

For the 'comply or explain' system to work effectively, companies must have a good reason to deviate from a particular code recommendation and disclose this to investors. Explanations from companies for the deviations must 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.

3.3 Building board director competence

Going forward, progress should be expedited on priority governance issues as discussed at the Council Meetings such as increasing the proportion of independent directors on public listed company boards, reducing cross-shareholdings, reforming securities report access and improving capital efficiency. This can be promulgated through the exchange of experience and learning opportunities – particularly between companies and investors.

ICGN encourages companies in Japan to commit to educating all board directors – executive and independent – on high standards of corporate governance to enhance their own effectiveness in exercising board responsibilities. We encourage companies to disclose their training policies for board directors and report on what actual training occurs over an appropriate period.

ICGN also encourages companies in Japan to have a formal process of induction for all new directors so that they are well-informed about the company as soon as possible after their appointment. This includes building an understanding of its strategy, business operations, regulatory obligations and other fundamental business drivers.

These recommendations are consistent with the Japan Corporate Governance Code which emphasises the importance of director-level professional development under Principle 4.14:

"New and incumbent directors and kansayaku should deepen their understanding of their roles and responsibilities as a critical governance body at a company and should endeavour to acquire and update necessary knowledge and skills. Accordingly, companies should provide and arrange training opportunities suitable to each director and kansayaku along with financial support for associated expenses. The board should verify whether such opportunities and support or appropriately provided."

While the Japan Corporate Governance Code is quite explicit, the practice of board level professional development in Japan appears to be relatively uncommon. We encourage companies to ensure that board directors participate in training activities the benefits of which include:

- Enhanced ability and knowledge of individual board directors to conduct their role competently;
- Improved board effectiveness and strategic decision-making to ensure long-term corporate sustainability;
- Higher reputation among shareholders and stakeholders by understanding corporate governance best practice; and

To conclude, it is incumbent on companies to create value, not only for shareholders, but for all stakeholders and to employ their resources into actively solving social and environmental problems – now and into the future. And investors must act as guardians of good governance through the power of share ownership and responsible stewardship practices.

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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