

CONSULTATION RESPONSE

REVISION OF JAPAN'S CORPORATE GOVERNANCE CODE

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PRI Association

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United Nations
Global Compact

An investor initiative in partnership with UNEP Finance Initiative and UN Global Compact

ABOUT THE PRI

The Principles for Responsible Investment (PRI) is the world's leading initiative on responsible investment. The PRI is now a not-for-profit company with over 3,800 signatories (pension funds, insurers, investment managers and service providers) to the PRI's six principles with approximately US \$100 trillion in assets under management.

The PRI supports its international network of signatories in implementing the Principles. As long-term investors acting in the best interests of their beneficiaries and clients, our signatories work to understand the contribution that environmental, social and governance (ESG) factors make to investment performance, the role that investment plays in broader financial markets and the impact that those investments have on the environment and society as a whole.

The PRI works to achieve this sustainable global financial system by encouraging adoption of the Principles and collaboration on their implementation; by fostering good governance, integrity and accountability; and by addressing obstacles to a sustainable financial system that lie within market practices, structures and regulation.

ABOUT THIS CONSULTATION

Based on the proposal from the "Council of Experts Concerning the Follow-up of Japan's Stewardship Code and Japan's Corporate Governance Code," jointly established by the Financial Services Agency and Tokyo Stock Exchange (TSE), TSE will revise its listing rules relevant to the revision of the Code. This consultation calls for public comments on the listing rules, which include the revision of the Corporate Governance Code. This revised Code is scheduled to be implemented in June 2021, while the revisions related to TSE's Prime Market will be implemented on April 4, 2022.

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PRI'S RESPONSE

The PRI welcomes the proposed draft of the revised version of the Corporate Governance Code, which explicitly recognises the importance of board independence, diversity and sustainability (including ESG issues) in creating long-term corporate value and sets out higher corporate governance standards for TSE Prime Listed Companies.

Our key recommendations include:

- **Setting a requirement for Prime Market companies to appoint a majority of independent directors;**
- **Providing training and development for board members on ESG issues;**
- **Introducing an explicit requirement for companies to use third-party independent reviewers for director evaluation;**
- **Improving diversity disclosure of listed companies;**
- **Adopting a mandatory approach on climate disclosures rather than comply or explain;**
- **Requiring disclosure of information on companies transition plans to net zero and adopting a phased implementation for TCFD disclosures**

Please see our comments below that draw on specific expertise and evidence from the PRI's work.

Enhancing Board Independence

Principle 4.8 – Effective Use of Independent Directors

The PRI welcomes enhanced requirements around the number of independent directors on the board. We recommend that a higher bar be set for companies listed on the Prime Market, in line with international best practice.¹ All Prime Market listed companies, regardless of whether they have controlling shareholders should appoint a majority of independent directors.

For companies listed on other markets, a minimum of one third of directors on the board should be independent. Given this is one of the most crucial aspects of good corporate governance, we also recommend that these companies further report on how they plan to increase this number to a majority of independent directors over time. To facilitate this transition, companies should develop and disclose clear criteria on board appointments and succession planning, including rationale for specific board appointments (highlighting skills, knowledge, contribution to diversity and experience). In addition, we believe this process should be led by a nominations committee consisting of majority of independent directors at all companies.

Supplementary Principle 4.8.2

Where board Chairs have executive responsibilities, we recommend that a Lead Independent Director (LID) is appointed. Investors generally consider LIDs a position that enables balance of power on the board and serves as a crucial conduit for shareholders' views. This is particularly important for

¹ See https://www.cii.org/corp_gov_policies and <https://www.icgn.org/sites/default/files/ICGN%20Guidance%20on%20Diversity%20on%20Boards%20-%20Final.pdf>

companies with controlling shareholders and where minority shareholders' interests need to be further protected.

Principle 4.10 Use of Optional Approach - Supplementary principle 4.10.1

We welcome the requirement for Prime Market listed companies to have a majority of independent directors on sub-committees and enhanced disclosure on mandates and roles of the committees, as well as the policy regarding independence. Greater clarity on the mandates of board sub-committees and their composition should be encouraged at all companies.

Supplementary Principle 4.11.1 – Skills matrix

We welcome the inclusion of disclosure of board skills, such as in a skills matrix. This requirement encourages companies to better articulate their position on board composition, skills and diversity, and to provide a well-considered view of how a nominee will contribute to the mix of skills and qualifications needed to deliver their business strategy.² Further contextual disclosure on how the board seeks to address material concerns regarding the balance of skills and experience will provide valuable insights for investors and inform their voting decisions.

In addition, the PRI strongly supports ongoing training and development for all board members. Regular assessment of skills and needs should be undertaken, and all members (beyond those undergoing inductions) and sub-committees with specific mandates should be supported by a training plan designed to address any areas of weakness or further development. Proactive training may also be supplemented with reactive training triggered by events such as, for example, mergers and acquisitions, or in response to systemic issues such as the urgent need to tackle climate change or stakeholder concerns.

We believe that boards need to be equipped with ESG related competencies given the growing investor interest in how companies maximise environmental, social and financial performance. A focus on ESG issues can enable companies to respond to legal and regulatory developments, protect their reputation and licence to operate, meet commitments to global goals such as the UN sustainable development goals, identify opportunities and evaluate the impact of their products, services and operations. Companies should ensure that their board members receive appropriate training to build expertise on ESG issues and are able to access internal or external counsel as needed, so they can provide robust oversight on relevant issues and guide the development of the corporate sustainability strategy.

Supplementary Principle 4.11.3 – Board evaluation

The PRI is supportive of the requirement for companies to conduct annual board evaluations. Such processes can improve investor confidence in board performance and highlight any areas for further development to ensure a diverse and well-functioning boardroom. To improve rigour and independence, however, we recommend introducing an explicit requirement for companies to use third-party independent reviewers for director evaluation. It is also valuable for investors to see clear disclosure on areas for improvement and actions taken to address any shortcomings identified in the evaluation and improve board effectiveness.

² <https://www.unpri.org/download?ac=1836>

Promoting Diversity

Principle 2.4 – Ensuring Diversity, Including Active Participation of Women – including supplementary principle 2.4.1

Diversity and inclusion on corporate boards and throughout an organization are material to company success and, as such, represent decision-useful information for investors. Through increasing disclosure and mandating minimum standards for board diversity, we believe the proposed principle and supplementary principle make progress in bringing diverse voices and perspectives to company leadership and provide investors with necessary data as they consider the risks and opportunities associated with board diversity.

We recommend that the code goes a step further in improving diversity disclosure of listed companies by clarifying how it intends to measure company alignment with the principles or by setting minimum standards for expected policies and targets. These minimum standards should improve the quality of "comply or explain" reporting and lead to clearer explanations for deviations from the requirements in the code. The standards should be set according to what the TSE considers should be the goals for diversity, equity and inclusion that reflect the Japanese society.

Supplementary principle 4.10.1 – Board sub-committees

PRI welcomes the inclusion of diversity as criteria for enhancing the board composition and governance functions. However, we recommend expanding on the definition of diversity beyond gender and specifying what "from the perspective of other diversity and skills" mean. This clarification will make the disclosure on board composition more standard and more comparable. When considering expanding on diversity beyond gender, the code should aim to include those characteristics which reflect the Japanese society, in order to improve the level of empowerment and participation of individuals with different identities.

Focus on Sustainability and ESG

Supplementary Principles 3.1.3 Disclosure on Sustainability

The PRI welcomes the requirement that TSE Prime listed companies disclose climate change-related risks and earning opportunities on their business activities and profits based on TCFD recommendations. Considering the importance and urgency of climate change, we recommend that the code should take a phased implementation of TCFD based disclosure for Standard and Growth listed companies. For example, the code could ask Standard and Growth listed companies to report one year after Prime listed companies start reporting based on TCFD recommendations.

We also recommend that the code requires information on companies transition plans. This builds on the TCFD recommendations and is in line with key asks from flagship investor climate programmes such as the Climate Action 100+ and the United Nations-convened Net-Zero Asset Owner Alliance. For every financial decision to take into account climate change, institutional investors, as illustrated by the Climate Action 100+ benchmark backed by over 540 investors with \$52 trillion in assets, need Japanese companies to disclose net-zero transition plans including the strategic alignment with the Paris Agreement objectives, including five, ten and 15 year targets GHG emission reduction targets (Scopes 1, 2 and most relevant scope 3 emissions), and capital expenditure plans and accounts aligned with these targets.

In order to help issuers to disclose investment decision useful information based on TCFD recommendations, and to reduce the costs and burden, the PRI recommends that FSA, Japan Exchange Group and Tokyo Stock Exchange provide technical support and/or issue guidance for companies on TCFD reporting, working with existing initiatives such as Japan TCFD Consortium.

The PRI recommends that a comply or explain approach on climate related information disclosure should be avoided, considering the urgency of climate change. More ambitious action by governments and financial regulators is now needed to address market information failures and help ensure investors and companies incorporate climate-related risk systematically in their investment and business development decisions. This would also be consistent with the Japanese government's newly announced climate policy and 2030 emission reduction target.

Supplementary Principles 4.2.2 Basic policy for the company's sustainability initiatives

The PRI welcomes the general direction of the code encouraging boards to get more involved in companies' sustainability initiatives especially from the perspective of increasing corporate value over the mid- to long- term. However, it's unclear what this basic policy would look like. Therefore, we recommend that FSA and TSE provide clear expectation on what such a basic policy would entail.

Other Comments

(1) Group Governance

Principle 1.4 Cross-shareholding

We note no proposed revisions to the code in relation to requirements on cross-shareholding. We urge the FSA to consider strengthening disclosures around the rationale and nature of cross shareholding in line with ICGN's recommendations.³

(2) Ensuring Confidence in Audits, Internal Control and Risk Management

Principle 2.5 Whistleblowing

Effective whistleblowing mechanisms are a key feature of good governance and anti-corruption systems, as well as being reflective of a healthy corporate culture centred on trust and responsiveness. The PRI recently published a report⁴ providing guidance on how investors can assess and engage with investee companies to improve corporate whistleblowing practices.

We welcome therefore the recognition of the importance of disclosure and explanation of the whistleblowing systems and the board responsibility for implementation and oversight of this framework. As evidenced in PRI's report, company boards have a crucial role in creating speak-up cultures; boards should clearly understand the steps taken to resolve issues raised through whistleblowing mechanisms and communicate how information received is integrated into the company's risk management strategy.

Accordingly, we recommend that related requirements are strengthened in the code. The code should encourage companies:

³ https://www.icgn.org/sites/default/files/ICGN%20Remarks%20to%20Japan%20FSA_31%20March%202021.pdf

⁴ PRI (2020), [Whistleblowing: Why and How to Engage with your Investee Companies](#).

- To expand the scope of the whistleblowing policy to include all business partners of the company. These parties should be made aware of the policy just as other employees covered by the policy.
- To report on number and types of reports made through the whistleblowing systems, as public disclosure around usage of these mechanisms, or a lack thereof, can provide valuable insights into a company's speak-up environment.
- To layout specific steps that will be taken to avoid or remedy any retaliation against individuals who assist in the investigation of the complaints.
- To allow for anonymous reporting from whistle-blowers and the possibility to report at least in one language other than Japanese, depending on countries of operation and the makeup of the workforce.

The presence, or absence, of disclosure of these aspects can enable investors to assess companies' risk management and human rights practices, as well as their overall corporate culture, and to identify areas where they should push for improvements on whistleblowing mechanisms. As whistleblowing mechanisms can help companies to mitigate the risks associated with unethical or illegal conduct, investors can help prevent corporate failures and loss of value by addressing the quality of the disclosures on the above-mentioned areas.

General Principle 1

While we note no significant changes to Principle 1, in relation to Principle 1.1 Securing the Rights of Shareholders and Principles 1.2 Exercise of Shareholder Rights at General Shareholder Meeting, we welcome the inclusion of wording from these sections in the revised Guidelines for Investor and Company Engagement.

Well-informed voting is an essential part of stewardship, enabling investors to communicate with companies in an efficient manner. Timely disclosure of information related to a company's general meeting is vital to allow institutional investor sufficient time to make well-informed voting decisions.

In addition, for voting to be as effective as possible it needs to be coupled with transparency and communication by investors toward companies, this enables companies to understand the rationale for their voting behaviour and to act on this. We welcome the requirement that companies should analyse the reasons behind opposing votes and seek dialogue with shareholders to under their voting decisions.

Principle 5.1 Policy for Constructive Dialogue with Shareholders

We note that with the increase in the number of institutional investors integrating ESG risks and opportunities into their investment process, investors are also interested in meeting with corporate sustainability departments. This should be listed as one of the internal departments to be included within the Board's policy to promote constructive dialogue with shareholders.

We also welcome the requirement for companies to seek to promote opportunities for dialogue aside from individual meetings with investors. In particular, companies should be open to having engagement meetings with collaborative groups of investors. This can be an efficient way of communicating with and understanding the views of several investors at once.