ICGN
International Corporate Governance Network
Inspiring good governance & stewardship

Remarks from Kerrie Waring, CEO, ICGN to the Japan Stewardship Initiative
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Hello Everyone

Thank you for inviting me to share ICGN's perspective on corporate governance reforms in Japan since the update of the Code last year. You may know that we submitted a response to the Council of Experts on Monday so my comments will draw largely from that. Emi has also invited me to update you the revised Model Mandate which sets out how asset owners can embed stewardship and sustainability obligations in contracts with managers.

For those of you less familiar with ICGN, our mission is to inspire high standards of corporate governance and investor stewardship to help preserve and enhance long-term corporate value, ultimately contributing to sustainable economies, societies and the environment.

This is communicated through the ICGN Global Governance Principles, which was published over 20 years ago and are used by many ICGN Members in their voting policies and company engagements. This is important given that they represent around $70 trillion of assets under management – many of whom have a stake in the 30% of listed equity held by overseas investors in Japanese companies. We also have many investor members in Japan including GPIF.

I should begin by emphasising that ICGN applauds the leadership of FSA, TSE and others for the many positive reforms over the last decade. We are grateful for the relationships we have built with organisations such as Keidanren and JSI to foster a deeper understanding between companies, investors and other market participants in our shared enveavour to preserve and enhance long term corporate value.

We encourage continued momentum on this journey and my comments celebrate successes while considering areas for improvement.

There are ten key areas I would like to address:

1. **The first point is around the quantity of independent directors.** We welcome the positive trend of more than 80% of companies listed on the JPX Prime Market to have at least one third of independent directors on the board. Going forward, we recommend that a timeframe be agreed for ALL Prime Market listed companies to achieve this. Further we think this should apply to all listed companies whether in the standard or growth market. And that all boards should aim for a majority of independent directors in the not too distant future.

2. **Secondly, effective corporate governance relies - not only on the quantity - but the quality of independent directors.** They are relied upon to hold management to account, scrutinise risks and opportunities, ensure financial discipline, and provide strategic direction.

We encourage companies to provide more information around the how the skills, experience and attributes of independent directors align with the company's purpose, succession planning, and long-term strategy. What is the rationale for their appointment? To what extent are the individuals truly independent?

Added to this is whether external board evaluations are conducted periodically and the degree to which director tenure is contingent on his or her performance on the board.

3. **Third, we recommend that companies demonstrate their commitment to board diversity, equity and inclusion** in clear policies expressing goals, action plans and measurable, time-bound objectives. Corporate boards should annually report against the policy including an explanation of how this aligns with the company's purpose, strategy and succession planning for the board and workforce.

4. **Fourth,** ICGN welcomes the increased number of companies listed on the JPX Prime Market having nomination and compensation committees. **Ideally we would welcome all Prime Market companies to adopt a three-committee system as an optimal governance structure**.

5. **My fifth point concerns capital allocation.** Companies around the world today face unprecedented systemic risks - climate change, Covid, Russia's war against Ukraine, supply chain disruption, energy shortages and more. It is prudent for companies to take a conservative approach to capital allocation in these challenging times to manage efficiencies, mitigate risk, and ensure resilience.

   However, compared to European and North American counterparts, Japanese companies take a markedly risk adverse approach evident in the continual build-up of retained earnings and cash deposits. This suggests the need for a greater appreciation among boards in Japan of a company's economic profitability and need for returns on capital.

   The Capital Allocation Policy should clarify how cash positions, debt and equity can be blended to achieve acceptable returns for investors, while maintaining sufficient liquidity to cushion against future risks. It will also guide management on how cash flows are distributed between capital spending, dividends, share buybacks, executive remuneration and so on.

   With this in mind, ICGN would encourage companies to improve their disclosures around the rationale for capital allocation decisions, for example, discontinuing existing businesses or acquiring new ones, making any large capital investments, or R&D expenditure.

   Additionally, the rationale for dividend policies and pay-out ratios could be improved. The general 30-40% dividend in Japan is conservative compared to other markets linking to investor perceptions of unjustifiably high cash hoardings in Japan.

6. **Number six concerns cross shareholdings** and while we recognise there has been much improvement, patricularly in the banking sector, there are many companies that retain cross-shareholding without a clear rationale - for example to "smooth business relations" or "expand business transactions." Going forward it would be helpful if companies could clarify the precise nature and rationale for cross-shareholdings, e.g., if they are a parent company, subsidiary, or supplier, and how they intend to be reduced or eliminated over time.

7. **Seven concerns corporate governance disclosure which we believe should be consolidated in the Yuho, made available in English and published before the AGM.** This will allow investors access to information around the business model, corporate strategy, audited financial results, Key Audit Matters and cross-shareholdings – all of which are vital for voting decision making.

8. **We also applaud the the continued development of the Sustainability Standards Board of Japan**, and national efforts to expedite reporting aligned with the TCFD, including in the Japan Code. Last year, we welcomed the establishment of the ISSB, and the more recent cooperation agreement between them, EFRAG and GRI. This will help enable better investment decision-making through consistent, comparable, and verifiable disclosure across sectors, markets, and industries.

9. **Nine - ICGN Members would welcome further clarity around their ability to act collaboratively** without being considered a 'concert party' to improve the governance and sustainability of investee companies. It would be helpful for the FSA to publish guidance on what constitutes acceptable engagement subjects to ensure investors do not breach rules regarding collective holding thresholds above which would trigger onerous reporting requirements.

10. **And, ten, it would be helpful if both companies and investors understood better how the 'comply or explain' system works in practice.** Companies should apply the Code recommendations and disclose how they have done so. If deviations are necessary, then meaningful explanations for the alternative approach should be provided along with the impact this may have.

    Investors on the other hand are expected to carefully consider this and pay due regard to individual company circumstances. They should also provide feedback to companies regarding their opinion on code deviations which may influence their voting decisions.

I look forward to discussing these points with you but, before that, I would like to update you on revisions to ICGN's Model Mandate.

Model Mandate

The Model Mandate was published in 2012 to provide guidance to asset owners to ensure that their investment strategy and their own fiduciary obligations to beneficiaries are properly reflected in the Investment Management Agreements (IMA), and that they can monitor whether their objectives and interests are being met. It provided a series of example contractual terms which embed stewardship obligations, beyond financial parameters, into IMA terms. This included:

- Alignment of investment risk and opportunities;
- Internal governance and risk management;
- Integration of ESG;
- Incentives and performance;
- Portfolio turnover; and
- Reporting to clients.

The example clauses we provided applied to multi-asset clases, and considered - not only risks and opportunities which affect the immediate volatility of portfolios - but also those which impact investment value over the long term. This is particularly acute in relation to sustainability-related factors and systemic risks.

Last year, ICGN decided to update the Model Mandate in response to regulatory developments requiring investors to explain how they assess and monitor sustainablity related factors in their investment processes.

Additionally, the introdution of Stewardship Codes around the world has increased the emphasis on investor responsibilities as stewards, not just in the interests of their clients and beneficiaries, but of the future of society and the planet itself.

Alongside this is increased public and political expectation that investors should contribute to long-term value creation, and make a positive contribuition to the UN Sustainable Development Goals (SDGs). So we were delighted when the UN supported Global Investors for Sustainable Development (GISD) Alliance approached ICGN to work in partnership in updating the Model Mandate.

The revised Model Mandate provides draft contract clauses with specific references to Sustainble Development Investment (SDI) which is directed towards the achievement of the UNSDG. The SDGs provide a blueprint to achieve a better and more sustainable future for everyone. There are 17 goals which address things like poverty, inequality, climate change, environmental degradation, peace and justice – challenges that create risks to our economic systems and all those who depend on them.

To achieve the SDGs, there is a pressing need to increase the level of financing committed to each of these goals. By allocating a greater share of their resources to SDI and being active stewards of those investments, asset owners and managers can make an essential contribution.

Of course, many investors already integrate sustainability factors into their investment decision-making and stewardship. Often they do so because:

- They recognise that systemic risks and opportunities will impact their returns on investments over the longer term,
- They have ethical concerns; or
- Are responding to client or regulatory pressure.

Typical examples of how this is reflected in investment mandates are:

- Negative screening - excluding certain sectors, companies, or projects for poor sustainability performance relative to industry peers; or how they negatively impact the SDGs;

- Positive screening – which is opposite of negative screening where investors include or overweight investments associated with positive sustainability performance or SDG impact; and

- Full integration - assessing sustainability factors across all aspects of the investment decision-making and portfolio management process.

But Sustanble Development Investing (SDI) goes further. It requires investors to intentionally target their investments with the express objective of supporting the achievement of one or more of the SDGs while also realizing a financial return.

An SDI perspective can also help investors identify emerging technologies, products and services that have potential for solving or addressing environmental and social challenges – as well as providing a framework for assessing risks.

So I hope I have given you an insight into the initiative and we will be launching the Model Mandate on 22 June in London. The event will be live-streamed so we will be sure to send you the details. Additionally we will be lauching a Japanese language version of the Model Mandate on 3 October at the Tokyo Stock Exchange so I hope to see you in person then!