

Dear Sir/Madam

EOS at Federated Hermes engages with companies around the world on behalf of global institutional investors, representing assets of US\$1.71tn (30 September 2021). We aim to deliver sustainable wealth creation that enriches investors, benefits society and preserves the environment – for current generations and those to come. This aim informs our expectations of the companies in which we and our clients are invested.

It is our strong belief that companies can only create and preserve long-term, good quality returns for investors if they provide goods and services that sustainably solve societal needs, guided by a clear purpose that serves not only shareholders, but also other stakeholders, society and the environment. Doing this effectively requires robust governance and a healthy culture, with leadership that sets the right tone from the top and emphasises ethical values across the organisation.

### Japan Corporate Governance Principles

Our expectations are set out in more detail in our 2022 Japan Corporate Governance Principles, which are enclosed. While we welcome steady progress in Japanese corporate governance practice in the recent years, we would like to highlight the following expectations for Japan-listed companies in 2022:

- **Climate change:** Earlier this year, the international business of Federated Hermes signed up to the Net Zero Asset Managers initiative (NZAM). This initiative now has the support of 220 signatory managers with \$57 trillion of assets under management<sup>1</sup> (42% of global AUM). Signatories to NZAM have committed to “implement a stewardship and engagement strategy, with a clear escalation and voting policy, that is consistent with [the] ambition for all assets under management to achieve net zero emissions by 2050 or sooner.” In 2022, we will continue to hold the chair or other responsible directors accountable through our voting recommendations where we believe companies’ actions are materially misaligned with the goals of the Paris Agreement, where company disclosures or responsiveness are insufficient. We assess companies using a range of frameworks and benchmarks, including the Transition Pathway Initiative (TPI),<sup>2</sup> the Climate Action 100+ benchmark,<sup>3</sup> Forest 500<sup>4</sup> and others. In principle, we support the emergence of so-called ‘Vote on Transition’ or ‘Say on Climate’ resolutions and will support those plans aligned to the goals of the Paris Agreement, as indicated by short, medium and long-term science-based greenhouse gas reduction targets and a clear and credible strategy to achieve these.
- **Diversity, equity and inclusion:** Many companies continue to fall short of reflecting the diversity of society on their boards, in senior management and throughout the workforce. We strongly advocate for boards of diverse composition, in its broadest sense, and for the execution of meaningful workforce-level diversity, equity and inclusion strategies. In 2022, we have

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<sup>1</sup> <https://www.netzeroassetmanagers.org/>

<sup>2</sup> <http://www.lse.ac.uk/GranthamInstitute/tpi/the-toolkit/>

<sup>3</sup> <https://www.climateaction100.org/progress/net-zero-company-benchmark/>

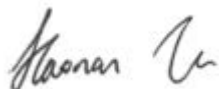
<sup>4</sup> <https://forest500.org/>

strengthened our policy to recommend voting against resolutions at companies that we judge to be making insufficient progress on diversity, including:

- Gender diversity: We expect at least 10% of directors to be female at all companies regardless of size. If this is not met, we will generally recommend voting against the nomination committee chair or board chair.
- If less than 10% of directors are female and neither the nomination committee chair nor the board chair is up for re-election, we will recommend a vote against new male directors
- **Human and labour rights:** How a company manages its human rights strategy is of critical importance to its licence to operate, its impact on people's lives and ultimately its ability to create and preserve long-term holistic value. Starting in 2022, we will consider recommending votes against relevant proposals, including the election of directors, where a company is in clear breach of its applicable regulatory responsibilities or those outlined in the UN Guiding Principles on Business and Human Rights, and/or if there is sufficient evidence that a company has caused or contributed to egregious, adverse human rights impacts or controversies and has failed to provide appropriate remedy.
- **Executive pay:** We continue to make the case for simpler pay schemes aligned to long-term strategy and the desired culture in the organisation, with an emphasis on long-term share ownership for executives. In Japan, we will continue to expect to hit the right balance between fixed and variable pay.  
In 2022, we will generally no longer support stock options unless the vesting period is at least three years or longer.
- **Cross-shareholdings:** We believe that the widespread practice of cross- or strategic shareholdings among Japanese companies leads to various problems and continue to press for a reduction of these holdings. In 2022, we will start recommending a vote against top executives of companies with significant cross-shareholdings (10% or more of net assets), while continuing to recommend a vote against directors representing cross-shareholding partners.

We welcome any comments and observations on our 2022 Corporate Governance Principles and would be glad to answer any queries or concerns they may raise.

Yours sincerely



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# Corporate Governance Principles

Japan

Our expectations of  
Japanese-listed companies

**EOS at Federated Hermes  
2022**

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## **Corporate Governance Principles: Our expectations of publicly-listed companies**

**2022**

### **INTRODUCTION**

EOS at Federated Hermes is a stewardship service provider representing a broad range of long-term institutional investors. EOS clients seek to be active stewards of their beneficiaries' assets by being active owners of shares or debt of the companies in which they invest. EOS engages with our clients' investee companies around the world to promote long-term, sustainable returns to investors, their beneficiaries, and other stakeholders.

These Principles express our expectations of board directors and companies across a number of important strategic and governance topics, focusing on areas which will inform the policies which guide our voting recommendations for 2022.

This document is not exhaustive. More detail on our expectations, particularly on environmental and social topics, can be found in our Public Engagement Plan,<sup>1</sup> which is updated annually.

### **COMPANY PURPOSE, CULTURE AND ETHICAL LEADERSHIP**

The board must set and find effective ways to oversee the values of the organisation, that must be founded on ethical integrity. Ethical considerations must underpin every decision made by the board. For example, the board must ensure that its president has the highest ethical standards and must not accept any lapses in that expectation during the president's time in office or beforehand, performing sufficient due diligence and having strong contractual provisions to enable the board to take sufficient action, including clawing back pay and dismissal for cause, should unethical behaviour come to light.

The board must ensure that a system exists to take multiple different soundings of the culture and micro-cultures in different parts of the organisation and guarantee that both the board and management take action to improve the culture where it is not aligned with the board's expectations. This should include robust and accessible whistleblowing systems together with a demonstrable commitment to protect those that use such systems.

It is our strong belief that companies can only create and preserve long-term, good quality returns for investors if they provide goods and services that sustainably solve societal needs. To achieve this, we expect companies to be guided by a purpose that serves not only shareholders, but also other stakeholders, society and the environment. Achieving this purpose will, in turn, require a healthy culture and an emphasis on ethical values across the organisation. The pursuit of a stakeholder-inclusive purpose in support of long-term societal interests will then help protect the long-term interests of the savers and pensioners – current and future – invested in companies, who require sustainable financial returns and an economy, society and environment

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<sup>1</sup> The latest public version of the EOS Engagement Plan can be found at: [www.hermes-investment.com/stewardship/eos-library](http://www.hermes-investment.com/stewardship/eos-library)

which can provide a secure future. This will require review of those critical ESG-related issues of concern to the company and its stakeholders, such as climate change or human rights, through an ethical lens.

A clear and meaningful business purpose should enable business leaders to identify the right things to do in the short term, in order to fulfil their purpose over the long term. This is critical in a time of crisis – such as that caused by the Covid-19 pandemic – when difficult trade-offs arise, particularly between shorter-term financial returns and maintaining strong relationships with key stakeholders, including government, the workforce, customers and supply chains.

As the effects of the pandemic continue to be felt around the world, it remains vital that boards and executive teams continue to consider their key stakeholders and their organisation's purpose, and make decisions that best support sustainable returns over the long-term. Companies need to be able to explain their decisions affecting key stakeholders. This includes the most difficult decisions, such as redundancies, but also how they allocate capital, including dividend payments and share buybacks.

We expect boards to consider and disclose capital allocation policy in the context of a company's purpose and long-term strategy. We are concerned that buybacks and similar diversions from re-investment in key stakeholders may be chosen to improve the share price or other related metrics over the short-term but are not always the best use of capital to support the creation of long-term, sustainable returns.

We are supportive of alternative corporate structures that explicitly mandate the consideration of key stakeholders alongside shareholders, where companies believe this to be beneficial in service of their purpose.

### **Stewardship and engagement**

Investors must act as responsible stewards and promote long-term sustainable returns on investment through constructive engagement with companies and their directors. All substantive correspondence from major institutional investors' representatives should be shared promptly with all board members to help directors fulfil their role to safeguard the interests of all shareholders. Our experience has shown that dialogue between companies and committed, long-term investors on strategy, finance, risk management and material environmental, social and governance (ESG) issues can improve the governance and performance of companies. Developing relationships of trust with long-term shareholders can be invaluable for boards, and we expect chairs and independent directors to make themselves available for investor engagement, beyond opportunities at formal shareholder meetings.

We expect companies to engage with long-term investors across a range of asset classes, including different types of corporate debt, in addition to their shareholders. Companies should now recognise that the expectations of debt investors are similar to those of long-term shareholders and substantially aligned in relation to governance, long-term strategy, capital allocation and environmental and social matters. Debt investors now expect accountability and

constructive dialogue on opportunities and risks which might enhance or impair earnings and cashflow.

### **ENDORSEMENT OF JAPAN'S CORPORATE GOVERNANCE CODE**

We welcome the progress Japan has made on corporate governance in recent years. In particular, since the introduction of the Corporate Governance Code in the country in 2015 as well as that of the Stewardship Code in 2014, we have observed an increased level of interest among companies in discussing corporate governance with institutional investors and their representatives, including EOS. Following the revision of the Corporate Governance Code in 2018, we have seen further improvements to governance practice of many companies. We are hopeful that the revision in 2021 will also accelerate change. We welcomed the added emphasis on long-term sustainability and ESG factors in the 2020 review of the Stewardship Code, which we believe will help expand the scope of investor-company dialogue. 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. 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. 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. Companies should not confuse superficial compliance with good corporate governance. We have concerns that a large number of companies use the same or very similar language when providing explanations of why they do not comply with the principles. We strongly discourage such boilerplate reporting, which suggests a box-ticking approach to governance rather than a thoughtful process specific to the company's particular circumstances. Explanations should be tailored to the company's position and provide a meaningful level of detail and a coherent rationale for the chosen governance arrangements. 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. We hope that constructive and meaningful dialogue between companies and their investors will continue to develop, in turn enabling higher standards of governance and enhancing long-term value creation for stakeholders, including shareholders.

### **BOARD COMPOSITION AND EFFECTIVENESS**

Boards should ensure they comprise members with strong ethics and diverse skills, experience, perspectives and psychological attributes, as well as sufficient independence and strength of character to challenge, as well as advise and support executive management teams. They should ensure overall composition and individual membership of the board is frequently reviewed and refreshed, and that directors are elected and re-elected by shareholders on a regular basis to ensure accountability. Biographies for all directors should be provided to shareholders, indicating which are considered independent and the particular attributes that they bring to the board. This should be accompanied by an

analysis of how the board as a whole displays the necessary skills, independence, diversity and other attributes to meet the company's evolving needs.

### Effectiveness

Disclosure of measurable aspects of boards, such as those outlined below, are important but insufficient indicators of a board's functionality.

Engagement with board directors provides a valuable opportunity for investors to sufficiently assess how well a board is functioning. Our white paper, *Guiding Principles for an Effective Board*,<sup>2</sup> highlights the factors that we consider to be most important in determining board effectiveness, focusing on the human, relational, and behavioural elements that are more difficult to assess.

They can be summarised as follows:

- Genuine independence, diversity and inclusion support directors' ability to effectively question long-held assumptions and mitigate the risk of groupthink.
- The role of the chair should be held by an independent director to support the overall conditions for board effectiveness, which includes setting and enforcing the expectations for a board culture that is based on mutual respect, openness and trust, and encouraging diverse voices and behaviours of independent thinkers.
- How the board allocates its time spent in board meetings and between board meetings is equally important. We expect a board to maximise the time spent on strategy and other forward-looking activities during structured board meetings, committee work, site visits and engagement with stakeholders.
- The board's relationship with the president should ideally be characterised by transparency, trust and constructive collaboration, and the board should build relationships with the wider workforce through formal and informal channels.
- A commitment to continuous improvement should be encouraged and supported through regular board evaluations, and disclosure should strike a balance between transparency and confidentiality.

### Evaluation

We expect boards to be committed to continuous improvement and therefore to be constantly reflecting on their performance. We encourage boards across markets and corporate structures to conduct regular evaluations with the goal of enhancing board effectiveness. When conducted with this intention, and not simply as a compliance exercise, the evaluation process offers a unique opportunity for the board to pause, reflect and optimise its performance. The board should embrace the evaluation process as an opportunity to recalibrate

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<sup>2</sup> <https://www.hermes-investment.com/wp-content/uploads/2020/04/guiding-principles-for-an-effective-board-april-2020.pdf>



focus, identify skills gaps on the board, highlight the need for succession, and raise concerns related to performance and culture.

Furthermore, conducting regular board evaluations signals to investors that the board is open to constructive criticism and willing to improve. We recommend that independent external board evaluations are conducted at least once every three years, with internal evaluations conducted in the interim years. The board should implement an action plan and a clear timeline for addressing the points raised in the evaluation. Disclosure should demonstrate how the board has taken the necessary steps to enhance performance and provide reassurance to investors about the quality of the board evaluation.

### **Role of the chair**

The chair of the board plays a significant role in leading the discussion and ensuring the effectiveness of the board. However, not many Japanese companies explicitly identify 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). The chair of the corporation is usually someone who was the president or senior executive immediately before appointment, and therefore non-independent. This arrangement suggests that there is often no clear separation between executive and monitoring and oversight functions. We encourage companies, as a first step, to reflect on the roles that the chair of the board should play, and then clearly name the 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.

### **Independence and tenure**

On all boards, we expect a strong core of independent directors, including an appointed lead independent director, to ensure that stakeholder interests are protected, to exercise objective judgement and, if necessary, to act as agents for change. This group should play an important role in guiding the boards' decision-making and in the recruitment and nomination of directors. It should be empowered to meet independently, including before and after board meetings, and should do so in practice. It should be granted unfettered access to members of management, information and resources as required.

In light of the Tokyo Stock Exchange restructuring taking place in April 2022 and revision of the Corporate Governance Code, we expect companies listed on the Prime Market to achieve at least one third board independence and other companies to have a minimum of two independent directors. We will recommend a vote against the chair of the board if these levels are not achieved. In addition, we would like to see the majority of directors to be independent at companies which have a controlling shareholder and are listed on the Prime market and one third of directors to be independent at other companies with a controlling shareholder. We see one third independence at controlled companies as a minimum standard but encourage controlled companies to consider a minimum of at least half of the board of directors to be independent. However, we place

real emphasis on quality, not quantity of independence. Ensuring sufficient levels and quality of independence is particularly important for founder-led companies, those with executive or non-independent chairs, significant shareholder representatives on the board (which we believe can be useful and justified, provided minority shareholder interests are protected) or significant management representation on the board.

We expect a healthy mixture of tenures on boards, supported by regular board refreshment. We consider the overall composition of boards and recognise the value that long-serving directors can contribute. However, too many directors serving concurrently can increase the risk of groupthink and complacency. We do not consider non-executive directors independent if their tenure exceeds nine years.

### **Statutory auditors**

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, even if there is a high level of independence among the statutory auditors. Similarly, it is not sufficient to have women on the board of statutory auditors alone, we expect companies to appoint female directors to the board as discussed below.

### **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 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 upheld unless the executive management has strong evidence to refute its recommendations. The nomination process and role of the nomination committee should be transparent and the chair of the committee and its members should be disclosed. In addition, meaningful dialogue with investors, in particular involving directors, on these issues is crucial.

### **Director attendance and commitment**

We expect board directors to be able to devote sufficient time to fulfil their duties, including to build and maintain a good understanding of the company and to fully absorb and be able to challenge the information presented to them by management. As a broad guideline, we do not support directors holding more

than five directorships at public companies and, in this context, we consider a non-executive chair role to be roughly equivalent to two directorships and, at complex companies, other committee chair roles, in particular the chair of the audit and risk committee, may be considered more burdensome than a typical non-executive directorship.

Whether a director may be over-committed depends on a range of factors beyond the number of other roles they hold, including the size and complexity of the company and additional responsibilities, such as being a committee chair. We consider that certain industries such as banking (due to its business model and regulatory complexity) and businesses with large and/ or complex operations will require site visits and therefore more time commitment.

We expect companies to encourage their executives to take on a non-executive role outside their own group of companies to assist in their development, bring current experience to boards and to build a pipeline of future board directors. However, we do not expect executives to hold more than one such role at listed companies outside the group of companies.

### **Succession planning**

Effective succession planning at the board and senior management level is essential for safeguarding the ability of companies to deliver long-term returns. It should involve contingency planning for the sudden loss of key personnel, as well as planning for foreseeable change such as impending retirement. It should include consideration of the current and future required diversity of skills, experience and other attributes required at board and senior management level, including the need for any candidate to demonstrate the highest levels of ethical integrity. Robust succession planning also can help to counter the tendency of many boards to over-pay current executives relative to the senior executive labour market and peers.

Overseen by the board, senior management should create a pipeline of suitable candidates from within the organisation to become senior managers and executive directors.

### **Senior advisors and consultants**

Many Japanese companies have the positions of senior advisors and consultants held by retired senior executives. While some of them are honorary positions and unpaid, others are paid, and the advisors and consultants often have access to company offices and vehicles. They are typically engaged in external affairs such as industry associations and are not meant to interfere with current management. However, we continue to be concerned about their potential influence over management, not least in the Japanese cultural context where seniority and hierarchy are important.

Although companies are now required by the Corporate Governance Code to disclose information about these individuals in the corporate governance report, such as their names and whether or not they are paid, we do not believe this arrangement fits into the formal governance structure of the company and lacks an appropriate level of accountability. These individuals are not board members and therefore not elected by shareholders. We encourage companies to consider

removing these positions or as a first step, provide further details on the individuals including their precise roles, interactions with management, pay and other entitlements.

### DIVERSITY, EQUITY AND INCLUSION

Beyond the clear moral and ethical imperative, the system-wide benefits of social and economic inclusion and the risks of continued exclusion, a growing body of evidence supports the link between more diverse company leadership and financial performance.<sup>3</sup> We believe improving diversity, equity and inclusion performance creates enduring value by improving decision-making, attracting talent, enhancing workforce satisfaction and stimulating insight and innovation.<sup>4</sup>

Boards should seek diverse composition in its broadest sense to support high-quality debate and decision-making, considering diversity of skills, experience, networks, psychological attributes and characteristics (including, but not limited to, race, ethnicity, gender, sexual orientation, age, disability, nationality and socioeconomic background). Boards should give careful consideration to how they can find members from outside of their typical networks and the breadth of attributes or perspectives that may be valuable to their decision-making. We welcome the steps taken by companies around the world to acknowledge and commit to addressing racial inequity, in the workforce and beyond, but we expect this to be followed up with concrete action. Although the issue of race is complex and the context is different in each country, we encourage Japanese companies, particularly those with significant overseas operations, to reflect on their current practice and take a step towards improvement.

Japanese boards have one of the lowest proportions of female representation in major markets. Only 8.4% of board members<sup>5</sup> are women, according to the World Economic Forum's Gender Equality Index. They are typically very homogenous, comprising a large majority of male Japanese executive directors who have been with the same company for many decades. We believe that boards with too much commonality of background run the risk of groupthink and complacency.

Despite the historical challenge<sup>6</sup> to secure a sufficient pool of female candidates, a growing number of companies have appointed female directors in recent years. We strongly encourage this trend and advocate for a substantial increase in the proportion of women on boards. In 2022, we will oppose the re-election of the board chair or president<sup>7</sup> of companies where less than 10% of directors are female unless they are able to provide a convincing explanation. We plan to raise this to 20% by 2025 and 30% by 2030.

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<sup>3</sup> For example, The 30% Club has compiled a list of studies examining the benefits of gender diversity <https://30percentclub.org/initiatives/investor-group>

<sup>4</sup> For example, [Delivering growth through diversity in the workplace | McKinsey](#)

<sup>5</sup> This includes statutory auditors, in addition to directors.

<sup>6</sup> 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.

<sup>7</sup> We will recommend voting against the chair of the nomination committee or similar when the role is identified.



We encourage Japanese 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. It is important to promote diversity at board and executive level, but companies should also focus on promoting a diverse and inclusive workforce. At least to be in line with the Japanese government's target of raising the ratio of female managers to 30% by 2030, companies should make plans including specific efforts to substantially improve the proportion of women at board and senior management level. We expect companies to report on investment in recruitment and subsequent support for women's progression.

Improving the representation of women should not be considered in isolation from other dimensions of diversity and, particularly, internationality and ethnic diversity. We 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.

### **PROTECTION OF SHAREHOLDER RIGHTS**

We rigorously defend shareholder rights on behalf of institutional investors, including the right to receive good quality corporate reporting and material information on a timely basis, to vote at shareholder meetings on issues such as the annual election of directors, to propose new candidates to the board or other shareholder resolutions.

We support a single share class structure, with one share one vote, and oppose any deviation from this.

### **Cross-shareholdings**

We believe that the widespread practice of Japanese companies holding shares of business partners, also known as cross-shareholdings, leads to various problems.

1. 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 reduce the free float.
2. Many companies believe it is acceptable to hold shares of other companies to maintain long-term business relationships, including the winning and maintaining 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. Cross-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, cross-shareholdings can also help to prevent takeovers.

4. The practice 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.

Many companies, including major banks, have begun to unwind some of the legacy holdings. However, more needs to be done. 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 shares could have a detrimental effect on their business. In the meantime, we ask companies to disclose the following:

- All cross-shareholdings, the aggregate amount and the percentage of total share capital it owns in each company.
- The board's approach to cross-shareholdings including: what factors it considers when conducting its review; anti-competitive or anti-ethical implications concerning any of its shareholdings and what it does in these cases, how it assesses the risk and reward of shareholdings; any cases where business cannot be conducted without cross-shareholdings and the reasons; and any cases where business is improved through these shareholdings as well as the reasons.
- Targets to reduce overall cross-shareholdings, such as [X%] by [date], as part of their strategy to eliminate all strategic holdings by [date]
- Details on how shareholder rights, including voting rights are exercised at each company.

We have begun to see some positive developments in this area and expect progress to accelerate. In 2022, we will start recommending voting against top executives of companies which hold significant cross-shareholdings (10% or more of net assets), while continuing not to support the election of outside directors who represent cross-shareholding partners,

### **Efficient capital management**

Companies should seek a balance when making capital management decisions. They should strive to optimise 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.

## Hybrid or virtual shareholder meetings

Annual and other shareholder meetings are a critical part of corporate governance. As well as being the highest decision-making procedure of the company, they allow shareholders to hear directly from the company about its performance and to challenge directors on important topics, supporting strong transparency and accountability.

We believe dialogue between shareholders and the board is enhanced by the in-person meeting format of annual meetings. Although formats vary around the world, when working well, it presents the opportunity for shareholders to make points to the whole board, the ability to ask questions immediately in response to board comments and to build on the questions asked by others. Further, it is more difficult for directors to avoid challenging questions or topics; directors must provide answers in a public forum and, accordingly, be accountable for them.

However, we recognise that the restrictions brought about by the Covid-19 pandemic rendered in-person meetings unviable for many companies and that there were already valid arguments in favour of adopting alternative formats to improve shareholder access and participation, for example, in geographically dispersed countries or for companies with a global shareholder register.

Given this, we are supportive of meetings being convened in a 'hybrid' format – where shareholders have the option to join the meeting via an online platform or to join in person, provided all shareholder rights are protected or enhanced in both formats. Online participation can increase opportunities for participation, while retaining the accountability of in-person meetings.

We do not generally support 'virtual-only' meetings unless these are a temporary solution in response to restrictions on in-person gatherings, such as those prompted by the Covid-19 pandemic, or other exceptional circumstances. In those cases, we expect all shareholder rights to be protected and the meeting to be run as it should be in-person: giving ample opportunity for any shareholder to ask questions, and for these questions to be answered live by the board. We also expect a clear commitment to return to in-person or hybrid meetings as soon as restrictions allow.

For further information please refer to our *Principles of Annual Meeting Good Practice*.<sup>8</sup>

We will generally oppose requests for the authority to hold virtual-only meetings unless we gain comfort that it is to be used in exceptional circumstances only, and that the rights and access of attending shareholders are comparable to those of in-person meetings. For smaller companies we may relax the expectation that virtual-only meetings are for exceptional circumstances.

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<sup>8</sup> <https://www.hermes-investment.com/ukw/wp-content/uploads/2021/03/eos-principles-of-annual-meeting-good-practice-february-2021.pdf>

### Pre-emption rights

As a representative of long-term investors, EOS strongly supports the principle of preemption. 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.

### Takeover defence schemes

We have concerns about the purpose, legitimacy and effectiveness of poison pill schemes and discourage companies from adopting them. 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.

## EXECUTIVE REMUNERATION

We encourage Japanese companies to ensure that remuneration schemes align management with strategic objectives, key drivers of business performance, longterm value creation, and important stakeholders. While on average, pay practices at Japanese companies are modest compared to those at their western peers, we have seen some foreign executives at Japanese companies receiving a substantial pay package, comparable with those at western companies. In these instances, we urge companies to disclose full details of the pay package, including the performance metrics and targets, in line with global best practice. We also request 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 president and other senior management, following the principle that no one should determine their own pay.

We continue to make the case for simpler pay schemes aligned to long-term success and the desired culture in the organisation, based on a combination of fixed pay and long-term time-restricted stock, with an emphasis on long-term share ownership for executives. In this light, and also because of the downside risk, we do not favour share options as they can focus executives on actions to drive up the share price rather than enhancing long-term strategic value. The focus on short-term performance may be exacerbated when the exercise period is short. In 2022, we may consider opposing proposals on share options if the exercise period is less than three years.



We expand on our views on executive pay in our paper, *Remuneration Principles: Clarifying Expectations*.<sup>9</sup>

They can be summarised as follows:

1. **Simplicity:** Pay should be simple; for example, fixed pay (mix of cash and long-term shares) plus a single incentive scheme (an annual bonus).
2. **Alignment:** Pay should be aligned to long-term strategy and the desired corporate culture, incentivising long-term value creation, including wider social and environmental outcomes. Where metrics and targets are used in incentive pay, they should reflect strategic goals, rather than focus attention on total shareholder return, stock price appreciation or earnings per share.
3. **Shareholding:** Management should become long-term stakeholders in the company's success through substantial shareholdings. Significant shareholding requirements should remain in place for at least two years following departure from the company.
4. **Accountability:** Pay outcomes should reflect outcomes for long-term investors and take account of falls in a company's performance or reputation. The board should intervene and apply discretion whenever formulaic outcomes do not achieve this. The potential pay outcomes under a policy should be rigorously scenario tested in advance, with a cap on the total possible pay published, to help reduce the risk of unintended consequences.
5. **Stewardship:** Pay outcomes should be communicable to all stakeholders, including employees and the public. Boards should take into account wider workforce pay practices and ratios when judging the appropriateness of pay opportunities and outcomes. Boards should then write to employees each year explaining the outcomes of executive pay and the alignment to long-term value, and the company's strategy and purpose. Companies and investors should regularly discuss strategy, long-term performance and the link to executive pay.

## **SOCIAL, ETHICAL AND ENVIRONMENTAL RESPONSIBILITY**

Taking a responsible and long-term approach to social, environmental and ethical issues is critical to the creation and preservation of long-term sustainable returns and should be reflected in the company's values, purpose, strategy and culture. Companies must identify and disclose the most material social and environmental issues for the company and its significant stakeholders. They must seek to address the associated risks and opportunities through their core business strategy and value proposition. We expect boards and management to have oversight of material sustainability issues and to be accountable to shareholders for effectively managing the associated risks and opportunities.

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<sup>9</sup> <https://www.hermes-investment.com/wp-content/uploads/2018/10/remuneration-principles-clarifying-expectations.pdf>. The principles contained in this paper are global in nature, but some of the specific references to structures are more applicable to certain markets such as the UK.

We support the UN Sustainable Development Goals (SDGs) and believe that the private sector has an important role to play in achieving them by the increasingly pressing deadline of 2030. Companies should assess the relevance of each SDG, identifying those that they can make a direct contribution to, and incorporate the most material SDGs into their strategies. We encourage companies to go beyond highlighting any SDG that the company could be connected to and to be purposeful in selecting those to which it intends to make an active, direct contribution, including through the allocation of resources and setting targets. We urge companies to report on their approach to the SDGs and to engage with its shareholders and civil society on how best to contribute to the SDGs.

Further detail on our views on and expectations of companies with regards to a wide spectrum of environmental and social issues can be found in the EOS Engagement Plan.<sup>10</sup>

Below we highlight two key environmental and social topics which will inform our vote policies in 2022: climate change, and human and labour rights.

### Climate change

The breakdown of the climate is a systemic risk to the value of our clients' portfolios, due to the social, economic, and political consequences of climate change.

We strongly support the goal of the 2015 Paris Agreement – to limit global warming to well below 2°C and pursue efforts to not exceed 1.5°C of warming – and we expect companies to publicly do the same, as well as ensuring that any third-party organisations they support or are members of, such as trade bodies or lobbying organisations, are aligned to this goal.

We urge companies to:

- Establish strong governance of the risks and opportunities presented by climate change and the energy transition. Boards should ensure that climate-related issues are included on the board agenda at least annually. We expect the board and senior management to engage with outside experts who can advise on strategic risks and opportunities that climate change presents, including challenging the company's approach if necessary. For those companies materially exposed to climate-related risks and opportunities, we expect the energy transition to be clearly articulated in governance documents, including board committee charters and the articles of association.
- Commit to achieving net-zero emissions by 2050 at the latest and set supporting short- and medium-term science-based targets to reduce greenhouse gas emissions in line with the goals of the Paris Agreement. This should include material Scope 3 emissions associated with a company's value chain or use of products with an explanation of why any Scope 3 emissions are not included.

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<sup>10</sup> The latest public version of the EOS Engagement Plan can be found at: [www.hermes-investment.com/stewardship/eos-library](http://www.hermes-investment.com/stewardship/eos-library)

- Integrate climate considerations into the forward-looking strategy for the company. Companies should consider the implications of the energy transition on their business, and what aligning to the goals of the Paris Agreement will mean for their strategy, minimising the potential risks and capitalising on the opportunities presented by climate change.
- Adopt the framework set out by the Task Force on Climate-related Financial Disclosures (TCFD) for the management and reporting of climate-related risks and opportunities. Where the risks are particularly acute (for example in energy intensive sectors), this should include conducting scenario analysis to establish the potential financial and other impacts of climate change on the business at different levels of warming. Companies should ensure that the financial risks associated with climate change and the energy transition are appropriately reflected in reports and accounts. As outlined in the Audit section below, the audit committee should be responsible for ensuring these risks are accounted for and the external auditor should be engaged to provide an opinion on this matter.
- Ensure board oversight and robust governance processes are in place to identify incidents of misalignment of views between companies and organisations of which they are members. Where issues are identified, all available avenues to influence these third parties should be used to encourage effective action on climate policy in line with the goals of the Paris Agreement. The company should be transparent about its governance procedures by describing the actions taken to reduce or eliminate any misalignment, and any progress made, in-line with the IIGCC Investor Expectations on Corporate Lobbying on Climate Policy.<sup>11</sup> Ultimately the board should be prepared to cease membership where misalignment persists without progress. Companies should also proactively support and advocate for positive action to mitigate climate change risks in their spheres of influence.

We engage intensively with companies across different countries and sectors on climate change and reinforce this through the voting recommendations we make to our clients at shareholder meetings.

In 2022, we continue to hold the chair or other responsible directors accountable through voting recommendations where we believe companies' actions are materially misaligned with the goals of the Paris Agreement and/or where companies are not responding sufficiently to the risks and opportunities posed by climate change. We include a particular focus on companies that are involved in activities that are clearly incompatible with limiting global warming to safe levels, such as causing deforestation and the expansion of coal-fired power. We assess companies using a range of frameworks and benchmarks, including the Transition Pathway Initiative (TPI),<sup>12</sup> the Climate Action 100+ benchmark,<sup>13</sup> Forest 500<sup>14</sup> and others.

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<sup>11</sup> <https://www.iigcc.org/resource/investor-expectations-on-corporate-lobbying/>

<sup>12</sup> <http://www.lse.ac.uk/GranthamInstitute/tpi/the-toolkit/>

<sup>13</sup> <https://www.climateaction100.org/progress/net-zero-company-benchmark/>

<sup>14</sup> <https://forest500.org/>

In addition to the above criteria, we may also reflect other concerns about a company's response to climate change in our vote recommendations, for example, where a company has been unresponsive to investor concerns or where we have concerns about the views held by particular directors regarding the reality and urgency of climate change.

We will consider and support on a case-by-case basis shareholder resolutions relating to climate change and may file or co-file resolutions where we believe them to be warranted.

In principle, we support the concept of having a shareholder vote on climate change transition plans (so-called 'Vote on Transition' or 'Say on Climate' resolutions). We will support climate change transition plans which are aligned to the goals of the Paris Agreement, with indicators of alignment including science-based greenhouse gas reduction targets over the short, medium and long-term, supported by a clear and credible strategy to achieve these.

### Human and labour rights

We believe that how a company manages its human rights strategy is of critical importance to its licence to operate, its impact on people's lives and ultimately its ability to create and preserve long-term holistic value. We endorse and expect companies to align with the UN Guiding Principles on Business and Human Rights (the UNGPs). The UNGPs framework outlines the corporate duty to respect human rights. Companies have a responsibility to disclose and act upon a policy commitment to human rights in their operations and value chains. This includes carrying out human rights due diligence to identify potential and actual human rights impacts; a plan to prevent, mitigate and account for how to address these impacts and providing or cooperating in the provision of remedy if a company has caused or contributed to adverse impacts.

Companies should have a governance structure for human rights which identifies board level oversight and executive accountability. They should report on obligations under the UNGPs, as well as under national legal requirements and relevant international frameworks.

The concept of human rights is simply the universal right to human dignity. However, we acknowledge that human rights strategies and impacts may involve complex and sensitive aspects and seek to engage with companies on these considerations. We may recommend a vote against relevant meeting items, such as re-electing a director, discharging management or approving its reporting if:

- a company is in clear breach of its applicable regulatory responsibilities related to human rights (such as the UK's Modern Slavery Act) or responsibilities outlined in the UNGPs; and/or
- there is sufficient evidence that a company has caused or contributed to egregious, adverse human rights impacts or controversies and has failed to provide appropriate remedy.



## TRANSPARENCY, TAX AND AUDIT

We believe that the quality of narrative reporting reflects the board's strategic thinking, its line of sight into operations and how well it oversees the company. Boards must report openly and transparently on the performance of the company and their stewardship of it over the year, acknowledging the challenges, as well as the achievements, the state of the market and the competitive landscape. It is also fundamental that each company reports in a way that allows investors to understand the main risks that the board has identified for the business, along with how the company manages and mitigates them. This includes environmental, social and governance, as well as financial and strategic, risks.

### Tax

Companies should recognise the importance of taxation to the funding of public services on which they and their stakeholders rely, and pay their fair contribution. The Covid-19 pandemic has emphasised the importance of companies paying their fair contribution as all businesses have directly or indirectly benefitted from government action to support the economy.

Fair payment of tax, based on the intention of tax law and in proportion to the location of economic value generated, is an important pillar of a company's social licence to operate. We believe that companies that seek to aggressively minimise their tax payments will face increasing reputational and financial risks.

We expect companies to:

- Comply with the intention of tax laws and regulations in all countries of operation.
- Pay taxes in-line with where economic value is generated.
- Publish a global tax policy describing their approach to tax risk, controls and oversight, including any material variations across the entity. This should include policy on corporate structuring in low tax jurisdictions, intra-group transactions and the use of tax incentives from public authorities.
- Ensure their tax policies and practices do not damage their social licence to operate in all jurisdictions in which they have a presence.
- Disclose publicly the full extent of taxes paid or collected by them in each country. Reporting on each country should include the purpose of the local corporate entity along with comparable corporate data such as revenue, profit before tax and number of employees. We recommend use of the GRI reporting standard on tax.
- Ensure they have sufficient oversight of tax policy, risk and controls in board and board committee work.
- Avoid the use or promotion of aggressive tax avoidance strategies either for their corporate taxes or those of employees, contractors or customers.

## Audit

Shareholders in listed companies rely on the quality and robustness of the audited information those companies report to the market when making investment decisions, and when holding company management and boards to account. High quality and effective audits are vital to ensure the markets trust and have confidence in the information companies report.

Audits should provide assurance to shareholders that the financial statements present a prudent, true and fair view of the financial results, cash-flows and financial strength of a company. In recent years, we have seen a spate of business failures following poor quality audits. These high-profile cases have raised questions about the quality, relevance, professionalism and independence of audits and external audit firms, and strengthened calls for reform.

### Audit committees

Shareholders, regulators and other stakeholders have increasingly focused on the role and performance of audit committees and how they discharge their duties. Beyond the oversight of the financial reporting process and the appointment and oversight of the external auditor, audit committees have important risk and compliance oversight responsibilities, including oversight of internal audit and whistleblowing facilities, as delegated by boards or as specified by laws or regulations. Assignment of substantial non-audit-related oversight mandates to audit committees may be seen as a signal that the audit committee is overburdened, with the risk that duties are being delegated to management. A better course of action may be to set up a further committee of the board to address other material non-audit matters.

### Auditor rotation

Maintaining independent external assurance is a fundamental pillar of good stewardship and the fiduciary duty of a board of directors. Independence, and potentially audit quality, is at risk when the same assurance provider is maintained for too long – whether the audit partner or audit firm. Only by rotating the audit firm at regular intervals can auditor independence and quality be protected, in the interests of shareholders and other stakeholders. Our view is that auditor rotation can also add value as it welcomes a new firm with a different approach and a new set of subject specialists with a fresh pair of eyes, fresh challenge and opinions.

We wish to see companies establish policies of mandatory rotation of the audit firm after 20 years tenure, with an open and competitive re-tender process at the interim point of 10 years.

### Non-audit services and fees

As part of overseeing the external auditor, the audit committee must establish and enforce a policy on what non-audit services the company can procure from the external auditor. We pay close attention to these services and related fees to ensure that they do not compromise auditor independence, which could compromise the integrity of the audit. The non-audit fees should normally be substantially lower than the audit fee.

As a guideline, non-audit fees should not exceed 50% of audit fees in any given year. If this is exceeded, there should be a clear explanation as to why it was necessary for the auditor to provide these services (for example, for certain services such as reviewing interim reporting or performing due diligence on transactions) and how the independence and objectivity of the audit was assured. In these cases, we also expect the committee to take action to ensure this does not reoccur, either by tendering for a new audit firm or reallocating non-audit work to a different firm.

We recognise that audit quality cannot be ensured solely through regular rotation of external auditors or reducing conflicts caused by the payment of fees for non-audit work. We expect audit committee chairs and committee members (statutory auditors in the case of a company with statutory auditors) to understand the organisation, challenge management and external and internal audit teams, and to follow best practice guidance when appointing audit firms.<sup>15</sup> Committee chairs and members should ensure they have sufficient time to fulfil their duties, which we expect to be significant, particularly for large, complex organisations.

The global best practice guideline is that audit committees should comprise entirely of independent directors and we encourage Japanese companies with audit committees to follow this. For companies that do not have an audit committee, we encourage a high level of independence among statutory auditors.

### Accounting practices

We are concerned that accounting standards, as applied, do not always reflect underlying company performance. We encourage companies to apply accounting standards in a manner which is prudent and provides a true and fair view. Where application of the standards does not provide such a view, we expect companies and their auditors to make this clear to investors.

As such, we expect companies to avoid aggressive accounting practices that represent the company's financial position in a flattering light. This creates a reliance on the most optimistic of outcomes transpiring in subsequent years, which can easily compound up to the point that a preventable collapse finally occurs. We expect companies to recognise liabilities in a timely fashion, and to only realise profits where there is a very high degree of confidence in their quality. We also expect a clear indication of the quality of any unrealised profits found in the company's income statement.

### Audit and climate change

Where material or potentially material we expect companies to disclose climate and other environmental and social matters in its financial statements and clearly discuss the connection between accounting assumptions and the climate change impacts based on alignment to the Paris Agreement. We expect the auditor to communicate climate and other ESG matters as critical audit matters

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<sup>15</sup> <https://www.ivis.co.uk/media/12498/Audit-tenders-guidelines.pdf>

to the audit committee where material and involving challenging, subjective and or complex auditor judgement.

To the extent a company's financial statement does not adequately consider material climate risks and there is no corresponding explanation as to why, we may recommend a vote against the audit committee chair and auditor ratification. For more information on our corporate governance expectations related to climate change, please see the Climate Change section above.