Presentation to the Japan Financial Services Agency
The Council of Experts for the Follow-up of Japan's Stewardship Code and Japan's Corporate Governance Code
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18th October 2017 (0930-1130)

Introduction

Thank you for inviting me to present as a Member of the FSA's Council of Experts Concerning the Stewardship Code. As the third largest economy in the world, Japan is a very important market to ICGN Members and we are pleased that so many reforms are being promoted by authorities such as the FSA.

My remarks today will draw on feedback from ICGN Members at our Annual Conference and our recently revised Global Governance Principles. I will refer to three areas of importance and have provided an annex with further reading (board leadership, poison pills, corporate reporting, AGM clustering and collective engagement):

1. Capital efficiency.
2. Role of independent directors; and
3. Influence of cross shareholdings.

1. Capital efficiency

ICGN notes that progress has been made since the minimum target of 8% return on equity (RoE) was introduced in the Ito Review[i] in 2014. However, RoE in Japan is still many times lower than US or European companies.

Whilst setting profitability targets are important, ICGN Members want to engage with Japanese boards on how such targets are being set and what progress is being made towards achieving them as part of a longer term strategy.

It would be helpful if Japanese boards could provide better disclosure to shareholders on the company's capital policy. This includes prioritisations for the use of current cash balances and future retained earnings. We need to encourage companies to reduce cash hoardings, accelerate investments in research and development, and invest in human resources to be truly competitive on a world stage.

Global investors want to engage boards on future risks and opportunities to enhance earnings power – growth, profitability and efficiency. Together, we need to engender a culture of trust to encourage longer term thinking and behaviour and encourage business and investment communities to work together – after all they share a mutual interest to preserve and enhance long term corporate value on behalf of all of us, society as a whole. This is the essence of Abenomics and the economic revitalisation strategy.

2. Role of independent directors

ICGN welcomes the increase of independent directors on Japanese boards since the introduction of the Corporate Governance Code in 2015. We believe that companies should strive for one-third independent directors or have a minimum of three as it would then be possible to have fully independent board committees – noting that our standard for widely held companies is for there to be a majority of independent directors[ii].

We need to move our focus beyond numbers and more towards competence and effectiveness. Independent directors play a crucial role in constructively challenging management, free from external influence[iii]. They can help offset the domination of decision-making by any single individual (such as the CEO). By drawing on their personal competencies and experience, they can contribute a diversity of perspectives to generate healthy debate in the boardroom and are well placed to represent the interests of minority long-term shareholders.

ICGN proposes a number of recommendations which may help strengthen the role of independent directors on boards in Japan:

- CEO selection. The lack of consultation with independent directors or use of external recruitment consultants in the appointment of a CEO sets Japan at odds with other markets. Independent directors can play a vital role in CEO appointment, removal and succession planning. ICGN would encourage wider use of Nomination Committees,[iv] when practicable, comprised of a majority of independent directors.

- Nomination disclosure. It may be helpful to encourage companies to provide better disclosure[v] in English around the selection process for the CEO and also independent directors. This could include the rationale for appointment, core competencies and factors affecting independence.

- Independence definition. We recognise that there is a definition of 'independence[vi]' in TSE Listing Rules however it may be useful to include this in Japan's Corporate Governance Code as this would provide clarity to boards in their independent director appointment processes. In particular, we recommend disclosure on factors that could impact independence including, cross shareholding partners, major client relationships and family ties.

- Communication channel. Appoint an independent director[vii] to be responsible for engagement with shareholders and encourage companies to disclose what efforts they are undertaking to engage with investors. Our Members particularly value the opportunity to engage at board level if contentious issues arise which is more likely to facilitate positive change.

- Induction. It might be helpful to provide formal induction[viii] and training for independent directors. This would help build an understanding of what their role entails and provide information on company strategy and business

operations. For example, financial literacy is particularly important to ensure that independent directors are able to challenge management on issues such as capital efficiency, the use of cross shareholdings and poison pills.

- Board evaluation. Outcomes from the board evaluation[ix] will help to inform the types of candidates of strategic relevance to the company. We stress the importance of having an external review, once every three years. The process for evaluation should be disclosed in English to shareholders and any material issues of relevance arising from the conclusions.

3. Influence of cross shareholdings

The practice of cross shareholdings amongst the business community in Japan is a major concern to ICGN Members. The perception in Japan seems to be that they are essential for successful business relationships whereas sentiment from the global investment community is very different as noted in a recent ICGN Yearbook article.[x]

Concerns include:

- Obstruction to fair competition: 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 as a means to prevent the investee companies from trading with competitors or refusing to trade with those without shareholding relationships is unreasonable.

- Unequal treatment of shareholders: 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.

- Inappropriate use of anti-takeover measures: cross-shareholdings can be used as an anti-takeover measure which may not be in the interest of other minority shareholders.

- Inefficient capital management: holding shares of companies for non-investment purposes raises concerns about inappropriate and inefficient financial capital management.

- Obstruction to board independence: a large number of companies have appointed non-executive directors who represent their cross-shareholding partners and designated them as independent which is questionable.

- Ineffective managerial challenge: since the holders of such shares seek to maintain amicable relationships with investee companies, they are likely to support management instead of exercising their shareholder rights appropriately to hold management and the board to account, which could contribute to sustaining poor governance practices and blocking attempts by other investors to improve governance at the investee companies.

I also refer you to a paper[xi] posted on the Harvard Law School Forum on Corporate Governance and Financial Regulation in which the authors found that *'managers of companies characterized by a high proportion of cross shareholding avoid making difficult decisions or risky choices (e.g., large investments, restructuring). They also found that monitoring by investors and independent directors mitigates these effects'.*

ICGN recognises that progress has been achieved by major banks in setting targets to reduce cross shareholdings following encouragement by the FSA. However, we believe that further measures might be helpful to expedite the unwinding of cross shareholdings in banks and across the corporate sector more generally.

Specifically we refer to company compliance with Principle 1.4 regarding cross shareholdings of Japan's Corporate Governance Code.[xii] A number of ICGN Members opine that disclosure provided by boards is inadequate and fails to describe an appropriate rationale for cross shareholdings.

ICGN encourages Japanese companies to commit to a target to reduce their cross shareholdings over a specified period of time. We believe that boards should 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.

Additionally, we suggest that companies should disclose 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. This would help provide greater transparency around progress being made and identify more clearly which companies are dominant in this practice.

Annexes:

1. Board leadership and influence

In addition to the recommendations to help improve the effectiveness of independent directors, the following are also important:

- Leadership. There should be a clear division of responsibilities between the role of the board chairman and the CEO. The chairman is responsible for leading the board, whilst the CEO is responsible for managing the company which are two distinct roles. This also helps to avoid the entrenchment of power in one single individual who may dominate board decision-making.

- CEO succession to chairman. ICGN discourages the practice of a company's retiring CEO remaining on the board and becoming chairman. We would encourage Japanese boards to communicate a convincing rationale in the annual report as to why CEO succession to chairmanship is in the best interests of the company.

- Use of consultants. ICGN welcomes the decision by the TSE to encourage more disclosure from companies around the appointment of former executives being retained as advisors to the incumbent CEO or chairman. Such advisors

should not be in a position to influence decision-making and it would be helpful for more transparency around the type of advice received and any associated fees.

2. Encouraging collective engagement

Constructive engagement with companies in Japan is important as it helps to offset the negative effects of cross-shareholdings. We must help domestic and overseas investors to build relationship and engage together with companies to challenge issues that they feel might need to be addressed.

In order to do so, ICGN Members would like further clarity around their ability to act collaboratively with other investors. They would like the Japan FSA to confirm that as long as they do not collude to vote in the same way on items related to the control and direction of the company (such as board elections) they will not breach rules regarding collective holding thresholds above which would trigger onerous reporting requirements.

ICGN welcomes reference to collaboration in the Japan Stewardship Code guidance for Principle 4 on engagement. This is an important step however, there is still nervousness amongst global investors around the potential to be perceived as colluding in a negative way (for example staging a hostile takeover) when in fact they wish to collaborate to improve the governance and sustainability of investee companies.

As I suggested at a previous Council meeting, the publication of guidance such as the list from the European Securities Markets Authority might help to give investors more confidence in being able to engage constructively with Japanese companies. It is a public statement made under the European Takeover Bids Directive (Directive 2004/25/EC) which indicates a list of activities indicating that co-operation by investors will not lead to a conclusion that the shareholders are acting in concert. This includes voting on proposals relating to directors' remuneration, capital and financial policies, the environment or any other matter relating to social responsibility.

<u>ESMA White List on shareholder cooperation</u>

"4.1 When shareholders cooperate to engage in any of the activities listed below, that cooperation will not, in and of itself, lead to a conclusion that the shareholders are acting in concert:
(d) other than in relation to a resolution for the appointment of board members and insofar as such a resolution is provided for under national company law, agreeing to vote the same way on a particular resolution put to a general meeting, in order, for example:
(A) To approve or reject:
(i) a proposal relating to directors' remuneration;
(ii) an acquisition or disposal of assets;
(iii) a reduction of capital and/or share buy-back;
(iv) a capital increase;
(v) a dividend distribution;
(vi) the appointment, removal or remuneration of auditors;

(vii) the appointment of a special investigator;
(viii) the company's accounts; or
(ix) the company's policy in relation to the environment or any other matter relating to social responsibility or compliance with recognised standards or codes of conduct; or

(B) to reject a related party transaction.

3. Eradicating the use of shareholder rights plans ("poison pills")

ICGN recognises that a number of companies have abandoned the use of shareholder rights plans ("poison pills"). Some investors consider that all poison pill programmes, at least among those proposed as voting resolutions, are inappropriate in Japan, where majority independent board oversight continues to be a rarity, and should be opposed on principle.

Unless management presents a very strong case that the plan would not permit management entrenchment to trump an unbiased assessment of shareholder interests in a proposed deal, ICGN Members would generally oppose poison pill defences by voting against all or some of the directors up for election.

ICGN encourages Japanese companies to allow their poison pills to lapse. Only non-conflicted shareholders should be entitled to vote[xiii] on such plans and the vote should be binding. Plans should be time limited and put periodically to share holders for re-approval.

4. Challenges to monitoring corporate governance disclosures

Monitoring can be quite difficult in Japan given the dispersed nature of governance related reporting and, for global investors, a lack of English language disclosure. The effect of this is that it is very time consuming to adequately assess any explanations for deviations to Corporate Governance Code compliance and make considered judgements on voting.

I do recognise that the Corporate Governance Code came into effect relatively recently and therefore companies are still adapting their approaches to corporate governance reporting. We would welcome greater harmonization of securities regulations and company law in Japan and any initiative that encourages simplicity and consolidation of corporate governance related information.

In terms of access to English language information, only 156 listed companies translated their Corporate Governance Reports into English this year. I do understand that there are costs associated with translating information into English however, given that the Japanese market is owned in excess of 30% by overseas investors, it might be appropriate to put more effort into this.

I should add that the clustering of AGMs in the last seven days of June also leads to a crunch on information gathering which can impact the ability of investors to qualitatively analyse investee company governance. I understand most companies have a financial year end of 31st March and that they tend to set the record date at

the same time. However, from the work METI has done on this, it seems that it is possible to set a record date after the year-end simply by changing the company's Articles. Therefore, AGMs could be held beyond the traditional June period if companies were willing to do so.

End Notes

[i] Ito Review of Competitiveness and Incentives for Sustainable Growth, August 2014

[ii] *ICGN Global Governance Principles: Guidance 2.5 re Independence: "The board of a widely-held company should comprise a majority of independent non-executive directors. Controlled companies should preferably have a majority of independent non-executive directors, or at least, three (or one-third) independent directors, on the board."*

[iii] *"To be effective it is crucial that the board comprises a balance of executive and non-executives who are independent from management. This balance insures that no single individual or group of individuals dominates decision-making to the detriment of others, and help provide the diversity needed to cultivate a healthy debate in the boardroom. A truly independent director can bring fresh ideas as a result of external experience and challenge management constructively without the constraints of a vested interest in the business. Independent directors also represent in the boardroom or views and interests as minority long-term shareholders." ESG Viewpoint published by BMO Global Asset Management, July 2017, written by Yo Takatsuki of BMO Global Asset Management, Meryam Omi of Legal and General Investment Management and Alison Kennedy of Standard Life Investments.*

[iv] *ICGN Global Governance Principles: Guidance 3.7 re Nomination committee: "The board should establish a nomination committee comprised of a majority of independent non-executive directors. The main role and responsibilities of the nomination committee should be described in the committee's terms of reference. This includes: evaluating the composition of the board taking into account the board diversity policy; developing a skills matrix, by preparing a description of the desired roles, experience and capabilities required for each appointment; leading the process for board appointments and putting forward recommendations to shareholders on directors to be elected and re-elected; upholding the principle of director independence by addressing conflicts of interest (and potential conflicts of interest) among committee members and between the committee and its advisors during the nomination process; considering and being responsible for the appointment of independent consultants for recruitment or evaluation including their selection and terms of engagement and publically disclosing their identity and consulting fees; entering into dialogue with shareholders on the subject of board nominations either directly or via the board; and proactively leading and being accountable for the development, implementation and continual review of director succession planning.*

[v] *ICGN Global Governance Principles: Guidance 3.3 re director nomination disclosure: "The board should disclose the process for director nomination and election / re-election along with information about board candidates which includes: (a) board member identities and rationale for appointment; (b) core competencies, qualifications, and professional background; (c) recent and current board and management mandates at other companies, as well as significant roles on non-profit / charitable organisations; (d) factors affecting independence, including relationship/s with controlling shareholders; (e) length of tenure; (f) board and committee meeting attendance; and (g) any shareholdings in the company. Consolidating this disclosure in a skills matrix can be an efficient way to identify how key skills are accounted for within the board as a whole. Company disclosure could provide information on the board recruitment process, including on the use of external advisors, search and selection criteria and diversity.*

[vi] *ICGN Global Governance Principles: Guidance 2.6 re Independence criteria: "The board should identify in the annual report the names of the directors considered by the board to be independent and who are able to exercise independent judgement free from any external influence. The board should state its reasons if it determines that a director is independent notwithstanding the existence of relationships or circumstances which may appear relevant to its determination, including if the director: is or has been employed in an executive capacity by the company or a subsidiary and there has not been an appropriate period between ceasing such employment and serving on the board; is or has within an appropriate period been a partner, director or senior employee of a provider of material professional or contractual services to the company or any of its subsidiaries; receives or has received additional remuneration from the company apart from a director's fee, participates in the company's share option plan or a performance-related pay scheme, or is a member of the company's pension scheme; has or had close family ties with any of the company's advisers, directors or senior management; holds cross-directorships or has significant links with other directors through involvement in other companies or bodies; is a significant shareholder of the company, or an officer of, or otherwise associated with, a significant shareholder of the company; is or has been a nominee director as a representative of controlling shareholders or the state; has been a director of the company for such a period that his or her independence may have become compromised. There is no fixed date that automatically triggers lack of independence; the norm can differ in varying jurisdictions between 8-12 years after which a non-executive director may no longer be deemed independent. Companies should be guided by local norms, and directors with longer tenure should not be classified as independent in terms of committee appointments or other board functions requiring independence."*

[vii] *ICGN Global Governance Principles: Guidance 2.2 re Lead Independent Director: "The board should appoint a Lead Independent Director (sometimes referred to as Senior Independent Director), even when the company chair is independent. The Lead Independent Director provides shareholders and directors with a valuable channel of communication should they wish to discuss concerns relating to the chair. The board should explain the reasons why its leadership structure is in the best interests of the company in the annual report and keep the structure under review."*

[viii] *ICGN Global Governance Principles: Guidance 1.5 re Induction: "The board should have in place 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. Directors should regularly refresh their skills and knowledge, through training as required, to discharge their responsibilities."*

[ix] *ICGN Global Governance Principles: Guidance 3.6 re Evaluation: "The board should rigorously evaluate the performance of itself (as a collective body), the company secretary (where such a position exists), the board's committees and individual directors prior to being proposed for re-election. The board should also periodically (preferably every three years) engage an independent outside consultant to undertake such evaluations. The non-executive directors, led by the lead independent director, should be responsible for performance evaluation of the chair, taking into account the views of executive officers. The board should disclose the process for evaluation and, as far as reasonably possible, any material issues of relevance arising from the conclusions and any action taken as a consequence. Extending a director's tenure for additional terms should be premised on satisfactory evaluations of his/her contribution."*

[x] Cutting through cross share holdings by Sachi Suzuki, Hermes EOS, ICGN Yearbook (2017)

[xi] Enjoying the Quiet Life: Corporate Decision-Making by Entrenched Managers, by Naoshi Ikeda, Kotaro Inoue, and Sho Watanabe, Tokyo Institute of Technology: "Quiet life hypothesis (first introduced by Hicks in 1935) finds that managers avoid making difficult decisions when they are protected from the disciplinary effects of the capital market. Because increasing investments (e.g., new facility development, acquisitions, R&D) require substantial effort on the part of managers, managers may decrease these investments, even if they are expected to increase firm value. Because many managers of Japanese firms are protected from the disciplinary effects of the stock market through cross-shareholding, the quiet life problem can be a cause of the poor performance of Japanese firms. Despite the importance of the quiet life problem, there has been no empirical study of the underinvestment problem caused by Japanese firm managers who entrenched themselves."

[xii] Japan's Corporate Governance Code: Principal 1.4: Cross shareholdings: "When companies hold shares of other listed companies as cross shareholdings they should disclose their policy with respect to doing so. In addition the board should examine the mid to long-term economic rationale and future outlook of major cross the shareholdings on an annual basis taking into consideration both associated risks and returns. The annual examination should result in the board's detailed explanation of the objective and rationale behind cross the shareholdings. Companies should establish and disclose standards with respect to the voting rights as to the cross shareholdings."

[xiii] *ICGN Global Governance Principles: Guidance 8.2 re Major decisions: "The board should ensure that shareholders have the right to vote on major decisions which may change the nature of the company in which they have invested. Such rights should be clearly described in the companies governing documents and include……(e) shareholder rights plans or other structures that act as antitakeover mechanisms. Only non-conflicted shareholders should be entitled to vote on such plans and the vote should be binding. Plans should be time limited and put periodically to shareholders for approval."*