



ICGN

International Corporate Governance Network

Disclosure Working Group
Financial Services Agency
Tokyo
Japan

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To the Disclosure Working Group of the Financial Services Agency:

ICGN Response to the Financial Service Agency's consultation on Current Issues Relating to Corporate Disclosure.

The International Corporate Governance Network (ICGN) is pleased to respond to the Financial Service Agency's (FSA) consultation on Current Issues Relating to Corporate Disclosure.

Led by investors responsible for assets under management in excess of US\$34 trillion, ICGN is a leading authority on global standards of corporate governance and investor stewardship. Our membership is based in more than 45 countries and includes companies, advisors and other stakeholders. ICGN's mission is to promote high standards of professionalism in governance for investors and companies alike in their mutual pursuit of long-term value creation contributing to sustainable economies world-wide. Our policy positions are guided by the ICGN Global Governance Principles¹ and the ICGN Global Stewardship Principles², both of which have been developed in consultation with ICGN Members and as part of a wider peer review. For more information on ICGN please see: www.icgn.org.

ICGN is actively involved in the dialogue regarding corporate governance and investor stewardship in Japan, and we have responded to recent consultations relating to stewardship and governance by the FSA, the Tokyo Stock Exchange (TSE) and the Ministry of Justice. As one of the world's leading equity markets, with over 30% of TSE market capitalisation owned by overseas investors, the quality of corporate governance and investor stewardship practices in Japan is important to ICGN members.

In this context, we are pleased to respond to this FSA consultation on corporate disclosure in Japan. The subject is one of our five global policy priorities:³ to promote higher standards of corporate reporting and disclosure – including both traditional

¹ See: Japanese language version of Global Governance Principles:
http://icgn.flpbks.com/icgn_global_governance_principles_jpn/

² See: Japanese language version of Global Stewardship Principles
https://www.icgn.org/sites/default/files/ICGN_Global_Stewardship_Principles_JPN_1.pdf

³ See: <https://www.icgn.org/sites/default/files/ICGN%20Policy%20Priorities%202017-2018.pdf>

financial statements, but also less traditional forms of disclosure such as integrated reporting.

Before addressing the individual questions outlined in the consultation paper, we would like to make some points at the outset, which are reinforced in the answers to the specific questions.

- As investors (both equity holders and creditors), we agree that the role of disclosure is to provide necessary information to investors, and to promote the dialogue between companies and investors. We also recognise, however, that while investors—as providers of a company’s risk capital—are of fundamental importance to corporate disclosure objectives, we also believe that positive stakeholder relations (employees, customers, suppliers, communities, etc.) are critical to sustainable value creation for investors. Therefore we also believe it is important for company management and directors to understand and manage key stakeholder relationships, and that corporate disclosure can also be used as a means to **build mutual understanding between the company and its stakeholders**.
- We believe that the integration of qualitative performance factors with financial statements is critical for investors to achieve a balanced understanding of a firm’s activities, opportunities and risks. We suggest that it might make specific reference to this form of reporting as an **integrated report**. The term integrated reporting is broad in nature and is increasingly used by investors and companies in both Japan and abroad. We offer as a general reference to your reflections ICGN’s Guidance on Integrated Business Reporting.⁴
- We note that the consultation makes reference to the term “non-financial” information. In making use of this term, it is important to note that investors increasingly are focusing on the future financial implications of this type of disclosure, insofar as it addresses issues that have the potential to affect company performance positively, or negatively, in the long-term.
- You have rightly identified narrative information such as business strategy, MD&A and risk information as constituting aspects of “non-financial” information. However, we believe this is incomplete and would note that there is no specific mention in this corporate disclosure consultation on **environmental, social and governance (ESG) factors**. To understand a company’s stakeholder relations, ESG issues can be very important, and there is growing evidence that a company’s ESG performance can affect long-term value creation. While ESG information may be implicit with regard to assessing “non-financial” risks, we believe it would be useful to make explicit reference to the use of ESG information as part of Japanese corporate disclosure.

⁴ See: http://icgn.flpbks.com/icgn-integrated-business_reporting/#p=1

- We encourage the use of reporting frameworks such as the <IR> integrated reporting framework, as well as the adoption of relevant global reporting standards that come under the aegis of the Corporate Reporting Dialogue as a coordinating body, and which include standard setters such as the Global Reporting Initiative (GRI), Sustainability Accounting Standards Board (SASB) and the Carbon Disclosure Project (CDP). For investors who are increasingly looking to analyse company ESG data consistently between sectors and countries, such frameworks can provide a global standard for ESG reporting to help facilitate comparisons.

Responses to questions:

Business Strategy

Q1: Are companies' purpose, objectives, business model and mid-to-long-term strategic plans appropriately disclosed? If not, how should the disclosure be improved?

ICGN's Global Governance Principles state that the board should provide an integrated report that puts historical performance into context, and portrays the risks, opportunities and prospects for the company in the future. This helps shareholders and stakeholders to understand a company's strategic objectives and its progress towards sustainable value creation. Such disclosures should:

- a) be linked to the company's business model;
- b) be genuinely informative and include forward-looking elements where this will enhance understanding;
- c) describe the company's strategy, and associated risks and opportunities, and explain the board's role in assessing and overseeing strategy and the management of risks and opportunities;
- d) be accessible and appropriately integrated with other information, for example remuneration, that enables shareholders to obtain a picture of the whole company;
- e) include information around risks and opportunities associated with environmental, social and governance matters which are material to the company's strategy and performance;
- f) use key performance indicators that are linked to strategy and facilitate comparisons;
- g) use objective metrics from external standard setters to allow for comparisons between companies or apply evidence-based estimates where external metrics do not exist; and
- h) be strengthened where possible by independent assurance that is carried out annually having regard to established disclosure standards.

Q2 Companies are obliged to disclose the business strategy that should be linked with MD&A and risk information, etc. in the United Kingdom. Do you think this would be useful for Japanese companies? If yes, how should the disclosure be improved?

Yes, we agree that this is important. As noted earlier we believe that an integrated reporting framework and inclusion of material ESG information should be areas for improvement. Boards of directors should be able to describe the company's strategy for long-term value creation and sustainable growth to investors and also how they are dealing with systemic threats. The discussion should have a forward looking orientation in terms of the economic environment the company expects to face in terms of risk and opportunity. This not only includes how financial performance will be achieved but also how this performance is sustained over the long term within the company's operating environment. Investors can then form a view of the effectiveness of the board process for overseeing strategy and risk mitigation.

MD&A

Q3 Are management's views and involvement of top level managers important? If yes, how should the management's views be presented in disclosure? Also, how should top management participate in the process of disclosure?

Management's views are critical. Company executives can contribute to the disclosure process through dialogue with the board on which non-financial or narrative reporting factors, including ESG issues, are most relevant for disclosure. Translation of these issues into objective and measurable key performance indicators (KPIs) is critical if management, the board and investors are to understand company performance in these areas. Management should include a description of how its allocation of resources will support the achievement of the company's strategy.

Q4 Is information by segments adequately disclosed? If not, how should it be improved?

Please see the answer to Q5 below with regard to specific information. It is important for investors to see and understand how the company manages its business, both financially and operationally, including sustainability information. Where sector-specific indicators or standards have emerged, companies should follow them unless they think they are inappropriate. And where standards do not exist, evidence-based estimates and narrative discussion are useful. It is also helpful for information to be provided on how the measures have been developed and for a consistent approach from one year to the next so that changes in performance over time can be evaluated.

Q5 Some investors point out that more information on cash flow, capital usage, fund needs/resources, KPIs, etc. should be disclosed. Do you agree? If yes, what information on these items should be disclosed? From what perspectives?

For companies that have diverse operations and business units, it is difficult, if not impossible, to properly analyse a company if there is insufficient segment data, by both business unit and geography. This includes financial information, including revenues, profit and cash flow from the operational perspective, and the allocation of capital – and returns on capital—from a balance sheet perspective. Again, for companies with diverse operations, segment reporting should also include more narrative factors including material strategic, risk and ESG factors. This will vary from company to company, depending on the sector and geography. As noted earlier, we encourage Japanese companies to adopt global standards for integrated reporting and ESG data.

Risk Information

Q6 Some are of the view that the current disclosure of risk information is boilerplate, that it is not specific to companies, and that there is not much information on mitigation measures, latest changes and materiality. Do you agree? How should the risk information be improved?

We do believe that there is the risk of boilerplate disclosure on risk in Japan. As noted earlier in this letter, company reporting on risk should describe the company's strategy, and associated risks and opportunities, and explain the board's role in assessing and overseeing strategy and the management of risks and opportunities. This includes the prioritisation of risks, risk mitigation measures and the current status of these risks.

ICGN's Guidance on Corporate Risk Oversight⁵ provides extensive focus on investor preference with regard to disclosure relating to corporate risk:

Comprehensive information

The board should concisely disclose information sufficient for investors to make judgments on the quality of the board's oversight of the risk management process.

Disclosure frequency

Disclosure should be made at least annually, in conjunction with an organisation's regular financial reporting process.

Disclosure format

Boards should provide investors with a statement that includes information on risk oversight procedures and board perspectives on risk in the approved strategy. This should be in a text identified as distinct from any reports or disclosures issued by management concerning specific risks faced by the company. The disclosure statement should be consistent with the size and complexity of the company.

⁵ See ICGN Guidance on Corporate Risk Oversight (2015):
http://icgn.flpbks.com/icgn_corp_risk_oversight/#p=1

Disclosure structure

Boards should explain to investors those aspects of the corporate governance structure that the board relies upon to oversee the strategy and material risks of the company, including whether a board level committee specialised in risk exists, the nature of its responsibilities, skills and the feedback loop into the board's strategy discussions.

Disclosure of policy

In disclosures, a board should describe the company's approach to risk within the context of current corporate strategy, the process used to set parameters of the company's risk tolerance, the frequency with which these parameters are reviewed, and whether any limits on risk-taking are imposed on management.

Boards should disclose (any changes in) material risks, including changes that result from modifications of strategy as well as changes in the company's environment (e.g., market shares and competitors).

Boards should disclose how they monitor the robustness of contingency and resilience planning for risk threats and opportunities.

Boards should clearly articulate how they ensure that variable pay practices for executives align with the company's strategy and risk management and the current state of the company.

Disclosure of process

Boards should explain to investors it has collectively reviewed, challenged and approved management's information on company risk and risk management in light of the company's strategy.

Boards should disclose risk oversight challenges that may have emerged over the reporting period, including actions taken or plans to address them. The board should describe how it dealt, in respect of procedure, with any failures of risk oversight. The board should explain how on an ongoing basis it seeks to improve risk oversight.

Boards should disclose how they ensure that broader economic risks and systemic industry risk that can affect probabilities of achieving the company objectives are taken into account. This explanation should include consideration of multiple events occurring simultaneously.

Employee Information

Q7 Should employment expenses (wages), turnover rate, etc. be disclosed on a consolidated basis? Is there any other information on employees necessary for investment decisions and dialogues between investors and companies?

Employees are important stakeholders in a company's long-term success. For example, in the <IR> integrated reporting framework "human capital" is one of the six critical forms of company capital – and this relates directly to the quality of and relationships with the company's labour force. Material KPIs and other disclosure items relating to employees can be important to companies, investors—and the employees themselves—to better understand employees related factors, including turnover and employment expense.

This is clarified in the ICGN Global Governance Principles, recommendation 6 .8 regarding employee incentives, which states that the board should ensure that the development of remuneration structures for company employees reinforces and does not undermine sustained value creation. Performance based remuneration for staff should incorporate risk, including measuring risk-adjusted returns, to help ensure that no inappropriate or unintended risks are incentivised. While a major component of most employee incentive remuneration is likely to be cash based, these programmes should be designed and implemented in a manner consistent with the company's overall long-term performance drivers.

Cross-Share Holdings

Q8 It has been noted that more disclosure on cross-share holdings, including a more detailed purpose and benefits of cross-share holding, cost/benefit analysis, discussion at the board, changes from the previous year and contents of proxy voting. What information should be disclosed? From what perspectives?

The practice of cross shareholding is an important area in Japan, and remains an area of concern for investors to the extent that cross shareholdings and capital management more broadly, are viewed to affect investor returns on capital employed. However, often companies only provide a boilerplate explanation on the purpose of the holdings. 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.

As noted to in our recent comment letter on the Japan Corporate Governance Code, ICGN supports the revisions to Principle 1.4 and in particular the new supplementary principles 1.4.1 and 1.4.2. It is hoped that the code revisions will help improve the quality of disclosure regarding the economic rationale for cross shareholdings. It is also hoped that the introduction of the supplementary principles will help encourage positive change in traditional business practices where cross shareholding

relationships are prevalent which can have a detrimental effect on the standards of corporate governance and can be an impediment to investor stewardship.

ICGN advocates for boards to justify what the business benefits, in a financial sense, are for having cross shareholdings and disclose this in the form of a cost/ benefit analysis. We also encourage Japanese companies to commit to a target to reduce their cross shareholdings over a specified period of time.

Q9 Some investors have suggested that the coverage of cross-share holdings disclosed in Annual Securities Reports should be broadened beyond the current requirement of top 30 holdings. Do you agree? If so, how many cross-share holdings should be disclosed?

ICGN believes that companies should disclose their policy towards capital allocation. This should include disclosure on the top 30 cross-shareholdings by value as well as the total number, not only in the Japan Securities Report, but also on the company's website in English. It would also be helpful for such disclosure to include the real identify of the cross-shareholder, for example whether or not they are a parent company, subsidiary, supplier and so on. This would help provide greater transparency around progress being made and identify more clearly which companies are dominant in this area. In the event that a company may have fewer than 30 cross-holdings – or holdings below a certain materiality threshold (to be defined)— it could be sensible in such cases to allow for fewer cross-holdings disclosures, as long as the company is able to explain this.

Q10 Some investors mention that when Company A discloses cross-share holdings of Company B, Company A should also disclose the number of Company A shares held by Company B. Do you agree?

Yes. The main focus of investors is on those cross-shareholdings that are material both financially and in terms of size of holding/share of voting rights to at least one party to the cross-sharholding relationship.

Q11 Some investors point out that all the material holdings of shares should be disclosed since there may be some cases where companies classify cross-share holdings as non cross-share holdings to avoid disclosure. Do you agree? If so, how should it be disclosed?

Yes, we agree that all material shareholdings should be disclosed. Again materiality has to guide disclosure decisions, but a company should be prepared to disclose and comment upon the strategic nature of its investment in any other company, whether or not it involves a cross-shareholding.

Q12 There is the view that since annual securities reports are not translated into English, foreign investors do not have easy access to information regarding cross-share holdings. Do you agree?

Yes, just because foreign investors—who generally communicate in English—may not speak or read Japanese, this does not mean that they are not interested in having similar transparency in English as in Japanese. This is particularly important given the large overseas ownership of the TSE. Overseas investors may in some ways be more sensitive to, and critical of, cross-shareholdings, and they should not be put at an informational disadvantage due to lack of English language data. Otherwise, there is the risk of an asymmetrical access to data that will disadvantage non-Japanese speaking investors.

Q13 It has been proposed that the information regarding cross-share holdings should be provided before annual general shareholder meetings. Do you agree?

We very much agree with this point. General shareholder meetings provide investors with an opportunity to both question management and to vote on management and shareholder resolutions. Having this cross-shareholding information ahead of a general shareholder meeting is important to allow investors to consider engagement questions or relevant voting resolutions with regards to cross-shareholdings and capital allocation more generally.

Executive Remuneration

Q14 Should calculations regarding portions of fixed salary, annual bonus, and long-term incentives be disclosed with more detail? Also, should a company disclose how business results and progress of KPIs are reflected in remuneration? If so, how should it be disclosed? From what perspectives?

As noted in ICGN Global Governance Principles, the board should disclose clear and understandable remuneration policies and reports which are aligned with the company's long-term strategic objectives. Such disclosure should facilitate comparability and accountability and include reference to how awards were deemed appropriate in the context of the company's underlying performance and long-term strategic objectives and whether remuneration consultants were involved in the process. Disclosure should refer to executive officers, directors and the CEO and reported on an individual basis, whilst also taking into account the company's overall approach to human resource strategy. This extends to non-cash items such as director and officer insurance, pension provisions, fringe benefits and terms of severance packages, if any.

With regard to the particular disclosure items, we agree it is important to disclose fixed salary, annual bonus and long-term incentives in detail. We encourage concise and clear reporting on how these aspects of performance relate to financial performance and non-financial KPIs. For greater detail on disclosure elements

relating to remuneration we recommend ICGN's Guidance on Executive Director Remuneration⁶ and ICGN's Guidance on non-Executive Director Remuneration⁷.

Q15 Should a company disclose who ultimately decides the amount of remuneration, with what authority and discretion, including information regarding statutory or voluntary remuneration committees and their composition, if any?

Yes, it is important to disclose not only what executives are paid, but also how and by whom key remuneration decisions are made. ICGN's Global Governance Guidelines state that the board should establish a remuneration committee comprised of a majority of independent non-executive directors.

Q16 There are some who argue that the current rule that requires the disclosure of individual remuneration in excess of 100 million yen may be preventing companies from compensating directors to avoid disclosure. Do you agree? If so, how should it be solved?

We agree that 100 million yen constitutes a materially high level of remuneration for any corporate executive. We do not know if this creates an artificial ceiling to avoid disclosure, but we believe that the remuneration of a company's senior executives, its CEO in particular, should be disclosed even if below this 100 million yen threshold. If this threshold level is having an unintended consequence on director remuneration, it may make sense to eliminate this threshold and require individual remuneration disclosure for all senior corporate management (eg the "C-Suite).

Others

Q17 Are there any other governance-related information that should be included in Annual Securities Reports? Should information on the activities of the board, independent directors and board committees be included?

Yes, increasingly investors are interested in assessing board composition and committee structures to understand the dynamics of a company's governance quality and board oversight. This should include disclosure of individual independence, committee memberships, attendance at board meetings and the number and nature of other board commitments that an investor may have. We believe best practice lies in a "skills matrix" summarising the background, role and individual expertise/contribution to the board's overall activity.

⁶ See ICGN's Guidance on Executive Director Remuneration: http://icgn.flpbks.com/icgn_executive-remuneration_2015/#p=1

⁷ See ICGN's Guidance on non-Executive Director Remuneration: http://icgn.flpbks.com/icgn_non-exec-dir-remuneration_2015/#p=1

Q18 US and UK companies provide audit committee reports that include information on the length of tenure of the current audit firm and assessment of the effectiveness of the external audit. Should there be more information on audit in Japanese disclosure? If so, what should be included?

The audit committee should engage with the company's auditor to discuss any risks or other concerns that were significant to the audit process, including any significant questions or disputes regarding accounting practices. The audit committee report should include a summary of its discussions with auditors, including how any major concerns were addressed, to enhance investor confidence in the audit process.

We hope these comments are useful in your deliberations. If you would like to follow up with us with questions or comments, please contact our Policy Director George Dallas: george.dallas@icgn.org .

Yours sincerely,



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