Material 5

Provisional Translation

Reference Document 2
(Follow-up on Corporate Governance Reform)

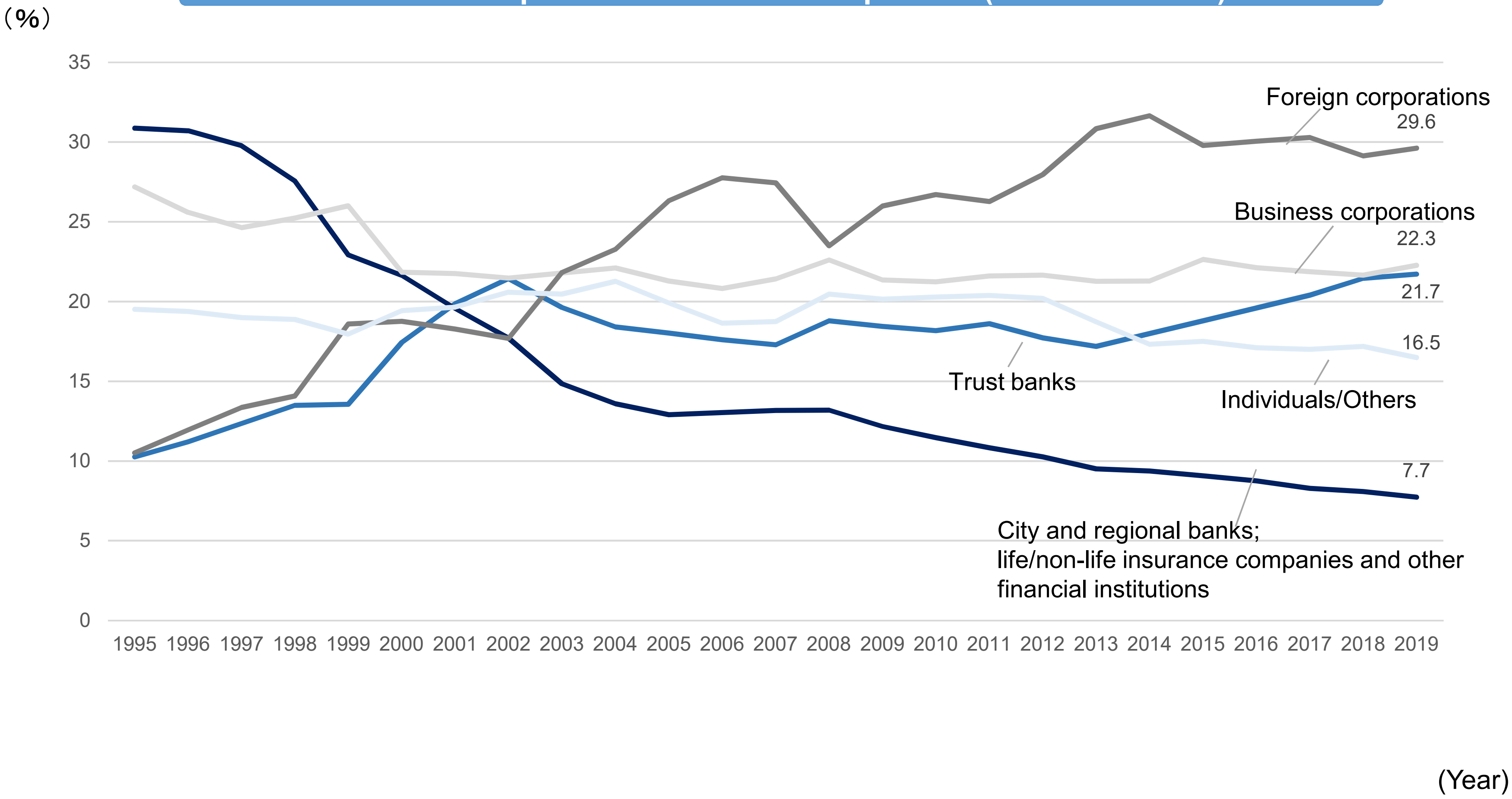
October 20, 2020

Financial Services Agency

Share ownership

- **Foreign corporations and trust banks have increased their ownership of Japanese shares in recent years.** On the other hand, the number of shares held by banks and life/non-life insurance companies has decreased.

Historical Japanese share ownership ratios (based on value)

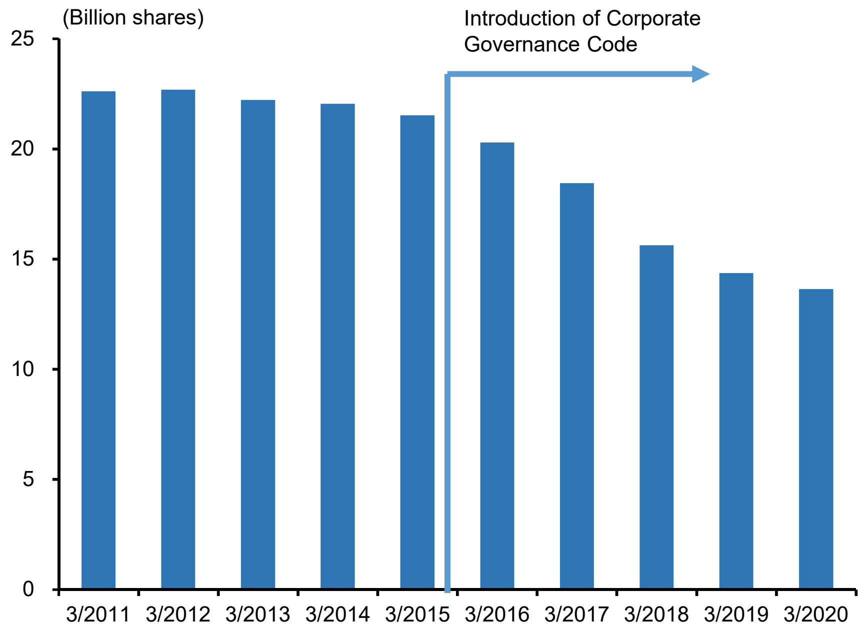


Note: Data for 2004 to 2009 includes companies listed on JASDAQ; from 2010 onwards, JASDAQ companies are combined with OSE or TSE listed shares.
Source: Prepared by FSA based on TSE's "2019 Share Ownership Survey"

Cross-shareholdings

- **The total number of shares held as strategic cross-shareholdings has declined in recent years. However, although the number of cross-shareholdings held by financial institutions is declining, cross shareholdings held by corporations have not decreased and remain at a high level.**

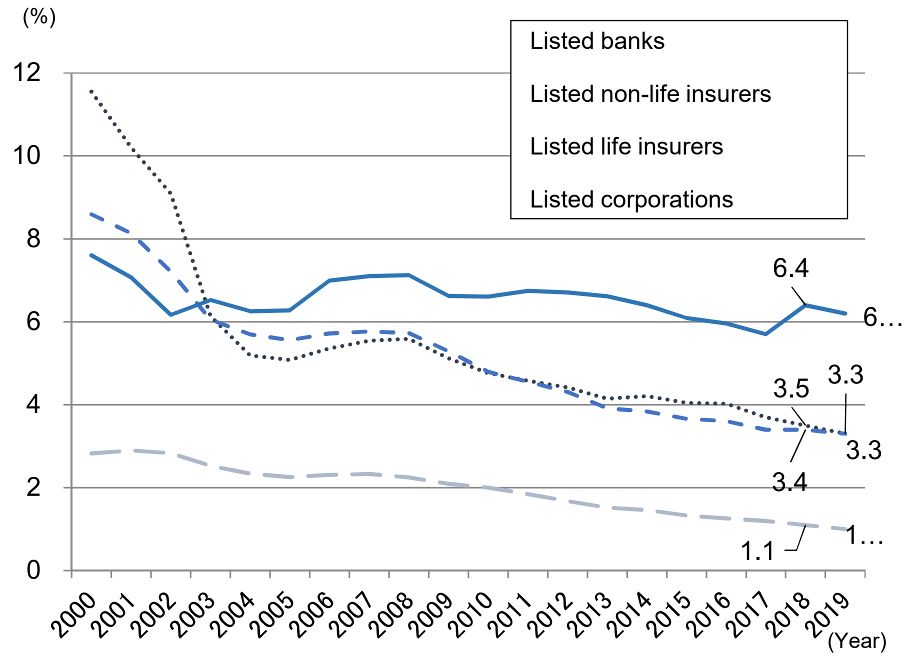
Change in total number of shares held as strategic cross-shareholdings



Note: Out of all listed shares, change in number of investable shares held as cross-shareholdings where market value can be calculated. Universe is 2,094 stocks eligible for investment for 10 years from March 2011. Data as at August 12, 2020.

Source: Mizuho Securities Equity Research Department, based on annual securities reports, QUICK Astra Manager

Breakdown of cross-shareholding ratio by type of shareholder (Ratio based on market value)



Note: Ratio of listed company and insurance company shareholdings of listed companies (market value) to total market capitalization of the market (excluding subsidiaries and affiliates).

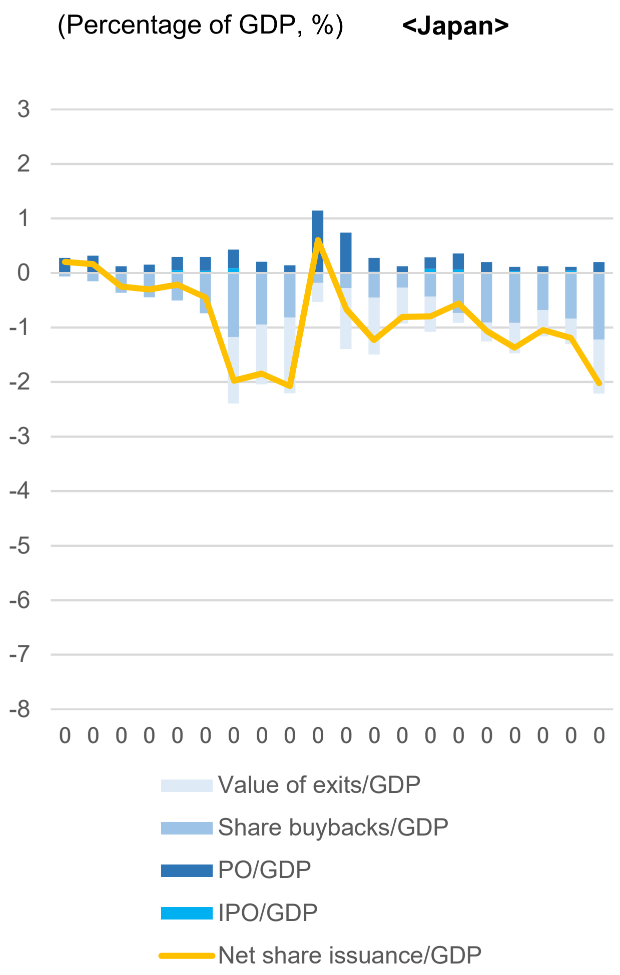
Note: Following a partial revision of the Cabinet Office Ordinance on Disclosure of Corporate Affairs, more detailed explanations are required in terms of the purpose and effects (including quantitative effects) of individual strategic shareholdings concerning the criteria and rationale of investments to enable distinction between pure investments and cross-shareholding investments. This applies to Securities Reports for the year to March 2019 onwards. In principle, the number of securities where individual disclosure is required has also been increased from 30 to 60.

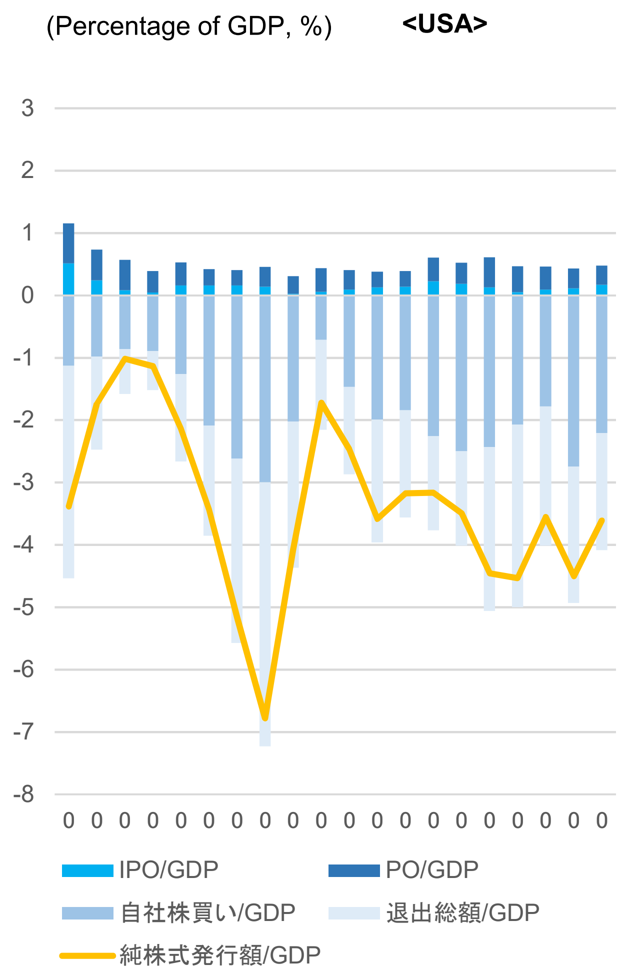
Source: FSA, based on data taken from the Nomura Institute of Capital Markets Research "Financial Information Update" (September 14, 2020)

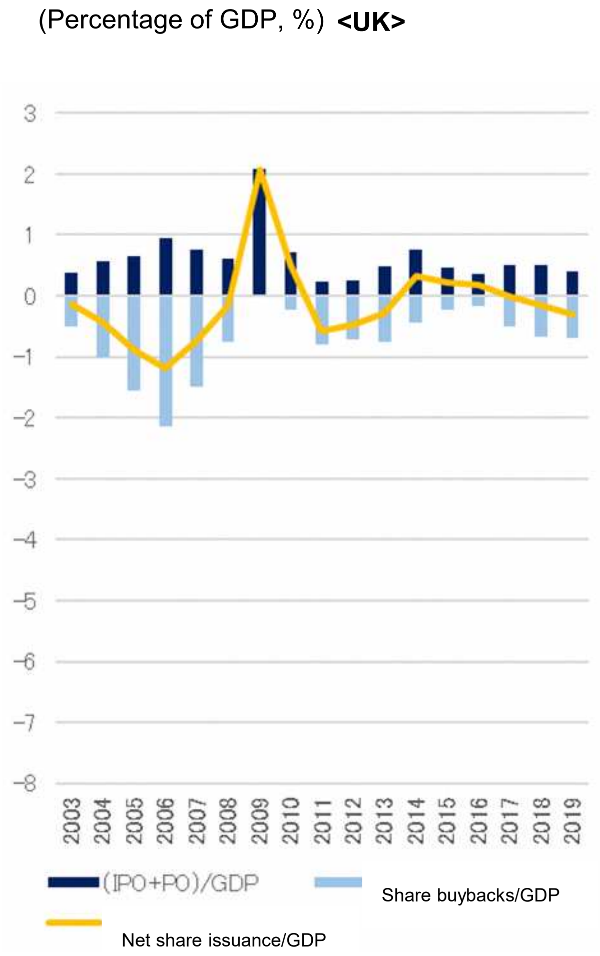
Updates on stock markets in the US, UK and Japan

☐ **In Japan, the US and the UK, stock markets are declining in importance as places to raise funds.**

Function of Japanese, US and UK stock markets as places to raise funds







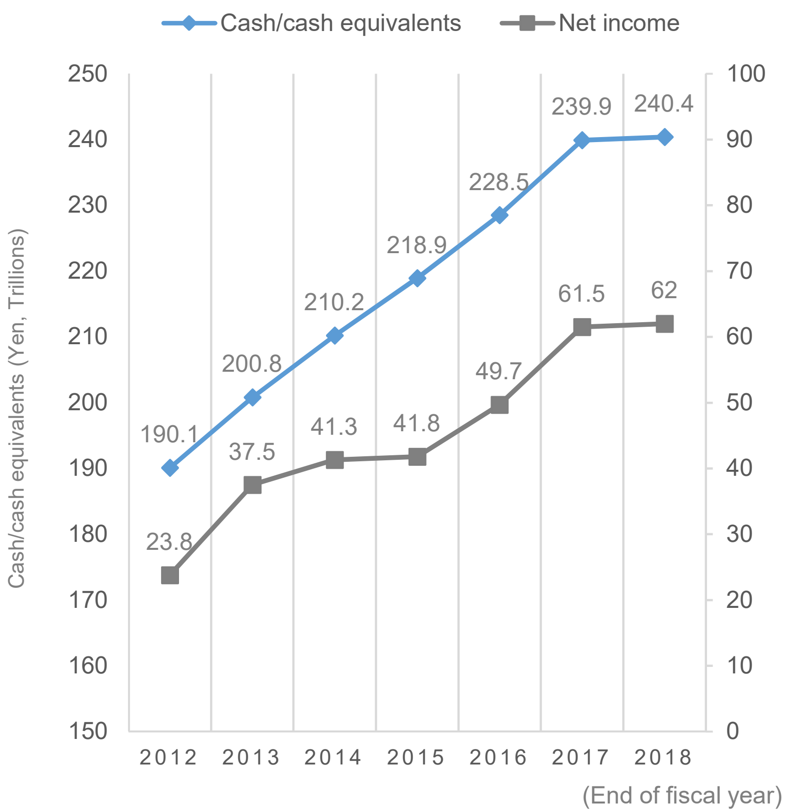
Note 1: Japan: Financial and non-financial institutions. IPO data from 2004; total value of exits from 2006.
Note 2: US: Domestic non-financial institutions.
Note 3: UK: domestic non-financial institutions. Data on total value of exits is not included.

Source: FSA, based on the following sources: Japan - QUICK, World Federation of Exchanges, Japan Exchange Group; USA - Federal Reserve Board (FRB); UK - Bank of England

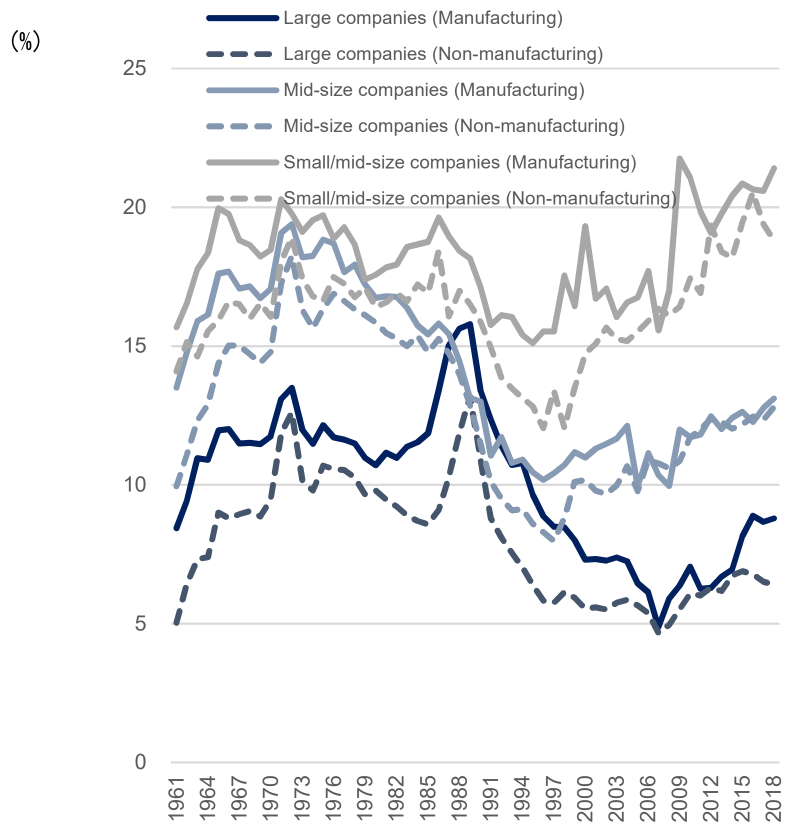
Cash and Cash Equivalents

- Over the past 10 years, **net income has been on an upward trend and cash and cash equivalents have been rising**.
- Cash to assets ratio varies depending on the size of the company. The increase in the cash ratio is especially evident in small and medium-sized enterprises (SMEs).

Cash/cash equivalents and net income



Cash to assets ratio by company size



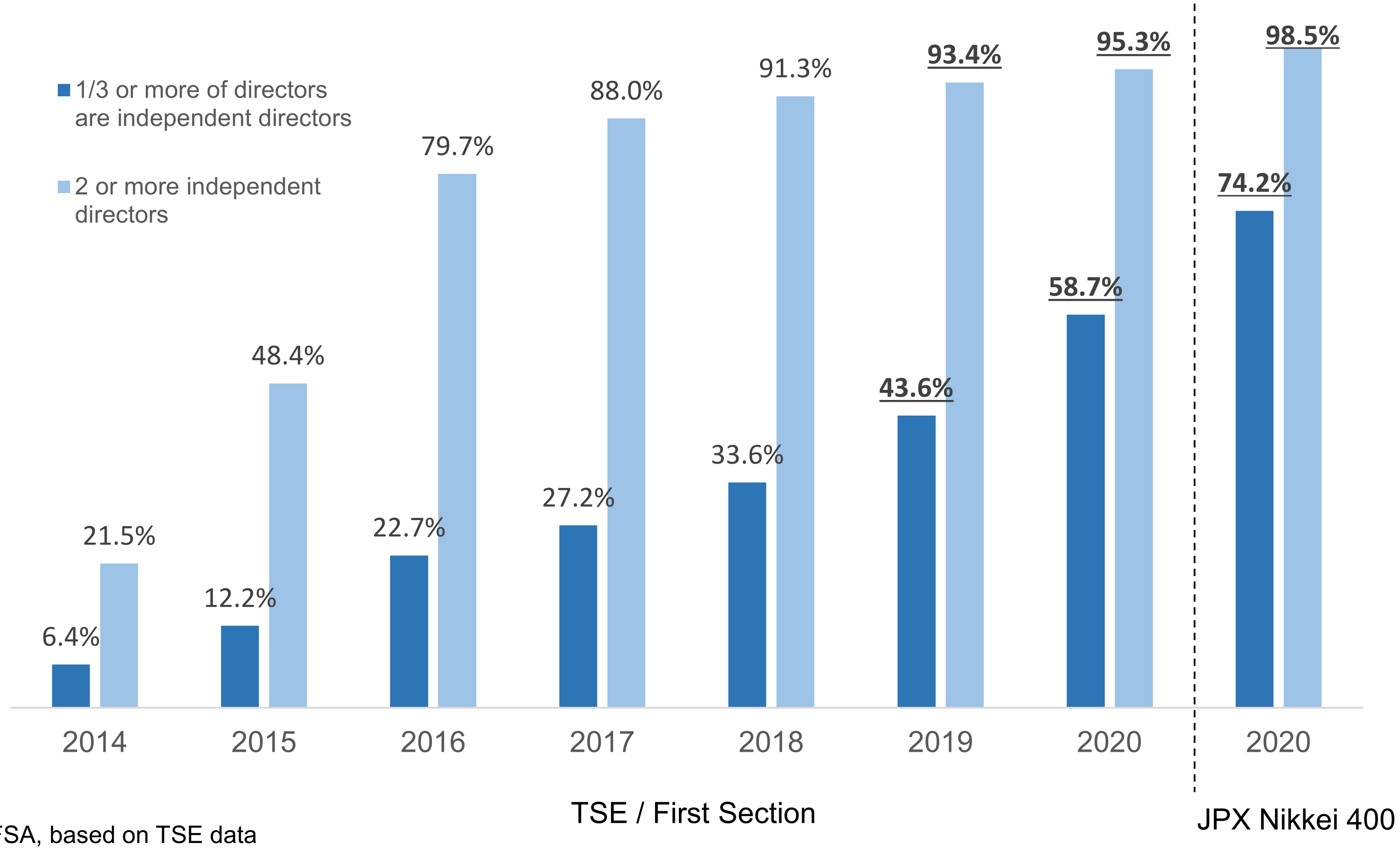
(Note 1) All industries included, except financial and insurance.
(Note 2) Cash and cash equivalents are cash and deposits + marketable securities (for trading or with maturity of one year or less)
(Source) Created by FSA from the corporate statistics

(Note 1) Cash to assets ratio: Cash and cash equivalents/total assets
(Note 2) Classification by size: large companies – Capital of 1.0bn yen or more. Mid-size companies – capital of 100mn to 1.0bn yen. Small/mid-size companies – capital of 10mn - 100mn yen.
(Note 3) All industries included, except financial and insurance.
Source: FSA, based on corporate statistics

Independent Directors

- **The number of companies with two or more independent directors** has increased significantly **to 95.3% of companies listed on the TSE First Section** and 98.5% of companies in the JPX-Nikkei 400.

Change in proportion of companies with two or more independent directors or where 1/3 or more of total number of directors are independent directors

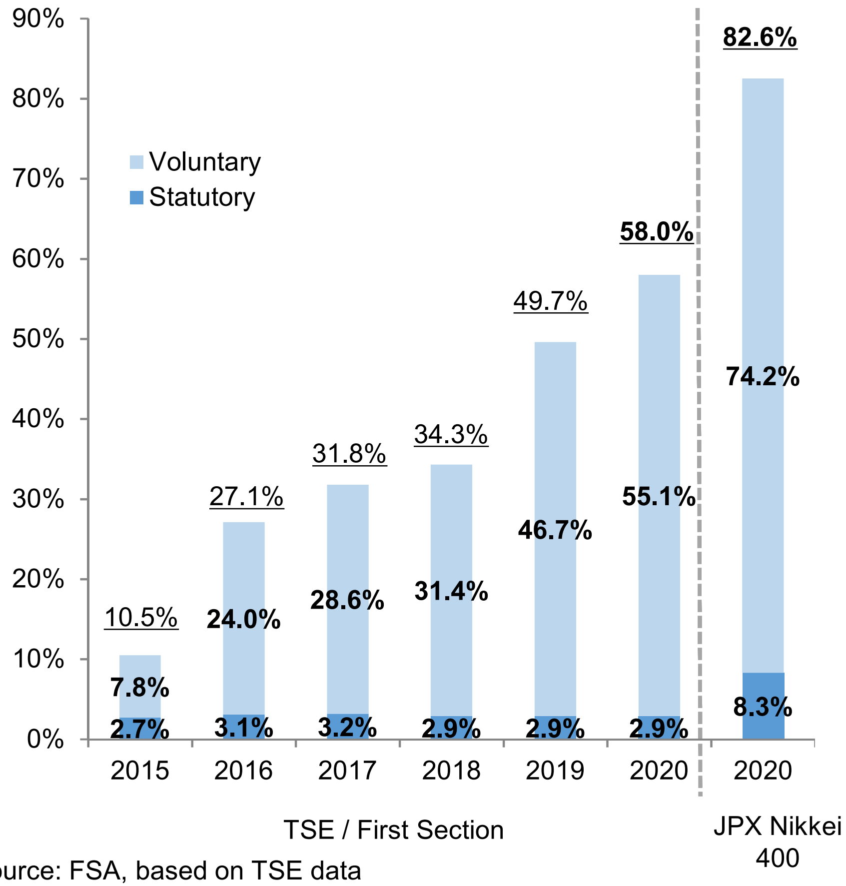


Source: FSA, based on TSE data

Status of Establishment of Nomination/Remuneration Committees

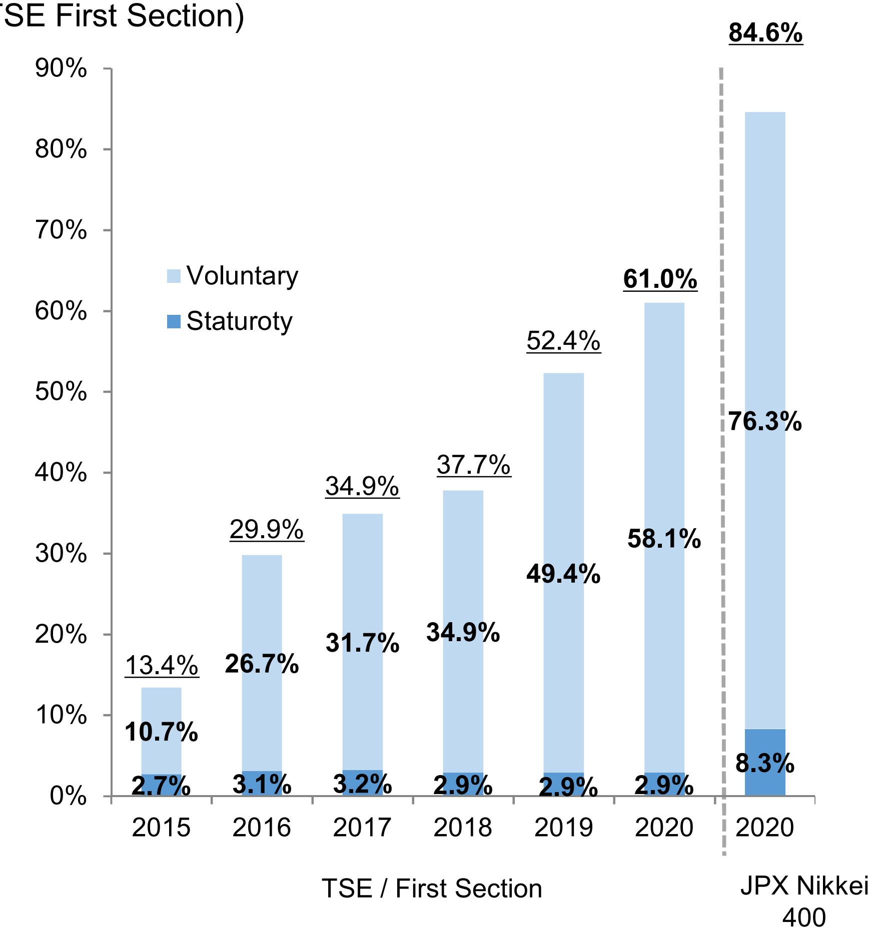
- The number of companies with statutory or voluntary **nomination committees and remuneration committees** is increasing, with approximately 60% of companies listed on the TSE First section now complying.

Growth trend of companies with a nomination committee (TSE First Section)



Source: FSA, based on TSE data

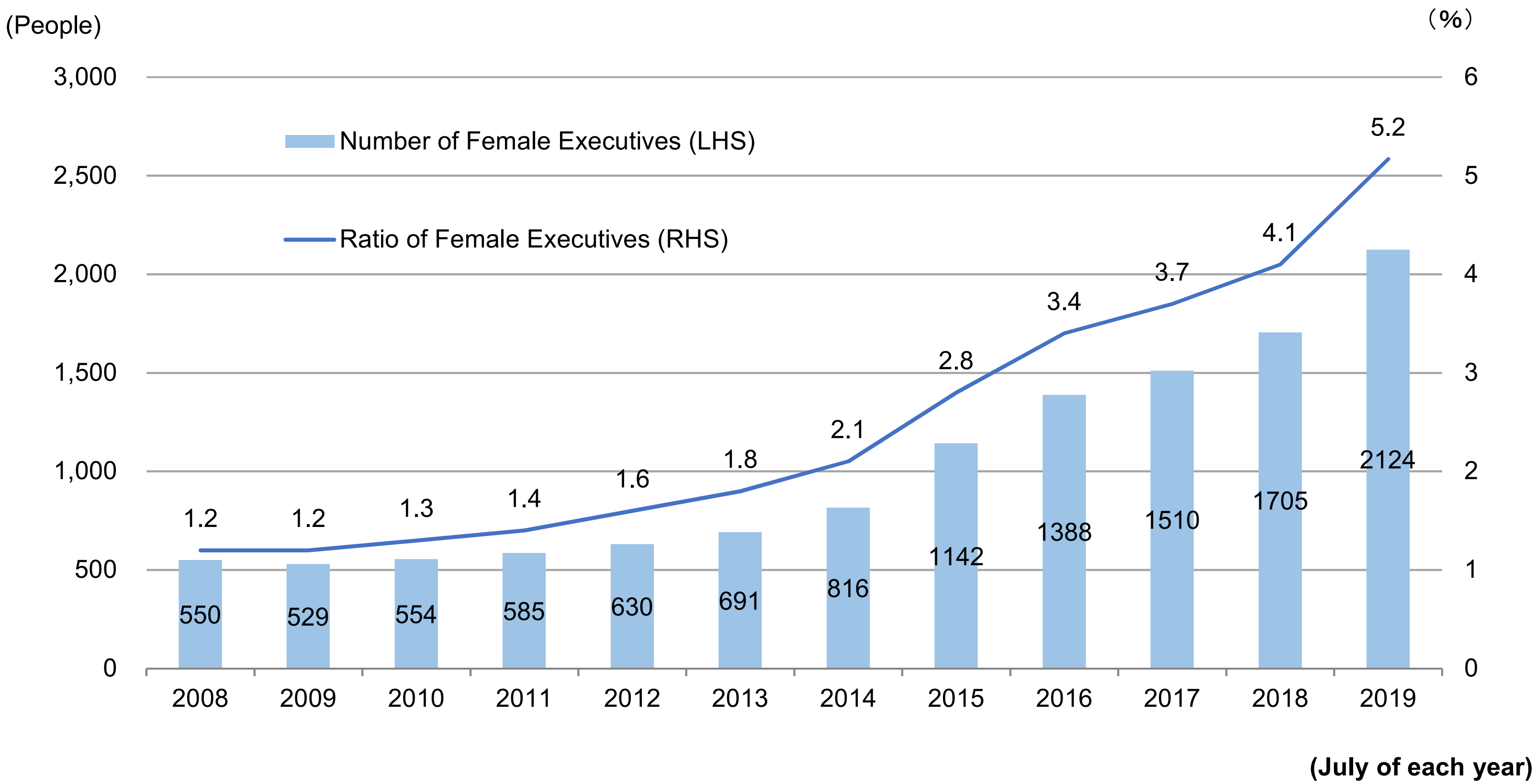
Growth trend of companies with a remuneration committee (TSE First Section)



Diversity (Female executives)

☐ Although there are now over **2,100 female executives** in listed companies, **only 5.2% of the total number of executives in listed companies are female.**

Change in number of female executives in listed companies

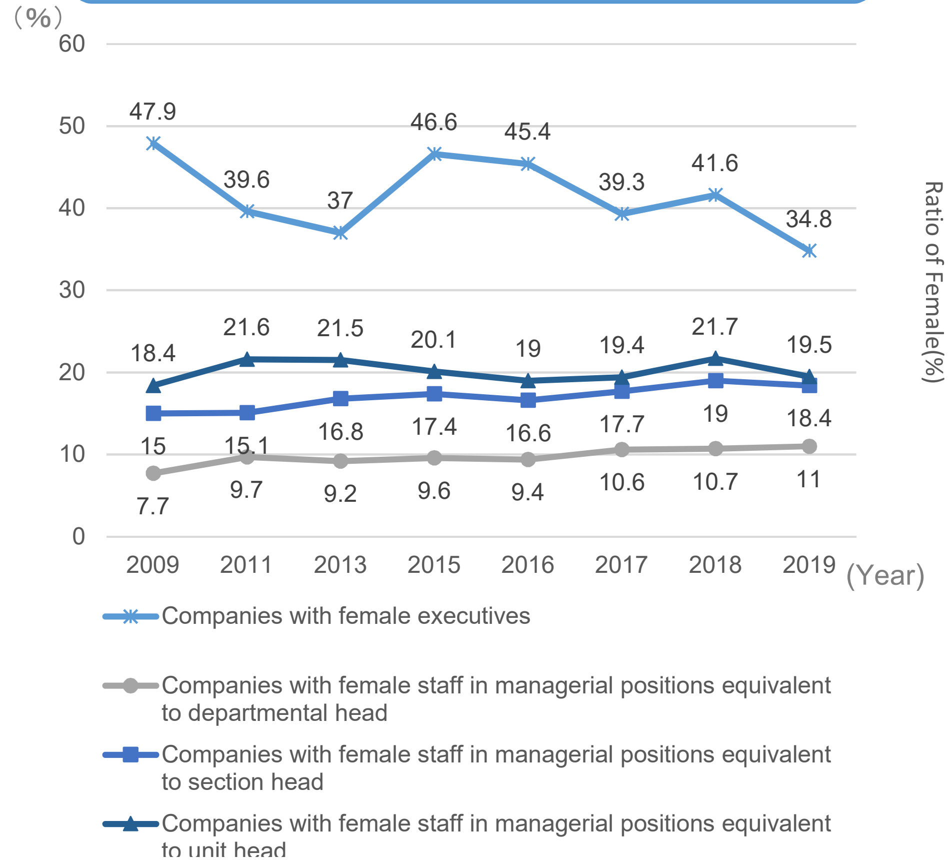


Note: The survey is typically carried out on July 31 each year. The survey comprises all listed companies, including JASDAQ companies.
"Executives" includes directors, accounting advisors, *kansayaku* (audit & supervisory board members), and *shikkoyaku* (executive officers) of Companies with Three Committees (Nomination, Audit and Remuneration).
Source: FSA, based on Cabinet Office data, "Yakuin Shikiho" (Executive Officers Handbook" Toyo Keizai Inc.

Diversity (Female managers)

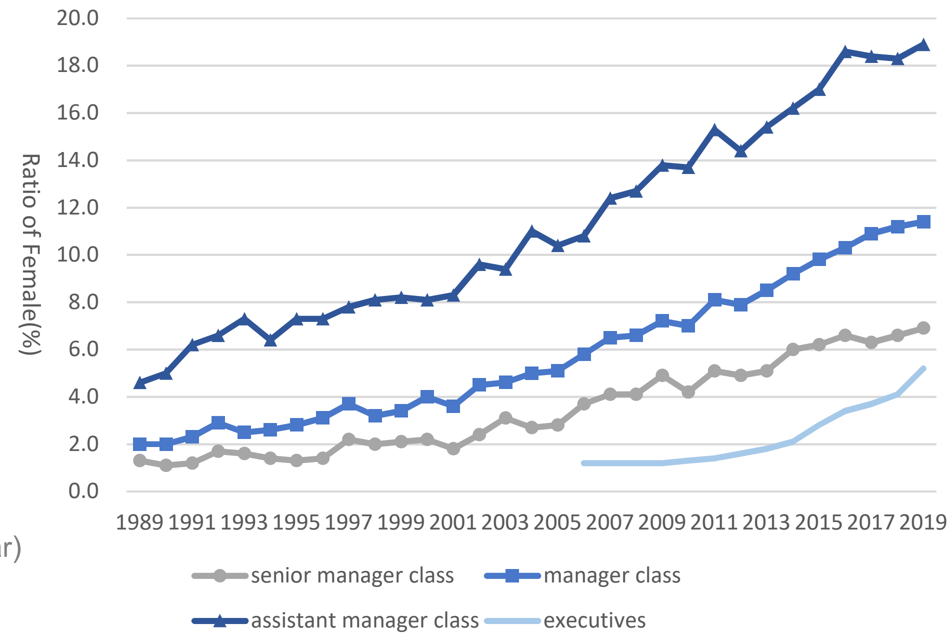
☐ **The percentage of companies with female staff in managerial positions,** whether department head, section head or unit head roles, **is lower than the percentage of companies with female executives.**

Change in percentage of companies with women in managerial positions (Companies with 10 or more employees)



Source: FSA, based on "2019 Basic Survey on Gender Equality in Employment Management" by the Ministry of Health, Labour and Welfare

Percentage of women in managerial or executive positions



Note 1: Staff without a defined period of employment in companies employing 100 or more regular workers.

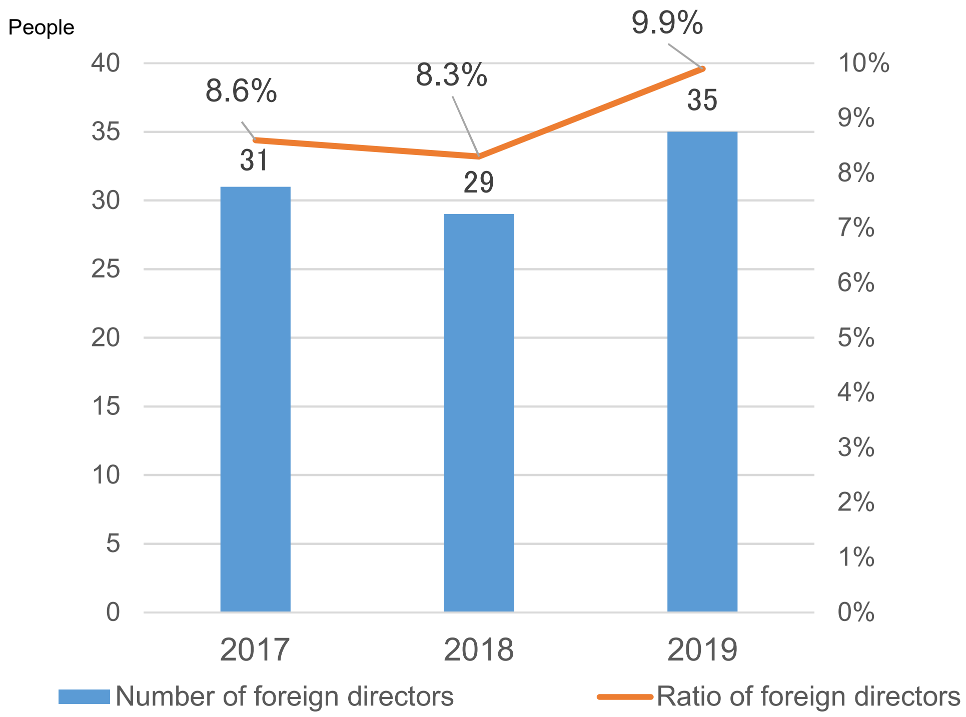
Note 2: Prior to 2017, the definition of regular workers is "workers employed without a defined period of employment," "workers employed for a period longer than one month" and "daily or monthly hire workers taken on in April and May for a period of 18 days or more." From 2018 onwards, the definition is "workers employed without a defined period of employment" and "workers employed for a period of at least one month."

Source: "White Paper on Gender Equality, 2020 edition", Professor Manabu Matsunaka, Nagoya University

Diversity (Internatilonality of foreign directors)

- The proportion of foreign directors in the top 30 companies by market capitalization is 9.9% (2019).
- Data also shows that the proportion of companies with foreign directors is 3.3% for Nikkei 225 (2018).

Trends in foreign directors (Top 30 companies by market cap)



Source: IR Japan

Ratio of foreign nationals on boards by country (2018)

France	UK	Germany	USA
35.0%	33.5%	25.3%	8.2%

Nikkei 225	TOPIX100
3.3%	5.0%

Source: Japan Spencer Stuart Board Index 2018

Percentage of companies with foreign directors (2018)

Nikkei 225	TOPIX100
20.9%	31.0%

Source: Japan Spencer Stuart Board Index 2018

Diversity (Mid-career recruitment)

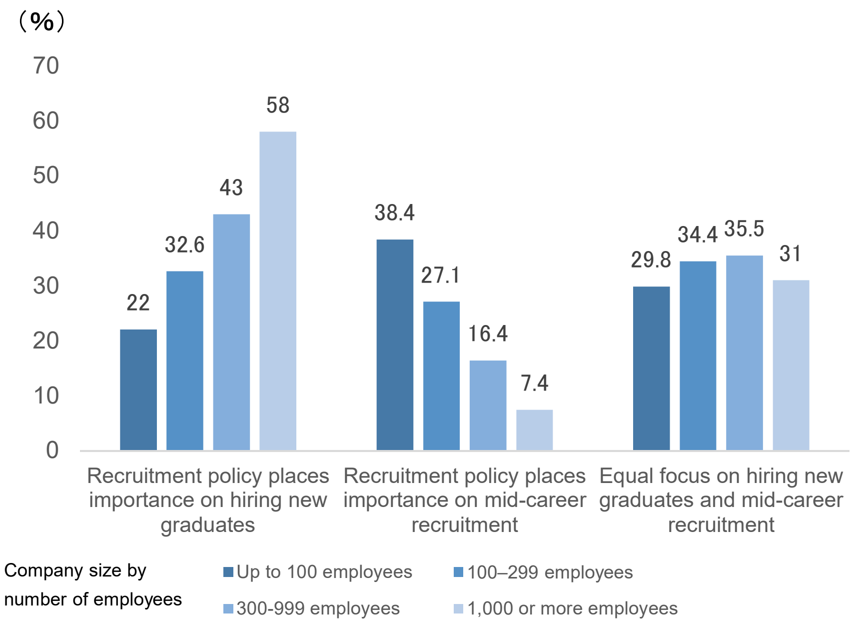
- In terms of mid-career recruitment, **the larger the number of employees in a company, the lower the mid-career recruitment rate.**
- In terms of recruitment policy, **some surveys indicate that the larger the number of employees in a company, the greater the emphasis on hiring new graduates.**

Ratio of recruitment: graduates; mid-career employees (2017)

		Number of companies	Recruitment ratio: New graduates (2018)	Recruitment ratio: Mid-career employees (2017)	Number of new graduates hired per company	Number of mid-career employees hired per company
Total		4,055	34.7%	**65.3%**	0.78	1.47
By size	5-299 people	2,084	23.3%	**76.7%**	0.38	1.25
	300-999 people	1,071	58.5%	**41.5%**	12.50	8.86
	1000-4999 people	710	59.6%	**40.4%**	35.71	24.20
	5000+ people	190	62.6%	**37.4%**	127.89	76.31

Note: New graduate recruitment refers to university graduate students and post-graduate students (graduation in 2018); mid-career recruitment (FY2017) refers to full-time employees.
Source: FSA data from "Mid-Career Employment Survey (2017 results)," Recruit Works Research Institute.

Recruitment policy for full-time employees

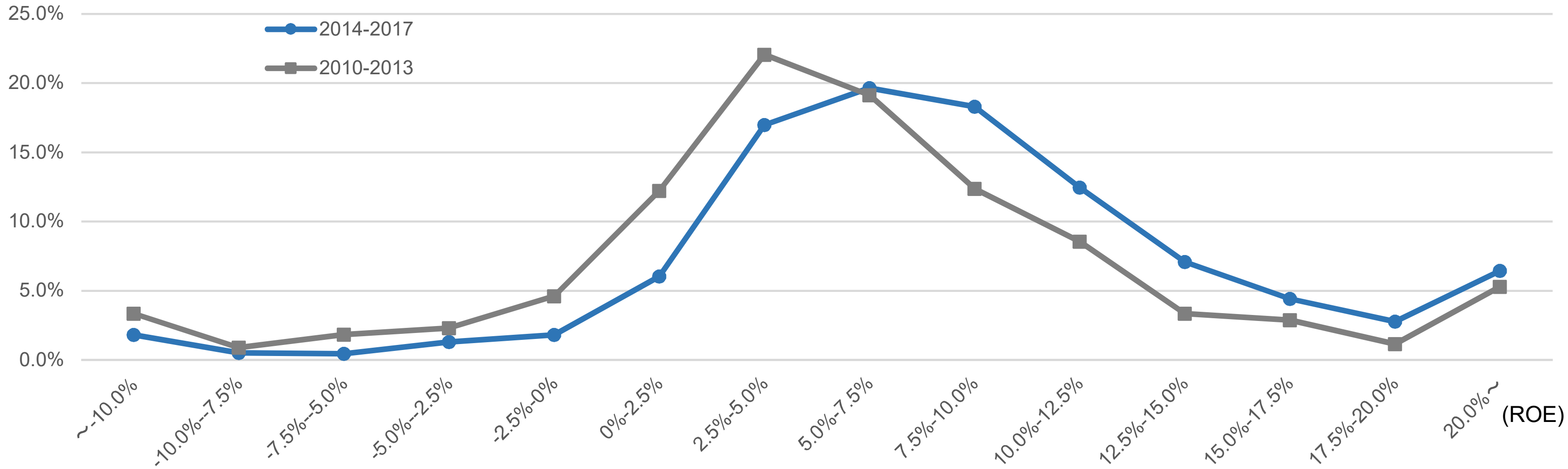


Note: Survey carried out in July 2017
Source: FSA, from Japan Institute for Labour Policy and Training, “Diverse Employment Policies of Companies.”

Cost of capital as a key management consideration (1)

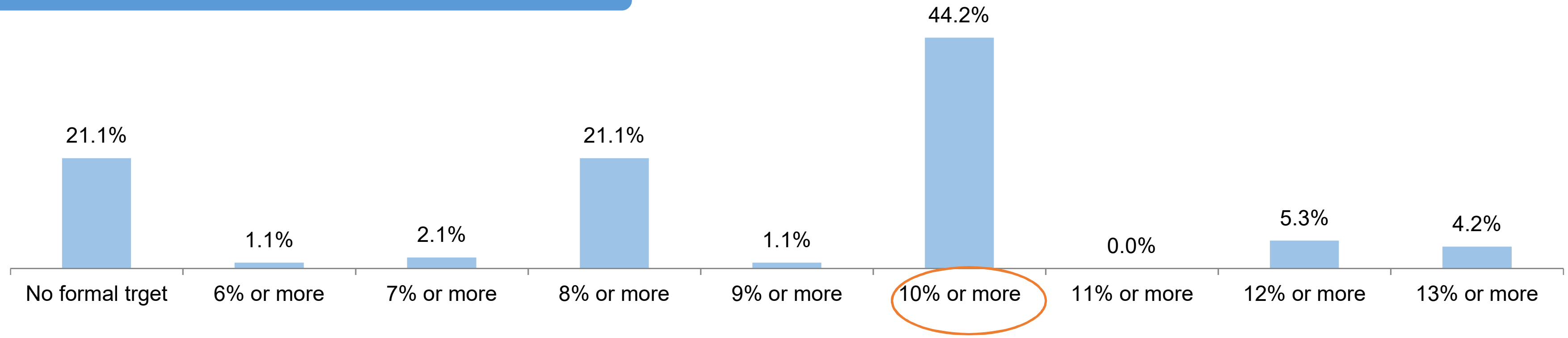
□ The proportion of companies focusing on ROE is rising overall, **but few companies are achieving the level expected by investors.**

Composition ratio for all companies



Note: TSE First Section companies - financial figures are shown for 2010 to 2017. Comparison shown between 2010-2013 and 2014-2017.
Source: FSA, based on data from Nikkei QUICK

Medium- or long-term ROE target (investors)

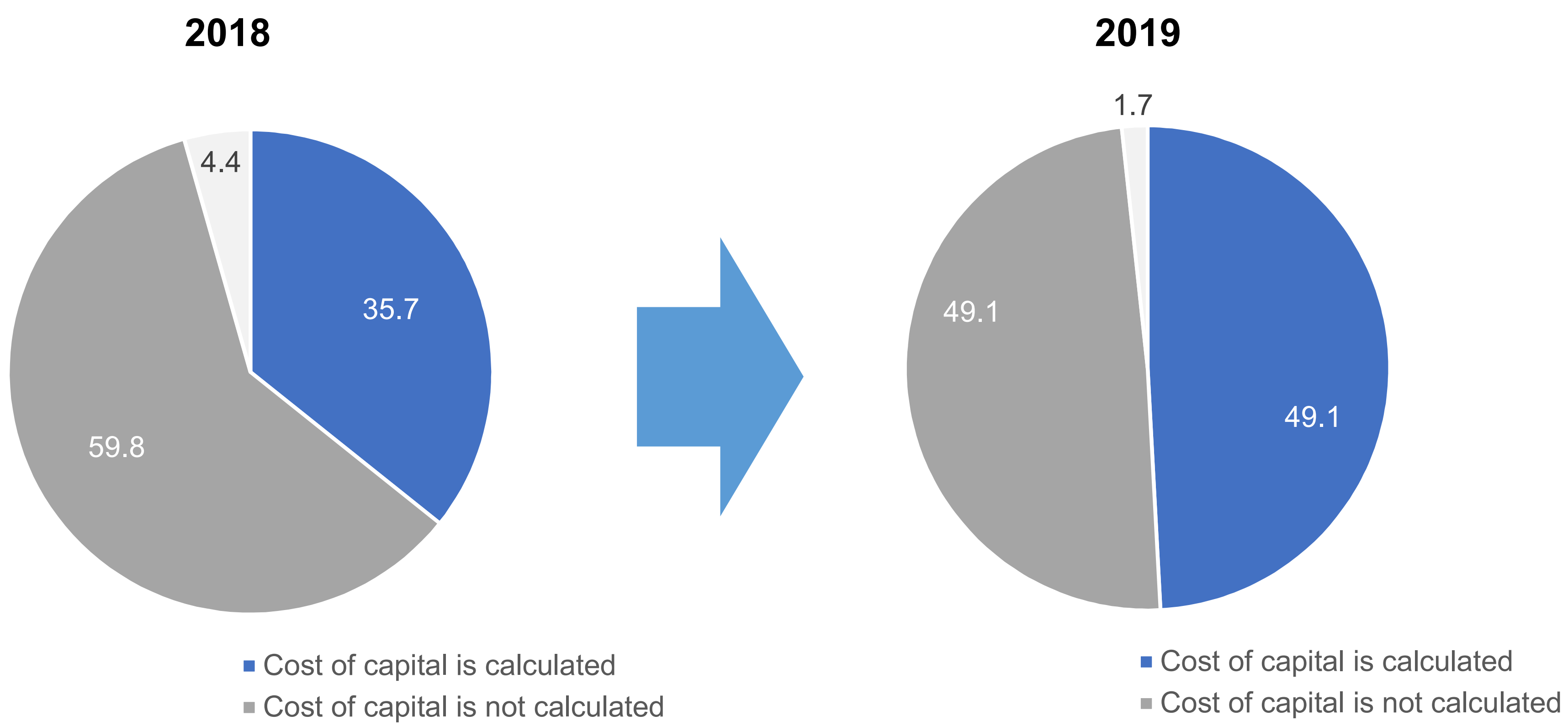


Note: Responses received from 97 institutional investors
Source: FSA, based on data from "Survey on Initiatives to Improve Corporate Value" (April 2020), Life Insurance Association of Japan

Cost of capital as a key management consideration (2)

- **The percentage of companies that calculate their cost of capital rose about 15% from 2018 to 2019**. While management awareness of the importance of cost of capital has **increased**, **approximately half of companies do not calculate their own cost of capital**.

Whether cost of capital is calculated (companies)



Source: FSA, based on "Corporate Governance Survey Results," Board Advisors Japan, Inc.

Cost of capital as a key management consideration (3)

- ROE is lower for Japanese companies than in Europe and the US. In particular, **there is a difference in profit margins between Japan and Europe/the US**.
- There has been no significant improvement in Japanese company margins since 2014.

<Comparison of Japan, US and Europe>

	Net profit margin (Net Income/Sales = ①)	Total asset turnover (Sales/Total assets = ②)	Leverage (Total Assets/ Shareholders' Equity = ③)	ROE (①* ②* ③)
Japan	8.5%	80.3%	3.9	10.1%
US	15.4%	66.0%	4.4	30.8%
Europe	19.1%	57.9%	6.0	17.5%

Note 1: Based on calendar year actual financial results.

Note 2: Data taken from TOPIX 500, S & P 500 and Bloomberg European 500 Index companies at year-end for which required data was available. Excludes companies recording a net loss or negative shareholders' equity.

<Japanese time series comparison>

	Net profit margin (Net Income/Sales = ①)	Total asset turnover (Sales/Total assets = ②)	Leverage (Total Assets/ Shareholders' Equity = ③)	ROE (①* ②* ③)
2019	8.5%	80.3%	3.9	10.1%
2018	8.8%	79.1%	4.0	10.5%
2017	8.6%	78.4%	4.0	10.1%
2016	8.2%	80.4%	4.2	9.5%
2015	8.0%	78.8%	4.1	9.0%
2014	7.4%	81.7%	4.2	9.0%

Note 1: Based on calendar year actual financial results.
Note 2: Data taken from TOPIX 500 Index companies at year-end for which required data was available. Excludes companies recording a net loss or negative shareholders' equity.
Source: FSA data compiled from Bloomberg

First revision of the Corporate Governance Code and formulation of "Guidelines for Investor and Company Engagement" (1)

More effective reform of corporate governance is required to increase corporate value over the medium- and long-term.
Revision of the Corporate Governance Code and establishment of guidelines for investor and company engagement ("New Economic Policy Package," Cabinet decision December 8, 2017).

Issues concerning corporate governance reform

- **Decisive management decisions**
- Policies on strategic and planned **capital investment, R&D investment, and human resources investment**
- Appointment/dismissal of CEOs based on objective, timely and transparent procedures
- **Ensure diversity of the board**
- **Reduce cross-shareholdings**
- **Increase investment management expertise of corporate pensions**

Revision of Corporate Governance Code

Stewardship Code
(Established in February 2014; revised in May 2017)

Formulation of "Guidelines for Engagement"
(Document accompanying both Codes)

Corporate Governance Code
(Established in June 2015; revised in February 2017)

Institutional investors

Constructive engagement

Companies

First revision of the Corporate Governance Code and formulation of "Guidelines for Investor and Company Engagement" (2)

June 2018

Issues concerning corporate governance reform	Key points in formulation of "Guidelines for Investor and Company Engagement" and revisions of Corporate Governance Code (*)
Decisive management decisions	• Making decisive management decisions on such matters as reviewing of the company's business portfolio, and clarifying the relevant policies based on such decisions • Accurately identifying the company's cost of capital
Policies on strategic and planned capital investment, R&D investment, and human resources	• Implementing strategic/systematic investments in property, plant and equipment, R&D, and human resources • Developing/implementing appropriate financial management policies including those on the use of cash on hand
Objective, timely and transparent appointment/dismissal of CEO	• Establishing an objective, timely and transparent process to appoint and dismiss CEO(e.g. using the independent Nomination Committee)
Ensure diversity of the board	• Ensuring that the board is equipped with sufficient knowledge, experience, and skills to appropriately fulfill its roles; and ensuring the diversity of the board (gender, international experience, etc.)
Reduce cross-shareholdings	• Reviewing objectives of cross-shareholdings and benefits/risks of such holdings, and clarifying its policy on cross-shareholdings
Improving expertise of corporate pension funds	• Sponsoring companies' efforts on recruiting and assigning qualified persons who contribute to increasing investment management expertise of corporate pension funds

(*) The revision of the Corporate Governance Code was made to address these key points.
In addition, "Guidelines for Engagement" was formulated to improve the effectiveness of dialogue between institutional investors and companies.

Outline of Stewardship Code

Established on February 26, 2014
Revised on May 29, 2017
Second revised on March 24, 2020

- **Principles of conduct for institutional investors, etc. to fulfill their responsibilities (stewardship responsibilities) for the sustainable growth of companies and enhancement of medium- and long-term investment returns for their clients and beneficiaries through engaging in a "constructive dialogue" with investee companies.**

Framework

- Expects each institutional investor to decide whether to sign up the Code or not. The FSA will publish the list of signatories, and thereby encourage more institutional investors to sign up the code.
- Principles-based approach: Determining whether **actions are truly appropriate based on aim and spirit, rather than language and rules**.
- "Comply or explain": The Code adopts an approach that requires companies to "**comply with the principles or explain why they are not complied with**" rather than mandatory requirements like laws/regulations.

Overview

Institutional investors should:

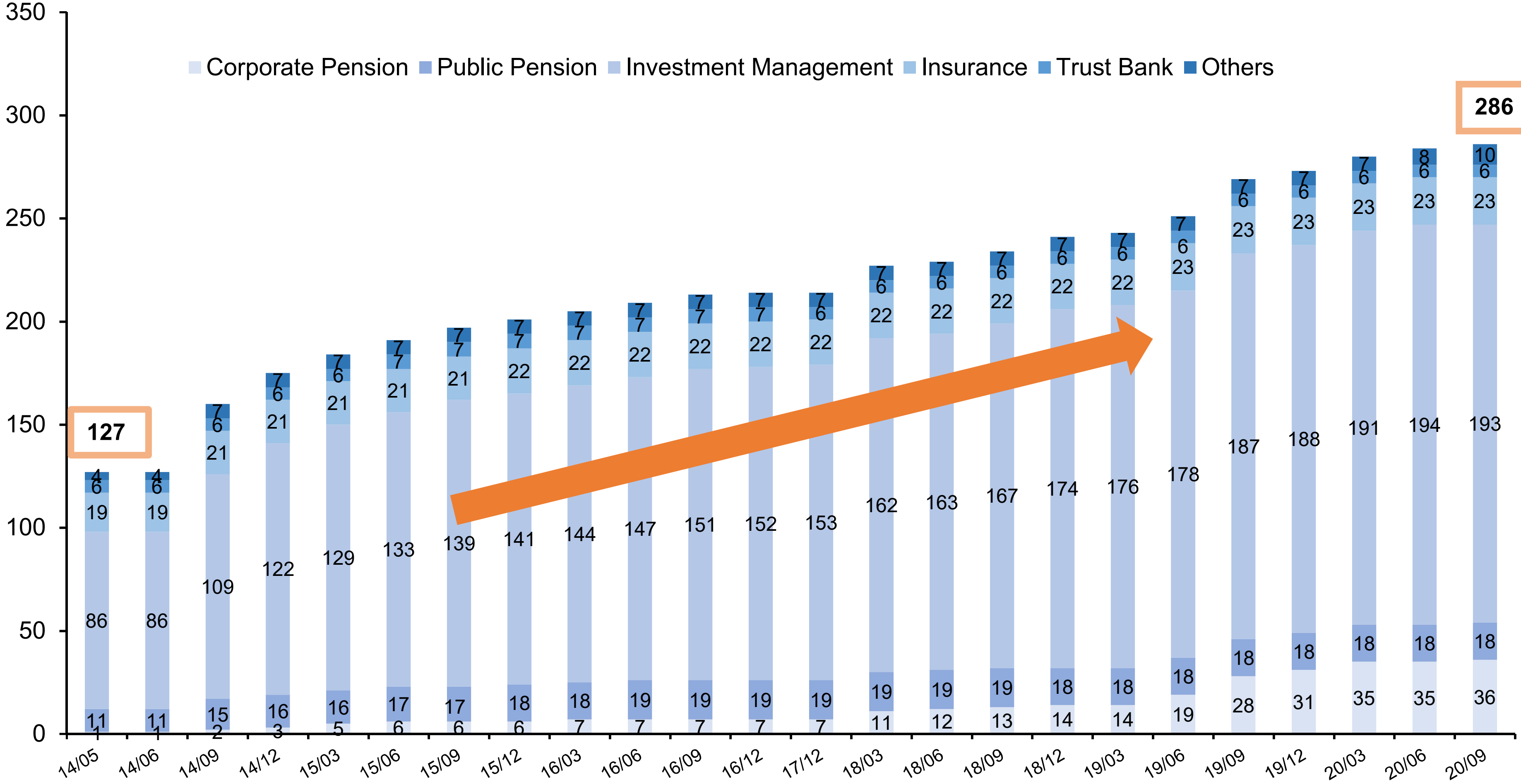
1. disclose a clear **stewardship policy**,
2. properly manage **conflicts of interest**,
3. **monitor** investee companies,
4. arrive at an understanding in common with investee companies and solve problems through **engagement**,
5. have a clear **voting policy** and **disclose voting records**,
6. **report** to clients/beneficiaries, and
7. have **skills & resources necessary for engagement**.

Service providers for institutional investors should

8. Endeavor to **provide services appropriately for institutional investors to fulfill their stewardship responsibilities**.

Acceptance of Japan's Stewardship Code

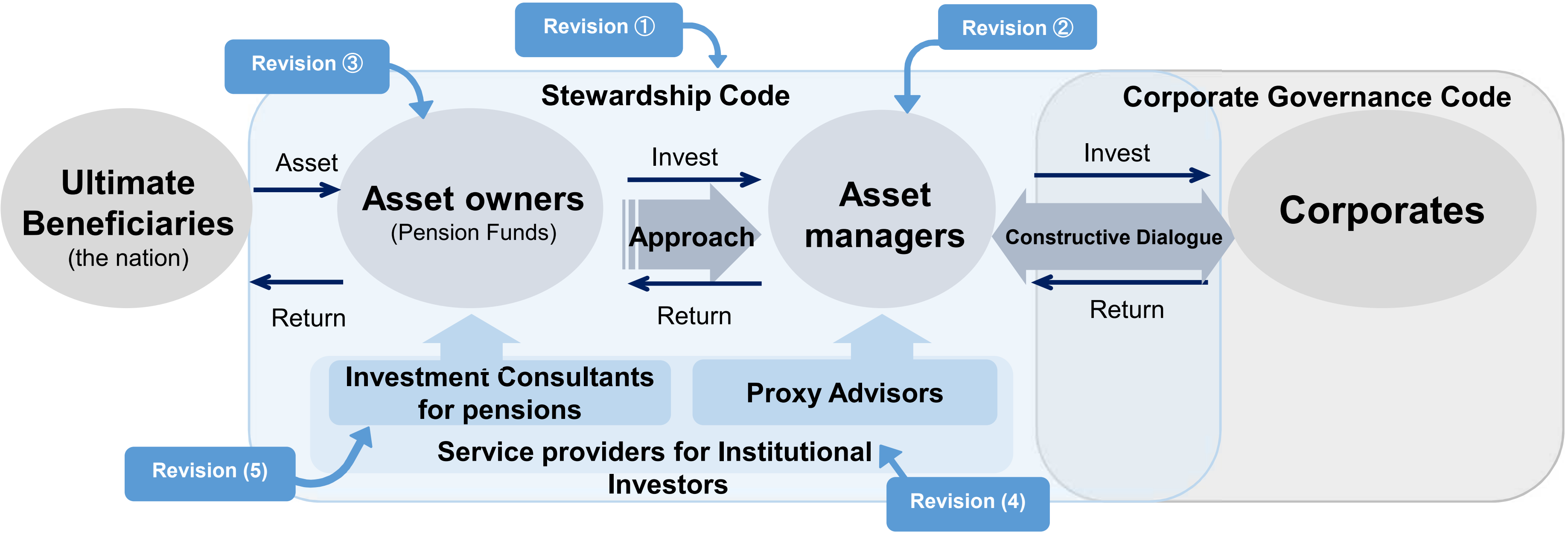
- After the establishment of the Stewardship Code in Japan in February 2014, the number of institutions that have accepted it has increased constantly, and **286 institutions** have announced their acceptance as of August 31, 2020.
- The revised Stewardship Code for March 2020 is already endorsed by **59** institutions (42 investment institutions, 17 corporate pension funds) (as of August 31, 2020).



Source: FSA

Key Points to the Second Revision to Japan's Stewardship Code(2020)

- To further promote the effectiveness of corporate governance reform, based on discussion in the Council of Experts on Stewardship Code (held three times between October 2019 and December 2019), Japan's Stewardship Code was revised.



<Key Points>

① **General Discussions:** (1) Consciousness of "medium- to long-term increase of corporate value"
(2) Consideration of "sustainability" (medium- to long-term sustainability)
(3) Applying to other asset classes

② **Asset Managers**: Improvement of disclosure to promote constructive dialogue

③ **Asset Owners**: Support for the stewardship activities of corporate pension funds

④ **Proxy Advisors**

⑤ **Investment Consultants for pensions**

(④, ⑤): Improvement of quality of services for institutional investors

Key Points to the Second Revision to Japan's Stewardship Code (2020)

	Key Points to the Second Revision
1) General Discussions	(1)Consciousness towards **the medium- to long-term increase of corporate value** in stewardship activities (2) Consideration of **sustainability** (medium- to long-term sustainability including **ESG factors**) (3) **Applying to other asset classes, e.g. bonds,** as far as it contributes to carrying out stewardship responsibilities
2) Asset Managers	• Asset managers should **disclose the reasons of votes on the agendas of investee companies, either "for" or "against"**, which are considered important from the standpoint of constructive dialogue with investee companies, including those suspected to have conflicts of interest or those which need explanation in light of their voting policy. • Regarding **self-evaluations and stewardship activities** including dialogue with companies, it is important to **disclose** them with consciousness of the sustainable growth of companies and the medium- to long-term increase of corporate value.
3) Asset Owners	• **Conduct stewardship activities corresponding to their size and capacity, etc.**
4) Proxy Advisors	In order to assure accuracy and transparency of proxy recommendations, proxy advisors should: • **develop appropriate and sufficient human and operational resources** (including setting up a business establishment in Japan) • **assure transparency of proxy recommendation process** • **exchange views actively with companies**
5) Investment Consultants for pension	• **Develop structures of conflicts of interest management.**

Issues concerning Corporate Governance (Summary of opinion statement of the Follow-up Council)

- In order to further promote corporate governance reform, the Council of Experts Concerning the Follow-up of Japan's Stewardship Code and Japan's Corporate Governance Code has summarized the opinion statement including **ongoing issues regarding corporate governance reform.** （published on April 24th, 2019）

Recommended Directions for Future Directions for Corporate Governance
(The Council of Experts Concerning the Follow-up of Japan's Stewardship Code and Japan's Corporate Governance Code : Opinion Statement No. 4)

Ensuring Confidence in (Internal) Audits	Promote the establishment of processes where the internal audit department **reports to organizations which are independent from management, such as the Board of Directors, Audit Committees, the kansayaku Board, etc**.
Group Governance	Continue to **review further group governance** from **the standpoint of protecting general shareholders**, based on the discussions with respect to group governance including discussions on governance of listed subsidiaries.