

Listing Department
Tokyo Stock Exchange
By email: jojo-kikaku@jpx.co.jp

27th April 2018

Dear Sir or madam,

Re: Revision of Japan's Corporate Governance Code based on the proposal of the Council

We welcome the opportunity to provide our comments on the proposed revisions of Japan's Corporate Governance Code. Hermes Investment Management is an asset manager with a difference. With GBP 33 billion (JPY 5 trillion)¹ in assets under management, we focus on holistic returns and consider the impact our decisions have on society, environment and the wider world – outcomes for our clients that go far beyond the financial. Our stewardship team, Hermes EOS, is one of the world's leading engagement resources, advising on GBP 336.2 billion (JPY 51 trillion)² on behalf of over 40 institutional investors globally. The views expressed in this communication are those of Hermes and do not necessarily represent the views of all clients. Our response is explicitly supported by Pension Fund Association (Japan), Calvert Research & Management (US), VicSuper (Australia), PNO Media (The Netherlands) and Environment Agency Pension Fund (UK).

We are encouraged by the proposed amendments to the Code, which in many cases provide more specific guidance to companies to achieve the stated principles and impressed by the standard it has reached within three years since the Code was first launched. We however have a few suggestions which we believe will accelerate the change and bring Japanese corporate governance closer to global best practice.

Please see below our comments on specific principles of the Code. Should you wish to discuss any of these comments further, please feel free to contact Sachi Suzuki at sachi.suzuki@hermes-investment.com

Yours sincerely,



Masaru Arai
Senior Advisor
Hermes EOS

^{1, 2} As at 31 December 2017

鈴木 祥

Sachi Suzuki
Associate Director – Engagement
Hermes EOS

Principle 1.4 Cross-Shareholdings

We firmly welcome the amendments to more explicitly promote the reduction of such holdings. We have been encouraging companies to reduce cross-shareholdings as we believe they have a number of negative consequences including potential hindrance to fair competition, obstruction to governance reform and unfair treatment of shareholders. While the first two of these points may be addressed in the revised code, we request further steps to ensure that 1.4.1 and 1.4.2 are strictly observed by corporations. We also propose elaborating on the third point. We are concerned that corporations as owners of cross-shareholdings may enjoy extra benefits such as favourable deals, which are not available to other groups of shareholders including institutional and retail investors. This would be an unequal treatment of shareholders which goes against the fundamental principle of Section 1 of the Code.

We would also like to highlight that the use of the term “Cross-Shareholdings” here can be somewhat misleading. We understand that these holdings are not always “cross” (mutual) but may be unilateral and some companies may be obliged to hold shares of their key business partners. We suggest that clarification should be made that all types of shareholdings other than what is considered ‘pure investment’ are included here, while details of pure investment must be disclosed and explained separately.

As part of the wider efforts towards reduction of these shareholdings, we suggest that companies enhance the level of disclosure about their large shareholders. Companies are currently required to disclose the names of about top 10 largest shareholders, however, these are typically custodians who manage institutional investors’ shares. Companies should disclose the names of underlying beneficiaries. We ask that the disclosure should be made about 30 largest shareholders, which should include major corporate (strategic) shareholders.

Principle 2.6 Roles of Corporate Pension Funds as Asset Owners

We welcome the addition of this principle, given the slow take-up of the Stewardship Code by corporate pension funds to date. It would be helpful in highlighting the importance of the roles corporate pension funds can play and clarifying expectations for them. We hope that this would encourage more corporate pension funds to take part in stewardship activities and promote constructive dialogue between companies and investors.

Principle 3.1 Full Disclosure

We believe the addition of the word ‘dismissal³’ to iv) and v) will be helpful in highlighting that transparency around dismissals of senior management is important. We support the proposition that companies should avoid using boiler-plate even in disclosures required by law. We strongly encourage companies to provide details specific to their circumstances in order to provide investors with meaningful information.

³ We would like to suggest replacing ‘dismissal’ with ‘(early) termination’ as the term ‘dismissal’ is not often used in the UK and US.

Principle 4.1 Roles and Responsibilities of the Board (1)

We welcome the amendments to Supplementary Principle 4.1.3 to encourage the board to play more active roles in succession planning and such planning to be done more systematically. Transparency around nomination is still limited at most Japanese companies. Even with a number of them setting up voluntary nomination advisory committees, how much authority they have in reality in nominating candidates remains questionable.

Principle 4.2 Roles and Responsibilities of the Board (2)

We support the suggestion of specific measures through which executive remuneration should be determined. This is because we find that remuneration policies remain unclear at most Japanese companies where such disclosure is limited. While we are not necessarily seeking disclosure of the amount paid to individuals, we strongly encourage companies to provide more details on their remuneration policy, including the proportion of performance pay and what metrics are used to calculate it. We also encourage long-term share ownership by executives in order to provide incentives linked to long-term performance.

Principle 4.3 Roles and Responsibilities of the Board (3)

We welcome the additional expectations for the board in relation to the appointment and dismissal of the CEO. We find that most companies still have a set number of years of service for CEOs and replace them once the period is over, rather than choosing the right time to appoint new management based on performance. We expect the proposed amendments to highlight the critical importance of CEO nomination and dismissal.

We strongly request additional notes on the treatment and governance of retired senior executives. We are concerned about a significant lack of transparency and accountability about the roles of senior advisors and consultants, who are typically former CEOs and senior executives. The level of influence they retain on management and corporate affairs is unclear, and very little information about these individuals is disclosed as they are usually not part of the board. Companies which maintain these positions for retired executives should disclose details including the number of individuals in these positions, their responsibilities, what authorities they have, remuneration and any other benefits they are entitled to and their tenure and when their contracts can be terminated. Ensuring that former senior executives do not interfere with the current management is as important as appointing the right person as CEO.

4.8 Effective Use of Independent Directors

While we think the amendments would add some encouragement for increasing board independence, we still find the wording somewhat weak and potentially confusing. Given that the vast majority of companies listed on the first tier of Tokyo Stock Exchange already have two independent directors, we suggest that the Code require that at least one-third of the board should be independent at companies on the first tier of the Tokyo Stock Exchange.

Roles of chair

We would like to highlight that the chair of the board plays a significant role in leading the discussion and ensuring the effectiveness of the board. We thus believe that the Code should articulate expectations for the chair. The UK Corporate Governance Code⁴, for example, elaborates on the roles the chair is expected to play. It also provides that the

⁴ <https://www.frc.org.uk/getattachment/ca7e94c4-b9a9-49e2-a824-ad76a322873c/UK-Corporate-Governance-Code-April-2016.pdf>

roles of chair and chief executive should not be exercised by the same individual. We believe that in the efforts to improve board independence and effectiveness at Japanese companies, having an independent non-executive chair can have a considerable effect. While very few companies have appointed an independent chair and the practice is still unfamiliar for a vast majority of companies, we would encourage them to consider this as a viable option.

4.9 Independence Standards and Qualification for Independent Directors

We find the existing criteria for independent directors set by the Tokyo Stock Exchange rather weak. As a result, a number of companies have so-called independent directors whose genuine independence is questionable because they represent significant shareholders and/or business partners. We encourage companies to apply more stringent criteria regardless of the TSE's standards when they appoint independent directors. Further, we propose to encourage limitation of the numbers of the companies one such individual work as "Independent Directors" because, naturally, one person can only have limited time.

4.10 Use of Optional Approach

We support the addition of 'independent' to Supplementary Principles 4.10.1. We have seen an increasing number of companies establishing voluntary nomination and remuneration advisory committees, which often consist of majority of independent directors. We think the new wording would further emphasise the importance of independence of these committees.

4.11 Preconditions for Board and Kansayaku Board effectiveness

We firmly welcome the amendments particularly the specification of gender and international experience as key elements of diversity, as we are concerned that most Japanese boards remain starkly dominated by male Japanese executives even at companies that operate internationally and have diverse customer bases. Diversity and equality has been among top priorities for many governments and companies globally in the recent years and we expect to see further progress. We would also add that companies should appoint directors who have the skills and attributes to be able to challenge management and provide different perspectives. We support the additional expectations for Kansayaku.

We appreciate that a number of companies have started conducting board evaluation since the introduction of the Corporate Governance Code in 2015, and now expect to see further improvement of the quality and effectiveness of such evaluation. As we believe that external evaluation can provide more rigorous and objective assessment, we propose adding to Supplementary Principle 4.11.3 that evaluation should be done by an independent third party.

5. 2 Establishing and Disclosing Business Strategies and Business Plans

We firmly welcome the addition of specific wording to encourage companies to elaborate on their capital policy more systematically. Many Japanese companies have retained a large amount of cash while limiting the dividend payout to a low level. Although many have increased their payout, they should also be able to explain to shareholders in detail how they plan to allocate capital in other ways such as investment and research and development. In addition, shareholder funds are often used in the form of cross-shareholdings, which we believe is not only an inefficient use of capital but also a restraint on governance reform and free competition. We encourage companies to address this matter when they devise their capital policy and reallocate the funds for better purposes.