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CORPORATE GOVERNANCE PRINCIPLES

Japan

Hermes EOS
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For professional investors only

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HERMES
INVESTMENT MANAGEMENT

CORPORATE PURPOSE AND HERMES RESPONSIBLE OWNERSHIP PRINCIPLES

Companies aim to provide goods and services for customers and society at a competitive quality and price. This can only be achieved sustainably if they create and preserve value over time, not only for their shareholders but also for stakeholders, society and the environment. Our expectation, therefore, is that companies should be run not only for shareholders, but should also have a wider purpose that benefits society. In turn, this supports the needs of savers and pensioners, who rely on sustainable returns from their investments, to provide them and their families with a secure future.

This document should be read in conjunction with the Hermes Responsible Ownership Principles. They provide our views on corporate purpose and other issues that we believe are important for companies globally.

INTRODUCTION

We welcome the progress Japan has made with corporate governance in recent years. In particular, since the introduction of the Corporate Governance Code in the country in 2015, we have observed an increased level of interest among companies in discussing corporate governance with institutional investors and their representatives, including Hermes EOS. As the Code was revised and strengthened in 2018, we hope that constructive and meaningful dialogue between companies and their shareholders will continue to develop, and help enable further governance progress that is required and achieve positive changes that lead to long-term value creation for stakeholders, including shareholders. The Japanese Stewardship Code (Principles for Responsible Institutional Investors), which was revised in 2017 following its launch in 2014, has encouraged Japanese institutional investors to become more active stewards of companies in which they own shares. We are pleased that some of them have appointed Hermes EOS to assist them with this.

As a representative of these long-term investors, Hermes EOS makes recommendations to most of its clients on how to cast their votes at shareholder meetings of investee companies globally, and engages with the boards and senior management of companies on matters it believes will preserve and add value. Our activities are based on the fundamental belief that companies with responsible, interested and involved shareholders are more likely to achieve superior long-term returns. In line with Japan's Stewardship Code, we expect pension funds and other long-term investors to play an important role in promoting best practice corporate governance. We welcome the role the Government Pension Investment Fund has played in raising awareness about the importance of environmental, social and governance issues in investment and promoting engagement between investors and companies.

CORPORATE GOVERNANCE CODE

We strongly support the comply-or-explain approach taken by Japan's Corporate Governance Code. We believe that a thoughtful and effective use of the comply-or-explain mechanism will help facilitate constructive dialogue between companies and their shareholders, as well as foster trust and good long-term relationships. Indeed, we have noted an increased level of interest from companies in discussing governance practices with investors since the introduction of the Code. While the effective implementation of the Code may still take some time, we strongly discourage a box-ticking approach or 'boilerplate' explanations. Explanations should be tailored to the company's position and be sufficiently informative. To ensure the comply-or-explain approach works as effectively as intended, there needs to be a shared belief about what constitutes good corporate governance and its value. Companies should not confuse superficial compliance with good corporate governance. We have concerns that a large number of companies state in their Corporate Governance Report that they comply with all or most of the principles of the Code when we do not believe that they do or we cannot form an accurate opinion from their limited disclosure. Japanese investors, helped by regulators, need to make continuous efforts to encourage and assist listed companies to gain a greater understanding of the purpose and standards of good disclosure, which should contain a meaningful level of detail and provide a coherent rationale for the chosen governance arrangements. We expect companies, particularly in their communications with investors, to demonstrate that good governance is important to them and that they are striving constantly to improve it.

ACCOUNTABILITY: OPEN AND ONGOING DIALOGUE WITH SHAREHOLDERS

Active and ongoing dialogue between a company's board, its management and its shareholders is essential to accountability. Hermes EOS believes that a relationship based on mutual understanding and trust between the company and its shareholders is central to good corporate governance and to the creation of value over the long term. A high standard of transparency and accountability reassures shareholders about holding shares for the long term and ultimately helps to reduce the company's cost of capital in an increasingly competitive global market. We encourage companies to consider corporate governance in a strategic manner and demonstrate a clear commitment from the top to ongoing improvements in corporate governance and culture, to support sustained growth, profitability and returns to shareholders. We therefore urge more Japanese companies to provide better access to their senior management and board members, including meetings with independent directors, who should provide shareholders with a different perspective from that of management. Importantly, these meetings also provide independent directors with the opportunity to hear shareholders' views.

¹ <https://www.hermes-investment.com/ukw/wp-content/uploads/sites/80/2018/03/final-responsible-ownership-principles-2018.pdf>

EFFECTIVE COMPOSITION OF BOARDS

To optimise the long-term value of companies, an effective system of checks and balances is required at board level. We believe that the board should comprise members with an appropriate and diverse range of competencies, knowledge and experience. These include leadership skills, decision making expertise, the ability and character to challenge executive management.

Independence

For boards to effectively discharge their responsibilities, they should include a sufficient number of independent directors. As they are able to exercise objective fiduciary judgement, they are therefore best positioned to hold management to account on a wide range of matters. They are also expected to direct a company in a way that ensures the creation of long-term value, and to advise and support the decision-making of the executives, assisting them to improve the performance of the company, to ensure sustained profitability and returns above the cost of capital.

While the Corporate Governance Code requires boards to include at least two independent non-executive directors, we strongly encourage companies – especially large ones – to ensure that at least a third or more of the board is independent. We also believe that the board should be of a size conducive to meaningful discussions and effective decision-making. If the size of the board exceeds 15 members, we expect it to achieve an even higher proportion of independence.

We expect independent directors to have unbiased views and we therefore urge boards to apply strict definitions of independence when considering candidates for such positions. For example, we do not consider independent those who work or recently worked for group companies; significant shareholders; business partners, including major lenders; or those who have any material transactions with the company. We also believe that long tenure undermines independence. We therefore believe that the independence criteria provided by the Tokyo Stock Exchange are not sufficiently stringent.

While we acknowledge the valuable contributions that statutory auditors can make to companies, we do not believe that independent statutory auditors can effectively fulfil the expected role of independent directors in particular because they do not have a vote at board meetings. We therefore expect companies to ensure a high proportion of independence among directors, regardless of the proportion of independence of the statutory auditors.

Role of chair

The chair of the board plays a significant role in leading the discussion and ensuring the effectiveness of the board. However, few Japanese companies explicitly name the chair of the board (gicho) as the assumption is that the board is typically chaired by the president or the chair of the corporation (kaicho)². This means executive and monitoring and oversight functions are rarely separated.

We encourage those companies as a first step, to reflect on the roles that the chair of the board should play and then designate someone as chair and disclose the responsibilities of the role. We believe that in the efforts to improve board independence and effectiveness, having an independent non-executive chair can have a considerable effect. While very few companies have appointed an independent chair, we encourage other companies to consider this as a viable option.

Diversity

Boards are most effective when they have access to a diverse range of knowledge, experience and skill-sets relevant to the company. In addition, a wide variety of viewpoints and perspectives will enhance debate and ultimately, we believe, lead to better decisions.

Japanese boards typically comprise a large majority of male Japanese executive directors who have been with the same company for many decades. As a result, boards tend to lack diversity in terms of gender, age, geography and experience. We believe that boards with too much commonality of background run the risk of groupthink and complacency. Japanese boards have one of the lowest proportions of female representation in major markets. Despite the historical challenge³ to secure a sufficient pool of women candidates, a growing number of large companies have appointed female directors in recent years. We strongly encourage this trend and advocate a substantial increase in the proportion of women on boards. From 2019, we plan to start opposing the re-election of the chair or president of companies which have no female director or statutory auditor unless they are able to provide a convincing explanation. As we believe that larger Japanese companies should have more than one female director or statutory auditor, we will increase our expectations over time. We encourage companies to consider younger candidates for director positions, which would not only add age diversity to the board but also help expand the pool of female candidates. We urge companies to accelerate their efforts to increase the gender diversity of their boards, senior management and across all levels of their organisations. They should make plans to meet and exceed the government's target of raising the ratio of female managers to 30% by 2020, including specific efforts to substantially improve the proportion of women at board and senior management level. We also continue to encourage companies, particularly those with significant international operations, to reflect this in their board composition. While many boards consider language a barrier to having non-Japanese directors, we continue to encourage companies to find a workable solution, as we believe diversity of nationality is beneficial for companies.

Nomination process

We welcome the voluntary establishment of a nomination and remuneration (advisory) committee at many companies in recent years. We believe these committees can help enhance focus and transparency on these matters. The nomination committee should play a key role in nominating independent directors, ensuring the right mix of skill sets, diversity and independence among board members, as

² The chair of the corporation (kaicho) is typically a former president and often retains executive power. Some companies designate the chair of the corporation as chief executive officer and president as chief operating officer.

³ Few opportunities for career development were available for women in Japan until the Equal Employment Opportunity Law was introduced in 1986, followed by the 1997 ban on gender discrimination in recruitment and promotion. This has resulted in a severe lack of female employees in senior positions at most companies.

discussed above. It should also lead on succession planning for key executives, including the chair and president, by identifying individuals who have the skills, diversity and expertise needed for the business, instead of endorsing seniority-based promotions.

It is important that the nomination committee has a majority – if not comprising solely – of independent directors, to be effective and to maintain objectivity. While the committee is usually described as an advisory body because companies are not legally required to have one, we expect boards to ensure that the committee's decisions are not undermined or dismissed as merely advisory.

The nomination process and the role of the relevant committee for appointing senior executives, directors and statutory auditors should be transparent. In addition, meaningful dialogue with investors, in particular involving directors, on these issues is crucial.

STRATEGIC SHAREHOLDINGS

We believe that the widespread practice of strategic shareholdings – also known as cross-shareholdings – among Japanese companies leads to various problems.

- 1 Despite being commonly referred to as 'strategic', many of these holdings lack a clear strategic purpose or are not proven to be the best use of shareholder funds. In addition, these holdings contribute to reducing the free float.
- 2 Many companies believe it is acceptable to hold shares of other companies to maintain long-term business relationships, including the securing of contracts for distribution and the stable supply of goods and services. This can, however, conflict with market principles of fair competition because it appears that companies are expected to do business with those with whom they have shareholding relationships instead of those who can offer the best quality products or services or the lowest price.
- 3 Strategic shareholdings may also contribute to poor corporate governance. The holders of such shares tend to support management of the investee companies instead of exercising their shareholder rights when necessary to hold management and the board to account. Similarly, strategic shareholdings can also help to prevent takeovers.
- 4 The practice therefore leads to the unequal treatment of shareholders because those who hold shares in such a fashion may receive benefits for their business, while other shareholders, including institutional and retail investors, do not.

While some companies have indicated plans to unwind many of the legacy holdings, and major banks have implemented their plans, more needs to be done. Hermes EOS would like to see these holdings phased out. We understand that this may not be easy in the short term, due to the number of parties involved and companies may fear that the unilateral sale of strategic shares could have a detrimental effect on their business. As a first step, we seek more transparency in relation to company policies on strategic or cross-shareholdings, as well as on how shareholder rights, including voting rights, are exercised at investee companies. We also encourage companies to disclose details of existing strategic shareholdings, including owners of their shares and

the specific purpose of these holdings. From this position, boards and shareholders can develop plans for unwinding strategic shareholdings more easily. We therefore welcome the proposals by the Financial Services Agency (FSA) to require companies to disclose how they validate the rationale for strategic holdings and to increase the number of strategic holdings companies are required to name from 30 to 60⁴. We have begun to see some positive developments in this area and will expect these efforts to become more widespread, and for progress to accelerate. We will continue not to support the election of outside directors who represent strategic shareholding partners.

EFFICIENT CAPITAL MANAGEMENT

Companies should seek a balance when making capital management decisions. They should strive to maximise long-term corporate value by implementing rigorous financial and business discipline. The best capital structure is a question for the board and depends on the particular circumstances of the company concerned. However, we note that many Japanese companies still have substantial cash balances or investments in strategic shareholdings for considerable periods of time, without providing a solid strategic plan or sufficient explanations for this use of shareholder capital.

More companies are setting targets for higher returns on equity (ROE) and are seeking to discuss their plans with shareholders. We welcome this development and expect management to clearly explain the company's capital policy, demonstrating a strategy and roadmap for using capital more efficiently, to enhance long-term corporate value and achieve sustained growth. In doing so, management should consider a wide range of metrics in addition to ROE.

PROTECTION OF SHAREHOLDER INTERESTS

In addition to unwinding strategic shareholdings and efficient capital management, we below are important points in ensuring the protection of minority shareholders.

Pre-emption rights

As a representative of long-term investors, Hermes EOS strongly supports the principle of pre-emption. We believe that it is a fundamental right, by which current shareholders of a company can retain their proportional ownership without finding their interest diluted by the introduction of other investors. We have seen a number of share issues which resulted in significant dilution of existing shareholders. Rights issues offer an important, efficient and fair way for companies to raise further equity, and we much prefer companies to choose them over private placements. We accept that flexibility and diversity of new sources of capital can be required to reflect the individual circumstances of companies. However, we expect companies to provide sufficient strategic explanations for any capital raising beyond a minimal level either with or without pre-emption rights, so that we can be assured that any funds raised will be used in the best interests of all shareholders. We encourage regulators to address this issue as well.

⁴ https://www.fsa.go.jp/news/30/sonota/20181102_2.html

Takeover defence schemes

We have concerns about the purpose, legitimacy and effectiveness of 'poison pill' schemes and discourage companies from adopting them. We will only accept such a scheme if the company is able to provide a convincing rationale for it and assure us that it will not be used merely to entrench management. We will carefully consider management's track record and the company's overall governance profile and progress, such as board composition and actions to optimise sustainable shareholder value, before making a decision on whether to support poison pills. We welcome the abolition of such schemes by a number of companies in recent years and continue to encourage others to abolish them. To support a poison pill, we require a specific explanation on how it will be in the interest of and protect minority shareholders.

REMUNERATION

We encourage Japanese companies to disclose details of their remuneration structure to ensure that remuneration schemes align management with strategic objectives, key drivers of business performance, long-term value creation, and important stakeholders. We also noted that any possible deferred remuneration should be disclosed and explained even if the precise amounts payable are not certain. Companies should also explain the process for determining the pay of the CEO and other senior management, following the principle that no one should determine their own pay. We firmly welcome the proposal by the FSA to require companies to disclose details of executive remuneration programmes including information on the performance link and payment history based on the programme⁵.

Following on from our pay principles⁶, our current thinking on executive pay in Japan can be summarised as follows:

Simplicity: pay schemes should be clear and understandable for investors as well as executives. Pay structures should be simple and, for example take the form of a single incentive scheme and not be as leveraged as in many international markets.

Shareholding: the executive management team should make material investments in the company's shares and become long-term stakeholders in the company's success. Significant shareholding requirements for directors should remain in place for a specific period of time following departure from the company, with no share sales allowed for at least one year.

Alignment and quantum: pay should be aligned to the long-term success of the company and the desired corporate culture. We welcome the moves by many Japanese companies to abandon the historic practice of paying lump sum retirement bonuses to directors and statutory auditors. Pay can sometimes be too high, which may not be in line with many shareholders' and other stakeholders' views of performance. Boards should be able to justify to investors, the

workforce and the public the rationale for the CEO's and the most senior management's pay, taking account of the pay of the wider workforce. Remuneration reports must explain how alignment with long-term shareholders is achieved.

Accountability: relevant committees should ensure that pay properly reflects business performance and that pay reflects outcomes for long-term investors. Relevant committees should take a robust view on pay, using their judgement and being accountable for their decisions. The potential outcomes of a pay policy should be rigorously scenario tested with a cap on the total possible pay published in advance, to help reduce the risk of unintended consequences.

Stewardship: companies and investors should regularly discuss strategy, long-term performance and the link to executive remuneration. Executives should be encouraged to achieve strategic goals and take account of the company's effect on key stakeholders.

We expect senior executives to willingly embrace these principles and, if they do not, for boards to consider the implications. Relevant committees should take responsibility for the design, disclosure and dialogue on executive pay and we will expect them to be accountable for this.

SOCIAL, ETHICAL AND ENVIRONMENTAL RESPONSIBILITY

Companies should effectively manage environmental and social factors that are relevant to their business, with a view to enhancing long-term sustainability. They should also disclose to shareholders on a regular basis how they identify and manage the relevant risks and provide evidence that these structures are effective. In addition, companies should clearly define board and senior management responsibilities for environmental and social issues. We believe that directors of companies are accountable to shareholders for the management of social, ethical and environmental risks and opportunities in the same way that they are accountable for the company's financial performance.

Ethical leadership

We expect companies to have best practice anti-corruption and anti-bribery policies and processes in place and robust compliance mechanisms to enforce them. However, these are not enough on their own. We expect the board to oversee the anti-bribery and corruption controls and – just as importantly – to set the tone from the top, to encourage the highest ethical standards, to drive the expectations and values of the organisation. This is to ensure that the culture is one in which corruption cannot thrive, and that the necessary organisational measures exist to provide the best possible defence against corruption. We therefore seek to engage with companies where we judge the culture and values to be lacking or the effective.

⁵ https://www.fsa.go.jp/news/30/sonota/20181102_2.html

⁶ <https://www.hermes-investment.com/wp-content/uploads/2017/09/Remuneration-Principles-Clarifying-Expectations.pdf>

Climate change

Climate change is a systemic risk to the value of the portfolios of our clients because of its economic and geopolitical consequences. We therefore support the goal of the 2015 Paris Agreement, which 195 countries signed up to, to limit global warming as a result of climate change, to well below 2°C. This historic commitment was helped by the intervention of companies globally, which publicly encouraged political action in the run-up to the Agreement.

Because of the systemic risk to the global economy, we expect every company to publicly support the Paris Agreement and to make this commitment a central tenet of its public policy and sustainability activity. In particular for companies whose value chain relies on significant energy usage or is exposed to the effects of climate change, the board should ensure that support for the Paris Agreement underpins the company's strategy. Every board should ensure that it has climate change on its board meeting schedules at least annually, and that it and senior management engage with experts who can advise them on the strategic risks and opportunities that climate change represents, and challenge the company's approach, if necessary.

We understand that companies may have different views on climate change from organisations of which they are members or from other organisations which they may be able to influence. Every board should make sure that the company uses all available avenues to influence these third parties, to encourage effective action on climate change in line with the Paris Agreement. Where a company and one of these third parties disagree on climate change, the company should explain publicly the action it has taken to argue for effective advocacy or action on climate change by that third party. It should also explain its reasons for continued participation in, funding or membership of the organisation despite this disagreement.

Task Force on Climate-related Financial Disclosure

We welcome the recommendations of the Financial Stability Board's Task Force on Climate-related Financial Disclosures. We expect companies to adopt the recommendations in full. Companies should conduct scenario analysis to assess future transition and physical risks which will be brought about by climate change. As part of this scenario analysis, they should also identify and discuss their strategic options for a net zero emission world. In addition, we expect companies, especially those in sectors where climate risks are most material, to demonstrate clearly that they are managing both their current and possible future risks effectively. Furthermore, we expect companies to report on the opportunities presented by climate change. For instance, companies in the financial sector should report how they will help to finance the energy transition.

UN Sustainable Development Goals

We expect companies to assess the relevance of each of the UN sustainable development goals (SDG) to their business and to consider how best to incorporate those which may be material into their business models and strategies. We encourage companies to report on how they are responding to the SDGs and encourage them to participate with civil society in how best to support them.

Tax

We expect companies to:

- comply with all tax laws and regulations in all countries of operation;
- recognise the importance of taxation to the funding of good public services on which they and their stakeholders rely, and their commitment to pay their fair contribution;
- ensure that their tax policies and practices do not damage their social licence to operate in all jurisdictions in which they have a presence; and
- disclose the taxes paid by or collected by them in each country.

Human rights

Licences to operate are increasingly affected by the reputation of companies, including their performance on human rights. We support the UN Guiding Principles on Business and Human Rights and the UN Global Compact. We expect companies to use the reporting framework for the Guiding Principles to disclose how they manage human rights issues that are salient to their business.

HERMES INVESTMENT MANAGEMENT

We are an asset manager with a difference. We believe that, while our primary purpose is to help savers and beneficiaries by providing world class active investment management and stewardship services, our role goes further. We believe we have a duty to deliver holistic returns – outcomes for our clients that go far beyond the financial – and consider the impact our decisions have on society, the environment and the wider world.

Our goal is to help people invest better, retire better and create a better society for all.

Our investment solutions include:

Private markets

Infrastructure, private debt, private equity, commercial and residential real estate

High active share equities

Asia, global emerging markets, Europe, US, global, small and mid-cap and impact

Credit

Absolute return, global high yield, multi strategy, global investment grade, unconstrained, real estate debt and direct lending

Stewardship

Active engagement, advocacy, intelligent voting and sustainable development

Offices

London | New York | Singapore | Denmark

Why Hermes EOS?

Hermes EOS enables institutional shareholders around the world to meet their fiduciary responsibilities and become active owners of public companies. Hermes EOS is based on the premise that companies with informed and involved shareholders are more likely to achieve superior long-term performance than those without.

For more information, visit www.hermes-investment.com or connect with us on social media:



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