

TSE Listing Department

By email: jojo-kikaku@jpx.co.jp

7th May 2021

Comments on the Proposed Revision of Japan's Corporate Governance Code

Dear Sirs and madams,

EOS at Federated Hermes welcomes the opportunity to provide our comments on this consultation on the Proposed Revision of Japan's Corporate Governance Code.

EOS at Federated Hermes is a leading stewardship service provider advising on USD1.5 trillion (JPY165 trillion) as at 31st March 2021. Our engagement activities enable long-term institutional investors to be more active owners of their assets, through dialogue with companies on environmental, social and governance issues. We believe this is essential to build a global financial system that delivers improved long-term returns for investors, as well as better, more sustainable outcomes for society.

The views expressed in this communication are those of EOS at Federated Hermes and do not necessarily represent the views of all clients. Our response to this consultation is explicitly supported by PNO Media (the Netherlands).

We are encouraged to see many of the suggestions we made in our previous discussions reflected in the proposal. In particular, we welcome the additional recommendation for the board to develop a basic policy for the company's sustainability initiatives and that for companies to set targets for diversity in managerial positions. We also strongly support the higher standards set for companies to be listed on the Prime Market (eg. Disclosure in English, use of electronic platform for proxy voting, disclosure in line with TCFD recommendations).

Below are our suggestions regarding some of the principles. We would be grateful if you could consider reflecting them in the final version of the revised Code.

1. We strongly support the references to the Sustainable Development Goals and the Task Force on Climate-related Financial Disclosure in the Notes under General Principle 2 of the revised Code. However, we are disappointed that there is no mention of the goals of the Paris Agreement (to limit global warming to well below 2, preferably to 1.5 degrees Celsius, compared to pre-industrial levels). While there is a wide range of environmental, social and governance issues and each has its own importance, climate change is a crisis the world faces and achieving the Paris goals to prevent climate change is an urgent task for the Japanese government.

Prime Minister Suga announced in October 2020 a commitment to achieve net zero green house gas emissions by 2050 (equivalent of the 1.5 degrees scenario), which

was followed by a new 2030 target to reduce GHG emissions by 46% from the 2013 level announced in April 2021. Companies need to shift their business models to what is consistent with the net zero goal and we therefore think that the revised Code and the consultation paper should explicitly mention the Paris goals. For example, the Notes under Principle 2 may be revised to say 'the Sustainable Development Goals (SDGs) were adopted at the United Nations Summit while long-term targets for the reduction of greenhouse gas emissions were agreed at the 2015 United Nations Climate Change Conference (COP21) and the number of organizations supporting the recommendation of the FSB's Task Force on Climate-related Financial Disclosure (TCFD) has increased...'. For your reference, TCFD reporting will become mandatory in the UK and the relevant policy documents refer to the Paris Agreement.

2. Supplementary Principle 1.1.1 states 'when the board recognizes that a considerable number of votes have been cast against...it should analyze the reasons...'. As there is currently no transparency on the process, we suggest that the Code goes further to require companies to disclose the result of such analyses and report in a timely manner the outcome of the shareholder dialogue or other measures taken.

3. Regarding Principle 1.4 on the reduction of cross-shareholdings, we think that current company disclosure of their views and reasons for these holdings is boilerplate and not meaningful in many cases. We are also concerned that the wording '(the board should examine) whether the purpose is appropriate and whether the benefits and risks from each holding cover the company's cost of capital' is leading companies to believe that they can justify these holdings if they receive beneficial treatment from the holding partners. Our view is that offering beneficial treatment based on shareholding is inconsistent with the market principle of fair competition and that the Code should strongly encourage reduction of such holdings. It should be also noted under Supplementary Principle 1.4.1 that holding shares should not be considered a tool or a condition to start, maintain or strengthen business relationships.

We think that strategic investments such as those in start-ups which have IT or artificial intelligence technologies essential for the company's business should be distinguished from cross-shareholdings and companies should make this clear in their disclosure. We would reiterate the importance of disclosing specific purposes for holding for each stock in any case.

Notwithstanding the recommendation 'Companies should establish and disclose specific standards with respect to the voting rights as to their cross-shareholdings...', we are not aware of any meaningful disclosures to date. We believe that companies should be required to disclose specific policies and results for voting in the same manner as institutional investors are and that this should be clearly stated in the Supplementary Principles 1.4.3 of the Code.

4. Supplementary Principles 2.4.1 which includes 'Companies should present their policies and voluntary and measurable goals for ensuring diversity in the

promotion...such as the promotion of women, foreign nationals and midcareer hires to middle managerial positions' is a step forward from the previous revision, but we feel this is insufficient. Japan ranked 121st in the Gender Gap Index in 2020, worst among developed nations, and there is no sign of improvement. In particular it ranked 131st in terms of the proportion of females in senior and leadership positions, well below the world average, while also ranking low in terms of gender pay gap. Given the room for improvement in female labour participation rate, there should be more emphasis on increasing female managers than promotion of foreign nationals or midcareer hires.

The revision to the Code only touches diversity in management, however, we believe that diversity, particularly an increase in female ratio, on the board is an urgent issue. Several countries including those in Europe have introduced a quota, which has significantly contributed to improving gender diversity on the board. In the UK, the government has given explicit guidance as to the expectations for gender diversity (an initial target of 25% female by 2015) which, while non-binding, on average was achieved for the FTSE 100 larger listed companies through market influence. Some studies¹ have demonstrated that higher female ratios on the board are associated with higher levels of return on equity as well as share price increases. We therefore believe that more explicit recommendations such as 'companies should appoint at least one female director' and/or 'companies should set a medium to long-term target for a female director ratio' should be added to Principle 4-11 of the revised Code.

5. We highly commend the detailed discussion on issues with the disclosure of non-financial information and roles of the board in improving them in the Notes for Principle 3, as this is in line with our argument. While Supplementary Principle 3.1.3 says '(companies should) enhance the quality and quantity of disclosure based on the TCFD recommendations', this is a rough guideline and leaves room for variance in the content and standards of disclosure among companies. We believe that the importance of setting medium to long-term (such as 2030 and 2050) targets for GHG (or CO2) emissions reduction which is essential for achieving net zero emissions should be highlighted in the Notes section.

6. We welcome the recommendations for higher board independence at companies with controlling shareholders under Supplementary Principles 4.3.8 given the concerns about the governance of these companies, particularly the protection of minority shareholders. We however think that the same level of board independence should be expected at non-controlled companies: a majority at companies listed on the Prime Market and 1/3 at those on other sections.

7. Principle 4.9 on independence standards and qualification for independent directors mentions '...taking into consideration the independence criteria set by securities exchanges'. We however have previously shared our view that these criteria are too weak. Many companies designate directors from major lenders or

¹ International Comparison of Women Board Members and Analysis of the Relations between Women Board Members and Corporate Performance, Takeshi OHNO <http://www.ritsumei.ac.jp/file.jsp?id=454500>

business partners (some of whom have transactions amounting to over 10% of total sales) as independent, who we do not believe can be sufficiently independent.

We therefore propose revising the stock exchange's criteria for director independence. For example, the Tokyo Stock Exchange's 'Practical Considerations When Appointing Independent director/auditor' (Japanese only) states 'Significant business partners may be...those with which the issuer has business transactions amounting to a considerable part of total sales, those that provide products or services essential to the issuer's business activities, main lenders.' We suggest adding specific numbers to this document, such as '...those with which the issuer has business transactions amounting to a considerable part (for example 2% or more)...'.

We also question the notion 'However not all main lenders will be considered "significant business partners", particularly if the amount of lending or other transactions is small.' Many companies continue to hold shares of main lenders in cross-shareholdings, which indicates that the banks are positioned as significant business partners regardless of the volume of lending or transactions. We therefore suggest deleting this part so that companies will not claim main lenders are not considered significant business partners. In addition, the fact that a number of companies continue to hold lenders' shares even if the amount of lending is small appears to suggest that the companies are seeking assurances of preferential treatment for when their business is in trouble. We consider business operations based on such an assumption problematic.

8. We welcome the strong recommendations for setting up nomination and remuneration committees and that companies on Prime Market should have the majority of the members of each committee be independent directors under Supplementary Principle 4.10.1. We suggest that the Code also recommends that these committees are chaired by independent directors. In addition, since it is important for investors to be informed of such committee structures including who the chairs are before they exercise their voting rights at the AGM, we ask that the Code recommends that companies disclose these details ahead of the AGM.

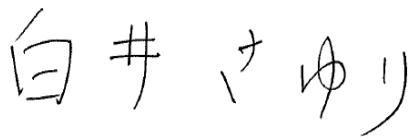
9. We welcome the addition to Supplementary Principle 4.11.1 of 'independent director(s) with management experience in other companies should be included'. However, it is highly possible that, even directors with management experience lack understanding of sustainability issues (particularly environmental and social), which is increasingly important, may not be making sufficient contributions to promoting the company's ESG business reform. It is important that the board has individuals with knowledge of sustainability, given that response to issues such as climate change and human rights is an imminent challenge for companies. We therefore recommend revising Principle 4-11 to '...diversity, including gender and, international experience, work experience, age and understanding of sustainability issues...'.

10. While Supplementary Principle 4.11.3 states 'Each year the board should analyze and evaluate its effectiveness as a whole' and 'A summary of the results should be disclosed', many companies conduct evaluation only internally, which could

potentially lead to complacency and inadequate evaluation. We believe that evaluation by an independent third party without conflicting interest should be recommended at least once every few years. If a company chooses to conduct evaluation internally, we would suggest that each board member assess themselves and every other member and particularly the effectiveness of the chair and committee members. It is also recommended that each board member assesses the dynamics of the whole board. A hybrid option would be where an external party to prepare the questionnaire without being involved in the assessment process. It is important to ensure confidentiality so that honest views are provided. In addition, the current disclosure of the evaluation results is not sufficient, with many companies merely stating that they believe board effectiveness is largely ensured. We suggest that the Code requires more specific reporting including quantitative disclosure.

We hope our views will lead to further improvement of Japanese listed companies. Please do not hesitate to contact us should you have any questions.

Yours faithfully,



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EOS at Federated Hermes