(Provisional translation)

The Thirteenth Council of Experts Concerning the Follow-up of Japan's Stewardship Code and Japan's Corporate Governance Code

1. Date and Time: December 21, 2017 (Thursday) 9:30-11:30
2. Venue: 13F, Central Government Building No. 7, Meeting Room No. 1

[Ikeo, Chairman] It's already the scheduled opening time. I'd like to open the thirteenth Council of Experts Concerning the Follow-up of Japan's Stewardship Code and Japan's Corporate Governance Code. Thank you very much for taking the time from your busy schedule.

Today, the representative of the Financial Services Agency (FSA) will first explain all the materials. First, he will talk about Japan's New Economic Policy Package, which was decided by the Cabinet on December 8, and then explain institutional investors' responses to the Stewardship Code, which was revised in May 2017, as the second one. Third, he will share opinions from foreign institutional investors concerning the Corporate Governance Reform. Finally, based on the previous discussion on dialogue between companies and investors, the representative will explain some points which need to be discussed further.

Now I'd like to hand it over to you.

[Tahara, Director of the Corporate Accounting and Disclosure Division, FSA] Good morning. I'll explain the materials we distributed today, one by one.

First, Material 1 contains excerpts from "New Economic Policy Package" decided by the Cabinet on December 8, 2017, as Chairman Ikeo introduced earlier. At our previous meeting in November, I explained that "Strategic Directions and Priorities 2017-2018" articulated that Guidance will be established to encourage corporate efforts through in-depth dialogue between investors and companies. In this Economic Policy Package as well, the Cabinet decided that the Government will establish Guidance for dialogue between investors and companies, and review the Corporate Governance Code as necessary. There are 5 areas of focus of expected corporate efforts, which are what this Council has discussed in previous meetings. I'll skip explanations on these points now, as I'll talk about them elsewhere later. Please just take a

glance.

Second, I'd like to explain Material 2 "Responses to the Revised Stewardship Code". Some time ago, this Council discussed necessary revisions to the Stewardship Code, and, in turn, the Council of Experts concerning the Stewardship Code made final decisions on the revisions to the Code. And each institutional investor was expected to update their disclosure items in accordance with the Revised Code by the end of November this year. We summarized the status of updating disclosure items.

Please look at page 2. Among 214 institutional investors which signed up for the Code, more than 80% or 178 institutions updated their disclosure items accordingly, and 13 institutions plan to update shortly.

Next, I'll explain major updates of disclosure items. First of all, concerning asset owners, the Revised Stewardship Code now requires asset owners to conduct effective stewardship activities, clearly specify what they expect from asset managers (issues and principles) in conducting stewardship activities, and effectively monitor asset managers. We quoted some examples of how public pension funds reviewed their policies in response to the revisions to the Code. First, the Government Pension Investment Fund (GPIF) established and published its "Stewardship Principles" and "Proxy Voting Principle". National Pension Fund Association also made similar responses. Some other public pension funds already had established such principles or guidelines prior to the revision, and modified their policies for adopting the revised Code by instructing their asset management companies (hereinafter, "asset managers") to conduct stewardship activities in accordance with their principles, etc. Furthermore, we understand that they responded to the revised Code by incorporating the monitoring of asset managers' stewardship activities into their policies.

The next section is about asset managers' initiatives, specifically the management of conflicts of interest. In the revised Stewardship Code, asset managers are required to identify specific circumstances that may give rise to conflicts of interest in their policies. This material describes examples of 3 companies. In their policies, they specified possible conflicts of interest in relationship with their plan sponsor companies, other divisions within a company, group companies and so forth.

The revised Code also requires asset managers to specify measures to prevent such

conflicts of interest. Typically, they established third-party committees, where outside directors constitute the majority, to oversee voting results. Furthermore, some limit personnel transfers across certain functions.

Next, I'll explain disclosures of company-specific voting records on an individual agenda item basis (hereinafter, "company-specific disclosures"). Prior to annual general shareholders meetings this year, some institutional investors have made company-specific disclosures. Currently, more than 70 institutional investors, including almost all large Japanese asset managers, have made such disclosures, and some of them also disclosed reasons why they cast "for" or "against" votes. Besides, there are some institutional investors which plan to make such disclosures in the future, so we understand that the number will increase in the future. We listed up the names of asset managers which have made such disclosures as far as we know. If you find any factual error, please let us know.

Such disclosures are required under 'Comply or Explain' approach, so we quoted some examples of explanations by institutional investors which have not made company-specific disclosures. Please look at the first example of Company D. While the company is aware that company-specific disclosure is one of effective ways for dispelling doubts about conflicts of interest, it explains that it puts off such disclosures because it needs to find out whether they adversely affect dialogue with investee companies. This is an example of explaining reasons for non-compliance.

Finally, please turn to page 8 concerning asset owners' responses. Many of them requested their asset managers to make company-specific disclosures. We listed up the names of asset owners which have actually made such requests, as far as we know. As for foreign institutional investors listed at the bottom, they have made company-specific disclosures of their own voting records.

This is the first report on responses to the [revised] Stewardship Code, and we will continue to monitor the progress in the future, and ask you to discuss it as necessary.

Now as the third agenda item, I'll explain Material 3 "Summary of comments by overseas institutional investors on the issues for deepening corporate governance reform". This material summarized opinions of foreign institutional investors on the issues which the Council members have discussed so far. From September to November, among foreign institutional

investors which signed up to the Stewardship Code, we sent questionnaires to those which submitted public comments at the time of revising the Code. We compiled responses from 17 institutional investors herein.

Please turn to page 2. As for the issue of whether the management is adequately making decisions in response to changing business environment, there were two major opinions. First, they pointed out that Japanese companies seem to have low awareness of capital cost, and they should increase returns, while being conscious of capital cost; and that although ROE is one of important management indices, other indices are also important. Second, some respondents argued that while many companies have been becoming conglomerates, they should focus on areas of competitive advantage. Individual opinions of respondents are shown in the box titled “Comments” at the bottom.

Next, concerning the issue of investment strategy/financial management, it was pointed out that companies should utilize available assets effectively and invest in fixed assets, R&D and human resources. Furthermore, it was argued that companies have not sufficiently explained and disclosed the use of their assets. It seems that such things constitute part of the basis of [investors’] judgment on whether assets are effectively utilized.

The next issue is about CEO appointment/dismissal and responsibilities of the board. As was mentioned by members of this Council, it was pointed out that as the appointment of CEO is important, it should be through a forward planning and transparent process. It was also suggested that an independent nomination committee should be involved in such a process. Furthermore, it is essential that the board maintains relevant qualifications and diversity; and from that perspective, it is important that independent directors play their roles effectively.

The next issue is about cross-shareholdings. Again, it was argued that sufficient explanations to shareholders and disclosures are not made concerning cross-shareholdings. As shown in Aberdeen’s comments at the top, institutional investors consider that cross-shareholding is dead money on corporate balance sheets, so it should be reduced as much as possible. Furthermore, it was pointed out that companies with cross-shareholdings should provide proper explanations about business benefits in the form of a cost/benefit analysis.

The last issue focuses on asset owners. Commenters expressed their concern about the fact that only few corporate pension funds signed up to the Stewardship Code. They also pointed out that corporate pension funds may not have sufficient expertise on investment management, and that corporate pension funds should be operated in the best interest of their members and beneficiaries, instead of the plan sponsor companies.

For your reference, the Securities and Exchange Surveillance Commission held a seminar to commemorate its 25th anniversary in early December. The seminar was moderated by Mr. Tanaka. As similar discussion was made at the seminar, I'll share some points with you.

First, concerning decisive decisions by management, while the board needs to evaluate return on invested capital in its evaluation of business divisions and the company, it has not established appropriate indicators for that purpose.

Concerning the issue of CEO/board, it was pointed out that the appointment of a CEO successor may not be what it should be; for example, an incumbent CEO's will is reflected on the appointment in an opaque way. As for the issue of cross-shareholdings, some argued that the situation has remained unchanged despite the establishment of the Corporate Governance Code and there could be an underlying problem on the side of "held companies" [i.e. issuing companies] which make certain companies hold their shares as cross-shareholdings. Mr. Tanaka, please make additional comments later, as necessary.

Now I'd like to explain Material 4. As described in Material 1 which I explained earlier, as well as the recently-released Strategic Directions and Priorities of the FSA, in order to help make corporate governance efforts more substantive through in-depth dialogues between investors and companies, what should be discussed during such dialogues? In Material 4, we sorted out and summarized your views which were expressed in the previous meetings as well as foreign investors' opinions which I shared earlier and discussions during the recent seminar.

There are 5 main categories of topics similarly to the material which I explained earlier. The first category is management decisions in response to changing business environment as shown on page 1. In this regard, what should be discussed during dialogues?

The first point is, as Mr. Uchida talked about business principles the other day, whether companies established concrete business principles as well as business strategies and business plans to increase the mid- to long-term corporate value. As written in the remarks column on

the right, while we are aware that the concreteness is important, we'd like you to discuss what should be the focus of dialogue to encourage companies to take initiatives for increasing mid- to long-term corporate value.

The second point is whether the management properly understands the cost of capital. Many people expressed their concern about it. In terms of increasing corporate value, the point here is whether the management runs the company, taking the cost of capital into account; and whether the company generates returns commensurate with the cost of capital over the mid- to long-term.

On this point, while it was mentioned that Japanese companies may not necessarily be conscious of their cost of capital, we'd like you to discuss what efforts are considered to be important to promote. For example, we'd like to know your views on the effectiveness of setting indicators of earning power, capital efficiency and so forth.

The third point is whether the management of a company properly understands the business environment and risks surrounding its businesses, and makes decisive business decisions on such matters as changing the composition of its business portfolio. We believe it important that dialogue effectively leads to encouraging the management make decisive decisions, that is one of the objectives of the Corporate Governance Code. For example, it would be important to have dialogue in order to check whether the process of reviewing a company's business portfolio works effectively.

The next topic is investment strategy and financial management. Overseas investors also referred to this issue as I explained earlier, and the members of this Council have discussed a lot about that. For the purpose of achieving returns which cover the cost of capital on a mid- to long-terms as a result of decisive decision-making, we believe that it is important to have dialogue about investments in capital expenditure, R&D, and human resources strategically and systematically. Furthermore, there is a concern about whether a company establishes and implements its financial management policy based on its business strategy and investment strategy. In the right column, a question is raised as to whether cash and deposits have been ever-increasing as internal reserves. Although it was pointed out at this Council that the situation varies from company to company, we'd like you to discuss how we should check this matter.

Next, as for the issue of appointment/dismissal of CEO and responsibilities of the board, we already had intensive discussions at this Council. Nonetheless, this issue is so important that we’d like to confirm the [Council’s] view once again. We’d also like you to suggest what is considered to be important in order to make a CEO selection process capable of responding to a changing business environment, instead of relying on internal logic.

The next topic is the remuneration of the management. We’d like you to discuss whether the remuneration system for the management is designed in a manner to properly function as an incentive for increasing corporate value over the mid- to long-term, and what mechanisms are required for that purpose. Some argued that it is also important whether remuneration amounts are determined according to the remuneration system. We’d like you to suggest overall what should be discussed regarding the remuneration during dialogue.

The Council has had a long discussion on appointment of independent directors and their functions. You may want to share your views on which qualifications and roles are especially important to focus on, and what should be taken into account when appointing independent directors. It was also pointed out that appointing *kansayaku* (corporate auditors) and the like is also important as in the case of independent directors. We’d like you to discuss this point as well.

Now I’m moving on to the issue of cross-shareholdings. We received comments that it is essential for a company to clearly explain reasons for its cross-shareholdings. We consider it is important to properly provide such explanations, and make right decisions on the appropriateness of cross-shareholdings. We’d like to hear your opinions about that.

Furthermore, when a company unwinds cross-shareholdings, we consider it is important to clarify its policy/view of unwinding and take appropriate actions in accordance with such a policy/view. We’d like to hear your opinions about that as well.

In addition, as a cause for impeding a reduction of cross-shareholdings, some referred to a problem on the side of “held companies”. We included it in the list, because if it is clearly specified that this issue should be a topic of dialogues between companies and investors, it will lead to rationalization of cross-shareholdings. This would be a topic of dialogue between investors and “held companies”, not holding companies.

The last category here is issues of asset owners. So far, regrettably, only 7 corporate

pension funds have signed up to the Stewardship Code. Among them, there is only 1 fund for a non-financed company. Little progress has been made. In addition, we received comments on their expertise of investment management.

In the meantime, corporate pension funds hold a large number of Japanese stocks. So, some expressed their concerns that, unless there is progress in their governance efforts, the corporate governance reform in Japan as a whole will not achieve a significant progress. In this sense, we included it in the list of topics of dialogue.

Corporate pension funds are implemented by their plan sponsor companies. A plan sponsor company plays significant roles. As “Reference” below, we quoted examples of initiatives by a certain corporate pension fund. In fact, the plan sponsor company has been providing significant support for activities of this corporate pension fund, by working on the enhancement of the fund’s expertise as well as effectiveness of its investment management. We consider it is important for plan sponsor companies, as asset owners of corporate pension funds, to take initiatives in the personnel and management aspects by using its initiatives as a reference, so that corporate pension funds perform expected functions. So, we included this matter as a possible topic for dialogue.

In doing so, as we wrote in the remarks column, the issue of conflicts of interest is considered to be discussed as well. So, we’d like you to discuss the ideal way of plan sponsor companies’ involvement, as well as what you think about the fact that only few corporate pension funds have signed up to the Stewardship Code so far.

That’s all from me.

[Ikeo, Chairman] Thank you very much. Now I’d like to open a discussion session. The secretariat summarized our views expressed in previous meetings in Material 4 for further in-depth discussion. In addition, the secretariat reported the current situation around the Stewardship Code. Taking them into account, please express your opinions or ask questions. Please feel free to make any comments.

Please go ahead.

[Toyama, member] Let me open the discussion. First, I’d like to make a comment on the Stewardship Code. This is just my impression. Page 7 [of Material 2] shows examples of companies D, E and F. Probably, I am a policyholder of one of these companies. Besides, it is

highly likely that I am an outside director of a company much of whose shares is held by one of these companies. Speaking from the both standpoints, I don't understand what they are talking about. I'm wondering if they are all right. As a policyholder, absolutely I'd like them to make [company-specific] disclosures. As an outside director, I don't mind, for instance, if they vote against a proposal for appointing me as a director. If they cast 'against' votes, we can rather deepen constructive dialogue. This is for sure. I would be happy to have dialogue, if they were against electing me as a director. And you said there are pension funds which have not signed up to the Stewardship Code. Can't you disclose their names?

[Tahara, Director of the Corporate Accounting and Disclosure Division, FSA] Corporate pension funds, which are not included in this list, have not adopted the Stewardship Code. Therefore, as a matter of fact, corporate pension funds which signed up to the Stewardship Code are publicly disclosed.

[Toyama, member] What I'm saying is that you could announce such a status on official gazettes or elsewhere. I believe that there is no problem with disclosing names of institutional investors which have not made company-specific disclosures.

In terms of compliance, it should be OK to disclose the fact that they do not disclose their voting records. Are there any reasons why their names cannot be disclosed?

[Tahara] We publicly disclose this list, with the notion that institutions, which are not included in the list, have not announced that they would make company-specific disclosures of their voting records.

[Toyama, member] I would say that, instead of describing them as Company D or E, you should disclose their names fairly and squarely. The reason why I say this is because we are their policyholders, and we'd like them to make disclosures. Not only existing policyholders but also potential policyholders should be given opportunities to choose whether they purchase insurance policies of life insurers which have disclosed their voting records or those which have not. All trust banks do that. Because people entrust their money, people need to know to what companies they entrust the stewardship. It should be disclosed to the public.

If what they say is true, some policyholders may choose insurers which do not disclose voting records. That's their logic. What they are saying is that they do not make voting disclosures, because they believe that people select insurers which do not make voting

disclosures. Then such a fact should be disclosed fairly and squarely. This is my first point.

The next point is related to the Governance Code, specifically business principles or philosophy as written in the first bullet point [on Material 4]. I agree with that. In reality, this is called into question typically upon the occurrence of corporate scandals. When corporate scandals occur, companies are criticized for contradiction between words and actions. A well-known example would be the scandal of Johnson & Johnson. Recently, we have seen various types of corporate scandals including misrepresentation. To tell you the conclusion first, such scandals would not have occurred, if companies acted in accordance with their business principles. Therefore, [companies and investors] should have in-depth dialogue about that. When we seek "concreteness" in this context, it does not mean specifics of their systems or events. We can see the reality of a company when such a scandal occurs. Accordingly, the focus of dialogue should be why a corporate scandal occurred or did not occur, and/or why something different from business principles occurs. If investors seriously sought explanations about that, it would rather contribute to long-term growth of the company in question for sure.

Needless to say, in most cases, if companies operate in accordance with their business principles, the companies will continuously become better. If you read their business principles, you can find that. Therefore, they should disclose such unfavorable information as short-term losses accordingly. Remember the famous case of Johnson & Johnson (J&J); the company recalled all products in a certain category, although it turned out that there actually was no product problem. As for decisions whether or not to do so, it is rather better for investors, if companies do so. J&J is an excellent company. The company has been constantly growing probably over the longest period of time in the United States, and what it does is socially meaningful. If I remember correctly, it is the only company which have been ranked in top 10 in terms of market cap for the past several decades. It does not at all mean that J&J has been motivated by money. Instead, it is famous as a company doing a great job for the society. So I agree with this point, and I believe it is important.

My next point is about the appointment/dismissal of CEO on page 2. We have had in-depth discussions on this point, and that is great. However, despite of our intensive discussions on this topic, I cannot see a clear correspondent relationship with the Corporate Governance Code. Even though we have intensively discussed a certain issue, it is not clearly stipulated in the

Code. I can only find related texts here and there. If this is an extremely important issue, I believe that the Corporate Governance Code should be revised in a way to reflect the points summarized in this material.

Frankly speaking, there was a controversy over the issue of appointment/dismissal of CEO, when the Code was being developed. And a compromise was reached: we got so close but avoided to get right to the point in the Code. I'm sorry that I'm not good at bureaucratic rhetoric, so I'll speak in a straightforward manner. It was almost there, but not quite there. However, after that, we have recently seen the surge of "OB governance" problems *[translator's note: domination of decision-making by former top management]* as well as various corporate scandals. As I mentioned in NHK's program yesterday morning, while various problems, which led to such scandals, arose at the front-line level, why did problems arise at the front-line level? It is because, as it turned out, the management made unreasonable demands on front-line workers, although it may not have been on purpose.

For example, companies often explain reasons for scandals that customers for their unprofitable business made difficult requests, and they had no choice but to go for an improper act in order to meet such requests. If that's the case, they should have discontinued such unprofitable business. Front-line workers cannot make such a decision to discontinue the business, while they are earnestly engaged in sales activities. It is the responsibility of the top management to decide that they withdraw from such a business. When I tell them this, they say they have a responsibility to supply products. If there is such strong demand for the products to the extent they feel responsible to supply, they should sell the products at higher prices. Then they say their customers will have a trouble. If their customers need to have the products so much, they will buy the products despite high prices. Therefore, everything is a problem with the top management in the end. Because the top management has not addressed a real problem or has not decisively made a painful decision, many companies end up continuing poorly-performing businesses, which cannot generate ROIC of 10% or even 8%.

As a result, they tend to replace this issue with the mid- to long-term research & development (R&D) issue. Such Japanese top managers are completely wrong. I'm aware that a representative from the Ministry of Economy, Trade and Industry (METI) is attending this meeting. Looking at the world trend, the level of R&D expenditures of Japanese

companies is low. Predominantly, American or Chinese companies invest in R&D. The reason is simple. They do businesses with an overwhelmingly higher value-added ratio (VAR) than that of Japanese companies. Unless they achieve a high VAR, they cannot secure funds for R&D. The most essential way to raise VAR is selling products or services at high prices. If they cannot sell at high prices, they discontinue such businesses. Therefore, it ultimately is a matter of the top management.

I took the long way to explain it, but the issue number (3) [of Material 4] is very critical. I think it is getting even more critical. Reflecting on various problems we have seen this year, such a comment that front-line workers have been getting weaker, is wrong, to be honest. Front-line workers are doing their best. They are working frantically. Their desperate choice is juggling the figures. Therefore, the Corporate Governance Code should include a clear-cut provision which corresponds to our discussion on CEO as in (3). This time, I won't compromise. Even if any business association offers objections, I won't give in.

Next, I'd like to make a comment on *kansayaku* (corporate auditors). As I wrote in my opinion statement [for the 11th Council meeting on Oct. 18, 2017], realistically speaking, in many companies, especially internal full-time *kansayaku* is unfortunately considered as if it were a consolation prize for those who could not take up the post of director. Consequently, the post of *kansayaku* is held by those who have engaged only in sales or production division, never read the Companies Act in their life, and do not know bookkeeping and accounting. This is nonsense. This post should be the goal post for those who have expertise in accounting principles and legal affairs, or relevant knowledge, or have gone through relevant training in the company. Rather, I would suggest that this post should be the goal post for those who achieved the most successful career – those who assumed the role of CEO or President. We could write about that in the Governance Code.

At present, every company is working on strengthening its compliance and internal audit on operation. To motivate people in charge of such work, it is absolutely better to regard the post as I said. Usually, people in that line will not become President. Nonetheless, in terms of motivation, it is important to prepare a glorious goal post, and I believe it will lead to strengthening *kansayaku* in a substantial way.

Now I move on to page 4 [of Material 4]. I've been feeling for a long time that it is difficult

to understand the issue of "held companies" which make certain companies hold their shares as cross-shareholdings. There is no easy-to-understand cross-shareholding now. A predominant case is cyclical cross-shareholding (for example, Company A holds Company B's shares, Company B holds Company C's shares, and Company C holds Company A's shares). If the fact that a certain company holds another company's shares as a stable shareholder brings about business advantages, it will be nothing but offering special benefits. Professor Kanda is a specialist on this matter. I've been wondering why such shareholdings are not regarded as offering special benefits. It seems to me that the grant of business benefits in exchange of shareholdings would be the same as paying money to *sokaiya* (corporate bouncers) in the economic term. I'm wondering how things are going.

In that sense, it is inappropriate in terms of compliance. If it does not fully constitute a violation of the Companies Act, I personally put it in gray area. In terms of the current rule of common sense of compliance, they deserve "no benefit of doubt". That's a certain kind of moral standard among Japanese companies at present. Therefore, the situation where companies mutually hold each other's shares because they are important customers, is obviously the grant of benefits. I've been wondering how this is interpreted in terms of compliance. In companies where I serve as an outside director, I tell them not to buy shares of another company which is their business partner, unless they can get a fair price from business with the partner and there is a right reason for which they were chosen by the partner. Otherwise, such shareholdings are not reasonable.

If they already hold such shares of a certain company, which is a business partner, I tell them to exercise voting rights more strictly than usual. I ask them, "If you find the partner company's proposal is not reasonable, please do not hesitate to vote against the proposal." If such voting adversely affects the business, it means such shareholdings used to be the grant of special benefits. It proves to be like that. If the partner company discontinues the business relationship, it turns out to be the grant of special benefits. I tell them so. I believe they could sell such shares. The point is "Don't do anything that can be misinterpreted." I think such a rule could be established somewhere. There should be no reasons for objections, in my opinion.

That's all.

[Ikeo, Chairman]　Thank you.

Mr. Oba, please go ahead.

[Oba, member]　I'd like to make comments on two issues, which are related to what Mr. Toyama mentioned.

The first one is the issue of cross-shareholdings. I believe today's discussion is for consolidating and summarizing our views, considering what was decided by the Cabinet. Keeping it in mind, I'd like to talk about cross-shareholdings first. General Principle 1 of the Corporate Governance Code stipulates that listed companies "should develop an environment in which shareholders can exercise their rights appropriately and effectively" and many companies comply with this principle. Furthermore, Principle 1-4 makes 3 points concerning cross-shareholdings.

First, it requires companies to explain the rationale behind cross-shareholdings. Second, it stipulates that companies should establish standards with respect to the voting rights as to their cross-shareholdings. Third, it requires companies to disclose such standards. Even though the Code clearly mentions these points, I have never seen media reports on these points. While media has reported asset management firms' initiatives on company-specific voting disclosures under the Stewardship Code to a certain extent, I have never seen any media coverage about companies' standards of voting rights as to their cross-shareholdings, as well as how they exercised their voting rights under their standards, even though the companies have declared that they have complied with the principle. Therefore, if the companies complied with the said principles, they should make disclosures according to the rule and guideline. In fact, I'm not even sure whether they have made disclosures. So, I think fact-finding is required on this point. This is my first point.

My second point is about asset owners, which is the 5th issue in today's material. My opinion may be close to Mr. Toyama's. Our association [i.e. Japan Investment Advisers Association] conducted a survey on asset management firms' response to the Stewardship Code. We have recently summarized survey results for this fiscal year. In the survey, there is a question, asking "How do you report on your voting results to you customers?" Nearly a half of the firms replied that they reported the results upon their customer's requests, but the number of customers who made such requests is limited. In other words, this survey result

revealed the reality where many customers are totally out of the scope as they do not make such requests.

Therefore, while it is assumed that many of them are corporate pension funds, one of the main focuses should be how we can articulate expected efforts of corporate pension funds in the Corporate Governance Code. As mentioned earlier, General Principle 1 of the Corporate Governance Code stipulates that companies should develop an environment in which shareholders can exercise their rights appropriately. Accordingly, companies could provide guidelines for efforts of their own pension funds, as a part of developing the environment where their own pension funds can exercise the shareholders' rights properly.

That's all.

[Ikeo, Chairman] Thank you.

Mr. Sampei, please.

[Sampei, member] Thank you. I understand what we do at this stage is sorting out issues to be addressed. When Guidance is eventually formulated based on our discussion, I assume something like Preamble is included. In my opinion, what is important for Preamble is that it should not require companies to give equal weight to every single item on this exhaustive list, although each item is important and reasonable in its own way. Key issues to be addressed may vary from company to company. They should focus their efforts on their own key issues. Otherwise, dialogue will be defocused. Therefore, every single item listed in this material is important, but choosing what to focus on is up to individual asset managers' skills. Unless they explore key issues in depth, I don't think the focus [of the governance reform] will move from "form" to "substance". Therefore, Guidance should not be regarded merely as a checklist.

We have talked about stewardship responsibilities of corporate pension funds. When corporate pension funds are increasingly working on fulfilling their stewardship responsibilities, for example, if Guidance is used like a checklist and they just ask "Have you done this and that?", asset managers will be guided to respond "We have done this and that" by just ticking the boxes of the checklist, thus not deepening governance efforts.

As for specifics [of Material 4], I'd like to comment on "(1) Management decisions in response to changes in the management environment". Each word therein sounds reasonable. However, the question whether companies established concrete corporate philosophies or

principles may not be relevant here. As Mr. Toyama also mentioned earlier, most companies have their corporate philosophies or principles. However, it is very unclear about how they incorporate such philosophies or principles into business models.

For instance, among companies which were established decades ago, few state or disclose why they are currently running multiple businesses, how they made such choices, and whether doing such businesses contributes to increasing corporate value. Most of them just say, "We have been doing this business for a long time, so we continue this business." I have a doubt about whether they have a perspective of increasing corporate value, while being that way.

Furthermore, when growth slows down, they add a new business to their business portfolio. It is not wrong, but they do not have a clear discipline about an investment period for such a business, when it is expected to get profitable, whether such a business is important to the extent that it will be a strategic pillar of the company in the future in terms of scale. At the same time, while they increase the number of such new businesses, they do not withdraw from existing businesses. As a result, the number of businesses in their portfolios gets bigger and bigger. Then they will have no choice but to allocate important management resources to diverse businesses. If they regard a new business as a strategic pillar in the future, they need to prioritize their investment in such a business. Nevertheless, because they cannot do so, the new business fails to achieve a significant growth over time. Therefore, while (1) refers to overall management, it is necessary to have clear dialogue about why companies run certain businesses, why they selected such businesses, and how such businesses are linked to corporate value.

I just mentioned withdrawal. Withdrawal from a business tends to be regarded as equal to unemployment, but I don't think so. There is an English expression "a good parent of the business", which is often used in other countries. It refers to whether a parent which runs the business is appropriate or not. A business will not grow, if its parent is bad – the problem does not lie in the business itself. If the business is run by an adequate parent, the business will significantly grow and become competitive. Therefore, it is necessary to consider a good match. If it is a good match, employees will be more rewarded. [Japanese] companies do not sufficiently have such a perception, and do not have sufficient dialogue about that.

Next, concerning the cost of capital, according to a survey by the Life Insurance

Association, there is a significant gap between the cost of capital in the eyes of companies and in the eyes of investors, or perception on whether companies generate returns that exceed the cost of capital. It would be pointless to ask corporate executives whether they conduct capital-conscious management. Instead, investors should tell them about the expected level of the cost of capital. In response, companies should try to understand why it is so, and fill the gap through dialogue. Otherwise, a significant progress cannot be achieved. If an investor cannot present or explain an appropriate level of the cost of capital for a company, then the investor does not have adequate qualifications.

Next, I'd like to discuss "(2) financial management". Actually, the term "financial management" does not sound right to me. Instead, I personally feel the term "capital disciplines" fits in better. What is important here is that, simply speaking, factors for increasing corporate value would be competitiveness and growth potential. In this light, it is necessary to check, for instance, whether companies are considering how resources need to be devoted to maintaining/strengthening their competitiveness, and whether companies are actually doing that. The more resources they devote, the more they grow. Therefore, unless investors check such points, dialogue will tend to be defocused.

This may overlap with what Mr. Toyama mentioned earlier. When a certain business does not become competitive or does not grow despite all devoted resources, the business is already in such difficult conditions. So it will be a waste of money to invest in such a business, just because the company has cash on hand. Such an investment is a big mistake.

The point (3) is related to whether or not they can make decisive management decisions. The opposite of making decisive management decision would be taking responsibility for a failure to act. In that context, is the failure to act – doing nothing – a result of their judgment and are they prepared to take the responsibility? Alternatively, when they make a resolute decision to do something, are they prepared to take the responsibility? They will not be able to accept such a responsibility without certain risk rewards. Then this is the issue of remuneration. However, concerning remuneration designs, there are some aspects that are quite difficult for me to understand. Even among companies which disclose an easy-to-understand formula of performance-based bonus, they say the payment ratio is approx.60% according to the formula, but they add special bonus and thus the final payment ratio is 98%. Then, in the eyes of

outsiders, it is difficult to figure out whether their assessment of achievement in increasing corporate value was 60% or 98%. While the computed result is 60%, the final figure is 98% due to the topping up. In that sense, while remuneration and incentives are very important, their design should be clear. It should be easy to understand so that outsiders can identify the degree of achievement in increasing corporate value and corresponding payment ratio.

Concerning cross-shareholdings, I'll give you an example. We had dialogue with Company A, which is one of top 500 TOPIX companies. Company X and Company Y are among top 10 largest shareholders of Company A. Company X is the 5th largest and owns 2.59% stake, and Company Y is the 9th largest and owns 1.6% stake. Company A owns 0.04% stake in Company X, and Company X is the largest among "deemed shareholdings" list disclosed in the Annual Securities Report. Company A also owns 3.67% stake in Company Y, and Company Y is the 2nd largest among "deemed shareholdings". Company X is a large company, which is ranked in the top 30 TOPIX companies, so despite the large amount of investment by Company A, the ownership ratio is just 0.04%.

This is "deemed shareholdings", where its retirement benefit trust holds shares, but a parent company has voting rights. As for the percentage of such shareholdings to total assets of the retirement benefit trust, shares of Company X account for 23% of total assets of the retirement benefit trust, and shares of Company Y account for 13%. Then can it be called a portfolio? Such a situation is an issue of fiduciary duties of corporate pension funds. I have a serious doubt about the situation. I asked questions about the situation to companies, but as they had never been asked such questions they could not respond on the spot. That means they have not looked at the matter in that way. And "deemed shareholdings" looks odd in the first place. Even though companies contribute such shares to their retirement benefit trusts which are their important assets, they secure respective voting rights as parent companies. At this point, such shareholdings are not pure investment. Since they are not for pure investment purposes, they are on the list. Then do retirement benefit trusts hold shares not for pure investment purposes? There are various contradictions. Therefore, regardless of whether corporate pension funds signed up to the Stewardship Code, are corporate pension funds fulfilling their fiduciary duties? As for the situation where a parent company forces its pension fund to do so, I believe that the Corporate Governance Code can sufficiently govern the

situation. In that sense, as the Corporate Governance Code refers to fiduciary responsibility in its Preamble 7 “Objectives of the Code”, we need to look at the matter in accordance with that.

Finally, the board is expected to check cross-shareholdings. Then such a function should be included in the scope of an evaluation of board effectiveness. Companies should disclose the fact that the board checked cross-shareholdings and how the board evaluated them, together with results of their evaluations of board effectiveness. I suggest that the Code should be revised in a way to require companies to make a certain form of disclosures so that shareholders can understand how they reviewed their cross-shareholdings.

[Ikeo, Chairman] Thank you. I’d like to hear opinions of various members, so please make your comment as brief as possible.

Mr. Oguchi, please.

[Oguchi, member] Thank you. I read through Material 4, and basically agree with the points of view expressed. So I’d only like to make specific recommendations.

Concerning ‘defensive’ governance on page 3, overseas investors cast wary eyes on recent corporate scandals. When a corporate scandal occurs, it is common that the company in question subsequently establishes a third-party committee, consisting of only independent members, that carries out a neutral, fair and objective investigation from an independent standpoint. Such a third-party committee investigates the matter from various angles. Actually, I talked about this 2 years ago at this Follow-up Council: considering that there is no end to corporate scandals, a third-party committee should be established beforehand and retained as a permanent body, instead of establishing it after the occurrence of scandals. Once again, I’d like to suggest that we should revisit *kansayaku* board (board of corporate auditors), audit committee and supervisory committee which are referred to on page 3.

When discussing audits by independent directors, I often hear a concern about the viability of auditing by those who are not familiar with business operations. According to the Third Party Committee Guidelines [for Company Scandals] issued by Japan Federation of Bar Associations, this concern can be addressed by requiring companies to establish a secretariat which consists of an appropriate number of employees and directly reports to the third-party committee. On the assumption that a third-party committee plays a certain role ex-post facto, an internal audit department could assume the role of the secretariat, and highly independent

kansayaku board (board of corporate auditors), audit committee or supervisory committee could play the role of such a third-party committee, where the secretariat reports to such a committee. In that case, since the said committees have legal authorities which a third-party committee does not have, we can expect that 'defensive' governance will be strengthened.

That's a formal logic. When I discussed it with a certain independent director, he said that outsiders do not really know front-line operations. So I asked him specifically how he works [as a director]. He said that the lack of such knowledge is rather an advantage for him, and that he visits sites as necessary. Then if something is wrong with what they usually do within the company, he will notice it. If he notices it, he could use the internal [audit] department, and challenge the company. This is associated with the issue of qualifications. I believe that outside directors need to have the qualification to challenge the status quo.

The second point is about cross-shareholdings. My view is close to what other members already mentioned. Let's consider return and cost by using simple figures, and omitting capital gain which could be either positive or negative. Suppose that dividend yield is around 2% and capital cost is 8%. If we look at it as normal investment, it results in the loss of 6%. Accordingly, based only on these figures, a concern arises: a "held company", which made another company hold its shares, therefore, compensates the deficit through business transactions with the latter; and the latter exercises its voting rights in compensation.

As Mr. Toyama mentioned earlier, although I'm not a legal expert, we come to a question whether this is the grant of benefits. Outsiders are unable to identify whether it really is the grant of benefits. If not, it is reasonable to make a company-specific voting disclosure, as institutional investors have already done, and as ACGA and APG pointed out that cross-holding companies should make disclosure on voting results for such holdings on page 8 of "Summary of comments by overseas institutional investors on the issues for deepening corporate governance reform". This is the same as discussions on company-specific disclosures by institutional investors. As long as they hold shares, they must externally and rationally explain such holdings. I suggest that such a stipulation should be included in the Corporate Governance Code, if possible.

Finally, my third point is about the issue around asset owners. At the bottom of page 9 of the summary of comments by overseas investors, Legal & General stated that pension funds

are less resourced [than asset managers], but they have a large influence and impact on the market and behavior of asset managers. As discussed at the previous meeting, considering the reality with such an imbalance, as the new policy package refers to the importance of asset owners' functions, we need to consider this issue as the issue of the entire investment chain, although it is originally the issue of individual asset owners. Looking at it as the issue of the entire investment chain, pension consultants have significance for less resourced asset owners. Therefore, by establishing a system where pension consultants can adequately evaluate stewardship activities or providing proper advice, the investment chain will be able to perform its functions more effectively.

Concerning asset owners, as the UK's Legal & General as well as USS, a UK pension fund, pointed out, it is essential to address the issue of conflicts of interest with parent companies. In the meantime, it is suggested that parent companies should take more initiatives in the personnel and management aspects. This is a dilemma. If parent companies take more initiatives, it will give rise to conflicts of interest. Therefore, on the side of asset owners, preventing possible conflicts of interest and securing the transparency will be more essential. On page 5 of the material about responses to the revised Stewardship Code, there are examples of measures taken by asset managers facing the issue of conflicts of interest. These can be used as reference. For instance, they set up the Stewardship Committee, which is a third-party committee dominated by outside directors. We should discuss the introduction of such a function to supervise stewardship activities, together with the discussion on strengthening the executive function.

Some may argue that they already have hard time securing human resources for the executive function, and thus cannot secure human resources for such a supervisory function. However, in response to the governance reform, parent companies have worked on strengthening the supervisory function or securing the transparency and fairness, and have gained insights on the matter. So, parent companies can not only send investment management experts, but can also make use of their insights for establishing the asset owners' independent and objective governance. I suggest that these should be discussed together.

That's all.

[Ikeo, Chairman]　Thank you.

Mr. Tsukuda, please.

[Tsukuda, member]　Thank you. I'd like to make 2 points.

The first point is about (3) of Material 4. I agree with what Mr. Toyama mentioned earlier today. In (3), it is written that, for those who assume the roles of CEO, independent directors, or *kansayaku* (corporate auditors), the most important point is whether they have adequate qualifications. The issue here is identifying what qualifications are the most important at present, while the business environment is rapidly changing. Therefore, companies need to explain during dialogue with investors what qualifications CEO must have in order to make decisive management decisions. Investors need to ask questions about that to the companies. Instead of discussing specifically who should assume the role, they should discuss what qualifications are required, and whether such qualifications align with the current business strategy. Without such serious and concrete dialogue, we cannot expect improvements in the effectiveness. In formulating Guidance, I'd like you to keep this point in mind. This is my first point.

Second, in Material 1 which is the summary of Japan's New Economic Policy Package, it is stipulated that the government will "review the Corporate Governance Code as necessary", so I'd like to make a comment about that. I'd like to request the review of Principle 4.8, which is written at the bottom of page 18 of the Corporate Governance Code.

The governance reform has achieved a certain progress in terms of Form. When considering how to enhance Substance, we should reconsider the first paragraph of Principle 4.8, the first paragraph: "Companies should appoint at least two independent directors". Under the current circumstances, do we think "at least two" should be the minimum standard? Naturally, there would be various opinions, and people have different views on stipulating "the majority" as the minimum standard. I believe that it would be reasonable to require companies to appoint "at least one-third" independent directors.

This is because of the proportionality. The Corporate Governance Code is applicable to a broad range of companies. A certain company may have 15 directors, and another company may have only 5 directors. The requirement by using an absolute number "two" would be a huge burden on some companies. If the requirement is "at least one-third", companies with 9 directors appoint 3 independent directors, and companies with 12 directors appoint 4

independent directors. I'd like you to consider this kind of standard.

I'm talking about this, because I have observed corporate governance reforms by various companies in the past few years, and found that the larger number of independent directors results in enhanced quality. As Mr. Oguchi pointed out the other day, it is debatable what is the coefficient, and what is the result. The management with a high level of awareness invited many independent directors. Meanwhile, because the company is run by the management with such a high level of awareness, the company can increase its corporate value. Nonetheless, "large numbers have power." In order to enhance the effectiveness in the future, I feel numbers are important. In that sense, I'd like you to reconsider the first paragraph.

In the second paragraph [of Principle 4.8], it is stipulated that "Irrespective of the above, if a company in its own judgment believes it needs to appoint at least one-third of directors as independent directors based on a broad consideration of factors such as the industry, company size, business characteristics, etc." I'm still not convinced by this statement. It means that, if a company believes it needs to appoint at least one-third independent directors, it may just appoint at least one-third independent directors in its own judgment, regardless of whether it discloses its policy. This should be in an opposite way. Rather, a company, which believes it does not need to appoint at least one-third independent directors, should provide a clear explanation about that. I don't think the second paragraph facilitates the advancement of governance of Japanese companies, so I suggest that we should consider the necessity to revisit the paragraph.

That's all.

[Ikeo, Chairman] Thank you very much.

Ms. Takayama, please go ahead.

[Takayama, member] I'd like to make 2 comments.

First, I'd like to talk about the first bullet point in Material 4, which reads "Whether companies established concrete business principles as well as business strategies and business plans to increase the mid- to long-term corporate value". It is very good to refer to business principles here. Business principles are the basis of companies, and companies formulate various strategies and plans under such principles. Certainly, many companies have in place business principles that are intended to increase mid- to long-term corporate value. However, I

feel something is wrong about asking whether business principles were concretely established, as written here.

This is because I believe that business principles of a company consist of more abstract, philosophical concepts, reflecting its corporate culture and history. I don't think it is appropriate to discuss such business principles at the same level as business strategies and business plans. However, I do think that business principles should be consistent with business strategies and business plans. Some Japanese companies have business principles, which are not linked with business strategies and business plans. Business principles should be properly established, and then business strategies and business plans, which are aligned or linked with such business principles, should be formulated.

My next point is about the appointment of independent directors and their responsibilities or functions on page 3. Concerning the appointment, it is described that "independent directors are appointed from those who have appropriate qualifications". I believe that the appointment process is important. Currently, in most companies, management teams take initiative for the appointment of independent directors – for instance, CEO asks outsiders with excellent profiles to be independent directors. Because they were at first appointed in that way, many independent directors feel a psychological hurdle to take part in the process of appointing outside directors. However, as in the process of appointing CEO, an independent nomination committee could play significant roles in the process of appointing independent directors. Certainly, CEO plays the most important roles in creating corporate value, but independent directors, who supervise CEO's management, are also extremely important. Therefore, I consider that the Code could enhance descriptions about the appointment process.

As for fulfilling their functions, while it is important to appoint those who have appropriate qualifications, I agree with Mr. Tsukuda's opinion. In order for independent directors to fulfill their functions effectively, there should be minimum requirements in terms of the form. That is the percentage or number of independent directors in the board. When the Code is revised, I believe that the Code should go into greater depth.

That's all.

[Ikeo, Chairman] Thank you. I have a similar view on the first point Ms. Takayama mentioned. Discussion on business principles should be written in Preamble or general

statement, as Mr. Sampei mentioned, and the first bullet point [on Material 4] should be changed to a question whether business principles are specifically translated into business strategies, etc. I think such an approach would give more clarity.

Mr. Uchida, please.

[Uchida, member]　Thank you. I'd like to make 6 points. Excuse me.

First, in Japan's New Economic Policy Package, it is described that the government will "make a necessary revision of the Corporate Governance Code". Because it says "a necessary revision", I understand that a significant review or revision is not expected this time.

At present, individual companies have been working on enhancing the quality of their governance efforts through dialogue, in accordance with the Code implemented in June 2015, and exploring various ways to make progress. If the Code is prematurely revised under this circumstance, companies will be confused and may turn to superficial means just for form's sake. I believe that, as the first step, it is important to verify whether corporate responses to the Code, including both what companies have already done and will do in the future, result in increasing corporate value. Accordingly, I'd like to suggest that the review of the Code should be limited only to the items, to which this time we identify that major revisions are absolutely necessary, and they are urgent and important. The review should be minimum.

Next, I'd like to discuss business principles, which are written in the first bullet of "(1) Management decisions in response to changes in the management environment" in Material 4. My opinion is close to what Ms. Takayama just mentioned. There are so many cases where business plans and business strategies are not linked to their management philosophy. Therefore, it is important that companies and investors have in-depth dialogue about that. Furthermore, as for the problem pointed out by Mr. Toyama, reflecting on the fact that a similar problem occurred in the company I work for, I believe that this is a very important point. Actually, I got an impression that non-financial discussions have not usually been made in the context of investor relations. I think such a non-financial aspect will be one of the topics of dialogue.

As for financial aspects, the allocation of management resources is also an important issue, as Mr. Sampei mentioned. In case business strategies and business plans are linked to their corporate philosophy, then it is necessary to discuss the allocation of management resources:

for example, how to allocate management resources to achieve business strategies/business plans, and whether investments in R&D, capital expenditures, human resources, and marketing are aligned with business strategies/business plans. It is important to ensure that there is a linkage between these two (business strategies/business plans and the allocation of management resources). In this connection, a member pointed out the issue of exit decision: Japanese companies used to be slow to make exit decisions, as they were concerned about the issue of unemployment. That is true. However, Japanese companies have recently become "familiar" with M&As – although this expression may not be good. They often talk about M&As, and sales of businesses are gradually increasing. Although it may take more time, there is such a trend.

Nonetheless, in case a company decides to discontinue a certain business, as an overwhelming majority of corporate managers in Japan consider that the employment is one of corporate social responsibilities, the speed of discontinuing the business is much slower than the case of an American companies. This is often pointed out, when I talk with the US investors. One of the causes would be the specific factor that Japanese labor market lacks liquidity.

My next point is about setting "indicators of earning power, capital efficiency, etc." I understand that Japanese companies now have greater awareness of the importance of earning power and capital efficiency. As described in overseas investors' opinions in Material 3, although ROE is certainly important, ROE does not give us the entire picture of a company. If we evaluate a company by using only ROE, there will be a possibility that the company makes a short-term response by reducing shareholders' equity to increase ROE. Therefore, it is important to make a comprehensive evaluation by using all relevant indicators, including ROIC and ROA. Furthermore, from the perspective of business continuity, such indicators as D/E ratio should also be looked at together.

Now I'd like to refer to the issue of cash on hand described in the section of investment strategy and financial management. Here, the issue is an evaluation of excessiveness to check whether a company holds excessive cash on hand to prepare for unforeseeable circumstances. This may vary from company to company. The situation is different between companies which can raise funds through direct finance and companies which cannot do so. During the turmoil

in the financial market, even companies, which can raise funds through direct finance, could not raise funds, despite the fact that they are large companies or companies with AAA rating. Accordingly, taking these points into account, a judgment as to whether a company holds excessive cash on hand should be made on an individual company basis. We cannot make a uniform evaluation here.

As for cross-shareholdings, the second bullet point describes "clarifying reduction policy". As I mentioned in the past, some companies cross-hold shares as a part of their business strategies, so I'm not comfortable with discussing toward reducing all cross-shareholdings. In the previous meeting [of the Follow-up Council], a representative from Omron, which is advanced in the area of corporate governance, made a presentation, and explained "We do not believe holding listed shares in itself is always wrong. There are cross-shareholdings for strategic business alliance purposes, etc. However, we will reduce unnecessary listed shares." I understand that there are many Japanese companies that take a similar stance. Furthermore, at the previous meeting of the Follow-up Council, I shared the data of Nikkei 225 companies. Taking the opportunity of the implementation of the Code, the companies have been unwinding and reducing cross-held shares which do not lead to increasing their corporate value. Considering such a move, the focus of our discussion should be limited to irrational cross-shareholding, instead of all cross-shareholdings. Accordingly, [as far as decision making on cross-shareholdings is concerned,] the first bullet point is sufficient. The second bullet point can be interpreted that all cross-shareholdings are in the scope. That is problematic, so I'd like to request the deletion of the second bullet point.

Next, I'd like to discuss the issue of "cross-held companies" that make certain companies hold their shares as cross-shareholdings. "To make other companies hold their shares" means that other companies are made to hold such shares. If the cross-holding companies consider that they were made to hold such shares, there is no rationale to hold such shares. Then, regardless of any pressure from cross-shareholding partner, they should sell such shares. Cross-holding companies should make judgments based on whether such shareholdings have significance. Regardless of the fact that they were made to hold such shares, if there is no rationale, they should sell the shares.

Finally, I'd like to refer to the current situation where only limited corporate pension funds

signed up to the Stewardship Code. According to the survey of the Pension Fund Association, roughly 80% of corporate pension funds have no more than 2 staff members in charge of asset management. Therefore, it is practically difficult for all corporate pension funds to adopt the Stewardship Code and have in place the structure specified in the principles of the Code. Again, each corporate pension fund should be allowed to decide whether it signs up to the Code, depending its own circumstances. What corporate pension funds are required to do, would be careful monitoring of asset managers' stewardship activities, rather than accepting the Code.

However, even though they should focus on monitoring, in order to make such monitoring meaningful in real terms, it will require a certain level of man-hours. Currently, there are roughly 600 corporate pension funds, just to count fund-type ones. Suppose that 600 corporate pension funds visit asset managers at one time for monitoring purposes. Then asset managers' cost is likely to increase, and that is problematic for corporate pension funds as well. Accordingly, it is desirable to figure out a common framework that is efficient for both corporate pension funds and asset managers, and is not for form's sake.

For example, guidelines focusing on important matters could be formulated, or a certain reporting format could be prepared. I'd like to request you to consider such a common framework.

That's all.

[Ikeo, Chairman] Thank you.

Professor Kawakita, please.

[Kawakita, member] First, I think today's discussion is concerned with qualifications of the board members, including outside directors. The number of outside directors is a very important point. If they increase the number, it will naturally give rise to the issue of the quality. We should not avoid discussing the quality. Currently, companies describe, in their Securities Reports, what kind of persons they appointed as directors from outside the companies for what reasons, but most of them are merely boilerplate descriptions. This should be discussed in depth. I suggest that the Code should use the term "quality" in its stipulation.

My second point is about capital cost. It depends on the top management's awareness. There are many companies where the top management is not conscious about capital cost. The boards, especially outside directors, should raise such an issue for discussion.

Meanwhile, investors should not depend simply on quarterly disclosures. Instead, they should have discussion from the mid- to long-term perspectives. Investors should develop such capabilities. In this light, investors should discuss the business environment, competitive conditions, and other matters by themselves. Of course, the boards should also have such discussions. To encourage such discussions at the boards, investors should take the initiative for inspiring companies. I believe it is important for both parties to improve by learning from each other.

My third point is about cash and deposits, and the equivalent. As I mentioned at the beginning, financial institutions should help companies when the latter have hard time. This discussion is out of the scope of this Council, and should be addressed by the financial administrative body. Yet, reasons why companies accumulate cash and deposits should be discussed in connection with capital cost. Then, companies accumulate cash and deposits as internal reserves, therefore the boards need to discuss underlying dividend policies – discussion on dividend payout ratio, and discussion on how they use accumulated cash and deposits. If companies do not use such cash and deposits, the companies need to allocate them to dividends. If companies can use such cash and deposits, they need to discuss which business lines they invest in. Then, the discussion will be expanded to the issue of profit margin of new business lines. If companies are just encouraged to use cash, they may end up with a similar situation as what happened in company T. So, another important point is risks, not only profit margin. They need to discuss associated risks. This should be a topic of the board discussion, and investors also need to discuss it with companies which expand into new business lines.

As for cross-shareholding, I previously stated that pure investment is not good. Of course, as Mr. Sampei mentioned, there is a controversy as to whether "deemed shareholdings" is good or not. That falls into the same category as pure investment. It is not good that companies hold shares for pure investment or have deemed shareholdings. Another point. Again, as mentioned in the previous meeting, when we discuss the issue of cross-shareholdings, from the viewpoint that governance by general investors does not work, we need to keep in mind that discussion will be expanded to the issue of listed shares of both parent and subsidiary companies.

Finally, I'd like to make comments on the issue of asset owners. Pension funds are involved in deemed shareholdings. As symbolized by that, pension funds do not have experts.

Rather, similarly to the appointment of *kansayaku* (corporate auditors) in the past, companies appoint the chairman of their pension funds as a certain kind of goal post. Therefore, if a company decides to establish its pension fund's own system, the company should bear sufficient costs, because a corporate pension fund has a significant impact on corporate finance, as I mentioned previously. Then, the company needs to select external expert(s) or set appropriate goals in terms of personnel affairs, as someone mentioned earlier.

That's all.

[Ikeo, Chairman]　Thank you.

Mr. Iwama, please.

[Iwama, member]　Thank you. I used to speak from the same standpoint as Mr. Oba's, but now I'm on the standpoint of asset owners. So I'll speak from such a standpoint.

I'd like to express my view on the issue of corporate pension funds as described in today's material. As Mr. Sampei mentioned, the issue of fiduciary duties includes various issues, which significantly affect investment management as well as governance and stewardship. That's what I've been thinking. When it comes to a question whether corporate pension funds can properly do so [i.e. fulfill fiduciary duties], there are problems pointed out by Mr. Uchida. It is not so easy to solve the problems. That's the current situation. Actually, even in the UK, a model country, the commitment of corporate pension funds as asset owners is very weak, and efforts have been made to improve such a situation.

There was a symbolic event. Investment Association, which is equivalent to Investment Advisers Association in Japan, and Pensions and Lifetime Savings Association issued a joint report. They started a stewardship survey from the last year … or this year. In terms of collective efforts, I think this is a very rational and realistic initiative. This would be feasible in Japan as well. What efforts are needed for overall improvement? I do not yet have a clear vision of how to do it, but I consider that guidelines could be formulated for encouraging efforts of both companies and investors which will be benefited from the improvement of corporate performance. If there is progress in that way, problems will be revealed, although this is like an impression rather than an opinion.

[Ikeo, Chairman]　Mr. Tanaka, please go ahead.

[Tanaka, member]　I'd like to make several comments. Professor Kawakita referred to the

issue of appropriate qualifications of outside directors - whether they are qualified. I'd like to talk about this issue. Since the implementation of the Corporate Governance Code, the number of outside directors has been increasing in a considerable way, yet several questions have arisen.

First, before discussing appropriate qualifications, we need to address a question whether outside directors have relevant basic knowledge. For example, whether or not they have read and understood the provisions of the Companies Act, which outside directors of public companies need to know. While discussing ROIC and ROE, which are the basics of finance, how many of them understand what ROE is? How many of them understand a formula or formulas for calculating capital cost, while there are various calculating methods, for example WACC formula. If a survey is conducted, the resulting statistics will be disappointing.

In the financial industry, when workers engage in securities business or various other businesses, they need to obtain various qualifications or certifications in connection with the Financial Instruments and Exchange Act (FIEA). They need to take relevant exams. Unless they pass such exams, they cannot engage in those businesses. In that light, how about introducing an exam to be outside directors? For example, the Tokyo Stock Exchange (TSE) could give an exam to check whether candidates have the minimum basic knowledge required to become outside directors of listed companies. Alternatively, a certification system could be established. That's sort of the minimum standard. For example, in appointing outside directors of public companies, companies could disclose whether candidates passed the exam, or obtained the certificate, and then consider whether such candidates are qualified. I believe that it is time to consider the minimum standard.

In this background, there are various factors. Recently, the number of foreign directors has been increasing. I'm wondering whether they really understand Japan's Companies Act, or make judgments only relying upon their home country's way. That's why I feel it is time to consider the minimum standard.

Another point. While many companies have been making efforts for newly appointing outside directors, there are many failure cases. Nevertheless, the companies cannot easily dismiss such outside directors. What should they do? This is another question. In Europe, it is common to set the tenure rules. They consider that a long tenure of director may give rise to

collusion and adversely affect the independence. On the other hand, as I mentioned the other day, in the US, there is a mandatory retirement age as a best practice. By adopting such a mechanism, they may address the said problem more smoothly, although it may take time. It would be also useful for addressing the issue of independence of the board.

My second point is about cross-shareholdings. As a result of my comments during the previous meeting, I got feedback from various people. When discussing cross-shareholdings, I think we should consider the issues of shares held by financial institutions, and the issues of shares mutually held among business corporations, separately.

For example, the FSA's report "Progress and Assessment of the Strategic Directions and Priorities 2016-2017" shows the comparison between three mega banks in Japan and financial institutions in the US and Europe. As for the ratio of cross-shareholdings to Tier 1 equity capital, the ratio for the three mega banks is 35.5%, while the ratio for the US and European major banks is 4.8%. The FSA's report pointed out 2 issues. First, when share prices drop, the impact on equity capital is not negligible. When the financial crisis occurred 20 years ago, this became a serious problem.

Second, the reduction of cross-shareholdings is an important agenda not only for enhancing banks' financial soundness, but also for advancing the corporate governance reform. The FSA's report clearly states these 2 points. Consequently, it concludes that companies should work toward reducing cross-shareholdings. The first one is not necessarily related to shares mutually held among business corporations. As I briefly mentioned earlier, and as Professor Kawakita and Mr. Uchida also referred to, so-called "financial Diet session" was convened in 1998, almost 20 years ago. At that time, I was the assistant to Chairman of the Japanese Bankers Association, and had a terrible experience. We were criticized for banks' reluctance to lend and credit withdrawal. One of the underlying reasons was a sharp drop of cross-held shares. Nonetheless, banks had to sell such shares to safeguard their equity capital. Whenever banks asked permission of small and medium enterprises (SMEs) to sell their shares, banks faced strong resistance. Their concern was that, if banks sold their shares under those circumstances, people would consider banks gave up on the companies. This was a real argument between banks and companies at that time. Prior to the emergence of such a situation, certain actions should be taken now. Unless actions are taken when share prices are rather high, it will be hard

to cope with the next crisis, and similar problems will occur. I strongly believe that we need to prevent such a situation.

Looking at financial results of banks for the first half of the year, their net business profits, especially domestic profits, were very poor. They may need to go for restructuring. In the meantime, they were very much helped by gain on sales of shares. Thanks to this Follow-up Council, banks decided to sell shares, and it positively contributed to their bottom line. I've been thinking about a virtuous cycle driven by the sales of more shares: banks sell such shares when share prices are high, use the gains for restructuring, and improve their financial situation; consequently, as pointed out earlier, companies believe that banks will help them in case of emergency, and therefore they can use cash and deposits now. This would be ideal.

I'd like you to discuss how to do that. Actually, there is an organization named Banks' Shareholdings Purchase Corporation (BSPC). The law [i.e. Shareholdings Restriction Law] was revised last year, and the life of BSPC was extended to March 2032. BSPC can purchase shares sold by banks. Therefore, banks can sell outstanding cross-held shares to BSPC, although no transactions were made last month and the month before that. When banks sell their shares to BSPC, then BSPC entrusts such shares to trust banks, etc. for investment management. In a certain sense, we can say that cross-held shares return to the investment chain, while trust banks make voting disclosures, etc. I think this should be encouraged. BSPC is expected to gradually sell the shares it holds, avoiding equity market disruption. If BSPC sells its shares to good-standing investment trusts funds, for instance, which are within the scope of NISA investment program, that will provide the path to long-term holding. I feel we should consider such a way. Accordingly, I suggest that we should consider cross-shareholdings by financial institutions, and cross-shareholdings among business corporations separately, in our discussion for the Corporate Governance Code.

Finally, I agree with what is written about directors' compensation here, but there are some big problems in doing that. One is the threshold for disclosing compensations for directors of listed companies – 100 million yen or more. I think that is a huge psychological barrier. During the period when I was in office of Vice President, my compensation once exceeded 100 million yen. Somehow my old classmates of elementary and junior high schools knew it. Consequently, whenever I joined a drinking party, I had to pay a larger portion of the bill.

Another is the gap between Japan and other countries. The level of compensation for foreigners is very high, conforming to the global standard. Only the level of compensation for Japanese is low. In the days when I was President of an American Bank, 10 American staff members were reporting to me, and their compensation level was much higher than mine. My direct subordinates got paid 5 times more than me. However, whenever we went out for drinks, I ended up paying the bill. When we have in-depth discussion without paying any attention to this gap, there remains a psychological barrier. Probably, all directors of Japanese companies are hoping that something must be done with the threshold of 100 million yen. When foreigners increasingly join Japanese companies, there remains the issue of such a gap. Therefore, without addressing this issue, I don't think the reform of the compensation system will make progress properly.

That's all.

[Ikeo, Chairman] Thank you.

Scott-san, please go ahead.

[Callon, member] Thank you. I'd like to join the discussion on cross-shareholdings, because the current level of cross-shareholdings is very troubling. I am both an investor and a member of management at a Japanese listed company, and also serve as an independent director. In carrying out these different roles, I have come to understand that the reduction of cross-shareholdings is arguably the least advanced area of Japan's corporate governance reforms. In my view, this is because a segment of Japanese companies are not fully convinced [that they should actually reduce cross-shareholdings] and thus their actions in this area are superficial. We thus need to more fully clarify the problems engendered by cross-shareholdings and move forward on their reduction.

Cross-shareholdings have three adverse effects. The first and biggest is what Mr. Toyama pointed out earlier: that cross-shareholdings damage shareholder democracy. Calling cross-shareholdings "AGM-oriented shareholdings" instead of "cross-shareholdings" might give a truer picture of the situation. Cross-shareholdings are simply a barter system for voting rights, and these cross-shareholding voting rights are exercised for the benefit of cross-shareholding counterparties and not for the benefit of normal investors and normal shareholders who do not have cross-shareholding's conflicts of interests. Cross-shareholdings

thus create the possibility that voting rights will be exercised in a way that harms corporate value or the shared interests of shareholders. This is a problem of a totally different dimension from [cross-shareholdings impairing] value creation. It is a challenge to shareholder democracy itself.

There are two other adverse effects of cross-shareholdings that are rooted in more traditional discussions of cross-shareholdings' effects on corporate value. One is a concern that cross-shareholdings negatively impact corporate activities for value creation. In Japan's New Economic Policy Package (Material 1), the second bullet point refers to retained earnings in the form of "Cash and deposits, etc." The "etc." here includes cross-shareholdings. Cross-shareholdings are a portion of a company's financial assets, and it is clearly written in the Policy Package that Japanese companies should use such assets for investments in their core businesses that increase productivity. As stated in the collection of opinions from overseas institutional investors (Material 3), cross-shareholdings should not be left as dead money trapped apart from core businesses, but should be used productively for employee salary increases, capital investments, and so on.

The third harm of cross-shareholdings is related to the point Mr. Tanaka made earlier. Because share prices generally drop in times of recession, financial institutions [whose capital is in part tied up in cross-shareholdings] become reluctant to lend money in the face of a decrease in equity capital. Not only financial institution, but also operating businesses have these equity capital exposures. Regardless of whether they are financial institutions or operating businesses, as long as they have cross-shareholdings, companies are exposed to the risk of significant impairments to the value of their equity capital due to a drop in share prices. This is a cause for concern, because cross-shareholdings may thus harm companies' financial stability and sustainable growth.

Of course, I understand what Mr. Uchida's earlier point. There may be some cases of highly rational cross-shareholdings for fully strategic purposes. Nevertheless, as long as these adverse effects of cross-shareholdings exist, I believe that it is very reasonable for us to decide that "in principle, companies should have no cross-shareholdings." From my experience, when companies are approached by cross-shareholding counterparties to reduce or unwind cross-shareholdings, approx. 10-20% of them willingly agree; about half agree to some

reduction but would like to maintain a certain level of cross-shareholding; and the remaining 30-40% of them do not agree at all with the cross-shareholding reduction or unwinding. We should not forget that in cases where a supplier has been made to hold shares of a client company, the supplier does not truly have the ability to sell the shares if the client company disapproves of the share sale. Japan needs a cross-shareholdings version of the Subcontract Act [which protects subcontractors from abusive commercial practices of client companies]. Due to the power relationship, companies which have been forced to cross-hold shares cannot sell the shares, even if they want to sell. This is a very widespread problem, and I often hear about it during our interactions with our investee companies.

Finally, when it comes to the problem of superficial responses to the Corporate Governance Code, please reference cross-shareholding rationales in Securities Reports. Most companies repeat the identical explanation for each and every securities holding. Then they state in their Corporate Governance Reports that they have complied with the Code by providing "explanations" for their cross-shareholdings, even though they are just cookie cutter, identical explanations that provide no real insight.

If companies are not convinced of the need to reduce cross-shareholdings, as a reform-minded group we collectively need to work raise awareness and develop a more positive way forward. Cross-shareholdings are the least advanced area of the Corporate Governance Code and are thus impeding the deepening of Japanese corporate governance. I would very much like to work on this issue with all of you. Thank you very much.

[Ikeo, Chairman] Thank you.

Mr. Takei, please go ahead.

[Takei, member] I'll try to make it short. First, I believe that the issue of qualifications of the board and outside directors is very important. In the current Corporate Governance Code, many sentences start with the subject "the board". The Code questions whether the board of your company has functions to fulfill each of such principles.

The Corporate Governance Code currently consists of 73 principles in total. There are 11 principles to which companies have applied 'Comply <u>and</u> Explain' approach instead of 'Comply <u>or</u> Explain' approach. These 11 principles include Supplementary Principle 4.1.1, which requires the board to disclose what it does. I assume most companies have complied

with Supplementary Principle 4.1.1. I believe it is important to explain what roles the board actually plays. Furthermore, Principle 4.1 stipulates that the board should establish business principles, as well as business strategies and business plans, which is today's topic. As for capital policy, Principle 5.2 stipulates that when establishing business strategies and business plans, companies should present targets for profitability and capital efficiency. So Principles 4.1 and 5.2 already cover the issue whether the board has members capable of discussing these matters.

Furthermore, in Supplementary Principle 4.11.1 that is inextricably linked with 4.1.1, it is stipulated whether the board has diversity and board size appropriate for discussing those matters. Supplementary Principle 4.11.1 is also under 'Comply and Explain' approach, and many companies have complied with this principle and disclosed explanations. The evaluation of the board effectiveness which someone already referred to earlier today was already described in Supplementary Principle 4.11.3 that the board should evaluate its effectiveness on an annual basis. Considering that the majority of companies have already complied with these principles, we need to consider how to deepen the substance here.

I think it is advisable for the listed companies to read the Governance Code once again, focusing on texts starting with the subject "the board" and deepen the substance of their responses to the Code. For example, concerning sustainability issues which is a hot topic, Supplementary Principle 2.3.1 stipulates that the board should take leadership in dealing with sustainability issues as a part of risk management. Where many companies have disclosed that they already complied with these principles, a question here is the substance of what they do. I suggested that we should draw their attention to reviewing the substance at this opportunity. I believe that Guidance itself should not be too detailed, but it is important to send the said message to companies. This is my first point.

The next point is about details. On page 3 of today's material, in the section on remuneration of the management, it is written as follows: "In judging whether a company has in place effective processes for designing the remuneration system and deciding remuneration amounts, what is considered to be important to focus on?" On the preceding page in the material, it refers to setting indicators of earning power, capital efficiency, etc. In the first place, we need to ask a question: did the board, etc. sufficiently discuss whether such indicators serve

the purpose of sustainable growth? If they complied with Principle 4.1, it is expected that they had a proper discussion. Based on such a discussion, in designing the remuneration system, a company should explain or discuss the linkage with the indicators set by the board or remuneration committee, etc. This flow is important. Many companies have not yet fully done it. It would be better to draw their attention to this point as well. I believe that Guidance should not stipulate specifics too much, but I'd like you to keep it in mind.

That's all.

[Ikeo, Chairman] Professor Kanda, please go ahead.

[Kanda, member] Thank you. I'll briefly make 3 comments. While I do not really have good ideas, I feel there remain difficult challenges.

The first point is about cross-shareholdings. As other members already pointed out, shares held by financial institutions and shares held by business corporations are totally different. In case of those held by financial institutions, as Mr. Tanaka pointed out, the government may adopt a policy to facilitate the unwinding or reduction.

In case of shares held by business corporations, regardless of whether or not they are cross-shareholdings, since they are not in a position to adopt the Stewardship Code, we cannot tell them to engage in stewardship activities. Then, from the standpoint of companies which hold such shares, this is an issue of the Corporate Governance Code, specifically Principle 1.4. However, merely requiring disclosure has limitations, so I'm wondering if we could seek a certain norm beyond disclosure. Anyway, I believe that Principle 1.4 is worth revising.

As for companies whose shares are held by other companies, or companies which made other companies hold their shares, we could require disclosure. However, legally, it is impossible to prohibit the sales of shares, so I think it will not be easy to require that the companies, which made other companies hold their shares, disclose information.

The second point is about corporate pension funds. As was already pointed out, big problems here are their operating structures and expertise. It would be impossible to ask them to establish necessary structures inside. They do not have to do everything by themselves. They can delegate some tasks to external parties, as in the case of investment management which they entrust to asset managers. I'm not sure how to express this in terms of wording, but they should be encouraged to entrust to external parties their stewardship activities. I hope such a

mechanism will be introduced.

The third point. This is most confusing for me. When I participate in discussions at this Council and elsewhere, people say, "let's make the equity market work as the equity market." Although it is logically correct, I feel there is a gap between such a view and what vision of the future economy of Japan we should have. I agree with the suggestion about the concreteness of business strategies and business plans, but I got an impression that after all, it is likely that every company presents similar strategies or plans with differences in figures. I suggest that we have a clear segmentation of listed companies, and give a different prescription to each segment. As was already pointed out, car manufacturers and internet companies are very different. Even though we use such same expressions as "increase in corporate value over the mid- to long-term" and "robust management decisions in response to changes in the management environment", I think there are huge differences among companies. The same could be said of company sizes. While there are companies with market cap of trillions of yen, there are many listed companies with market cap of less than 10 billion yen. So prescriptions would be different. Furthermore, a little fewer than 20% of listed companies have a parent company or controlling shareholder. The prescription for them should be also very different.

Although this may be a somewhat off-point, looking at other countries – companies like Google or Facebook, while their market cap would be much larger than that of any Japanese listed companies, control of the companies is secured stably: the founders hold complete control of the companies. There are only few such listed companies in Japan. I said "few", because they are not comparable to Google or Facebook in terms of size. From the viewpoint of equity market participants, I've been wondering if such companies are welcome. I hope we can have discussion from the viewpoint of industry.

I'm sorry I took a long time. That's all.

[Ikeo, Chairman] Thank you. It's almost the scheduled closing time. I know you still have a lot to say, but I'd like to close today's discussion here. Now I'd like to hand it over to Director Sakamoto from the Ministry of Economy, Trade and Industry. He is here as an observer and would like to share some information with us.

[Sakamoto, Director, Corporate System Division, Ministry of Economy, Trade and Industry] Thank you. As a representative from the Ministry of Economy, Trade and Industry, I'd like to

share with you a recent development in our initiatives for shifting the focus of the corporate governance reform from Form to Substance, in a manner aligned with the discussion of the Follow-up Council.

In May 2017, on the same day as the release of the revised Stewardship Code, the METI published Guidance for [Integrated Corporate Disclosure and Company-Investor Dialogues for] Collaborative Value Creation, to facilitate dialogue between investors and companies. In order to use this Guidance to facilitate constructive dialogue and accumulate best practices, we started “the Forum for Integrated Corporate Disclosure and ESG Dialogue” on Dec. 18, in line with this year’s Growth Strategy as well as the policy package for productivity revolution decided by the Cabinet on December 8. With the hope that our initiatives combined with the Follow-up Council’s initiatives will facilitate progress of the corporate governance reform, I shared the updates with you. Thank you.

[Ikeo, Chairman]　Thank you. Based on your opinions expressed today, the secretariat will sort out and compile key points for further discussion in the upcoming meetings.

Now I’d like to hand it over to the secretariat for administrative announcements, if any.

[Tahara, Director of the Corporate Accounting and Disclosure Division, FSA]　Thank you for your active discussion today. We appreciate your cooperation throughout the year. The next meeting will be held next year. I will let you know as soon as the date is fixed. Thank you in advance for your cooperation.

[Ikeo, Chairman]　Thank you. Now I declare the meeting adjourned. Have a Happy New Year.

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