Material 2

Group Governance (Studies by the Corporate Governance System Study Group)

March 5, 2019

Ministry of Economy, Trade and Industry

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2. Governance of listed subsidiaries

(1) Structures of conflicts of interest

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Consideration of the future of group governance

- In response to the Investments for the Future Strategy 2018, and as Japanese companies become more global and diversified, we will study and establish practical guidelines on the future of group governance in both offensive and defensive aspects in order to improve the earning power of groups.

Position of the growth strategy

Investments for the Future Strategy 2018—Change to Society 5.0 and Data-driven Society—.

(3) New concrete measures that should be taken

i) Corporate governance reform

Continuing from the revision of the Stewardship Code in May of last year, the Corporate Governance Code was revised in June of this year. In addition, the Guidelines for Investor and Company Engagement (“Engagement Guidelines”) were established, as a supplementary document to both codes, to summarize the main issues on which engagement between institutional investors and companies is expected to focus. In response to these developments, **the following measures will be implemented to promote the strengthening of corporate governance, resolute management decisions, and bold business reorganization, etc.** (Excerpt)

- **Practical guidelines on the future of group governance, including how to best implement governance from perspectives both offensive and defensive and how to optimize the business portfolio in order to improve value for the entire corporate group, will be developed around spring of next year.**

Measures up until now

As **globalization and diversification** become more important, companies need to ensure continued growth and cope with environmental changes. The Corporate Governance System Study Group (2nd Term), which has been conducting studies to consider the measures to **strengthen governance as a corporate group** and organize best practices, from perspectives both offensive and defensive, in order to **improve the earning power of corporate group as a whole,** is due to develop practical guidelines on the future of group governance.

Overview of the Corporate Governance System Study Group (2nd Term) (list of members, group history and schedule)

Study Group members (without titles)

Hideki Kanda, Professor, Gakushuin University Law School (Chairman)
Katsumi Ao, Executive Officer, Tokyo Stock Exchange, Inc.
Jun Aoki, Executive Corporate Officer, Shiseido Company, Limited
Takeyuki Ishida, Executive Director, Institutional Shareholder Services Inc.
Kunio Ito, Adjunct Professor, Graduate School of Business Administration, Hitotsubashi University
Akitsugu Era, Director, Head of Investment Stewardship, BlackRock Japan Co., Ltd.

Kenichi Osugi, Professor, Chuo Law School
Junji Ota, Member, Audit Committee, Toshiba Corporation
Akiyoshi Oba, Chairman, Japan Investment Advisers Association
Yuri Okina, Chairperson, The Japan Research Institute, Limited
Hiroyuki Kansaku, Professor, The University of Tokyo Faculty of Law and Graduate Schools for Law and Politics
Masanori Koguchi, Senior Executive Vice President, Mitsubishi Heavy Industries, Ltd.
Gen Goto, Associate Professor, The University of Tokyo Faculty of Law and Graduate Schools for Law and Politics
Yoshimitsu Kobayashi, Chairperson, Director of the Board, Mitsubishi Chemical Holdings Corporation

Soichiro Sakuma, Planning Division, Chair, Committee on Economic Law, Japan Business Federation
(Executive Advisor, Nippon Steel & Sumitomo Metal Corporation)
Minoru Sawaguchi, Partner, Mori Hamada & Matsumoto
Kazuhiro Takei, Partner, Nishimura & Asahi
Hideo Tsukamoto, Partner, Anderson Mori & Tomotsune
Shirou Terashita, Representative Director, President, and CEO, IR Japan, Inc.
Kazuhiko Toyama, Managing Partner and CEO, Industrial Growth Platform, Inc.
Toyoaki Nakamura, Director, Hitachi, Ltd.
Tomotaka Fujita, Professor, The University of Tokyo Faculty of Law and Graduate Schools for Law and Politics
Nobuko Matsumoto, Professor, Faculty of Law, Gakushuin University
Hiroshi Mitoma, Partner, Nagashima Ohno & Tsunematsu
Hideaki Miyajima, Professor, Faculty of Commerce, Waseda University
Noriyuki Yanagawa, Professor, University of Tokyo Graduate School of Economics

[Observers]
Toshikazu Takebayashi, Counsellor, Minister's Secretariat, Ministry of Justice
Toshitake Inoue, Director, Corporate Accounting and Disclosure Division, Policy and Markets Bureau, Financial Services Agency

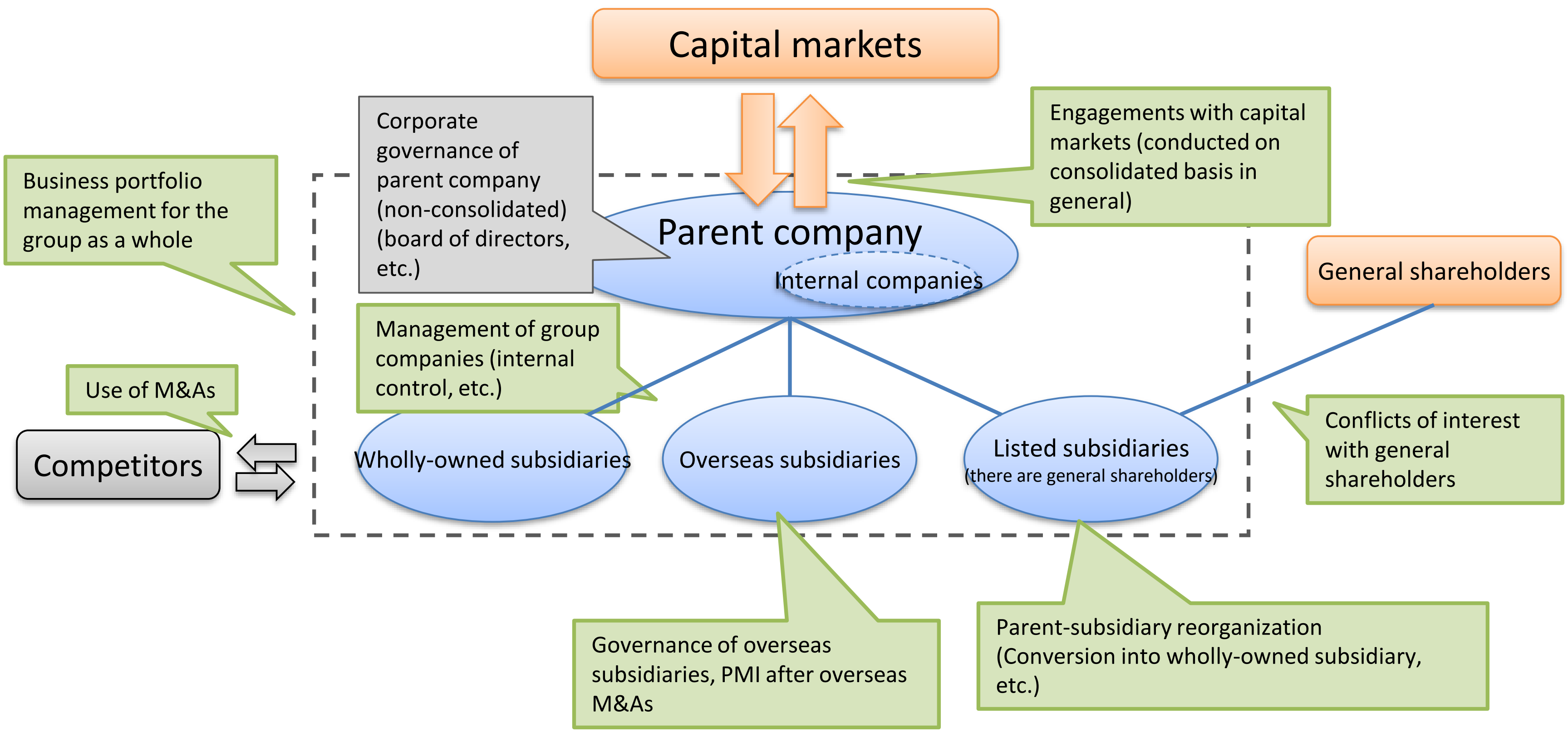
Group history and schedule

Session 1 (December 8) Explanation of the purpose of Study Group, identification of main issues, etc.
Session 2 (January 16) Reports on interviews with companies, presentations by group members
(Study Group members Miyajima and Kobayashi)
Session 3 (February 22) CGS Guidelines follow-up (1)
Session 4 (March 29) CGS Guidelines follow-up (1)
Session 5 (April 24) Interim report by Study Group
Session 6 (May 25) Group governance (1)
(Reports on current situation and issues, presentations by experts)
Session 7 (June 22) Issues of "defensive" governance (1)
Session 8 (July 24) Issues of "defensive" governance (2)
Session 9 (September 5) Proposed revision for CGS Guidelines, etc.
Session 10 (October 10) Issues of "offensive" governance
Session 11 (November 12) Appointment of senior management (role of nomination committee in group, etc.)
Session 12 (December 13) Remuneration design for senior management (role of remuneration committee in group, etc.)
Session 13 (January 21) Other issues, summary outline draft
Session 14 (February 13) Draft of Guidelines
Session 15 (March 15) Compilation of Guidelines
Session 16 (April 18) Compilation of Guidelines

Basic approaches to strengthen governance of group subsidiaries

- Future of governance (effective management of subsidiaries, internal control systems, integration process after M&As (PMI), etc.) including group subsidiaries
- Promotion of business portfolio optimization (business restructuring by curtailment of non-core businesses and strengthening of core businesses)

(Reference) Various issues related to the group governance (portion)



Current situation and issues within Japanese companies regarding group management

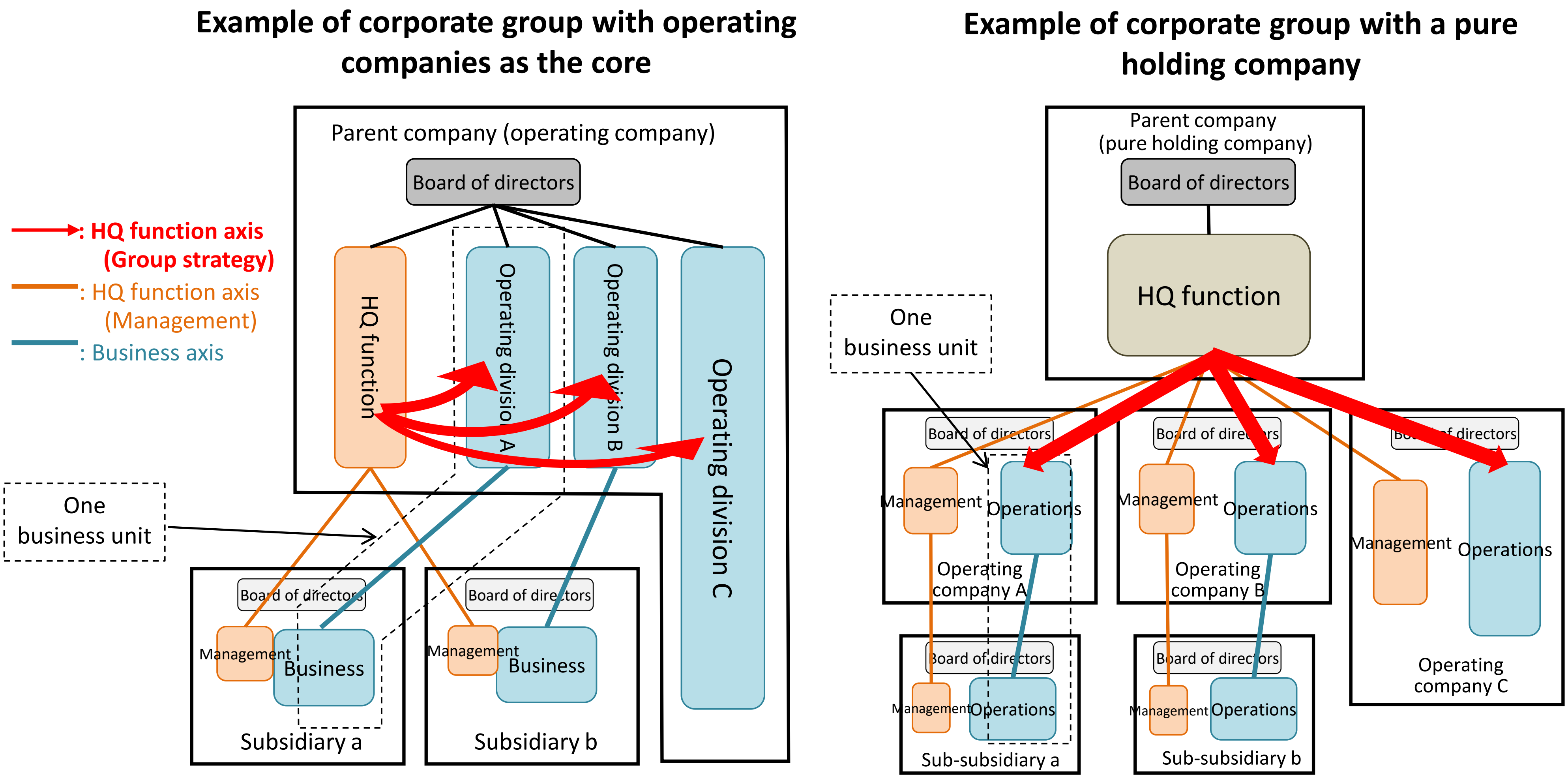
- In light of the results of interviews with companies in Japan and surveys overseas, it was found that issues regarding group management in Japan include the following examples.

Issues regarding group management in Japan (some examples)

Offensive governance	• As a result of delegating authority to business divisions in order to enable prompt decision making, business divisions now have too much authority and the optimal allocation of management resources for the group as a whole is not being achieved. • Only a small number of companies have implemented clear mechanisms for the standards and processes for reviews of the business portfolio for the group as a whole, including the disposal of a part of business etc.
Defensive governance	• The HQ function related to risk management and legal affairs, etc. is weak, and while management is being left up to each subsidiary or each business division, they lack adequate risk management due to a shortage of human talents.
Nomination and remuneration at subsidiaries	• The board of directors, nomination committee, and remuneration committee of the parent company need to provide appropriate oversight on the nomination and remuneration of CEOs, etc. at major subsidiaries from the perspective of improving the corporate value of the group as a whole. • Issues related to remuneration design at global companies include overseas subsidiaries paying much higher remuneration than its parent and the use of non-financial indicators such as SDGs.

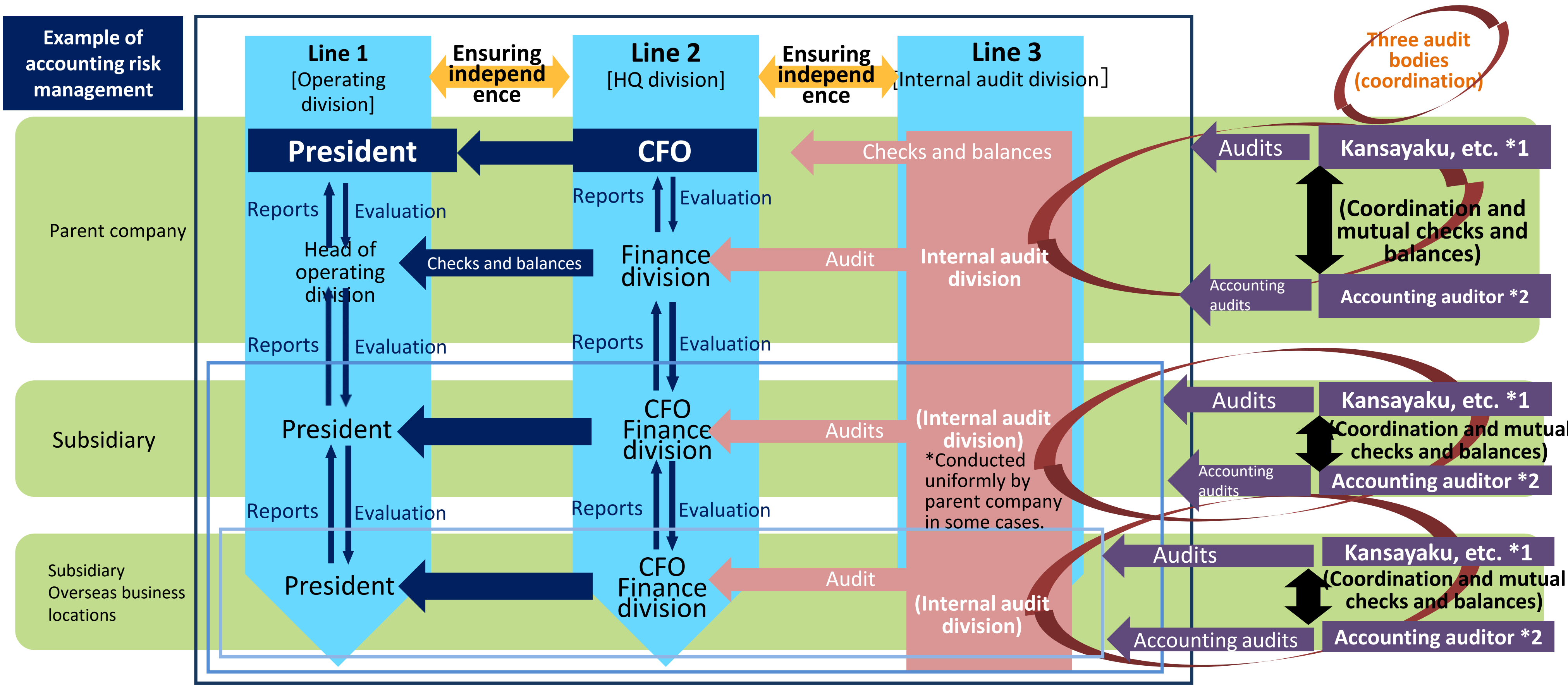
Issues within Japanese companies regarding group management

- An issue within Japanese companies regarding group management is the weakness of HQ function axis (horizontal axis) over the business axis (vertical axis), both offensively and defensively.



Defensive governance (example of "Three Defense Lines" implementation)

- In order to effectively implement the Three Defense Lines that support internal control systems, it is important to insert horizontal channel between the parent company and subsidiaries through authorities related to personnel and performance evaluation, budget allocation, etc. in the second line and third line and to put checks and balances in place against the first line.
- The lack of independence of the second line and the third line has been pointed out as a factor in corporate scandal incidents.



*1: Same applies in the case of a supervisory committee or audit committee
*2: Establishment is necessary at companies with supervisory committee, companies with three committees, and large companies (Article 327, Paragraph 5 and Article 328, Paragraph 1 and 2 of the Companies Act)

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(1) Structures of conflicts of interest

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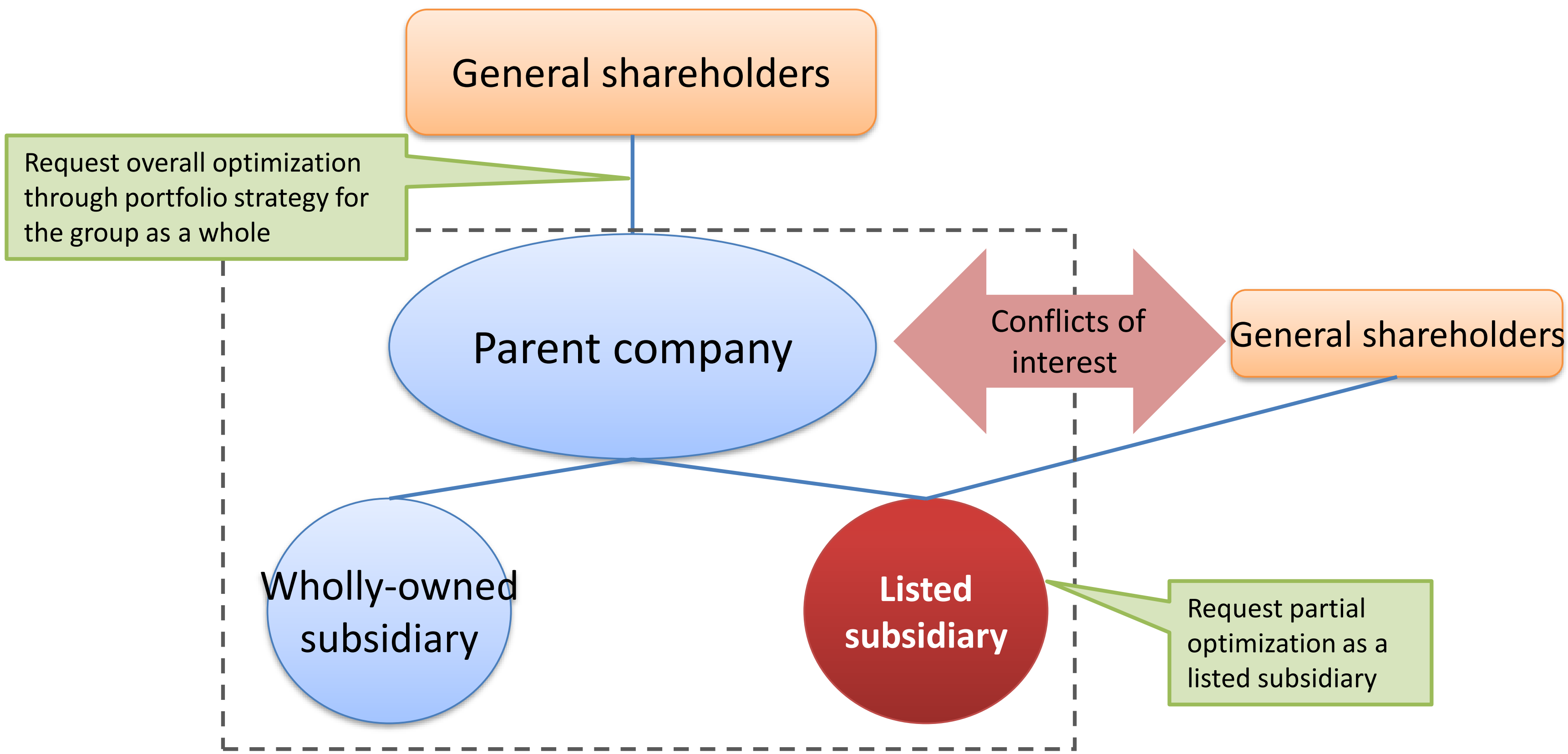
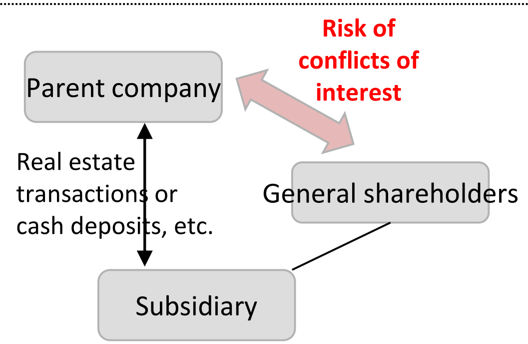
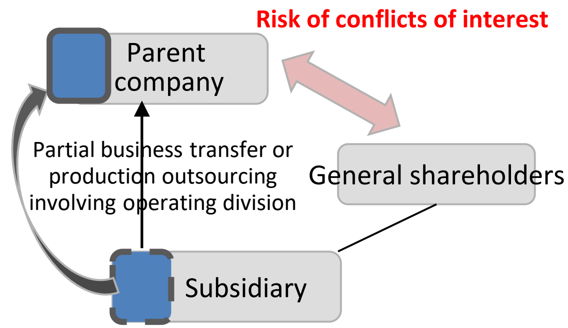
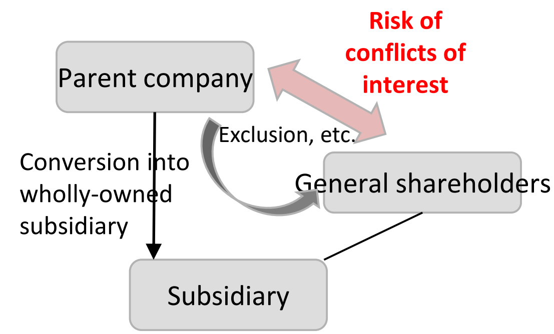
Structures of conflicts of interest at listed subsidiaries

- Listed subsidiaries have structural risks of conflicts of interest between their controlling shareholders and general shareholders.
- In particular, investors have indicated strong concerns regarding the interests of general shareholders of listed subsidiaries that could lead to a possible discount in the corporate value of a listed subsidiary.



Specific situations in which conflicts of interest can arise at a listed subsidiary

- There are three main categories of transactions in which conflicts of interests could arise for listed subsidiaries.
- Because of risks that conflicts of interest between the parent and its subsidiary could emerge in such transactions, listed subsidiaries need to take appropriate action that gives sufficient consideration to the interests of general shareholders.

	Category (1): Direct transactions (excluding (2) and (3))	Category (2): Business transfer or adjustment	Category (3) Conversion into a wholly-owned subsidiary by a controlling shareholder
Transaction Image			
Conflicts of interest	(In the case of cash deposits) • The parent company wants to make use of the cash which the subsidiary deposited with at the lowest interest rate possible. • The subsidiary wants to invest cash in its own company unless an interest rate that covers the cost of capital is paid.	• The parent company wants to consolidate competing or duplicate businesses to optimize the entire group at the lowest cost possible. • The subsidiary does not want to transfer, adjust, downsize, or abolish its business unless fair compensation is paid in consideration of future profitability and business continuity.	• The parent company wants to exclude the shareholders of the subsidiary and convert into a wholly-owned subsidiary at the lowest cost possible. • The general shareholders of the subsidiary does not want the subsidiary to be acquired unless a fair price is presented in consideration of factors such as future cash flows.

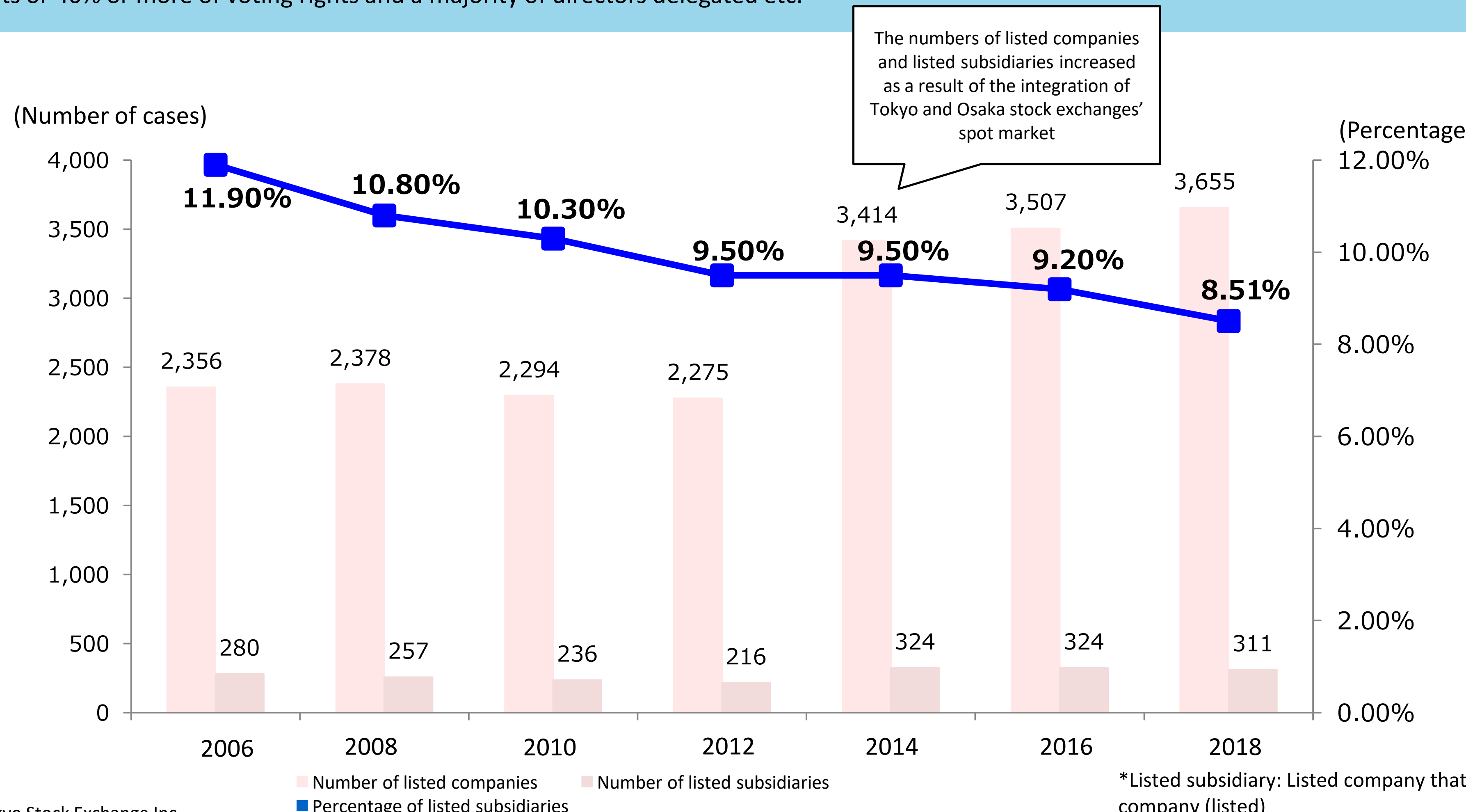
The most serious case of conflicts of interest is believed to be found in category (3): conversion into a wholly-owned subsidiary by a controlling shareholder. The **Fair M&A Study Group** is considering the development of guidelines on the role of measures to ensure fairness to protect the interests of general shareholders.

Current situation of listed subsidiaries

- Of all listed companies, 628 have a controlling shareholder (17.5%) (information provided by the TSE).

*Of the 628 companies, 311 have controlling shareholders that are listed companies (8.51% of all listed companies).

Note: The Securities Listing Regulations of the Tokyo Stock Exchange define a "controlling shareholder" as a shareholder with over 50% of voting rights or 40% or more of voting rights and a majority of directors delegated etc.



*Listed subsidiary: Listed company that has a parent company (listed)

Source: Tokyo Stock Exchange Inc.

Reference: Listed subsidiaries in other countries

- The number of listed subsidiaries and percentage in the market in Japan is by far bigger than US and Europe.

*Note that because the method of counting listed subsidiaries differs from that used in the White Paper on Corporate Governance 2017 from the TSE, simple comparison is not possible.

Percentage of listed subsidiaries in each country

Country (target market)	Total number of listed companies	Number of listed companies with a listed controlling shareholder (Ratio to total number of listed companies)	
		Controling shareholder has ownership of 50% or more	Controling shareholder has ownership of 30% or more
US (Nasdaq Capital Market; Nasdaq Global Market, Nasdaq Global Select, New York Stock Exchange, NYSE MKT LLC (AMEX))	5,348	28 (0.52%)	48 (0.89%)
UK (London Stock Exchange(LSE), AIM)	1,920	0 (0.00%)	4 (0.20%)
France (Euronext Paris)	806	18 (2.23%)	30 (3.72%)
Germany (Deutsche Boerse, Xetra, Hmburg Stock Exchange, Munich Stock Exchange)	794	17 (2.14%)	28 (3.52%)
Japan (Tokyo Stock Exchange, TSE JASDAQ)	3,892	238 (6.11%)	418 (10.73%)

Note 1: Investigated the number of cases in which both a controlling shareholder (owning at least 30% or 50% of the issued shares of the listed company) and the target company are listed on an exchange (not necessarily the same market) in the same country.
Note 2: Created by White & Case LLP International Law Firm based on search results by S&P Capital IQ (https://www.capitaliq.com) (as of December 2018).

Source: Session 3 of the Fair M&A Study Group (Overseas Research interim Report Materials (White & Case LLP International Law Firm))

Current situation of governance at listed subsidiaries (comparison with listed companies in general)

- In terms of the governance of listed subsidiaries, there are fewer independent directors and *kansayaku* at listed subsidiaries in comparison with listed companies overall.

Analysis items	Listed subsidiaries (313 companies)*	Listed companies (3,696 companies)
Number of independent external directors	**Average 1.92 people** (16% have 3 or more people)	**Average 2.09 people** (27% have 3 or more people)
Number of independent external kansayaku	**Average 1.63 people** (11% have 3 or more people)	**Average 1.84 people** (24% have 3 or more people)
Presence of nomination committee or remuneration committee	**25%** (49% for companies with sales of 100 million yen or more)	**26%** (54% for companies with sales of 100 million yen or more)
Presence of incentive remuneration for directors	**67%** (79% for companies with sales of 100 million yen or more)	**69%** (83% for companies with sales of 100 million yen or more)
Presence of policy for determining remuneration amounts for directors and calculation method	• For both categories, companies with bigger sales are more inclined to have some kind of policy.	

Source: Created by the Ministry of Economy, Trade and Industry based on EOL data as of November 2018. *Here "listed subsidiary" is limited to subsidiaries with a controlling shareholder that is a listed company (so-called "parent-subsidiary listing").

Corporate Governance Questionnaire Survey (FY2018 Flash Report)

- The Ministry of Economy, Trade and Industry conducted a questionnaire survey on corporate governance in FY2018 targeting listed companies (covering TSE First Section and TSE Second Section companies)(*).

  *Gathering and summary of data conducted by Deloitte Tohmatsu Consulting on consignment.

- This survey also assessed the current situation of listed subsidiaries as a matter related to group governance.

Responses to the questionnaire survey targeting listed companies

Percentage of companies responding by market

TSE first section	Total number	2,107	
	Responding companies	722	34.3%
TSE second section	Total number	502	
	Responding companies	100	19.9%

Percentage of companies responding by organizational design

Companies with three committees	Total number	63	
	Responding companies	40	63.5%
Companies with supervisory committee	Total number	673	
	Responding companies	180	26.7%
Companies with kansayaku board	Total number	1,873	
	Responding companies	602	32.1%

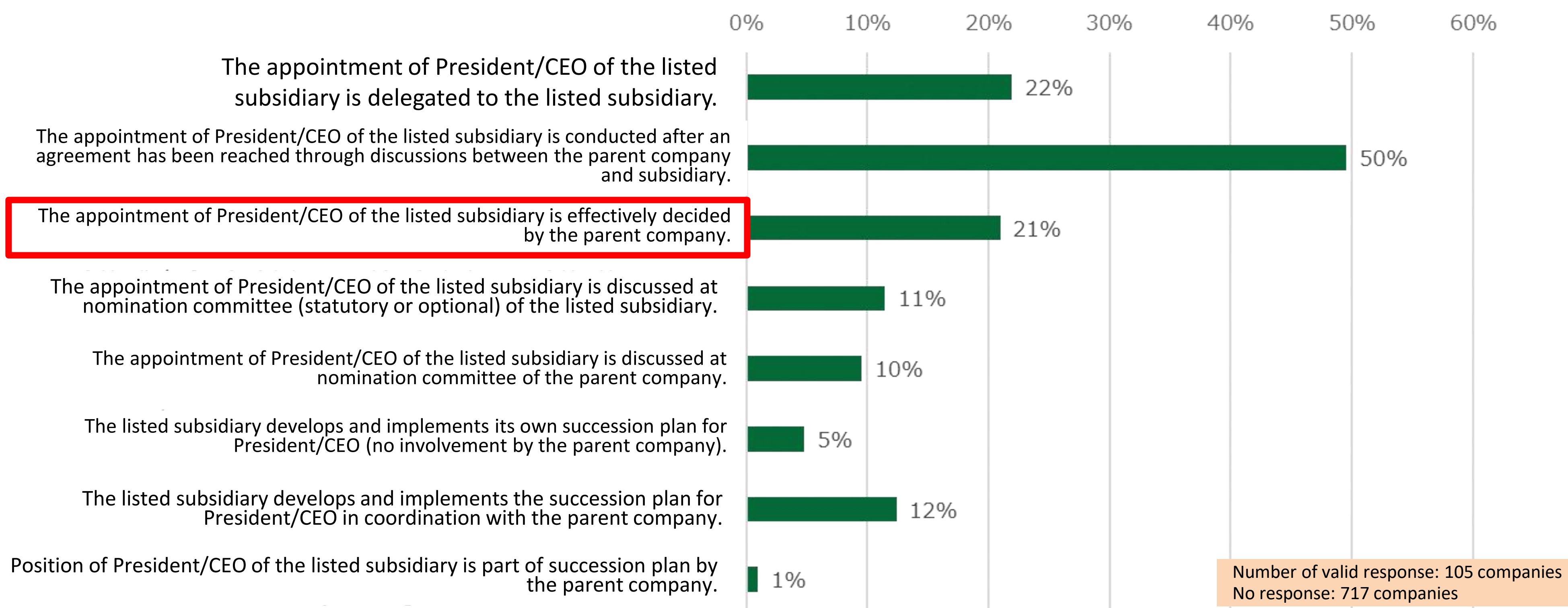
Percentage of companies responding by scale of sales

Up to 50 billion yen	Total number	1,289	
	Responding companies	266	20.6%
50 billion yen to up to 100 billion yen	Total number	395	
	Responding companies	125	31.6%
100 billion yen to up to 500 billion yen	Total number	628	
	Responding companies	244	38.9%
500 billion yen to up to 1 trillion yen	Total number	142	
	Responding companies	81	57.0%
1 trillion yen to up to 3 trillion yen	Total number	105	
	Responding companies	67	63.8%
3 trillion yen or more	Total number	50	
	Responding companies	39	78.0%

Nomination of President/CEO at listed subsidiaries

- 50% of valid response say that the nomination of President/CEO of a listed subsidiary is conducted after an agreement has been reached through discussions between the parent company and subsidiary.
- 21% answered that decisions were effectively made by the parent company. Meanwhile, only 11% said that "the appointment of the President/CEO of the listed subsidiary is discussed at nomination committee (statutory or optional) of the listed subsidiary."

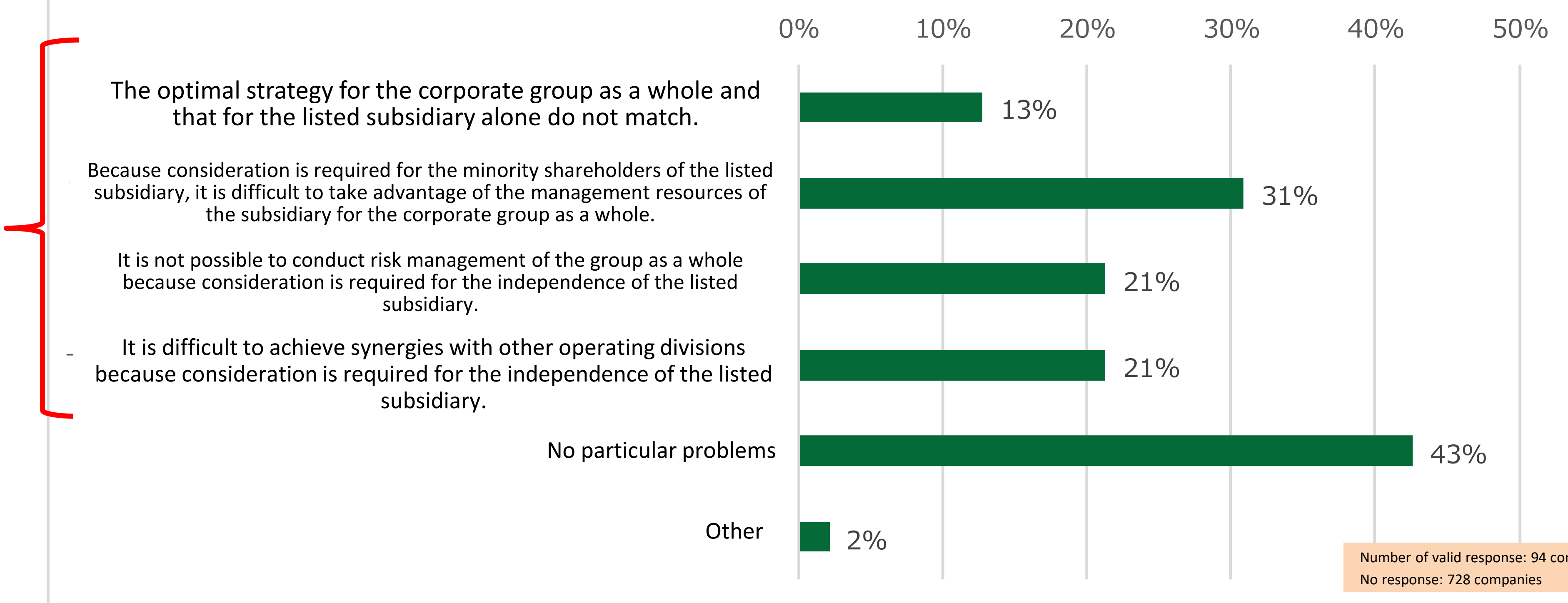
Question 43. Please select the answer that accurately describes how President/CEO is nominated in the listed subsidiary (multiple choice allowed).



Development and execution of business portfolio strategy for the group as whole

- A little under 60% of companies recognized that there were some issues involving a listed subsidiary.
- Common answers in terms of specific issues include: "because consideration is required for the minority shareholders of the listed subsidiary, it is difficult to take advantage of the management resources of the subsidiary for the corporate group as a whole." (31%), "it is not possible to conduct risk management of the group as a whole" (21%), and "it is difficult to achieve synergies with other operating divisions" (21%).
- 13% of companies responded that "the optimal strategy for the corporate group as a whole and that for the listed subsidiary alone do not match."

Question 55. Please select the challenges in connection to the listed subsidiary in the development and execution of business portfolio strategy for the group as whole. (Only companies that have a listed subsidiary should respond, multiple choice allowed)

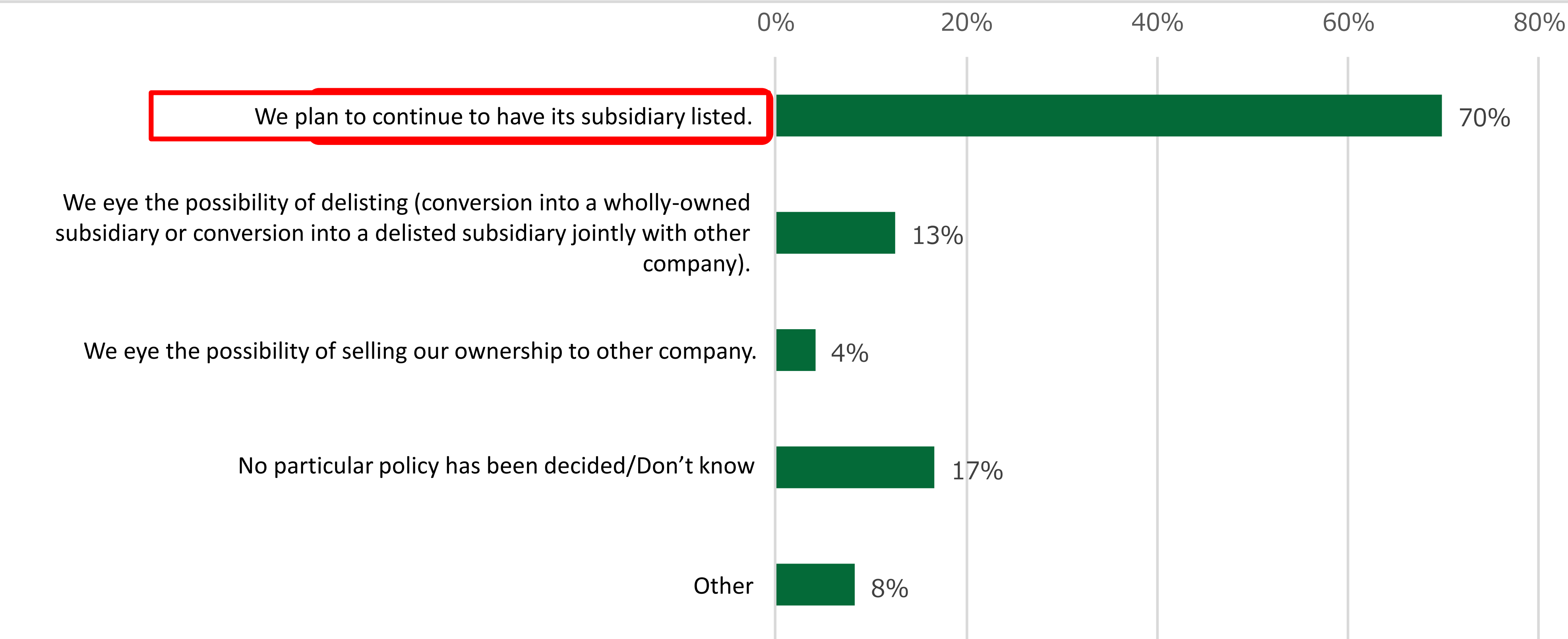


Number of valid response: 94 companies
No response: 728 companies

Future policy for listed subsidiaries

- Approximately 10 to 20% of companies eye the possibility of reorganizing its listed subsidiary, while 70% are to continue to have its subsidiary listed.

Question 56. Please select the future policy for your listed subsidiary. (Only companies that have a listed subsidiary should respond, multiple choice allowed)

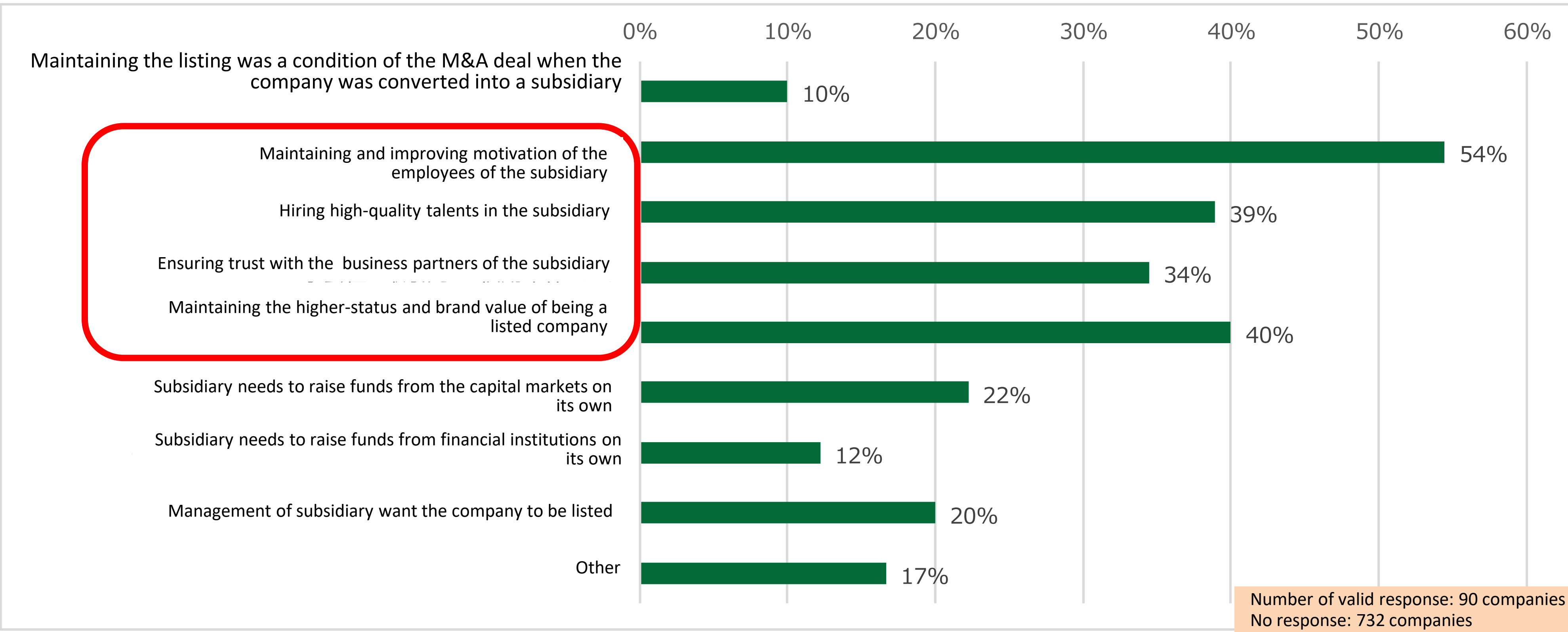


Number of valid response: 96 companies
No response: 726 companies

Reasons for owning a listed subsidiary

- As to the reasons for owning a listed subsidiary, many responded “maintaining and improving motivation of the employees of the subsidiary”, “hiring high-quality talents”, and “maintaining the higher-status of being a listed company”.

Question 54. Please select the answer that accurately describes the reason for owning a listed subsidiary.
(Only companies that have a listed subsidiary should respond, multiple choice allowed)



Views of investors on parent-subsidiary listings (1/2)

- Here the views of investors on parent-subsidiary listings.

➢ **US institutional investor**

- **The share price of listed subsidiary in Japan before TOB is already discounted.** In the US, maintaining listing is fairly costly do to various factors including fiduciary duty regulations, etc. Perhaps the lack of such regulations in Japan explains the presence of parent-subsidiary listings.

➢ **US institutional investor**

- In Japan, there is no axis in the capital market and in some cases listed subsidiaries have good business results. In the US, the situation would be regarded as an impossible. Meanwhile, **the mere existence of a listed subsidiary would seem unusual.**
- In terms of investment decisions, the value of the parent company will be discounted if the subsidiary is strongly independent and the value of the subsidiary will be discounted if the parent is impeding the subsidiary, **so both parent and subsidiary are apt to face discount on their values.**
- In terms of the motivation of employees, the status of being a listed company might help when trying to hire people, but **the fact that it might lead to vagueness in management steering is horrible.**
- In response to the claim sometime made that they lack funds for conversion into a wholly-owned subsidiary, I think companies should let go of subsidiaries if not financially feasible and buy them if it is financially feasible, even if it means borrowing. **In Japan, the focus is only on employees and business expansion, and the perspective of shareholders is lacking.**
- We sometimes invest in listed subsidiaries. **We do so on a case-by-case basis because at times the driving force could be the subsidiary rather than the parent.**

➢ **Japanese asset owner**

- Parent-subsidiary listings on most securities exchanges overseas are limited to those in the process of becoming a wholly-owned subsidiary. The situation in Japan is different; **parent-subsidiary listings here have no effective corporate governance what so ever.**
- **Parent-subsidiary listings should be prohibited and abolished.** For now, they are mere opportunities for overseas investors.
- **I see inconsistency in the attitudes of parent companies in the cases of a parent-subsidiary listings.** Specifically, because parent companies must strive to maximize profits for every item on their balance sheet, they should of course purse profits for subsidiaries under their control. On the other hand, it is necessary to ensure the independence of the subsidiary in the case of parent-subsidiary listings, and if a general shareholder of a subsidiary says something to its parent company, they will be dismissed and told the subsidiary is independent. This alleged duplicity is very unpopular.

Views of investors on parent-subsidiary listings (2/2)

- **Japanese asset owner**
- **From the perspective of general shareholders, parent-subsidiary listings could impede effective governance, and damage the interests of general shareholders.** Such listings are not good for commercial relationships or as a common practice.
- **Japanese fund**
- If you seek engagement with the parent company as a shareholder of the listed subsidiary, you will be rejected and told to talk with the subsidiary because the subsidiary is independent. As a result, **listed subsidiaries could becomes a sort of sacred cow for their executives, or their shares left at cheaper levels.**
- Considering the fact that parent companies are due to accountability, **we would like have it clarified that parent companies have an obligation to respond to engagement with the shareholders of subsidiaries.**
- The listing of a subsidiary should not be allowed. Even if it is allowed, **listing regulations should require such subsidiaries to have a majority of truly independent directors in order to protect the general shareholders of subsidiaries.**
- **Japanese researcher**
- If asked whether listed subsidiaries are **consistent with the demands of portfolio management as a group, the answer for investors would be no.** Every investor would say no in response to this question. **A listed subsidiary that is making an extremely significant contribution to corporate value should be converted into a wholly-owned subsidiary, and other listed subsidiaries should be sold off.**
- Shareholders of the parent company want immediate selloff because such listing seem like half measures.
- **The shares of listed subsidiaries are easy targets.** They can be bought at a discounted price, and a claim for fair value can be made.
- There are synergies both from the perspective of the parent company and the subsidiary. There is no denying that synergies can be achieved through the use of the R&D infrastructure of the parent company and looking for human resources. **While investors may say "No", there are some benefits from the perspective of group management.**
- We should look at the appointment and dismissal of the top management of listed subsidiaries. This is something that should really be done by independent directors of the subsidiary once it is listed. If a subsidiary is where those with managerial background in the parent company get plum jobs, it should be converted into a wholly-owned subsidiary; if good tension is to be maintained the appointment of President should be left up to shareholders of the subsidiary.
- **While some listed subsidiaries maintain good tension with the parent company, others slip into complete passivity, so it would be difficult to make generalizations.**

Strengthening the governance of listed subsidiaries (future approach)

- While listed subsidiaries have some significance at least as a transient choices within the business portfolio strategy, listed subsidiaries need to work to strengthen governance in order to address the risk of conflicts of interest with general shareholders.

(1) Practical response	Future of governance of listed subsidiaries (Role of independent external directors, etc.)	Because legislative response may take time, the following guidelines are indicated initially as practical response. • The role of independent external directors is particularly important in order to protect the minority shareholders of listed subsidiaries and ensure their independent decisions making. • Because independence from the controlling shareholders is essential for listed subsidiaries, in terms of the independence judgment criteria for independent external directors, at the very least, someone originally from the controlling shareholder (those who have worked for the parent company that is the controlling shareholder within the last ten years) should not be selected as an independent external director. • Efforts should be made to increase the ratio of independent external directors in the board of directors (at least 1/3 or a majority) of listed subsidiaries. • Assuming that immediately achieving such action may be difficult, a framework should be established so that specific situations involving conflicts of interest are discussed and considered in a committee fully composed of, or made up of a majority of, independent external directors (or independent *kansayaku*) from the perspective of protecting the rights of minority interests, and the results of those discussions are respected by the board of directors.
	Information disclosure	• Parent companies shall fulfill their accountability toward investors, etc. through the disclosure of information on the reasonable grounds for maintaining a listed subsidiary and the effectiveness of governance system. • Listed subsidiaries shall also disclose information to investors, etc. on what kind of governance systems have been established to ensure the interests of minority shareholders.
(2) Legislative response		The following is stated in the CGS Report in light of discussions up until now. • A legislative response should be considered in the future in light of the practical response in (1) above to ensure confidence from international capital markets.

Source: Excerpt from the materials for Session 14 of the Corporate Governance System Study Group of the Ministry of Economy, Trade and Industry