Report: 27th Meeting of the Council of Experts Concerning the Follow-up of Japan's Stewardship Code and Japan's Corporate Governance Code

The "27th Meeting of the Council of Experts Concerning the Follow-up of Japan's Stewardship Code and Japan's Corporate Governance Code" ("Follow-up Meeting") was held on May 16. This was the first meeting since March of last year, when the proposed revisions to the Corporate Governance Code ("CG Code") were discussed, and was streamed in real time on the Financial Services Agency's official YouTube channel (only available in Japanese).

The agenda included the three themes announced in advance on the FSA's website: (1) Interim review following the 2021 revision of the Corporate Governance Code, (2) Challenges for sustainable growth, and (3) Issues related to dialogue between companies and investors. Below is an overview of the issues that were raised by the FSA secretariat in the explanatory materials and the comments made by the Follow-up Meeting members in response to (1) to (3).

(1) Interim review following the 2021 revision of the Corporate Governance Code

The explanatory materials cited the increase in the ratio of independent outside directors among prime market listed companies and the promotion of the establishment of nomination and compensation committees as outcomes of governance reforms, including the latest revision of the CG Code. The corporate side pointed out several issues, including "Compliance with the Code has become a formality" and "There is a question of it relating to an increase in corporate value and 'earning power'?" while investors indicated such points as "Further reforms are needed to achieve a substantial dialogue" and "Further utilization of cash and cash equivalents/retained earnings and so on should be considered." The materials also included a summary of empirical studies and a report on interviews with companies.

In regard to the above, Follow-up Meeting members commented that extending the CG Code to enforcement matters in the revision has led to a formal response, and notably, they expressed a negative view of further detailed regulations. While a certain degree of recognition was given to the results of governance reforms, there were still many companies with P/B ratios below 1x, and improvements in ROE and ROIC were stalled, which was seen as problematic because this was not evident in the overall performance of the companies. Some Members suggested that prime market listed companies "should aim for a majority of outside directors" and "should be required to be a company with a nominating committee, etc." The impact of these proposals on future discussions will be monitored closely.

(2) Challenges for sustainable growth

The secretariat reported through the explanatory materials that investment in growth by Japanese companies (capital investment, R&D/IP investment, human capital investment, etc.) has remained modest, and consequently, the most recent retained earnings and cash and deposits have accumulated to a high level. Specifically, the issue of companies being less aware than investors of the importance of investments in intellectual property and human capital was noted. It was also pointed out that dividends and share buybacks by Japanese companies are not excessive compared to those in the U.S. and the U.K.

During the discussion at the meeting, many Members expressed concern about the lack of awareness toward investment in growth, especially human capital. While the accumulation of retained earnings was roundly criticized as a sign of a lack of confidence in "earning power," some expressed an understanding of the need to prepare for the current COVID-19 infection and geopolitical risks. On this point, the suggestion that capital policies should be formulated and explained on both a short-term and medium- to long-term basis may be pertinent. In addition, the perspective of recovery was missing from investments in general, the importance of exits and sales was not recognized, and a lack of awareness of the cost of capital was also identified as problematic.

(3) Issues related to dialogue between companies and investors

The delineation of the line between collaborative engagement and "joint ownership" or "material proposed actions" was the dominant topic of discussion. In 2014, the Financial Services Agency provided examples of applicable/non-applicable activities in its "Clarification of Legal Issues Related to the Development of Japan's Stewardship Code," but it was later reported that the scope of such activities was still unclear. Members expressed their expectations for collaborative engagement, but also recognized that the above scope will ultimately have to be a matter for legislative discussion. Other issues related to investor capacity, such as the difficulty for passive investors to engage in high quality engagement with all investment targets, were also noted.

Next year corresponds to the timing of the revision of the Stewardship Code, which is "approximately every three years." However, some Follow-up Meeting Members also commented that they were not aware of any major issues that would arise in the immediate future, and it is unclear whether revisions will actually be discussed during the current year. Nevertheless, the direction taken by the discussions at the Meeting will have some influence on ongoing governance and capital market reforms. Developments will continue to be monitored closely.