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

Material 2

Provisional translation

Secretariat Briefing Pack

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金融庁
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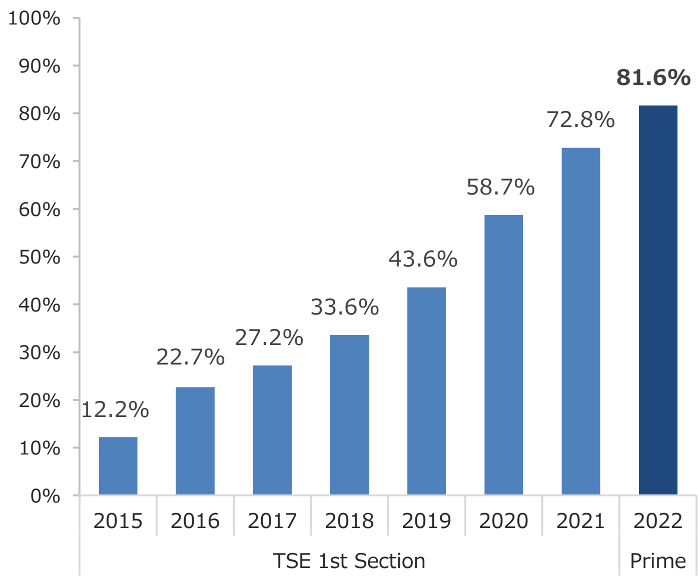
Contents

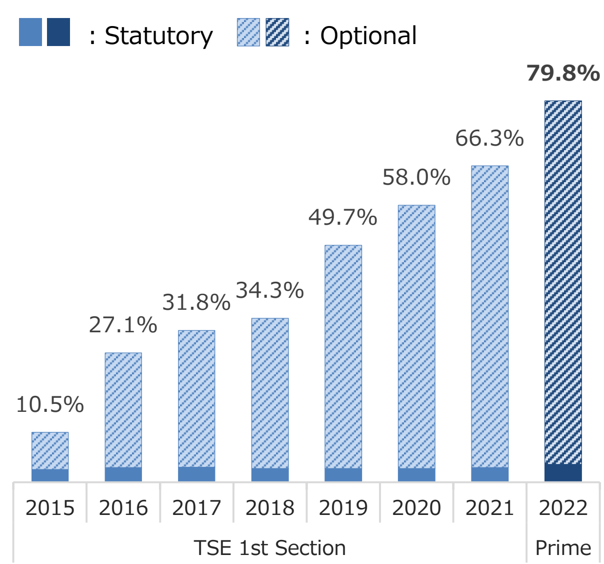
Interim review following the 2021 revision of the Corporate Governance Code (1)

- Since the formulation of the Stewardship Code in 2014, a series of corporate governance reforms have been implemented. Following the 2021 revision of the Corporate Governance Code, companies have made progress in their efforts to reform corporate governance systems.
- Examples of the progress of corporate governance systems of listed companies as of April 2022 are:
  - At more than 80% (81.6%) of companies listed on the Prime Market, at least one third of their directors are independent directors.
  - Slightly less than 80% (79.8%) of companies listed on the Prime Market have established nomination committees and more than 80% (82.0%) have established compensation committees, both including optional (non-statutory) ones.

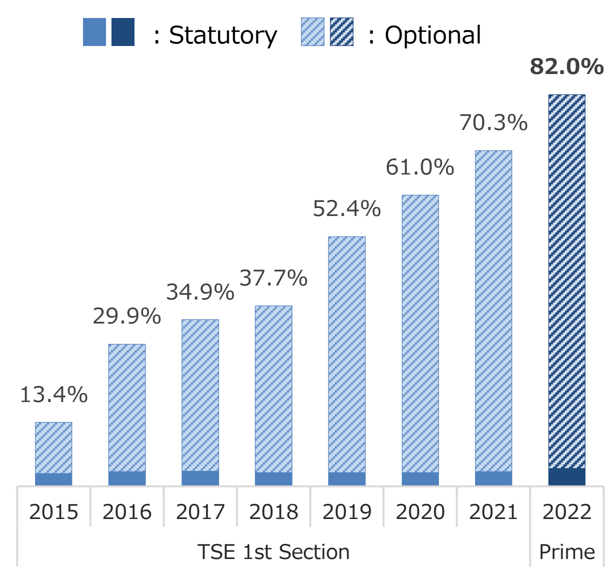
Trend in the proportion of companies where 1/3 or more of the directors are independent directors



Trend in the number of companies with a nomination committee



Trend in the number of companies with a compensation committee



Note: 2022 figures are based on the corporate governance reports as of April 14, 2022.
Source: Tokyo Stock Exchange, Inc.

Interim review following the 2021 revision of the Corporate Governance Code (2)

- While corporate governance reforms of Japanese corporates are making progress, companies and investors have pointed out the following issues.

  Companies say:

  - Although the Code is a framework of "comply or explain," companies are concerned about whether investors will fully understand if the companies choose to "explain," and the consideration process for such explanation is strenuous. Under such circumstances, in some cases, responses to the Code may become formalistic.
  - It should be examined whether Code revisions and corporate governance reforms of Japanese corporates lead to improvements in corporate value or "earning power."

  Institutional investors say:

  - Further reforms, including on the institutional settings that support constructive engagement, are necessary.
  - Further utilization of hoarded cash and deposits and accumulated retained earnings should be considered to realize sustainable growth.

- As part of the interim review following the 2021 revision of the Corporate Governance Code, the following two pieces of work were carried out when companies' responses to the revised Corporate Governance Code came out and the TSE stock market restructuring was launched.
  - i. Review of empirical research on the effects/impacts of corporate governance
  - ii. Interviews with companies about their corporate governance initiatives

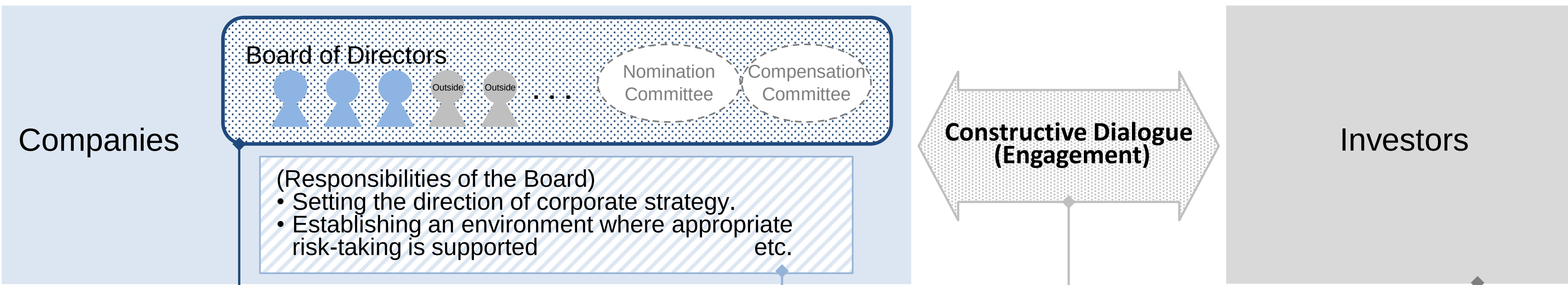
Focus of the review

- ✓ Details of initiatives to enhance and strengthen the governance of listed companies; their effects and factors that contributed to such effects; ideas to link governance to earning power; and issues to be tackled towards substantial reform at present.
- ✓ Evaluation of and issues for constructive engagement between investors or stakeholders and listed companies, as well as ideas to make engagement effective

Contents

Empirical research on effects/impact of corporate governance reforms - summary

- Overseas, there has been an accumulation of empirical research on the conditions under which corporate performance is affected by corporate governance systems and shareholdings by institutional investors.
- On the other hand, the number of empirical studies covering the period after the implementation of Japan's corporate governance reforms is not yet large, and the research results vary, resulting in an undetermined evaluation of the reforms.



Implications from Empirical Research

Outside Directors

(Pre-reform research)

- **Appointment of outside directors boosts market valuation.**

(Post-reform research)

- **No statistically significant relation between the appointment of outside directors and corporate value**

Committees

Firms with nomination & remuneration committees have higher ROA growth rate.

Capital Policy

Reduction of surplus cash and deposits by companies with poor capital efficiency boosts market valuation.

Cross-shareholdings

- **The higher the number of cross-shareholdings, the lower the profit margin, and the profit margin improves by selling them.**
- **Unwinding cross-shareholdings increases share repurchases and dividends**, **but does not contribute to increases in R&D, real investment, or M&A.**
- After the formulation of the Corporate Governance Code, the probability of sale of cross-shareholdings has increased.

Engagement

Engagement with institutional investors leads to better governance and higher share prices.

Shareholders

- **The higher the ratio of active investors, the better the R&D results of manufacturing companies become.**
- **Higher company's institutional / foreign shareholder ratio leads to the higher productivity and market evaluation.**

Note: "Empirical research" refers to analyses on how corporate governance reform initiatives (including the appointment of outside directors) have affected corporate performance measured by ROE, ROA, share price, etc., using statistical methods.

Source: Prepared by JFSA, using materials provided by Professor Hideaki Miyajima, Waseda University, Associate Professor Takuji Saito, Keio University Graduate School, and Professor Tsumuraya

[Appendix] Empirical research on the effects/impact of corporate governance reforms - global

- Globally, there has been an accumulation of empirical research on the conditions under which corporate performance is affected by corporate governance systems and shareholdings by institutional investors.

Corporate Governance	● Gompers et al. (2003) found that a well-developed corporate governance system enhances corporate performance. ● For pathways to firm performance: ➢ Multi-country comparisons, particularly in emerging economies, show that well-developed corporate governance systems promote risk taking and M&As. For example, John et al. (2008) showed that well-developed corporate governance increases risk taking as measured by earnings volatility. ➢ Many studies in the United States have shown that the existence of management right markets and block shareholders promotes business reorganization. ➢ Kaplan & Minton (2012) showed that recent changes in corporate governance in the United States have led to an increase in the frequency of management changes and in the performance sensitivity since the 1990s.
Engagement and Share Owners	● For U.S. companies, clear empirical findings on the effect of existence of block shareholders and institutional shareholding ratio on firm performance are scarce. On the other hand, Ferreira & Matos (2008) showed that the foreign institutional shareholding ratio of listed companies in 27 countries around the world, including emerging countries, has a positive effect on market evaluation and ROA. ● On the other hand, Short et al. (2002) in the United Kingdom and Jeon et al. (2011) in South Korea showed that large holdings by institutional investors increases dividends, while no clear effects on capital policies such as dividends and cash holdings have been detected in the United States, and Aggarwal et al. (2011) showed that institutional ownership increases the performance sensitivity of management changes in 23 emerging economies.

Source : Prepared by JFSA from "Corporate Governance and Growth Strategies" (edited and written by Hideaki Miyajima, Toyo Keizai Inc., 2017)

Recent empirical research on the effects/impacts of corporate governance reforms (1) – outside directors

- At present, the number of empirical studies conducted after the implementation of corporate governance reforms in Japan is not necessarily large.
- The majority of empirical research on the relationship between outside directors and corporate value prior to the implementation of reforms indicated that the introduction of outside directors would increase market evaluation. On the other hand, many studies conducted after the implementation of reforms shows that there is no significant relationship between outside directors and corporate value, resulting in an undefined evaluation of the reforms.

Recent empirical research on the relationship between outside directors and corporate value

	Year of analysis	Independence	Explained variable	Results
Oyanagi & Sekiguchi (2001)	2000	Not considered	Original score, which is the sum of growth rate in sales and ratio of ordinary profit to sales	Mixed results
Miyajima, Haramura, Inagaki (2003)	2002	Not considered	Tobin's Q, ROA	No impact
Yoshikawa & Phan (2003)	1999 - 2000	Considered	ROA, TSR	No impact
Miyajima, Nitta, Saito, Omi (2004)	1986 - 2000	Not considered	TFP	No impact
Miwa (2006)	FY 2004	Considered	Tobin's Q	Significantly positive
Miyajima & Nitta (2006)	1998 - 2004	Partially considered	ΔROA	Significantly positive
Irie & Noma (2008)	March 2007	Considered	Tobin's Q, ROA	Significantly positive on Q, not significant on ROA
Uchida (2009)	FY 2003 - 2004	Not considered	Tobin's Q, ROA	Significantly positive on Q, not significant on ROA
Saito (2009)	1996 - 2006	Not considered	ROA	Significantly positive
Miwa (2010)	2004 - 2008	Considered	Tobin's Q, ROA	Significantly positive on Q, not significant on ROA
Shimizu (2011)	2004.3 - 2008.3	Not considered	Tobin's Q	Significantly positive
Uchida (2012)	2002.12 - 2011.03	Not considered	Tobin's Q	No impact
Saito (2012)	1997 - 2007	Not considered	ΔROA	Significantly positive
Miyajima & Ogawa (2012)	2005 - 2010	Considered	ROA	Mixed results
Takeda & Nishitani (2014)	March 2012	Considered	Tobin's Q	Significantly positive
Kim & Kwon (2015)	2005 - 2010	Not considered	TFP	No impact
Miwa & Ramseyer (2015)	1986 - 1994	Not considered	Q, TSR, ROA, ROE (ordinary profit), growth rate of total assets	Significantly negative
Morikawa (2019)	FY 2009 - 2016	Considered	ΔROA and ΔTFP	No impact
Kochiyama & Ishida (2020)	2015 - 2016	Not considered	Tobin's Q, ROA	No impact
Noma & Fujimoto (2020)	2014 - 2017	Considered	CAPEX, R&D, ROA, TFP	No impact
Noma &Fujimoto (2021)	2004.3 - 2016.3	Not considered	Tobin's Q, ROA, ROABEI, dividend ratio	Significantly positive on Q, ROA and dividend ratio

Source : Prepared by Professor Tsumuraya

Recent empirical research on the effects/impact of corporate governance reforms (2) - establishment of committees, capital policy

- Some research on the establishment of committees indicates that the establishment of nomination and compensation committees improves ROA.
- Some research on capital policy indicate that if a company with poor capital efficiency reduces its surplus cash and deposits, the market's evaluation will increase.

Recent empirical research on the relationship between board structure, capital policy, and corporate value

Area		Start of analysis	End of analysis	Results
Establishment of Committees	METI (2018)	2013	2017	• The following features have a positive correlation with the growth in ROA over the formulation of the Corporate Governance Code: - Establishment of a nomination committee (particularly at companies whose nomination committee discusses the appointment of the President and CEO) - Establishment of a compensation committee (same as above) - Companies whose board of directors or nomination committee oversees the succession plans of the President and CEO
Establishment of Committees	Ohashi (2018)	2004	2016	• There is no statistically significant difference between companies with three committees and companies with an audit & *Kansayaku* board in terms of the timeliness of loss recognition (loss recognition is faster than profit recognition). • Although the timeliness of loss recognition is not statistically significantly related to the externality of an audit committee in a company with three committees, it increases as the size of the audit committee becomes smaller or the number of accountants becomes fewer.
Capital policy Cross-shareholdings Outside director	Ito et al. (2017)	2013	2017	• Over 2015, - increase in dividends and changes in ROE, ROA, and Tobin's Q have a statistically significant positive correlation. - decrease in surplus cash and deposits has a statistically significant positive correlation with changes in Tobin's Q for companies with ROE below 8%. - decrease in cross-shareholdings has a statistically significant positive correlation with changes in Tobin's Q. - increase in the number of outside directors from zero to one results in an increase in changes in ROE and ROA (significant).
Capital policy	Oku, Takahashi, Watanabe (2018)	2016	2016	• Among companies that acquired shares in other companies or conducted share buybacks, "companies with room for improvement in capital efficiency" (e.g., excess cash holdings) experienced higher share price growth than "other companies," although statistical significance was not obtained.

Source : Prepared by JFSA

Recent empirical research on the effects/impact of corporate governance reforms (3) - Cross Shareholding etc.

- A study indicates that the more cross-shareholdings a company holds, the lower its profit margin, and that selling them improves its profit margin. Another study indicates that unwinding cross-shareholdings increases share repurchases and dividends but does not contribute to an increase in R&D, investment in tangible assets, or M&A.

Recent empirical research on the relationship between board structure, capital policy, and corporate value

Area		Start of analysis	End of analysis	Results
Cross-shareholdings	Tsumuraya, Yagira, Kim (2020)	2010	2018	• Companies with more cross-shareholdings have lower profit margins in the next fiscal year, and higher profit margins and sales growth rates after the sale of cross-shareholdings (both results are statistically significant). • Although the profit margins of companies with a large amount of cross-shareholdings tends to stabilize significantly, it does not increase further at companies with a certain level or more cross-shareholdings.
Cross-shareholdings	Jidinger & Miyajima (2020)	2011	2017	• Unwinding cross-shareholdings contributes to increased share repurchases and dividends, but does not contribute to increased R&D, investment in tangible assets, or M&A.
Cross-shareholdings	Noguchi (2022)	2018	2021	• Profits of companies with a high ratio of cross-shareholdings are reflected statistically significantly lower in share prices, while profits of companies with a ratio of 0% are reflected statistically significantly higher.
Other	Ishima (2019)	2009	2017	• Audit fees for companies that disclose critical internal control issues are statistically significantly higher than for companies that do not disclose them. • Companies that revise annual securities reports during a fiscal year are statistically significantly more likely to disclose critical internal control issues at the end of the fiscal year.

Source : Prepared by JFSA

Recent empirical research on engagement and share ownership

- Some studies indicate that engagement with institutional investors contributes to improving corporate governance and stock prices.
- A study indicates that a high ratio of active investors' ownership improves R&D performance in manufacturing, while that of passive investors do not. Another study indicates that a high ratio of institutional shareholders and foreign investors improves productivity (ROA) and market valuation.

Recent empirical research on the relationship between engagement or share ownership and corporate value

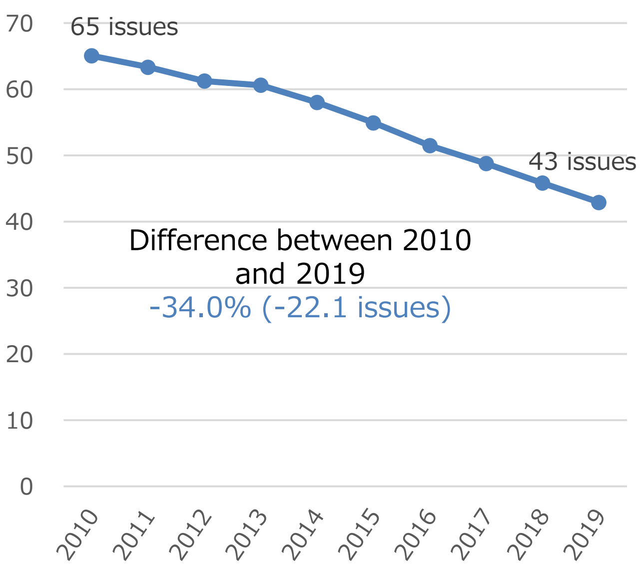
Area		Start of analysis	End of analysis	Results
Engagement and Share ownership Outside director	Inoue (2020)	2011	2018	• The probability of business sales is statistically significantly higher for companies with a higher ratio of institutional investors, foreign investors, active investors, and outside directors (since 2016). • A high ratio of active investors has a statistically significant positive effect on manufacturing companies' R&D performance, while the ratio of passive investors has no positive effect.
Engagement and Share ownership Board Structure	Kojima et al. (2020)	2014	2018	• Family-owned companies have better Tobin's Q but worse ROA than non-family-owned companies (both statistically significant). • Institutional shareholders have a statistically significant positive effect on the performance of both family-owned and non-family-owned companies. • Size of the board of directors is positively correlated with the performance of non-family-owned companies, but not with that of family-owned companies. • While foreign ownership increases the ROA of both family-owned and non-family-owned companies, the independence of the board of directors statistically and significantly hinders the performance of family-owned companies.
Engagement and Share ownership	Sakawa & Watanabe (2020)	2010	2016	• The higher the ratio of institutional investors or foreign shareholders, the higher the Tobin's Q and ROA of Japanese companies (both statistically significant), and such effect becomes statistically significantly greater after the formulation of the Stewardship Code. • The above monitoring function by foreign shareholders is stronger in high growth companies.
Engagement and Share ownership	Fujita & Yamada (2021)	2008	2019	• For corporate groups : - The larger the ratio of minority shareholders, the more profits are shifted to the parent company. - The larger the ratio of minority shareholders, the higher the growth rate of sales of subsidiaries.
Engagement and Share ownership	Hidaka, Ikeda, Inoue (2021)	2017	2019	• Engagement improves the governance (i.e., increase in the ratio of independent directors, reduction in the ratio of cross-shareholdings, elimination of anti-takeover measures, and increase in the ratio of directors' holdings), especially when multiple investors engage with the same company. ROE is also Improved.
Engagement and Share ownership	Becht et al. (2021)	2009	2019	• The average cumulative abnormal return (CAR) before and after the achievement of engagement objectives is announced for the companies with which Governance for Owners Japan engages was around 2.6%.

Source: Prepared by JFSA

[Appendix] Progress on the unwinding of cross-shareholdings? – "Empirical research on cross-shareholdings (tentative title)"

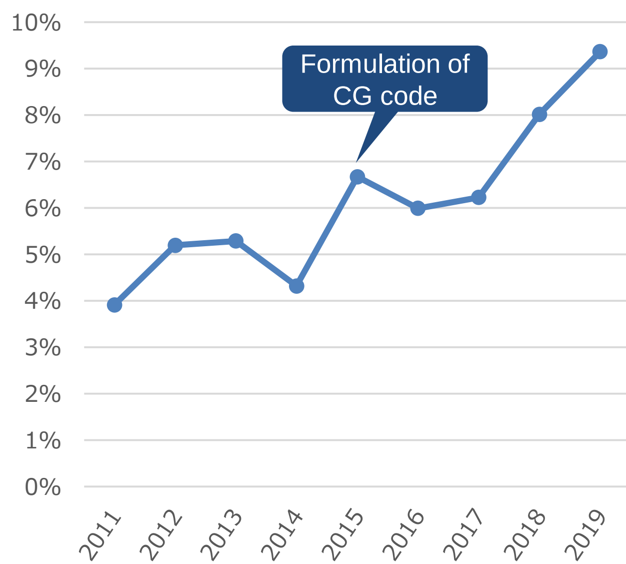
- Since the introduction of disclosure requirements for cross-shareholdings in 2010, the average number of cross-shareholdings has decreased by approximately 34%.
- After the formulation of the Corporate Governance Code in 2015, the probability of selling cross-shareholdings increased, and Principle 1-4 (Cross-Shareholdings) and Principle 4-8 (Effective Use of Independent Directors) of the Code may have facilitated the sale of cross-shareholdings.
- On the other hand, sales of cross-shareholdings were concentrated in small holdings, and the ratio of cross-shareholdings to total shares outstanding decreased by only about 0.8%pt, resulting in sluggish progress of sales of cross-shareholdings among business companies.

Average number of cross-shareholding issues



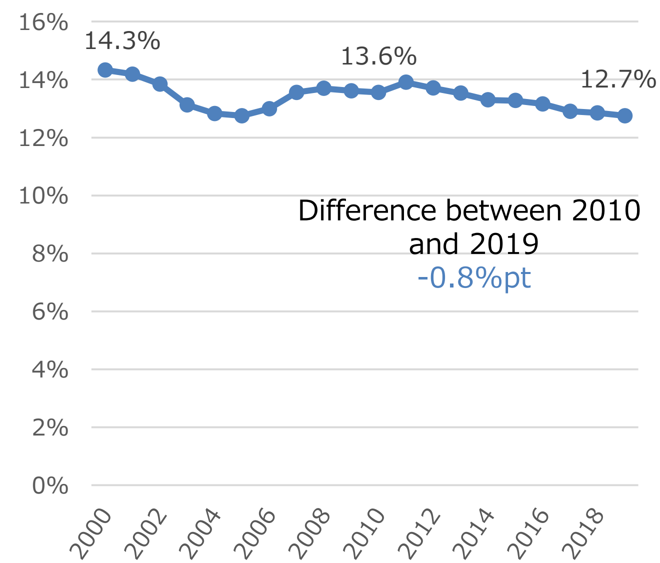
(Note) Companies listed on the TSE First Section (excluding financial services) which held at least 10 cross-shareholdings as of 2010.

Probability of sale of cross-shareholdings



(Note) "Sale probability" refers to the number of issues sold during a year divided by the total number of cross-shareholding issues

Average ratio of cross-held shares to total shares outstanding



(Note) Companies listed on the TSE First Section (excluding financial services) which held at least 10 cross-shareholdings as of 2010.
“Ratio of cross-held shares” is calculated by the following equation: (Ratio of shares held by business companies) – (Ratio of shares held by business corporations that hold 15% or more of shares outstanding) - (Ratio of shares held by asset management companies of founding family)

Source : Provided by Professor Hideaki Miyajima, Waseda University and by Associate Professor Takuji Saito, Keio University

[Appendix] Analysis of determinants of sale of cross-shareholdings – "Empirical research on cross-shareholdings (tentative title)"

- Analysis of cross-shareholdings since 2010 indicates that cross-shareholdings are less likely to be sold, while business relationships that are considered to be weak lessen the stickiness.
- It was also indicated that an increase in the number of outside directors promotes the unwinding of cross-shareholdings, including those with a large holding ratio.

Method of analysis

- Data used: disclosure of cross-shareholdings after 2010
- Companies listed on the TSE First Section (excluding financial services)
- Period: FY 2011 to FY 2019
- Unit of observations: holding company - held company - fiscal year
  (e.g., Dummy variable that takes 1 if some shares of Company B were held by Company A in year XX)
- Model: Pr (sale = 1) = f (characteristics of a holding company, characteristics of a held company, relationship between both companies, year dummy)

- Key results are:
  - Cross-holdings are less likely to be sold.
  - Shares of companies with weak business relationships are more likely to be sold.
  - Increase in the number of outside directors promotes the sale of cross-shareholdings, including those with a large holding ratio.

Source: Provided by Hideaki Miyajima, Professor, Waseda University and by Takuji Saito, Associate Professor, Keio University

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Contents

Interviews with companies: survey methodology and list of companies

- Between December 2021 and April 2022, The Financial Services Agency (JFSA) conducted a series of interviews with individual companies in order to look into their corporate governance initiatives and their views.
- JFSA selected 16 companies from among companies listed on the Tokyo Stock Exchange, including those suggested by Keidanren (Japan Business Federation).
- For most companies, interviews were conducted twice, first at the working level (e.g., board secretariat) based on a common set of questions, and second at the executive level (CEO, president, chairman of the board, and other executives) based on the working level responses.

Interviewed companies (in alphabetical order)

- Astellas Pharma Inc.
- Ebara Corporation
- FP Corporation
- Omron Corporation
- Kao Corporation
- Sun Frontier Fudousan Co., Ltd.
- Shin-Etsu Chemical Co., Ltd.
- Suzuki Motor Corporation
- Sumitomo Electric Industries, Ltd.
- TDK Corporation
- Nitori Holdings Co., Ltd.
- Fujitsu Limited
- Mitsui & Co., Ltd.
- Mitsui Fudosan Co., Ltd.
- Yamaha Corporation
- Yokogawa Electric Corporation

The JFSA expresses sincere gratitude to all the interviewed companies

Overview of the interviews with companies on corporate governance reforms

- FSA, with the cooperation of Keidanren (Japan Business Federation), conducted a series of interviews with companies in order to look into their corporate governance initiatives and their views.

[Interviewed companies (in alphabetical order)]
Astellas Pharma, Ebara, FP Corporation, Omron, Kao, Sun Frontier Fudousan, Shin-Etsu Chemical, Suzuki Motor, Sumitomo Electric Industries, TDK, Nitori HD, Fujitsu, Mitsui & Co., Mitsui Fudosan, Yamaha, Yokogawa

Key Takeaways

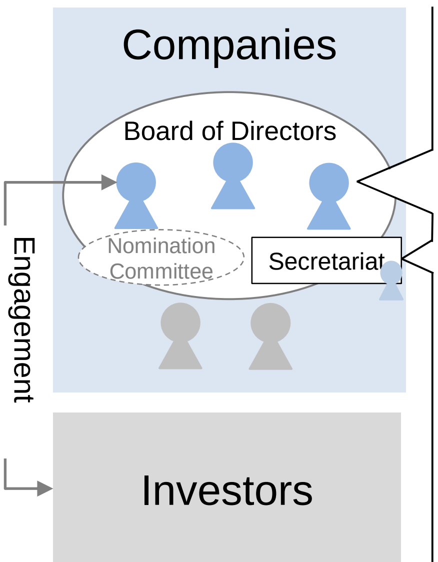
Evaluation of the Corporate Governance Reforms

- Most companies, including the management side, said that enhanced deliberations by the board of directors and deepened discussions on medium- to long-term business strategies had a positive impact on their business, and that engagement with investors gives useful suggestions to the management, suggesting that the direction and effectiveness of corporate governance reforms are widely supported.

Key Issues

- Given the pressure to comply on the companies' side, if the Corporate Governance Code refers to even details of businesses, it may lead to formalistic responses by companies, resulting in an insubstantial reforms.
- High-quality engagement should be promoted by addressing issues such as exercise of voting rights based on a check-the-box by institutional investors, the lack of opportunities for engagement at medium-sized and smaller companies, and the difficulty for companies to identify beneficial owners.

Opinions of Companies



Corporate Governance

Board Effectiveness

Relation with the Management

Management Appointment

Evaluation of the Board Effectiveness

Engagement

- Corporate governance reforms help to increase corporate value in the long-run, and the direction of the Corporate Governance Code that aims to improve corporate value is highly appreciated.
- By original and ingenious initiatives, such as methods of explanations provided by the management to the Board, the Board of Directors' deliberations were enhanced, and valuable suggestions and advice were provided by outside directors, which led to decisive decision-making.
- Medium - to long-term management strategy was discussed at the Board of Directors, and authority was transferred to executives. The monitoring of management through progress report increased the speed of decision-making and enabled management in line with the medium - to long-term strategy.
- By gaining trust from within the company, a nomination committee can endow the nominated management team with strong leadership.
- Applying a PDCA cycle of corporate governance reforms that hinges upon the evaluation of the board's effectiveness can substantiate the functions of the board.
- Engagement by the president, the chairman of the board and outside directors actively and continuously with investors who see the company on a medium to long horizon and give them helpful suggestions.

Interviews with companies: opinions of companies on corporate governance (1)

- Many companies said that corporate governance reforms help to increase corporate value in the long-run, and the direction of the Corporate Governance Code that aims to improve corporate value is highly appreciated.
- There were concerns that, given the pressure to comply on the companies' side, if the Corporate Governance Code refers to even details of businesses, it may lead to formalistic responses by companies, resulting in counterproductive reforms.

Opinions on Corporate Governance

General remarks on corporate governance

- **Governance reforms greatly contribute to increasing corporate value in the long-run.** Some people say that governance reforms will not lead to increasing corporate value. However, by separating supervision and execution, and continuing governance reform, management can focus on execution without worrying about non-executive matters, resulting in the creation of value. (Chairman of the Board)
- **The reality of the governance of Japanese companies is "executive-first," which should be called "*ekiden management,*" where a president "passes on a sash" to the next. The following presidents who have taken over the sash cannot deny what their predecessors did, and therefore cannot increase corporate value.** Typical conflicts at boards in Japan are "executive-first vs. stakeholder-first" rather than "stakeholder-first vs. shareholder-first." (Chairman of the Board)
- **There are limitations to "executive-first" governance, when it comes to dealing with scandals and power struggles in the company,** as can be seen in some Japanese companies. It is important for the board of directors **to exercise its supervision function in order to create an environment in which management are not distracted by non-executive matters and can concentrate on the creation of value.** (Chairman of the Board)
- **Our primary principle of corporate governance is to ensure the agility, appropriateness, and transparency of management, to fulfill fiduciary responsibilities and accountability to shareholders, and to appropriately cooperate with all stakeholders.** (Executive Chairman and Chairman of the Board)
- **Since most accountability issues to stakeholders have already been incorporated into the Corporate Governance Code, I do not believe that there is further need to revise the Code and hammer out the details**. (Executive Chairman and Chairman of the Board)
- **The Corporate Governance Code is a soft law,** and I always tell board members to **think about what is the best for the company. Under the "comply or explain" approach, it is important for management to explain reasons why they cannot comply with a principle based on their philosophy.** (Executive Chairman)
- Despite the "comply or explain" approach, **we feel the pressure for compliance**. (Corporate Planning Department)
- The Corporate Governance Code has given us a chance to think about corporate governance, making us shift to "systematic management." **Instead of "locomotive-type" management where only the founder leads the company, we are shifting to a "*Shinkansen*-type" management in which all employees have driving force.** (President and Chairman of the Board).
- We were surprised that the 2021 Code introduced terms on intellectual property, TCFD, and mid-career recruitment, and are concerned that the inclusion of such items in the Code would **lead to formalistic responses by companies, resulting in counter-productive reforms**. (Legal Department and Board Secretariat)

Note: Positions at the time of the interview

Interviews with companies: opinions of companies on corporate governance (2)

- Companies said that by being creative, including, for example, in management's explanations to the board, the Board of Directors' deliberations were substantiated, engendering valuable suggestions and advice from outside directors that led to decisive decision-making.
- Some companies greatly delegated to the executives, and the board focusses on medium- to long-term management strategy. By monitoring management through progress reports, decision-making was accelerated and management in line with the medium- to long-term strategy was secured.

Opinions on Corporate Governance (Continued)	
Board Effectiveness	■ **The Board of Directors has the responsibility to "establish a system in which the management can focus on business execution" in accordance with the mandate from stakeholders**. A person who is "convenient" for executives should not be appointed, and companies must respond to investors' expectations for the creation of an environment easy for executives. (Chairman of the Board) ■ **The Chairman of the board attends all important meetings, such as the risk management committee, sustainability committee and management meeting. This enables the Chairman to make a responsible agenda-setting for the board, to understand management matters that should be discussed at the board**, and to design board discussions. The executive side considers what was discussed or pointed out at the outside directors meeting and the board by the next meeting. This enabled the board to understand details of projects and to deepen the deliberations. (Chairman of the Board) ■ **We distribute meeting materials and explain agenda topics to board members a few days before a board meeting. In addition, following an appointment of outside director, we hold training camps, lectures and plant tours to deepen their understanding of the corporate philosophy and our business**. Understanding the corporate philosophy helped the board in selling a business unit, enabling them to make a decision based on the philosophy and as the "best owner," and to take into consideration the ideal future of the company, the happiness of our employees, as well as the contribution to society. (Board Secretariat) ■ In response to comments from outside directors at the Board of Directors meetings, some proposals were resubmitted three times, and in some cases they were withdrawn. **While deliberations became substantive, attention to time management is also needed**. (Board Secretariat)
Relation with Management	■ **Speed is key to management**. To increase speed, a cycle should be adopted in which the board holds the core of authority, transfers that authority to each division through the executive meeting, and the executives exercise the delegated authority properly and reports to the board. **This cycle of "Empowerment and Transparency" frees the Board of Directors time to discuss important management issues. If the executive meeting is just a place to report to the President, everyone stops thinking. By having frank discussions at executive meetings, the executive side can gain the trust of the board and can be delegated**. (Executive Chairman) ■ Annual plans for the Board of Directors include, in addition to matters to be resolved and reported, issues that should be thoroughly discussed by the Board from the perspective of long-term shareholders, such as medium- and long-term or future issues and progress of mid-term business plans. **Discussions at the Board of Directors from a medium- to long-term perspective made executives contemplate and make judgment carefully, which fortunately, has resulted in an increase of the corporate value**. (Board Secretariat)

Note : Positions at the time of the interview

Interviews with companies: opinions of companies on corporate governance (3)

- Some companies said that by gaining trust from within the company, a nomination committee can endow a nominated management team with strong leadership.
- There were comments that applying a PDCA cycle of corporate governance reforms that hinges upon the evaluation of the board's effectiveness can substantiate the functions of the board.

Opinions on Corporate Governance (Continued)	
Management Nomination	■ Corporate value can be increased only by executives. What the Board of Directors can do for corporate value is to create a good environment for the executives, one of which is the appointment of the President. **Nomination committees should obtain trust from within the company, and by doing so, they gain legitimacy to the appointment of the President. At the same time, it enables executive officers and the President to exercise their authority without excessively caring about their predecessors**. (Chairman of the Board) ■ In appointing the President, our **non-statutory nomination committee first discussed what qualities are required of the next President**, and then narrowed down the list of candidates. Committee members were provided with direct exposure to candidates, such as by having candidates participate in meetings, so that they can understand the qualities and aptitude of candidates. (Legal Department and Board Secretariat) ■ In Japanese companies with a three-committee system (nomination, audit and remuneration committees), committees composed of a couple of directors have the final authority of nomination and compensation. **Rather than having only three or four people involved in important decisions, such as the appointment and removal of presidents (or succession plans), it would be more appropriate for such matters to be determined by the Board where outside directors make most of their knowledge.** (Executive Chairman and Chairman of the Board)
Evaluation of the Board Effectiveness	■ If board members are aware of their responsibility for stakeholders, they should naturally want the board's effectiveness to be evaluated to judge whether they are heading in a right direction. **The evaluation of the board's effectiveness is a must, and without it, governance reform will not advance.** (Chairman of the Board) ■ Based on the third-party evaluation of the board effectiveness, the Chairman and the secretariat take an initiative to make a plan for the following year and the board discussed and decided on the plan. In the following year, we conducted a self-evaluation to ask the directors how they did in the year. **The quality of the Board of Directors gradually improved by applying this PDCA cycle.** (Office of the Board of Directors) ■ **In every annual evaluation of board's effectiveness, we specify key themes for the following year and, during the following year, we work on them.** For example, in response to comments in an effectiveness evaluation on the sustainability as a key theme, the Board of Directors set forth a basic sustainability policy and sustainability goals, and sorted out materialities. These policy and goals promoted many sustainability initiatives in the company, leading to the enhancement of corporate value. (Board Secretariat)

Note : Positions at the time of the interview

Interviews with companies : opinions of companies on engagement

- Many companies said that active and continuous engagement by the president, chairman of the board and outside directors with investors who see the company on a medium to long horizon gives the company helpful advice.
- On the other hand, the following issues were pointed out: voting rights are exercised in a mere box-ticking manner by some institutional investors; there are few opportunities for engagement with investors for especially medium-sized and smaller companies, resulting in few or no incentives to reform; and that companies are struggling to identify beneficial owners of shares of the company.

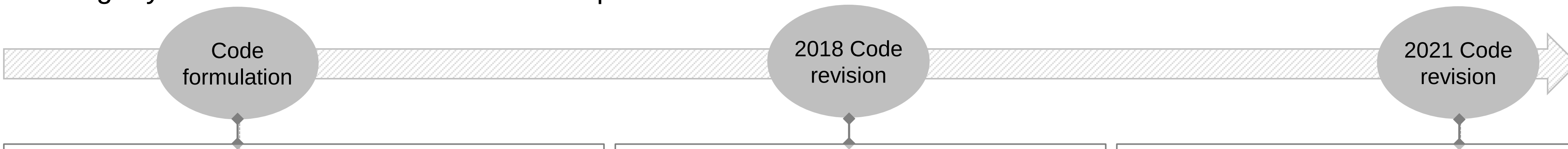
Engagement	■ **Investors who provide external opinions other than the board are extremely helpful for management**. When the Board of Directors works on the medium to long time horizon**, investors who have a medium- to long-term perspective are important. Increasing the number of these investors is beneficial for the executive side.** (Executive Chairman and Chair of the Board) ■ **Expert teams of U.S. institutional investors that have industry expertise often ask very sharp questions and since their analyses are based on information of competitors, engagement with them is informative for the company, too**. (Executive Chairman and Chairman of the Board) ■ It is important to have a dialogue with investors who want to improve the quality of management. **In particular, investors who invest in carefully selected companies are like consultants as important stakeholders**. Reflecting investors' perspectives and skills in management will improve performance and increase corporate value. (Board Secretariat) ■ **Major investors seem to have adopted a policy to carefully check policies of investee companies and the stance of management with a view to medium- to long-term investment**. As an executive, I welcome medium- to long-term investors, and we want to manage the company with the same time horizon and distribute the created value to stakeholders. (Executive Chairman) ■ **It is important to continue dialogues with investors despite their severe comments. What a company should do is naturally determined based on dialogues with stakeholders, mainly investors, and its accountability**. (Executive Chairman and Chairman of the Board) ■ **Not only the President and CFO, but also the Chairman and other outside directors actively engage in dialogues with investors**. Making the majority of the board consist of outside directors alone does not raise share prices. **Outside directors discuss and provide advice based on the company's reality while incorporating their objective viewpoints, and thoroughly explaining this to investors can improve the evaluation of the company**. (Executive Officer) ■ **We talk to analysts as part of IR, but we have few opportunities for engagement with investors**. Since passive investment by GPIF is limited to tracking indexes with such themes as women and ESG, to those with a market cap of JPY100 billion or more, our company falls outside of passive investment and therefore cannot receive its benefits. We want to reform our governance, but it is difficult to cover the cost given a small expected impact on share prices. (Executive Officer) ■ There are cases in which investors own shares via custodians and **the company cannot identify their beneficial owners**. In addition, **some investors and proxy advisors may make decisions merely in a check-the-box manner without considering the details of our explanation of the corporate governance report**. (Board Secretariat)

: Positions at the time of the interview

Contents

Corporate governance reforms and growth investment

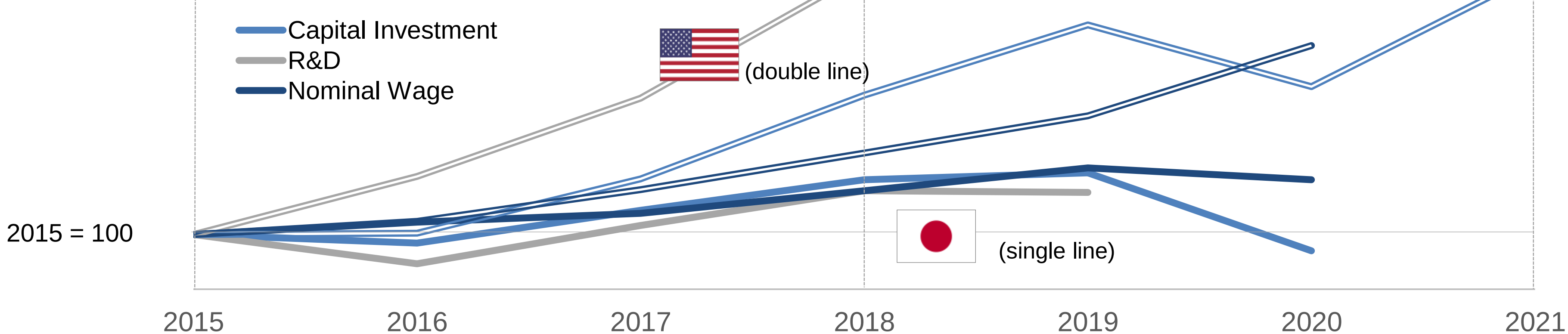
- Corporate governance reforms have been aimed at supporting management's decisive risk-taking from the perspective of increasing the medium- to long-term corporate value. However, investment by Japanese companies (e.g., capital investment, R&D and IP investment, human capital investment) has grown only slightly since the formulation of the Corporate Governance Code.



General Principle 4
Given its fiduciary responsibility and accountability to shareholders, in order to promote sustainable corporate growth and the increase of corporate value over the mid- to long-term and enhance earnings power and capital efficiency, the board should appropriately fulfill its roles and responsibilities, including:
(1) Setting the broad direction of corporate strategy;
(2) Establishing an environment where appropriate risk-taking by the senior management is supported; and
(3) Carrying out effective oversight of directors and the management (including shikkoyaku and so-called shikkoyakuin) from an independent and objective standpoint.

Principle 5.2 (revised)
When establishing and disclosing business strategies and business plans, companies should articulate their earnings plans and capital policies, and present targets for profitability and capital efficiency after accurately identifying the company's cost of capital. Also, companies should provide explanations that are clear and logical to shareholders with respect to the allocation of management resources, such as reviewing their business portfolio and investments in fixed assets, R&D, and human capital, and specific measures that will be taken in order to achieve their plans and targets.

Supplementary Principle 4.2.2 (new)
The board should develop a basic policy for the company's sustainability initiatives from the perspective of increasing corporate value over the mid- to long- term.
In addition, in light of the importance of investments in human capital and intellectual properties, the board should effectively supervise the allocation of management resources, including such investments, and the implementation of business portfolio strategies to ensure that they contribute to the sustainable growth of the company.



Source: Prepared by JFSA using "System of National Accounts" of Cabinet Office; OECD Statistics; and Bureau of Analysis. Calendar-year base for both Japan and the US

Progress in discussions and corporate awareness after the 2021 revision of the Corporate Governance Code

- After the 2021 revision of the Corporate Governance Code, discussions on investment in intellectual property and human capital have progressed in and out of the government, but companies do not seem to have yet fully recognized their importance compared with investors.

Development after the 2021 revision of the Code

Cabinet Secretariat

- Study Group on Effective Disclosure and Governance of Intellectual Property Investment and Utilization Strategy (Aug. 2021 – Jan. 2022)

⇒ "Guidelines on Disclosure and Governance of Strategies for Investment and Utilization of Intellectual Property and Intangible Assets" (Jan. 2022)

- Non-Financial Information Visualization Study Group (Feb. 2022)

Ministry of Economy, Trade and Industry

- Study Group on Dialogue that Contributes to Long-term Corporate Management and Investment for Creation of Sustainable Corporate Value (May 2021)
- Guidance for Collaborative Value Creation Working Group (Nov. 2021)
- Study Group on Disclosure Policies for Non-Financial Information (Jun. 2021 to Mar. 2022)

⇒ "Preliminary Thoughts on the TRWG Sustainability Disclosure Prototypes" (Mar. 2022)

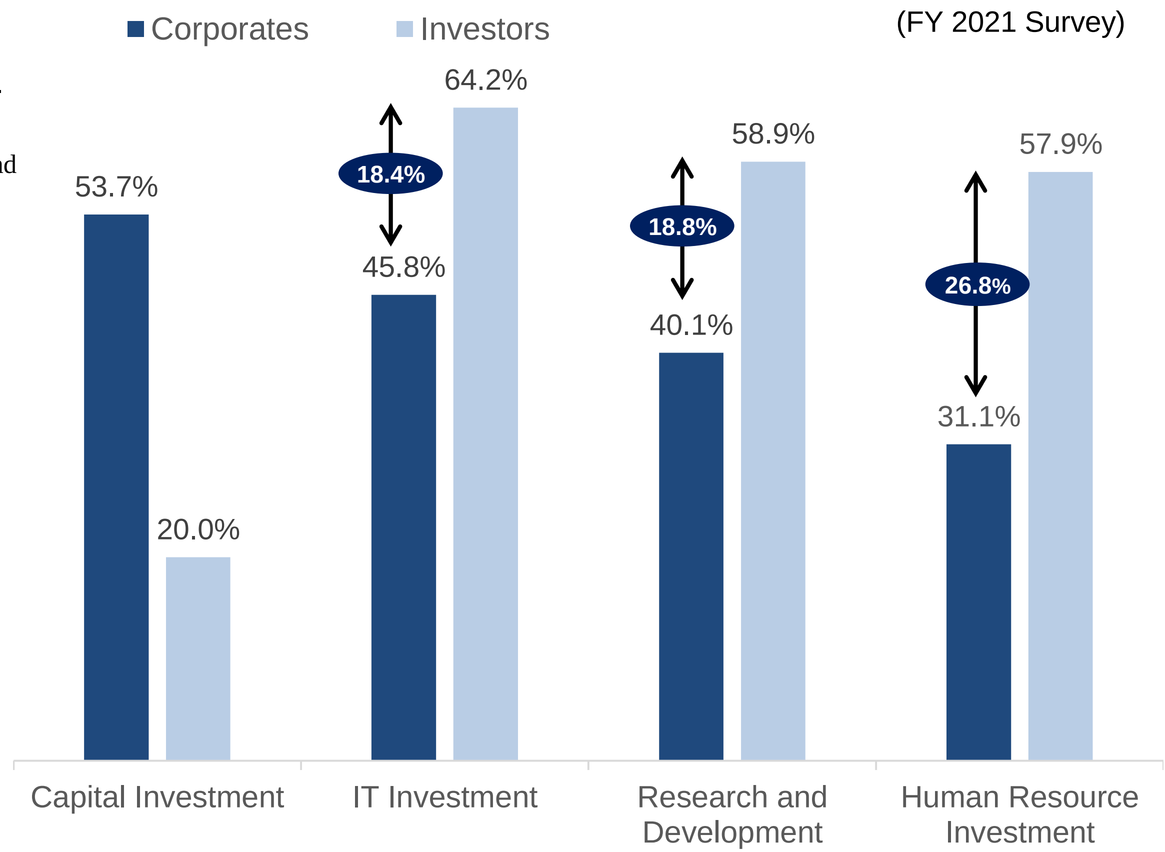
- Study Group toward Achieving Human Capital Management (from Jul. 2021)
- Corporate Governance System (CGS) Study Group (Phase 3) (from Nov. 2021)

Overseas

- ICGN

⇒ Revised ICGN Global Governance Principles (Sep. 2021)

Key items/priorities in medium- to long-term investment and financial strategies

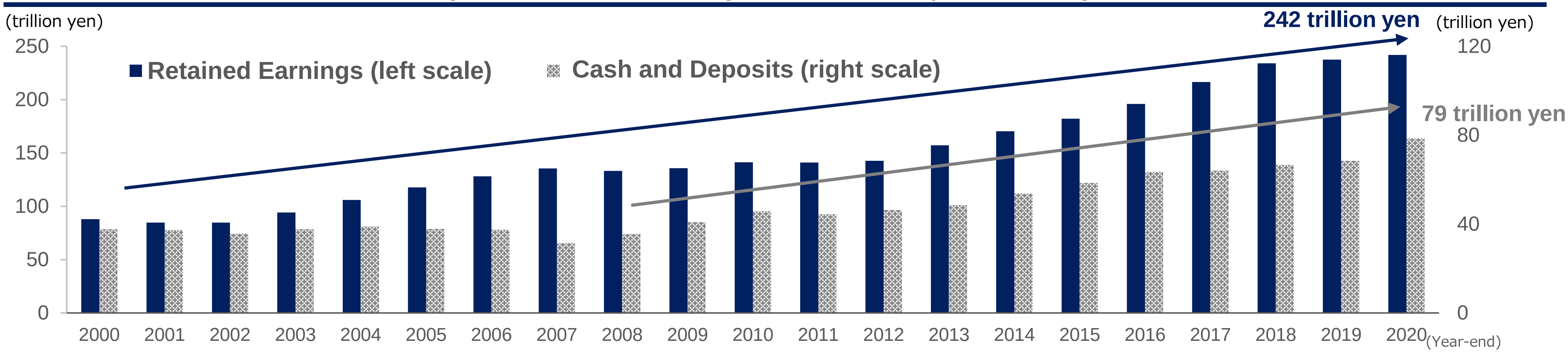


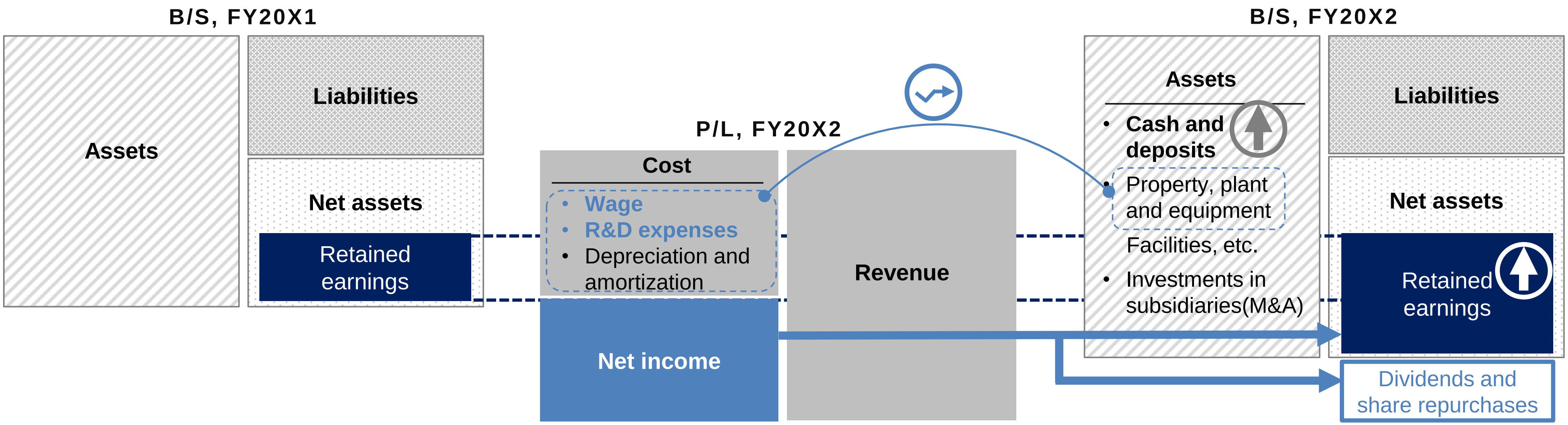
Source: Prepared by JFSA based on various websites, Life Insurance Association of Japan, "Questionnaire on initiatives to enhance corporate (FY 2021 ver.)"

Build-up of Retained Earnings and Cash Deposits at Large Firms

- Currently, large Japanese companies have accumulated retained earnings of 242 trillion yen and cash and deposits of 79 trillion yen.

Changes in retained earnings / cash and deposits at large firms

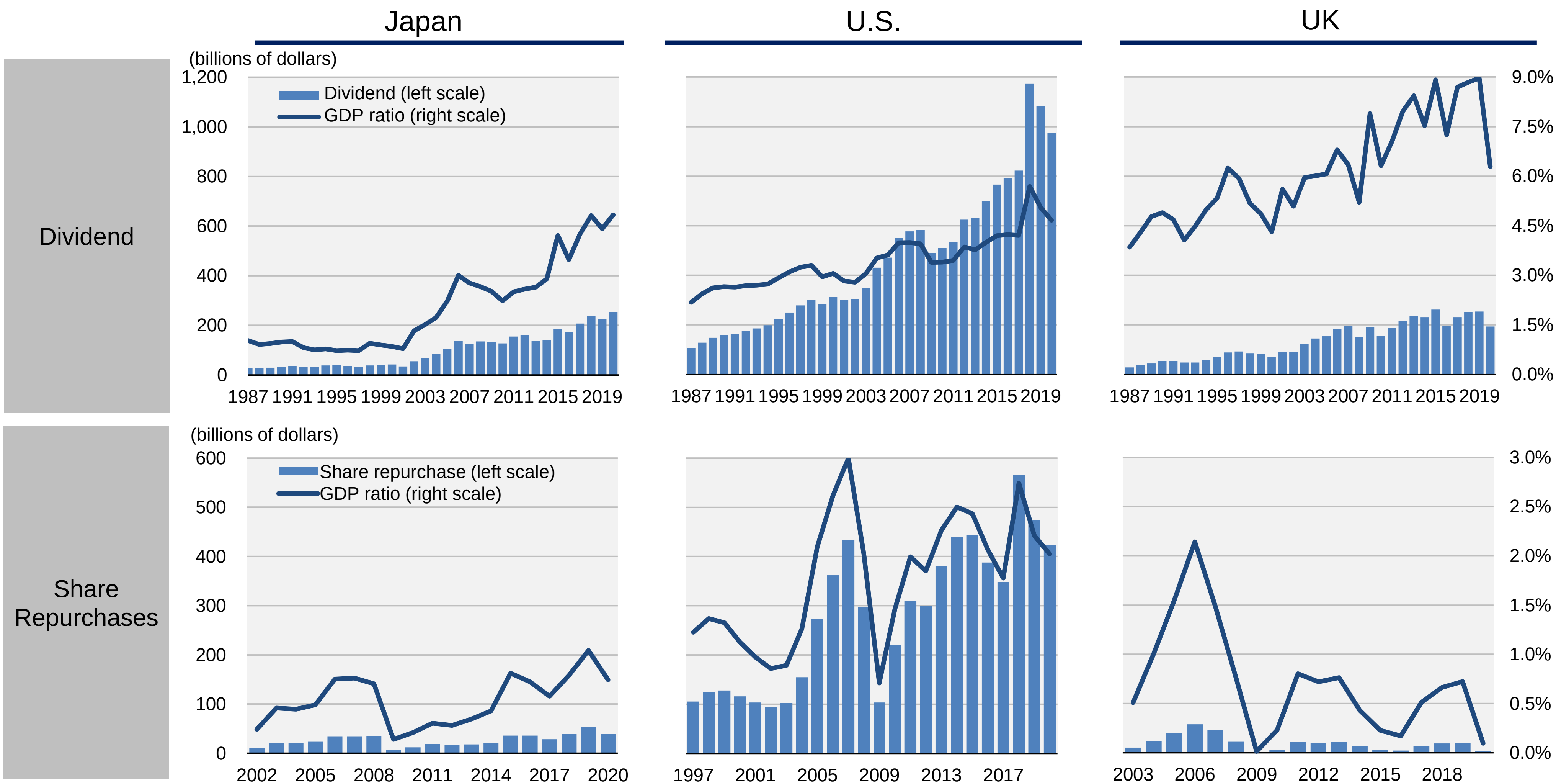




Source: Prepared by JFSA based on the "Survey for the Financial Statements Statistics of Corporations by Industry" (excluding financial and insurance industries, capital of JPY 1 billion or more), Ministry of Finance

[Appendix] Shareholder returns (dividends and share buybacks)

- Looking at the level of shareholder returns, Japanese companies' dividend and share repurchases are not necessarily excessive, compared to the United States and the United Kingdom.



Sources of data on dividends: Ministry of Finance, "Survey for the Financial Statements Statistics of Corporations by Industry", U.S. Bureau of Economic Analysis, U.K. Office for National Statistics, Bloomberg, United Nations, OECD. (Note 1) Figures for total dividends paid in Japan exclude those for financial services and insurance. Figures for total dividends paid in the U.S. are for non-financial corporations. Figures for total dividends paid in the U.K. are for private non-financial corporations. Figures for Japan are on a fiscal-year basis, and figures for the U.S. and the U.K. are on a calendar-year basis. (Note 2) Figures for total dividends paid in Japan and the U.K. are converted to U.S. dollars at the exchange rate as of the last transaction date in December of each year. (Note 3) Figures for GDP of each country are based on nominal GDP. Figures from 1987 to 2019 are from the United Nations Database and figures from 2020 are from the OECD Database.

Source of data on share repurchase: Quick, U.S. FRB, Bank of England, Bloomberg, United Nations, OECD (Note 1) Figures for Japan are on a fiscal-year basis, and figures for the U.S. and the U.K. are on a calendar-year basis. (Note 2) Figures for total share repurchase in Japan, the U.S., and the U.K. are for non-financial corporations. (Note 3) Figures for total share repurchase in Japan and the U.K. are converted to U.S. dollars at the exchange rate as of the last trading day in December of each year. (Note 4) Figures for GDP of each country are based on nominal GDP. Figures from 1987 to 2019 are from the United Nations Database, and figures from 2020 are from the OECD Database.

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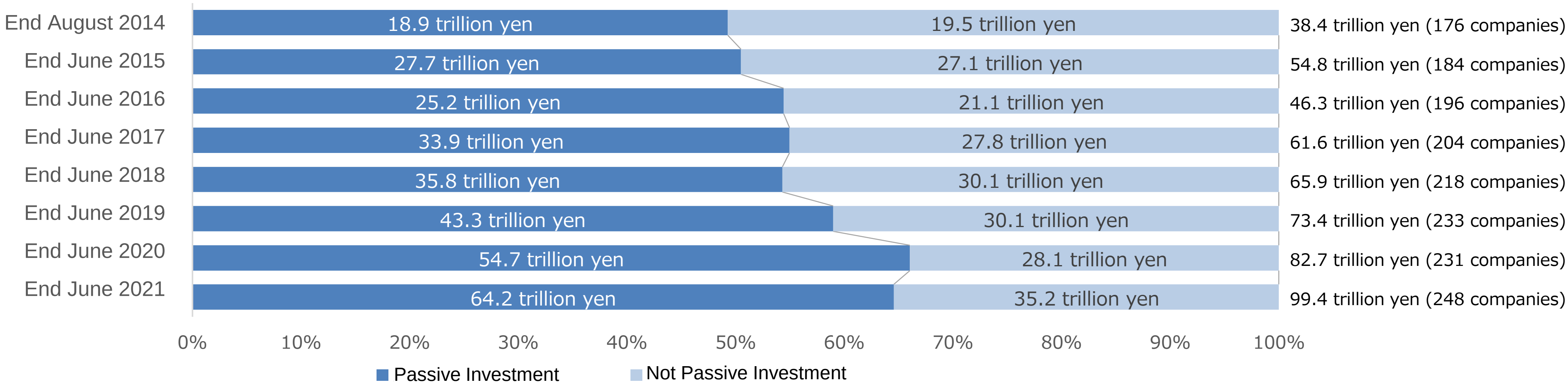
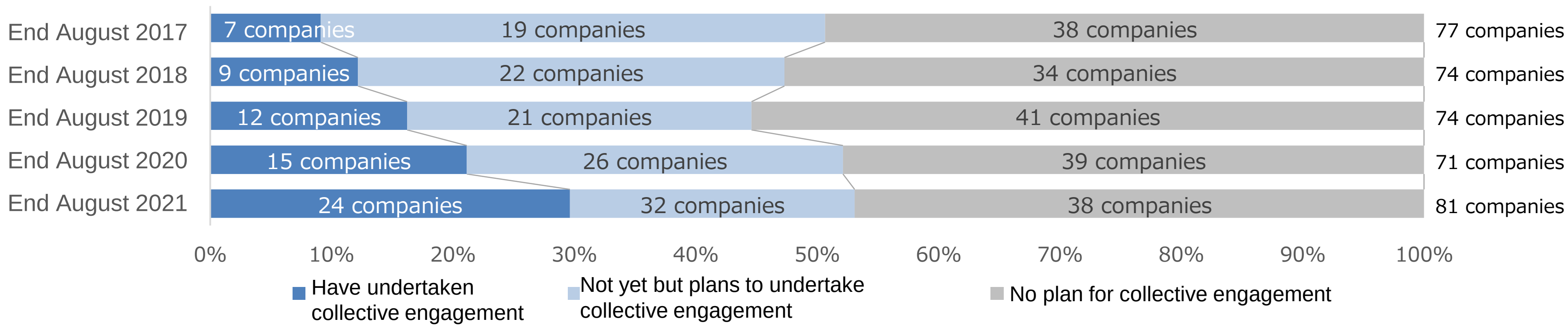
Recent developments in dialogues – Increase in passive investment and collaborative engagement

- In recent years, passive equity investment has become further prevailing, leading to an increase in the number of investors who have conducted collective engagement. (Note 1)

Changes in the ratio of passive investment to total investment in Japanese equities (Note 2)



Changes in the proportion of investors who have conducted collective engagement



Note 1: Collective engagement refers to taking action against individual investee companies in cooperation with other investors.
Note 2: Data before the end of June 2016 refers to index management and non-index management as a percentage of investment in Japanese stocks.
Source: Prepared by JFSA from “Survey Report on the JIAA member Companies to the Questionnaire for the Japan Stewardship” (October 2014 - October 2021), Japan Investment Advisers Association

Issues regarding institutional settings that support engagement (1) – Collaborative engagement

- The Council of Experts on the Stewardship Code pointed out issues on institutional settings that support engagement, such as the legal framework for collaborative engagement.
- In the most recent survey, more than half of investors mentioned the lack of clarity in the terms "joint holder"(Note 1) and "act of making important suggestions"(Note 2) as a challenge in collaborative engagement.

(Note 1) Under the large shareholding reporting system, shareholders are required to calculate their holding ratio of share certificates, etc. by including the shareholding of "persons who have agreed with another shareholder to jointly exercise voting rights and other shareholder rights." ("joint holders").
(Note 2) An "act of making important suggestions" means suggesting matters specified in Article 14-8-2, Paragraph 1 of the Order as those that will cause material changes or materially influence the issuer's business activities at a general shareholders meeting of investee companies or to their corporate directors.
For institutional investors, the deadline for submission of a large shareholding report, etc. is relaxed by a special reporting rule in consideration of the excessive clerical burden of disclosure. However, this rule does not apply to cases where the purpose of holding is an "act of making important suggestions."

Issues regarding collaborative engagement

Proposed Revisions to the Stewardship Code (December 2019)

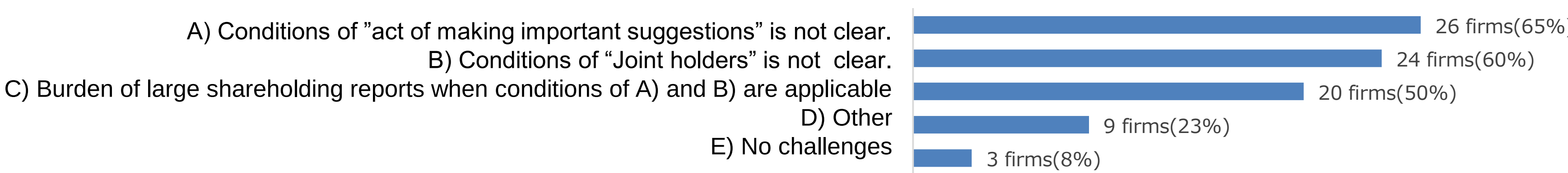
In addition, the following comments were also raised during the discussion of the Council. Further review by the Council based on actual conditions is considered necessary. The Financial Services Agency is also expected to review them.

- With the expansion of passive investment, is it necessary to reconsider how to improve engagement?
- <u>Some people point out that the "Clarification of Legal Issues Relating to the Development of Japan's Stewardship Code" does not give sufficient clarification on the scope of collaborative engagement. Is it necessary to deal with these arguments</u>?

c.f.) Responses to public comments to the draft revised Stewardship Code (March 2020)

As it was pointed out that the "Clarification of Legal Issues Relating to the Development of Japan's Stewardship Code" does not give sufficient clarification on the scope of collaborative engagement, it is expected that the FSA will consider how to respond to such issues as requested in "Second Revision of the Stewardship Code."

Survey on challenges for collaborative engagement



Note 3: Respondents were 40 institutional investors that had outstanding Japanese equity investment as of the end of June 2021 that had "undertaken" or "planned to undertake" collaborative engagement activities as of the end of August 2021.
Source: Prepared by JFSA from "Results of the 8th Questionnaire on Responses to the Japanese Version of the Stewardship Code (October 2021)", Japan Investment Advisers Association

Issues regarding institutional settings that support engagement (2) – Collaborative engagement

Problems arising from lack of clarity in the legal terms related to collaborative engagement

The 19th Follow-up Meeting (April 2019) Kerry Wailing Member

ICGN Members would welcome further clarity around their ability to act collaboratively with other investors without being considered a ‘concert party.’ It would therefore be helpful for the FSA to publish guidance on what constitutes acceptable engagement subjects to <u>ensure they will not breach rules regarding collective holding thresholds above which would trigger onerous reporting requirements</u>.

The 7th Follow-up Meeting (April 2016) Ueda, Ryoko Member

<u>(T)he UK investors and investors’ associations</u> […] often <u>tell us about their concerns: if they take part in collective engagement in Japan, it will be regarded as “acting in concert,” and they will become subject to regulations on large volume holding of shares</u>. […] Even though the FSA has already sorted out and published legal issues related to the Stewardship Code, such doubts have not been easily cleared up. Then we many need to consider other methods.

The Council of Experts on the Stewardship Code (October 2019) Tanaka, Wataru Member

The large shareholding report regulations are still said to be having a chilling effect. Regardless of the comprehensive management control indicated by “Act of Making Important Suggestions,” in addition to the breadth of the original provisions in which all actions of a certain level of importance were seemingly included among the “Act of Making Important Suggestions,” <u>the concept of “joint exercise of shareholder rights” can be read as having extremely comprehensive application because, unlike in the UK and other countries, there are no requirements that it be for the purpose of management control</u>. In the end, I think it would be best to resolve this through legislation.

<u>Because such provisions exist under the current legal system, I have heard it said that an investor wanting to make a suggestion has no choice but to do so in the form of a question</u>, that is, to ask the management team what they think about a particular matter. […] the people I have spoken to have made <u>it clear that ideas are not being conveyed, saying that the investor’s intent is not communicated to corporate managers</u>, or at least to certain corporate managers, simply by asking questions. An approach must be developed to allow things to be stated more directly.

Issues regarding institutional settings that support engagement (3) – Beneficial shareholders

- As the number of shareholder proposals has been on the rise in recent years, it has been pointed out that a system enabling listed companies to identify "beneficial shareholders" should be considered with a view to deepening dialogue with shareholders.

Issues pointed out in the report of the Study Group on the Process of Shareholders Meetings in a New Era (METI) July 2020

- ✓ On the other hand, the identification of beneficial owners, which is important in dialogue in the general shareholders meeting process, has not been sufficiently discussed. This is because, while companies have a need to identify beneficial owners, beneficial owners may have the advantage of keeping their information confidential. However, as stated above, the need to identify beneficial owners is increasing as the importance of dialogue increases. Below, we present the current situation and desirable directions going forward by defining beneficial owners as those who make decisions on the exercise of voting rights.

- ✓ The Japanese government has not yet introduced a system of publication like that in the United States, nor a system of the right to identify beneficial owners like that in the EU. However, as dialogues with institutional investors continue to progress, the need for mutual trust between companies and institutional investors is no different from that in the United States and Europe. From the viewpoint of building a relationship of trust, the approximate number of shares is often referred to in dialogues in practice. In light of these circumstances, practical considerations should be made to enable companies to efficiently identify beneficial owners (institutional investors with whom companies try to have dialogue) and their number of holding shares as of the record date for voting rights.

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Questions for Discussion (1)

Interim review following the 2021 revision of the Corporate Governance Code

- Since the formulation of Japan's Stewardship Code in 2014, a series of corporate governance reforms have been implemented. However, the number of empirical research on the effects of these reforms is not yet large, and the evaluation of their effects has yet to be determined. On the other hand, companies that have reformed their governance systems in an original and ingenious way have indicated that they are realizing certain effects, such as enhanced deliberations at the board of directors.

- In light of this:
  - How do members of the Council evaluate the effects of Japan's corporate governance reforms to date?
  - What are the views of members on how the government should take into account the experience of companies about the effects of their corporate governance reforms and criticism of the reforms, such as that the Code should not be made into detailed rules?
  - Other than the papers listed in this presentation, are there any analyses that should be looked at as part of the review?
  - Based on the evaluation, are there any issues that need to be addressed in future corporate governance reforms?
  - Are there any corporate initiatives that should be discussed in detail at future meetings of the Council?

Questions for Discussion (2)

Challenges for sustainable growth

- Although the corporate governance reforms have been encouraging Japanese companies to bolster investment, including in PPEs, research and development / intellectual property and human resources, that would contribute to their sustainable growth, the growth of these investments in Japan in recent years has been sluggish in comparison with that in the United States, resulting in the large accumulated retained earnings of companies, particularly in the form of hoarded cash and deposits. Although various bodies in and out of the government are discussing ways to strengthen the investment in intangible assets, which form the basis of value creation, corporate initiatives have been so far sluggish.

- What are the views of members of the Council on the following points with a view to mobilizing Japanese companies' accumulated retained earnings (especially cash and deposits)?
  - Appropriate allocation of financial resources between capital investment, research and development / intellectual property, human resources investment, etc. to maximize the medium- to long-term corporate value; and balance between growth investment and shareholder returns with consideration of cost of capital
  - Policy on holding cash and deposits under highly uncertain conditions, such as the COVID-19 crisis, inflation of raw materials, and the Ukraine Crisis
  - Roles of the board of directors, investors, and dialogue between them as well as the accountability of corporates in addressing the above issues

Issues related to dialogues between companies and investors

- While various discussions are making progress on how to make dialogues between companies and investors more constructive, some members of the Council and the Council of Experts on the Stewardship Code raised issues including the lack of clarity of some legal terms related to collective engagement.
  - Do members think that any response is needed to address the issues pointed out?
  - Are there any other issues that should be considered in terms of institutional settings related to engagement?