(Provisional translation)

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

1. Date and Time: March 5, 2019 (Tuesday)　16:00-18:00

2. Venue: 13F, Central Government Building No. 7, Meeting Room

[Ikeo, Chairman]　Although it is not yet the scheduled start time, all prospective participants are here, so I'd like to open the eighteenth 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.

At the last meeting on January 28, we had discussion in response to corporate managers' views on last year's revision of the Corporate Governance Code.

And on February 28, we had Mr. Larry Fink, CEO of BlackRock to exchange opinions with the Follow-up Council members, highlighting issues around the Corporate Governance Reform from the global perspectives. Today, the summary of Mr. Fink's presentation and Q&As have been distributed to you for your reference. Please refer to it as necessary.

Well, it is expected that the Stewardship Code will be reviewed periodically, once every three years or so. Therefore, I think it is time for the Council to move the discussion forward, taking into account the next revision of the Stewardship Code.

First, I'd like to ask a representative of the Financial Services Agency (FSA), as the secretariat, to explain Material 1 and opinion statements from the Council members. Now I'd like to hand it over to you.

[Inoue, Director of the Corporate Accounting and Disclosure Division, FSA]　Thank you. I'd like to explain Material 1-1. We also distributed Material 1-2, compiling reference materials related to topics of Material 1-1, but due to the time constraint, I will leave out the explanation of Material 1-2. Please refer to it as necessary.

As shown in the table of contents of Material 1-1, we sorted out particular issues on stewardship by actors, namely asset managers, asset owners including corporate pension funds,

proxy advisors, and investment consultants. Furthermore, as issues on corporate governance, we focused on the review of the disclosure system as well as governance related to executive remuneration.

First, for the purpose of general discussion, page 3 shows the overview of the last revision to the Stewardship Code (May 2017) once again. The Code was revised to encourage asset managers to strengthen their governance and conflict of interest management, promote disclosures of voting records for each investee company on an individua agenda basis, and clarify roles of asset owners including pension funds.

On page 4, taking into account earlier discussions at the Follow-up Council, we, as the secretariat, have listed issues which would need discussion going forward in order for asset managers and asset owners, including pension funds, to enhance constructive dialogue with investors and companies, and to fulfill their stewardship responsibilities.

You can see the proposed issues on the bottom of the page. We consider it is necessary to further discuss such issues as enhancing disclosures by asset managers, and facilitating stewardship activities by corporate pension funds, as well as issues concerning proxy advisors and investment consultants. I'll explain more about these issues later in the specific sections.

On page 5 is the overview of the proposed revision to the UK Stewardship Code published on January 30, 2019. Public comments will be accepted until March 29, and the final version will be published in summer 2019.

Let me explain the main points of the proposed revision: the principles are to be followed on an "Apply and Explain" basis instead of "Comply or Explain" basis; signatories are now required to disclose information on their governance structures and results of their stewardship activities; and separate principles are established for service providers including investment consultants and proxy advisors.

Now I'll move on to specific points of discussion. The first one is about asset managers. On page 7 is the same material which has already been provided to you at the 16th meeting of the Council in November 2018. The breadth and depth of disclosure [on stewardship activities] significantly varies across institutional investors. Some disclosed specific names of investee companies with which they had dialogue; some disclosed examples of how they exercised their voting rights based on dialogue with companies in question; and some did not provide specific

descriptions of their activities.

Please turn to page 8. In December 2018, the International Corporate Governance Network (ICGN), an international investor-led organization where Ms. Waring serves as CEO, published guidance on disclosing engagement activities by institutional investors [i.e. Guidance on Key Disclosure Elements], based on the recognition that disclosure of stewardship activity reports is a vital contributor to enhancing dialogue with companies. As summarized on this page, the guidance focused on 6 important points concerning disclosure, including strategically conducting engagement activities, establishing a clear policy on engagement, and building a consensus view within an organization to ensure consistent engagement activities.

As a trend in other countries, Page 9 introduces "Tiering" in the UK, where the Financial Reporting Council (FRC) assesses and categorizes signatories to the Stewardship Code into tiers for the purposes of increasing transparency in the UK market and maintaining confidence in the Stewardship Code. With respect to Tiering, while some value it positively and call for continued implementation, the Kingman Review, which reviewed the FRC and made proposals for organizational reform in December 2018, sharply pointed out that the tiering approach focuses predominantly on checking the content of stewardship statements, not on actual effectiveness or outcomes. We understand that the tiering approach has had a mixed reception.

Now may I move on to the third section "concerning asset owners including corporate pension funds". Page 11 is also quoted from the material for the 16th meeting of the Council. Recently, some corporate pension funds have signed up for the Stewardship Code, but the total number of such signatories is still only 14. We are aware that such development must be pushed forward.

On page 12, we quoted Keidanren (Japan Business Federation)'s request to its member companies dated December 25, 2018 concerning stewardship activities by corporate pension funds. We hope to continue strengthening cooperation with the business community, and encourage corporate pension funds to conduct stewardship activities.

Now we look at proxy advisors from page 13. At the time of the previous revision of the Stewardship Code, it was pointed out that proxy advisors were enhancing their influence on institutional investors' exercise of voting rights. With respect to the use of proxy advisors by

institutional investors, you can see the current status in the pie chart on the left side of page 14. According to the survey by the Japan Investment Advisers Association, roughly 40% of institutional investors use proxy advisors.

On the right side of the page, you can see examples of disclosures by institutional investors concerning their use of proxy advisors. Some institutional investors disclosed specifically how they use such advisory services, or referred to names of their proxy advisors.

Page 15 shows overseas trends of regulations for proxy advisors. First, in the US, in November 2018, the Securities and Exchange Commission (SEC) held a roundtable on the issue of proxy process, including ways of proxy advisors' involvement. We understand that, based on this roundtable discussion, the SEC is currently considering measures to address issues concerning proxy advisors, including clarification of their analyses for making voting recommendations as well as their decision-making processes.

For your information, although a bill requiring proxy advisors to register with the SEC [Corporate Governance Fairness Act] was submitted to the US Congress, the bill has been discarded, as it was not adopted by the end of the session in January 2019.

Page 16 shows developments in Europe. The EU Shareholder Rights Directive was revised in 2017. Accordingly, proxy advisors are required to disclose, at least on an annual basis, relevant information, including procedures put in place to ensure quality of their services and qualifications of the staff involved; whether and how they take into account company-specific circumstances; whether they have dialogues with companies; and measures to address potential conflicts of interest. In response to the revised Shareholder Rights Directive (SRD II), EU member states are supposed to have the requirements implemented in their national laws by June 2019.

Now I move on to the fifth section "Investment Consultants". Page 18 shows the current situations of investment consultants which serve as asset management advisors for corporate pension funds, etc. The graph on the left side of page 18 shows the use of investment consultants by asset size of corporate pension funds. Roughly 70% of pension funds with assets of over 100 billion yen are using investment consultants. The use of such consultants are more common among relatively larger pension funds.

The graph on the right side shows responses to a survey question for asset managers.

Approximately 60% of asset managers answered that their investment consultants have not asked any questions about their activities under the Stewardship Code in the past year. It can be pointed out that investment consultants do not sufficiently understand asset managers' stewardship activities.

Please turn to page 19, showing a recent development outside Japan. The UK's Competition and Markets Authority (CMA) conducted an investment consultancy market investigation and published its final report in December 2018. In the report, CMA pointed out a problem that firms which offer both investment consultancy and fiduciary management services have advantage over firms which focus solely on one of the two services, and also referred to a conflict of interest where such firms invest in or induce clients to invest in their own investment products. Based on such findings, in February 2019, CMA published a draft Order to regulate investment consultancy and fiduciary management firms.

That's all for the secretariat's material concerning stewardship.

Next, let's move on to the specific issues on the Corporate Governance Reform. First, as a corporate governance issue, page 21 shows the entire picture of the review of the disclosure system. The revised Cabinet Office Ordinance went into effect on January 31, 2019. The enhancement of corporate governance information is to be applied from the fiscal year ending March 2019; and the enhancement of narrative (non-financial) information concerning management strategies and MD&As, as well as audit-related information is to be applied from the fiscal year ending March 2020.

At the 17th meeting of the Council, we distributed the draft principles on disclosure of narrative information as a reference material. The FSA has undergone the public consultation process, and is currently working toward finalizing the principles, aiming at publishing them together with best practices this spring.

As for the overhaul of audit reports stated on the lower right of the page, it refers to the inclusion of Key Audit Matters (KAM) in audit reports. Early application is due in the fiscal year ending March 2020, and the application will become mandatory from the fiscal year ending March 2021. We expect that the overhaul of both securities reports and audit reports will contribute to enhancing disclosures of corporate information.

Next, page 22 summarizes the overview of the revised Cabinet Office Ordinance. As we

already explained the draft Ordinance for public consultation at the 16th meeting of the Council, I will leave out the explanation today.

Finally, I'd like to explain governance concerning executive remuneration. Please take a look at page 24, which shows the current status of governance of executive remuneration. Please look at the upper-left bar chart, showing whether companies have a statutory or optional remuneration committee. More than 40% of the listed companies on the TSE First Section and more than 70% of those on the JPX-Nikkei 400 have already established such committee. Here we can see some progress. However, when we look at the lower-left pie chart showing the committee composition or members' attributes, it is apparent that independence of committee members is not fully secured.

It is also pointed out that committee meetings are not necessarily held frequently as shown in the upper-right pie chart; and only a limited number of companies designate the contents of disclosure on executive remuneration as a matter for deliberation by such a committee, as shown in the lower-right bar chart.

That's all for the explanation of Material 1-1 from the secretariat.

Now I'd like to share opinion statements from the members who are absent today.

First, let me share Mr. Kobayashi's opinion with you. He argues that a listed company is a "public entity of society", which widely supports the economic lives of people after retirement, and therefore listed companies, which are not clearly aware of such a concept or which cannot generate returns in excess of the cost of capital, should exit the market. He suggests that the Follow-up Council should actively promote the slogan "from form to substance", and further work on advancing the reform, while deepening discussion on the TSE Premium market for companies that satisfy higher requirements than those for the TSE First Section.

Mr. Toyama also submitted his opinion statement. As a top priority issue on group governance, Mr. Toyama refers to the fact that Japan has no laws or regulations which explicitly provide that a controlling shareholder has a fiduciary obligation to protect interests of minority shareholders, and calls for early legislation. With respect to specific methods for implementing the legislation and avoiding risks of various lawsuits from minority shareholders, in principle, autonomy should be granted to individual companies. He suggests that it is required to immediately start the legislation process with a clear deadline; and that should be

incorporated into the Corporate Governance Code in a way aligned with the legislation.

Lastly, I'll summarize Dr. Ueda's opinion. She points out the importance of protecting minority shareholders of listed subsidiaries. As the first step, she suggests that the METI should establish guidelines which listed subsidiaries can refer to. In order to further enhance the effectiveness, she expects stricter requirements to be incorporated in the Corporate Governance Code and the TSE's independence criteria, etc.

That's all for the explanation from the secretariat.

[Ikeo, Chairman] Thank you very much.

Next, before we start discussion, I'd like to ask a representative from the Ministry of Economy, Trade and Industry (METI) to present the current discussion on group governance, which was also referred to in opinion statements from Mr. Toyama and Dr. Ueda.

[Sakamoto, Director, Corporate System, METI] Thank you for the opportunity to make a presentation for you today. I'd like to briefly explain group governance according to Material 2.

As shown on pages 2 and 3, in accordance with the last year's "Future Investment Strategy 2018", at the 2nd-Term Corporate Governance System Study Group chaired by Professor Kanda, members had extensive discussions on how to increase the effectiveness of governance of corporate groups in terms of both "offense (growth)" and "defense".

The discussions on overall group governance focus mainly on two themes. One is governance of an entire group including subsidiaries. It refers to defensive governance, or governance of subsidiaries, including the post-merger integration of overseas subsidiaries acquired through M&As. The other is the optimization of business portfolio: members look at the process from a dynamic viewpoint, and discuss how a group should optimize its business portfolio for an ideal group formation including the spin-off of certain businesses and strengthening of core businesses.

Please take a look at page 5. We summarized issues or trends of management of larger Japanese corporate groups, based on our hearings with companies and overseas visits. With respect to offensive or growth-oriented governance, while business divisions have considerable authority, corporate functions across the company seem relatively weak. Few companies seem to have a mechanism to review their business portfolios. With respect to defensive governance,

it is pointed out that the risk management of subsidiaries tend to be poorly conducted due to resource constraint. In addition, there is a need to consider how a parent company's nomination or remuneration committee should be involved in the nomination or remuneration at its subsidiaries; and how to redesign a remuneration system to address a "reverse phenomenon" where the level of remuneration for the top management of overseas subsidiaries is higher.

We sorted out the issues and prepared charts on pages 6 and 7. On page 6, business divisions are shown in blue as vertical lines, and head office functions or corporate functions are shown in red as horizontal lines. Corporate functions (horizontal lines) tend to be a little weaker. This is an overall discussion. As for defensive governance shown on page 7, we would like to sort out issues concerning how to increase the effectiveness of the check function, while securing the independence of "3 lines of defense", especially the second and third lines, through case studies of corporate scandals.

Next, I'd like to focus on governance of listed subsidiaries, which Mr. Toyama and Dr. Ueda referred to in their opinion statements. As you know, in a listed subsidiary, which herein refers to a listed company with a controlling shareholder, there is a risk of structural conflicts of interest between the controlling shareholder and the general shareholders of the listed subsidiary. Investors have expressed strong concern about such conflicts of interest. It is also pointed out that it leads to a decline in corporate value of listed subsidiaries.

Specifically what situations may give rise to such conflicts of interest? On page 10, we indicated 3 typical occasions. Type 3 on the right side is the situation where a controlling shareholder squeezes out minority shareholders and wholly owns a listed subsidiary. As for such cash-out, squeeze-out situations, the Fair M&A Study Group is currently discussing the issue, focusing on fair procedures for such situations. As for other situations of possible conflicts of interest, type 1 on the left side shows the case of a direct transaction or cash deposit between a parent company and a subsidiary; and type 2 in the middle shows the case of transfer of business, business coordination, or consigned production between such companies. As these situations may similarly give rise to conflicts of interest, and there is a need for managing the situations with consideration for the interests of general shareholders, the Study Group has been discussing the issues.

The current status is summarized on page 11. According to the data from the TSE, out of all

listed companies, 628 companies or 17.3% of the total have a controlling shareholder. As for "parent-subsidiary listing" where a controlling shareholder is a parent company, 311 companies or 8.5% of the total are so-called listed subsidiaries.

Page 12 shows a comparison with other countries, concerning listed subsidiaries. As the definition of "listed subsidiary" here differ from that of TSE stated on page 11, the numbers do not match to a dot. Here, the table on page 12 shows the current status across countries including Japan on the same basis. Please look at the second from right most column, showing numbers of listed companies with a controlling shareholder that holds at least 50% of the shares. The number of such companies is extremely large in Japan.

The table on page 13 compares governance-related data of listed subsidiaries (limited to cases of parent-subsidiary listings) with total listed companies on an average basis. As for the first 2 items, namely numbers of independent directors and independent *kansayaku*, we have only the numbers of such members, and the percentages of independent members among the boards are not yet available. Anyway, the average numbers of independent directors and *kansayaku* among listed subsidiaries are roughly 10% less than the total averages.

From page 14 and onwards, you can see results of the corporate governance survey 2018, which we conducted with cooperation of companies listed on the First and Second Sections of TSE. We received responses from 822 companies. Page 15 is about [the nomination of President/CEO of] listed subsidiaries. 21% of the respondents [total: 105] stated that President of a listed subsidiary is essentially appointed by its parent company; 50% responded that President is appointed upon consultation between parent and subsidiary companies; and 11% stated that the nomination is deliberated by the nomination committee of the listed subsidiary. We also asked listed parent companies whether they acknowledge any challenges in handling the listed subsidiaries from the strategic business portfolio perspective. Almost 60% of them stated there are some challenges. Specific challenges are as follows: an optimum group strategy does not match with an optimum strategy for a listed subsidiary; it is difficult to use resources of a listed subsidiary for the entire group; it is difficult to centralize risk management of the entire group. I'll move on to page 17 [concerning the future policies concerning listed subsidiaries]. 10-20% of listed parent companies responded that they are in consideration of possible disposal of listed subsidiaries, while 70% of them plan to maintain listed subsidiaries

– this is a general trend. On page 18, you can find reasons for owning listed subsidiaries – why their subsidiaries are also listed. Common reasons are for motivating employees, recruiting, gaining trust from business partners, status and brand value. Compared to those reasons, the percentage of fund-raising as a reason is lower, 22%. Such are the reasons for holding/utilizing listed subsidiaries.

On pages 19 and 20, we summarized concerns raised by institutional investors in Japan and overseas on parent-subsidiary listing, based on our interviews with them. As represented by the second feedback on page 20 from a Japanese fund, many claim that as a general rule the listing of a subsidiary should not be accepted; and in exceptional circumstances where such listing is accepted, independent directors must have a majority on the board.

Finally, as shown on page 21, taking into account the current status and investors' feedback, we outlined a direction for measures to be taken [for strengthening governance of listed subsidiaries] as a draft, which was presented to the Corporate Governance System (CGS) Study Group in February and is still under discussion. Although the listing of a subsidiary has a role to play as a transitional option, in seeking for practical measures for strengthening governance of listed subsidiaries, the importance of roles that independent directors play must be emphasized. Here are some comments raised by the Study Group in defining independence criteria; those who have worked for a controlling shareholder in the past 10 years must not be entitled to be appointed as independent director; in order to enhance the independence of the boards, the share of independent directors on the board of listed subsidiaries must be boosted to one-third or the majority; there are challenges in securing independent directors because the number of qualified human resources is limited. It has also been suggested that although boosting the independence of the boards would not be made in the short run, the committee system may be utilized over time where discussions are made by the group denominated by independent directors or independent *kansayaku*, for example in certain situations where transactions involving specific conflicts of interest arise. With respect to information disclosure, the members suggested, as possible practical measures, that guidelines should include the following requirements: in case a parent company chooses to maintain its listed subsidiary despite being aware of various issues, the parent company should disclose to investors rational reasons for doing so, together with information on the effectiveness of the governance system

of the listed subsidiary, including considerations on appropriate exercise of its authority to appoint/remove the management [of the subsidiary], thus fulfilling its accountability; and the listed subsidiary should also disclose information on its own governance system. The guidelines aim at incorporating such practical measures. As for legal measures, as Mr. Toyama also mentioned in his opinion statement, a considerable number of the CGS Study Group members pointed out that ultimately, a relevant legislation is required. Accordingly, the Study Group is currently considering that it should be referred to in the CGS Report as an issue to be discussed in the future.

Thank you.

[Ikeo, Chairman] Thank you very much.

Now I'd like to hear your opinions. As Ms. Waring submitted her opinion statement and is present here, I'd like to ask her to express her views first.

[Waring, member] Thank you to Chairman Ikeo for convening such an eminent meeting again, and hello to all of my Council colleagues. Also, thank you to Director Inoue for kindly introducing many activities that ICGN has been very busy undertaking, and also to Fujimoto-san for all of the support.

Before I introduce my remarks, I would just like to concur with what Director Sakamoto from METI mentioned. All of the issues that she has raised are extremely important to minority shareholders, and global investors.

ICGN has long advocated that at least one third of the board should being independent directors. Three would be a good start, and maybe the number "three" should be mandated either through the TSE Securities Listing Regulations or at least in the Corporate Governance Code.

I understand the nature of this meeting is to consider next steps for stewardship reform in Japan, and would like to make three remarks.

I would like to just reflect on how investors prioritize engagement efforts. Number two, what constitutes an effective engagement approach. And thirdly, just some initial reflections on what next steps might be, in order to further advance this reform in Japan.

So I would like to just refer to some survey results from ICGN members. We had a very good response rate. In response to the annual survey, ICGN members said that they engage

with up to 500 companies a year, with quite a number stating more than 500 companies. 62% of engagement happens in the home market or home region. And, engagement takes up to 33% of an investor's workload. The survey also found that stewardship is taken seriously at the highest level with the team directly reporting to CIOs and CEOs.

Given the scale of investment portfolios both in terms of size and geography, investors really must optimize their use of human resources to prioritize their engagement efforts most effectively. The ways in which investors do this is aligning the engagement approach with their investment strategy, client objectives, and overall investment beliefs.

Then engagement is prioritized based on the scale of investment in terms of size of holding, level of value at risk, and the materiality of risks and opportunities relative to asset exposure and financial performance. Of course, responding to unforeseen events is also a type of prioritization. For example, the resignation of the Chairman or CEO, an acquisition which seems out of kilter with a defined strategy, or accounting irregularity.

So what are the elements of effective engagement? We would establish that there are six elements of effective engagement.

Firstly, investors need to be clear about the rationale for engagement and how this contributes towards enhancing and preserving the assets being managed on behalf of beneficiaries or clients.

Secondly, as just discussed, prioritization: how the investor operates strategically to identify most effective engagement outcomes in alignment with their investment beliefs.

Thirdly, escalation. Communicating how and when engagement might be escalated in the event company dialogue is failing.

Fourthly, integration. Does the investor have the resources and processes in place to conduct engagement efficiently, and how is this coordinated and integrated within the investment organization, particularly between portfolio management and corporate governance teams?

Fifth, collaboration. Collaborating with others to leverage a higher degree of influence to positively affect an engagement outcome. I should note that ICGN members still remain nervous about engaging in Japan collaboratively, notwithstanding the good legal guidance that was published a few years ago. In order to make investors feel more comfortable, I would still

recommend that additional guidance should be provided, clarifying what is considered good engagement approach in terms of agenda-setting.

The sixth element is transparency. We expect investors to disclose their engagement policies and review the effectiveness of their engagement approach periodically.

So what could be done as next steps? Well, actually I've been doing homework looking at Japan's Code and ICGN's code.

What struck me first is that I feel we need to place more emphasis on ESG integration in Japan's Code. So this would address the need for investors to identify, analyze, and integrate ESG factors into their investment decision-making processes.

Secondly, we need to incorporate the perspective of systemic risks in the Code. ESG factors may be included. This would raise investors' awareness of long-term systemic risks or threats, including overall economic development, and financial market quality and stability.

Finally, with respect to the principle around proxy voting, I think we really need to strengthen some of the wording here. For example, there is no reference to stock lending in the principles and guidance of the current Code. It is also necessary to require disclosure on processes of making voting decisions, clarifying who is accountable for voting.

That's all.

[Ikeo, Chairman] Thank you.

I'd like to hear opinions from other members. Who would like to make comments?

Mr. Matsuyama, please go ahead.

[Matsuyama, member] Thank you. I know there are many points to be discussed, but I just want to make comments on proxy advisors. From the issuing companies' perspectives, it has been pointed out that while proxy advisors have significant influence on institutional investors, their criteria-setting processes lack transparency; that they do not have appropriate organizational structure in making reviews; that they apply one-size-fits-all criteria to all companies; or that they lack room for dialogue.

On the other hand, issuing companies fear that those proxy advisors that merely meet formal conformity might be encouraged. The Stewardship Code already has Principle 5 concerning voting by institutional investors, and proxy advisors' services. I'd like to confirm the actual status and thoroughly examine the implementation status here in the Follow-up

Council, and reflect the findings on our opinion statement in the future.

That's all.

[Ikeo, Chairman] Thank you.

Who would like to speak next?

Mr. Oba, please.

[Oba, member] There are many issues to be discussed. First, listening to the earlier presentation, I found a significant change, specifically the revision of UK's stewardship code. The 'Apply and Explain' approach, where the application of the principles becomes mandatory, is a very big change. Basically, the UK's code had been principle-based, taking the "Comply or Explain" approach. Could you explain what the causes of this change are?

[Ikeo, Chairman] I'd like to hand it over to the secretariat.

[Inoue, Director of the Corporate Accounting and Disclosure Division, FSA] As mentioned on page 5 of the Material 1-1, we understand that the structure is to be changed from two layers consisting of principles and guidance to three layers consisting of principles, provisions, and guidance. In the draft revision, it is proposed that all asset managers and asset owners should apply the principles at the top layer. In that sense, as far as the principles are concerned, there is no choice but to apply the principles. However, as for specific requirements in the provisions or guidance, we understand that the "Apply and Explain" approach is not applied to the same extent. Basically, to increase the effectiveness of what is stipulated in the Stewardship Code, the principles embody shared values.

[Ikeo, Chairman] Certainly.

[Oba, member] So, it was judged that the principles embody shared values, and so applying the principles is a matter of course and also effective. Is my understanding correct?

[Inoue, Director of the Corporate Accounting and Disclosure Division, FSA] That is correct about the UK's code. Of course, institutional investors have options on whether they sign up to the code. Yet once they sign up to the code, they must apply the principles. That's what is written there.

[Oba, member] Then, I think many may perceive that big frameworks are made into rules. It is quite different from the principle-based approach. I'm wondering how we digest this change and consider next steps in Japan. This is a significant change, so I wanted to clarify that.

[Ikeo, Chairman] Please discuss the matter after digesting it.

Anybody else?

Please go ahead.

[Waring, member] The FCA requires investors to apply the principles and state if they have an alternative approach which is better than the principles. So unless the investors have an alternative approach, or unless they provide explanations on why they use an alternative approach, then they have to adopt the principles.

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

[Kawakita, member] I'd like to discuss particulars about service providers, including asset management firms and proxy advisors. Of course, I agree with such points as enhancing the quality and eliminating conflicts of interest, as stated in Material 1-1 prepared by the secretariat.

In doing so, in case of asset management firms, for example, their disclosures focus on voting: they disclose their criteria for voting standards, and voting results. Rather, they should explain how they had dialogue, or conducted engagement activities, and how they will conduct such activities in the future. And, if dialogue fails, as the representative from the ICGN explained earlier, I believe that explaining the overall process somewhere will contribute to improving the quality.

Next, ESG is becoming a trend. They just use data or indicators provided by some sufficient institutions. For example, if they talk about ESG just to follow the fashion, that is not, and such dialogue is contradictory to dialogue or engagement with companies under the Stewardship Code. It is important to have in-depth dialogue with companies, and occasionally engage with them. Then the most important thing is the process allowing asset management firms to figure out whether companies promote ESG just to follow the trend, or have their own strategies; and what unique strategies they have.

Speaking of the issue of parent-subsidiary listing or controlling shareholders, raised by the METI, the Japanese market has allowed giant companies to go for parent-subsidiary listing. We cannot discuss the issue without referring to this fact. Otherwise, a very important point will be missing from the discussion. Then how do we address the issue? For example, as stated on the last page of the METI's material, strengthening of governance would be necessary as a

transitional measure. Looking beyond there are a lot of ongoing discussions, including the possibilities of restriction on parent-subsidiary listing, or change of market segments in the TSE including possible introduction of the premium market as stated in Material 1-1. In doing so, too many qualitative elements may cause external pressure. Introducing quantitative elements – forcing companies with a controlling shareholder that holds 50% or more out of the market, for example – may help deliver the restructuring of the market segments. I have an impression that such discussion would be necessary to cope with the issue of parent-subsidiary listing.

That's all.

[Ikeo, Chairman] Thank you.

Mr. Oguchi, please go ahead.

[Oguchi, member] Thank you. The members have expressed various views, and we have various points to be discussed, so we should go back to basics. I'd like to start from what we have discussed and agreed on at the Follow-up Council. On page 3 of Material 1-1, we can see the key phrase "from form to substance". I believe we have no doubt about the need for realizing it, and have discussed ways to realize it so far.

Then what should be done? There would be various answers. For example, Mr. Oba earlier referred to hardening principles into rules. What we have been discussing is aiming at further deepening of corporate governance efforts from form to substance through engagement or constructive dialogue between companies and investors.

Then what is needed for constructive dialogue? It should be disclosure – meaningful disclosure. Companies should not aim at superficial compliance with the principles for the form's sake. Rather, companies should provide substantial explanations. Then, based on such explanations, companies and investors can have constructive dialogue. That's what we have discussed.

Under such a framework, our discussion tended to focus on companies or the Corporate Governance Code, but naturally, this discussion is also applicable to other players in the investment chain, including asset owners and asset managers, subject to the Stewardship Code.

In that sense, I believe it is obviously important to aim at enhancing disclosures of their stewardship activities to the public.

I'd like to focus on contents of such disclosures. It has already been 5 years since the Stewardship Code was established in 2014. There still are investors which have not disclosed their stewardship activities. Anyway, it has been 5 years, so I assume they have advanced from the "output" stage to the "outcome" stage. The output stage means disclosing their activities – what they have done, and the outcome stage means disclosing whether they achieved intended outcomes as a result of their stewardship activities. I believe "outcomes" are accumulated, and some institutional investors are already at the stage where they can disclose outcomes.

Earlier, the secretariat explained the draft revision of the UK's stewardship code, but did not go into detail. Is it on page 9? No, it is on page 5. The second point from the bottom reads, "…requires submission and disclosure of annual report on activities and outcomes". I checked the original text out of interest. In English, it is called "Annual Activities and Outcomes Report". Whether to require the same level in Japan at this stage is another story, but there are institutional investors which have accumulated outcomes of their stewardship activities. If they get into disclosures of outcomes – how such disclosures are perceived by the society would be a part of this move – and that triggers "disclosure competition" in a good sense, it will lead to deepen efforts from form to substance, as I repeatedly mentioned. I suggest that we should have discussion toward enhancing "substance" – or increasing the effectiveness – through disclosing what they intended and what outcomes they achieved.

In the meantime, even if asset managers as parties in charge carry out and disclose their stewardship activities, if asset owners as their clients cannot appropriately judge the "substance", there will be a risk that such disclosures rather encourage "form" instead of "substance". I'm concerned that it may make institutional investors think all they are required to do is publishing a large volume of reports, and encourage the reverse flow from substance to form.

Then I'd like to refer to the ICGN Global Stewardship Principles, which Ms. Waring also referred to earlier. I studied the ICGN Principles, and shared my findings at the 9th meeting of the Follow-up Council two-and-a-half years ago. Part 3 of the ICGN Principles focuses on the ecosystem of stewardship. In the background, the limitation of resources is everywhere, as Ms. Waring explained earlier. Therefore, it is necessary to consider the effective use of external bodies including proxy advisors in such ways as outsourcing.

Applied in Japanese context, aside from proxy advisors, it is pension investment consultants that cover a shortfall in available resources of pension funds for investment management. On page 18 of Material 1-1 which was explained earlier, many large corporate pension funds are using investment consultants. Considering stewardship in this context, when asset owners are expected to carry out stewardship activities more actively, they could use not only pension investment consultants but also other service providers that make up the shortage of resources, contributing to fulfilling stewardship responsibilities substantially, not formally. I think I already raised this point two-and-half years ago. In that sense, the fact that proxy advisors and investment consultants are included in today's agenda is very important, because our discussion will be expanded to include the ecosystem of stewardship. I would welcome further discussion.

That's all.

[Ikeo, Chairman] Mr. Tanaka, please.

[Tanaka, member] Thank you. I'd like to make a few points. I think what Mr. Oba mentioned is a very important point. I'd like to ask a question to Ms. Waring. Ms. Waring, may I ask you a question? In the draft revision to the Stewardship Code, the approach to the principles is changed from "Comply or Explain" to "Apply and Explain". As a result, what will change substantially?

[Waring, member] There has been an exercise to make the principles more succinct to actually mirror the corporate governance code. We need to remember that the UK code is quite old. Since the establishment in 2010, no revision has been made. The reason is to synchronize it with the Shareholder Rights Directive (SRD) in Europe. The SRD comes into effect in June. So regardless of whether or not the UK leaves the EU, the UK still has to implement the requirements of the SRD in its national law. Accordingly, asset owners are required to disclose their investment strategies linked with the profile and duration of their liabilities, as well as how they incentivize asset managers, and their engagement approaches. I assume that the FCA has to ensure the alignment with the SRD in Europe, and therefore, adopted the term "Apply and Explain" instead of using the term "Comply" in its Code. But investors still can choose not to apply by choosing another alternative strategy.

However, I think there are the two most significant changes. One is that stewardship

responsibilities apply across all asset classes, not just equities. And the second one is the introduction of the annual activities and outputs report, as mentioned earlier. Many investors already produce these reports, but this is going to be mandatory and investors will need to be disclosing from next year.

[Tanaka, member] Allow me to speak in Japanese. If "Apply and Explain" approach allows investors to present an alternative way instead of applying the principles, I don't think there is a significant change from "Comply or Explain" approach. Is my understanding correct?

[Waring, member] I think you're right. There's not much, it's more symbolic.

[Tanaka, member] I now understand more about that. Thank you.

May I make one more remark?

[Ikeo, Chairman] Sure, but please note that time is running out.

[Tanaka, member] Because I will soon be taking up a position speaking for issuers, I'd like to ask a question. It is about protecting the interests of minority shareholders, on page 10 of the METI's material [Material 2], specifically type 1 and type 3. Let me share my personal experience. I had served as chief executive of the Union Bank, a listed subsidiary of the Mitsubishi UFJ Financial Group, Inc. ("MUFG") in the US, where the parent company had a 66% stake at that time. This is the very example of parent-subsidiary listing – cross-border parent-subsidiary listing.

From my actual experience, external directors always claimed the protection of minority shareholders. For example, suppose that the MUFG, New York Branch decided to collaborate with the Union Bank; and when the Union Bank conducted a certain transaction, the transaction – say, lending – was booked at New York Branch of the parent company. The external directors say this is not right. Because expenses were booked at the Union Bank and profits at the parent company, they claimed, it was not at all in the interest of, and would only be disadvantage for, the minority shareholders of the Union Bank.

There was a more extreme case. When Japan's Financial Services Agency introduced the capital requirements on banks, not only the parent company in Japan but also the Union Bank, its US subsidiary, became subject to compliance with the Japanese regulation. Since the requirements in Japan and the US were different, the Union Bank had to bear expenses for complying with Japanese regulation. Then the external directors claimed that such expenses

were problematic in terms of the protection of minority shareholders. I mean, a company owning a listed subsidiary quite often faces such specific business issues.

In addition to such conflict of interest, I also experienced the process of becoming a wholly owned subsidiary, as shown in the right side of the Material. At that time, I was sort of forced to face a hostile takeover from the very parent company who sent myself into the Union Bank as chief executive. What happened then was that a special committee was established in the subsidiary. The mission of the committee was… although it is stated "general shareholders" in the Material, it should be "minority shareholders" instead…anyway, the special committee was dedicated to maximizing the interests of minority shareholders. And because I had been involved with both parties, I was banned from having communication with either side. I was left out of the loop, having nothing to do but play golf or something.

May I bring up another issue, although it is not mentioned in the METI's discussion. Being a listed company, the Union Bank had offered its employees stock options. When the employees of a listed subsidiary had stock options, what issues would arise? What if a change-in-control provision was included in the stock option agreement? In such cases, making the company a wholly owned subsidiary right away will have a significant impact on human resources management. I cannot find such points in this paper, but I believe it is necessary to carefully examine the fact that, in practice, there are such issues, before making judgments – although these examples are cross-border cases.

Listing of subsidiaries itself is not prohibited in the US, either. It is important to ensure the ways to protect the interests of minority shareholders, establishing the awareness of external directors. I believe it is necessary to take into account such practical issues in discussing the protection of minority shareholders.

That's all I have to say.

[Ikeo, Chairman] Thank you very much. Please note that time is running out. Mr. Tsukuda, please go ahead.

[Tsukuda, member] I always make brief remarks. Today, I just want to make two points.

The first point is about constructive dialogue, which I believe is today's main topic, as shown on page 4 of Material 1-1. The secretariat proposed some issues to be discussed in the future. It has not been long since the constructive dialogue started, so I assume that both

companies and asset managers are still sort of groping in the dark, seeking best practices. Under such circumstances, what is called for is the commitment of both companies and asset managers, as well as their ability for dialogue.

Under such circumstances, it is vital that both companies and asset managers engage in dialogues with each other: for example, what kind of engagement a company expects from an asset manager, or conversely, what actions an asset manager expects from a company in response to its engagement activities. Based on facts, they should identify issues concerning constructive dialogue, and then consider how to make improvements. I believe such process will be extremely important in revising the Stewardship Code. Accordingly, in the next few months, or maybe 6 months, it is important to actually find out and understand the real facts about "the current status and issues of constructive dialogue" in the first place. This is my first point.

My second point is about parent-subsidiary listing, as stated in the METI's Material 2. Mr. Toyama and Dr. Ueda also referred to this issue in their opinion statements. It attracts a lot of interest from the public, including myself, and is a crucial topic in terms of corporate governance.

Mr. Tanaka just mentioned what I wanted to say. The point is clear. It is all about thoroughly managing the conflicts of interest, and protecting the interests of minority shareholders or general shareholders. What is at stake is exactly how quickly and in what ways.

On the other hand, speaking from the standpoint of myself who know the reality of Japanese corporate practices, for example, there is a situation where a controlling shareholder seeks candidates for independent directors of its listed subsidiary. This is weird, but in reality, there is a practice where a parent company looks for candidates for independent directors of its subsidiary. Another example. A person, who serves as an external director of a listed subsidiary, makes a fair argument from the perspective of protecting the interests of minority shareholders. Meanwhile, the chief executive of the parent company may not be comfortable with such argument. Consequently, the external director, who makes a fair argument, ends up leaving office soon. This is the real world. So, although on the last page – page 21 – of the METI's material, it is stated that "aiming at increasing the percentage of independent directors on the

board of a listed subsidiary", merely "aiming" is not sufficient. It should be stipulated as a requirement. Furthermore, although it is stated as "at least one-third or the majority", I believe practically "the majority" would be appropriate, if possible.

I see that it is vital to promptly move forward the practical and legal measures listed here. I'd like to suggest the Follow-up Council to consider the issuance of another "Opinion Statement" in relation to enhance governance of listed subsidiaries.

That's all.

[Ikeo, Chairman] Mr. Callon, please.

[Callon, member] I totally agree with what Mr. Tsukuda and Mr. Tanaka just mentioned. As Director Sakamoto from the METI explained earlier, I am also aware that the governance of listed subsidiaries is a significant issue. Highly irregular from a global perspective, one in every 10 Japanese companies is a so-called listed subsidiary, and it is very unclear whether such a company is run for the benefit of its minority shareholders or its parent company.

Japan has seen a significant progress through the Corporate Governance Code and the Stewardship Code. However, the issue of parent-subsidiary listing, which inevitably gives rise to a concern about conflicts of interest, is hardly understood by foreign investors. Among remaining issues concerning corporate governance in Japan, I believe that the top priority goes to enhancing governance of listed subsidiaries.

As Mr. Tanaka mentioned, there is no need to prohibit listing of subsidiaries. To protect interests of minority shareholders, it is important to enhance governance to a certain extent through the measures listed on page 21 of the METI's material. This is a significant issue, and I hope relevant measures will be promptly implemented without waiting for the revision of the Governance Code in 2 years.

[Ikeo, Chairman] Thank you very much.

Mr. Iwama, could you make your comments briefly?

[Iwama, member] Sure. I'd also like to make comments on the issue of parent-subsidiary listing. Needless to say, enhancing governance is essential. I also think we would need kind of external pressure from investors, especially those capable of speaking up for protecting interests of minority shareholders. There would also be need for an environment which encourages more collaborative engagement, as Ms. Waring mentioned earlier.

In short, there is a need for not only an internal reform, but also external pressure. Not necessarily hostile pressure. Rather, pressure that makes sense. We could devise a way to create such pressure. I've been long thinking that it would be ideal to have something like collective engagement.

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

[Sampei, member] Thank you. As with other members, I'd like to express my view on listed subsidiaries.

In the METI's material, the term "controlling shareholder" is used, but as mentioned in Mr. Toyama's opinion statement, I think it should be stated as "dominant shareholder". Without clarifying this point, I don't think the issue will be solved.

Then what is the threshold of dominant shareholders? For instance, if an entity holds 20% or more of voting rights, the equity method is applied. There is another threshold associated with the Companies Act: Article 67, Paragraph 1 of the Ordinance for Enforcement of the Companies Act concerning "relationship that may allow substantial control" refers to 25% or more of voting rights. I assume the threshold would be around there. Mr. Toyama, in his opinion statement, referred to lower percentages, say 10-15%. The threshold in Belgium, Spain, France and Finland is 10%, and the one in Italy is 2%. However, considering the Japanese context, I think it is around 20-25%.

Another point. I agree that the majority or at least one third of board members should be independent external directors. However, in the case of listed subsidiaries, I don't think "at least one-third" is appropriate, it should be "the majority". With respect to disclosure, parent companies are required to disclose "rational reasons for maintaining listed subsidiary/ies". Simply said, they must explain why they wanted the public listing of their subsidiaries despite higher cost of capital. On page 19 of Material 2, there are comments from the third US institutional investor from above, and I totally agree with them. A parent company controls its subsidiary with a relatively small capital investment, while raising funds from external investors. It could be said that the parent company uses minority shareholders as a kind of steppingstone. On the other hand, if a subsidiary has a truly independent board, and well manages conflicts of interest between the large dominant shareholder and minority shareholders, then the direction of the subsidiary's management strategy may not align with

that of the parent company, so there are not many benefits [from the listing of the subsidiary]. Therefore, naturally, such a practice is not common in the US and the UK, when cost of capital is higher, and the parent company does not have control. However, in case a company plans to establish a business in an emerging country by using the local currency, the listing of a subsidiary may be a rational option, but this is a limited case. So, I suggest that we should clarify exactly what the companies are required to explain. This is my first point.

I'd also like to ask some questions to Ms. Waring concerning the ICGN's opinion statement.

My first question is about the new use of the term "collaboration". We used to say "collective engagement", but now it's "collaborative engagement". Is that because the term "collective" gives rise to a concern about legal issues? I'd like to know the differences in nuances of these two terms, and the background of the new use of the term "collaborative".

The next question is about escalation when engagement is failing. First of all, when you say, "dialogue is failing", I think you say so from the standpoint of investors. It may be that the companies no longer wish to listen to the investors becausearguments are not convincing for them. However, in the event dialogue is failing, the engagement is to be escalated. It sounds as if investors are always right. I doubt that. There must be many cases where investors lack understanding of companies. So, with only a short history of engagement in the Japanese market, I am not comfortable with the idea of investors swarming for immediate escalation.

Another question. The expression "a higher degree of influence" is used in your opinion statement. If it means that investors can increase their voting power by collaborating with other investors or acting collectively, it will be something close to the joint ownership of shares, so I think the meaning of "collaborative" is unclear.

Again, there seems to be an assumption that what investors are saying is right. If a company does not listen to investors, investors will increase their voting power, thus applying pressure. Is this really an appropriate solution? Considering that engagement started just recently in Japan, I believe we should reconsider this point.

Furthermore, Mr. Oba earlier referred to the "Apply and Explain" approach. It is not yet decided whether Japan's Stewardship Code will adopt the approach, but if we are on such trend, I think what I just mentioned is very important. I am dreading the day that escalation would

routinely take place; everybody would routinely agree to collaborating with other investors; and the “Apply and Explain” approach would be the basis of activities. I’m concerned whether that is really all right.

The final point. On page 13 of Reference Material 1-2, examples of disclosure by the winner of ICGN Global Stewardship Disclosure Award, namely BlackRock. An important point here is that BlackRock disclosed a list of companies with which it had dialogue, and engagement case studies separately. While many people are interested in engagement, if investors disclose case studies quoting company names, everything they are doing will be revealed. As a result, management teams of such companies may lose face; or if employees find that the management team initiated a reform in response to an investor’s recommendation, the employees may become dissatisfied, and therefore, the further reform may become difficult. When Annual Activities and Outcomes Report is to be issued, the important point is to disclose the list of companies and examples of engagement separately, just as BlackRock has done.

That’s all.

[Ikeo, Chairman] We do not really have time for this, but could you answer the question?

[Waring, member] I am not sure where to start. Mr. Sampei, in Fidelity’s statement on collaboration, I think it is stated that the first thing you do for escalation is to collaborate with other investors.

What is missing in Japan’s Stewardship Code is a reference to such escalation. In most stewardship codes around the world, when a dialogue is failing, there is reference to ways in which the dialogue can be escalated. That can be collaborating with other investors, making a public statement, or blacklisting companies. Those are included in collaboration. It is common to disclose ways to escalate engagement in many countries, and I don’t know why you don’t have that approach in Japan, but maybe we can come back to that later.

There is no difference whatsoever between collective or collaborative. Collaborative is a softer word, and therefore used to avoid being perceived as something related to “acting in concert”.

It is fairly common to see the use of case studies to evidence successful engagements. I assume that, in most cases, they obtained consent from companies for case studies prior to the disclosure. Otherwise, it will negatively affect future engagement.

[Ikeo, Chairman] I'm sorry, I got slightly mixed up. We still have some more time. I'm sorry about that. Professor Kansaku, please.

[Kansaku, member] Thank you. In connection with page 4 of Material 1-1, I'd like to address 3 points on stewardship activities.

First, I'd like to start from the situation in the US. The US Stewardship Code was established by the private sector, and came into effect on January 1, 2018. Historically, under the Prudent Investor Rule, the US management firms are subject to legal obligation to manage funds based on modern portfolio theory. Especially, in case of passive investors, once an index is adopted or a portfolio is established, they are supposed not to incur unnecessary costs for exercising their voting rights – this is the way to fulfill their legal obligations. In the US, I think people used to be rather skeptical about the stewardship activities by passive investors. So, it is notable that very influential, large institutional investors have signed up to the Code since the implementation on January 1, 2018.

There may be various reasons behind that, but I think the most important point would be an increasing recognition of the significance of so-called agency issues between institutional investors and ultimate investors that cannot be solved by the modern portfolio theory.

The fundamental point is that stewardship activities should contribute to the benefit of ultimate investors. I think we should have in-depth discussion on key issues from such a perspective. First of all, as for enhancing disclosures by asset managers, it is the issue of managing conflicts of interest, which is the biggest cause of agency issues. The Stewardship Code stipulates the principle requiring institutional investors to establish a policy for preventing conflicts of interest. Furthermore, upon the revision, the Code requires disclosure of voting records for each investee company on an individual agenda item basis, which could reflect any relationships involving conflicts of interest, as a result of institutional investors' actions. In the meantime, the Financial Services Agency established the Guidelines for Investor and Company Engagement, showing key points of dialogue with investee companies, on June 1, 2018. In the Guidelines, it is stated that there are diverse issues for engagement and stewardship activities, and there is no single uniform way, but institutional investors and companies are expected to discuss investment strategy and financial management policy from the perspective that the companies achieve returns which cover the cost of capital on a mid- to

long-term basis. Specifically, the Guidelines refer to several key agenda items, including appointment/dismissal of CEO, responsibilities of the board, and cross-shareholdings. Furthermore, in the Preamble, as mentioned earlier, it is pointed out that because priorities vary, it is important to have effective engagement that takes into consideration each company's specific circumstances; and that it is especially important to have dialogue with the objective of achieving returns which cover the cost of capital over the mid- to long-term.

Needless to say, I do not deny the importance of ESG, but discussion over ESG tends to be too general, too common to all companies, I'm afraid. Of course, there may be some companies that give ESG issues top priority. However, in Japan, the most important points to consider are stated in the Guidelines for Investor and Company Engagement, as I mentioned. So, the companies and investors should be evaluated on the basis of whether they conduct their activities in accordance with the Guidelines. If not, they must be encouraged to explain reasons in a more appropriate and meaningful way. This is my first point.

My second point is about encouraging corporate pension funds to conduct stewardship activities. As shown in Material 1-1, the number of corporate pension funds which signed up for the Stewardship Code is gradually on the rise. We can see an improvement in that regard. Because corporate pension funds take a mid- to long-term perspective in order to increase their assets under management, they are very much suitable for stewardship activities. Accordingly, it is very important to look at various measures in support of stewardship activities by corporate pension funds.

My third point is related to the second one. Investors, including those with passive strategies, conduct stewardship activities with a view to increasing mid- to long-term corporate value. Thus, it is the investment consultants that have massive impact on asset owners, and the proxy advisors on asset managers in exercising their voting rights. It has been pointed out that some proxy advisors make recommendations in a uniform manner, without taking into account specific circumstances of each company. With regard to investment consultants and proxy advisors, for the purpose of increasing mid- to long-term corporate value, it is expected that best practices for addressing agency issues or managing conflicts of interest would be further improved.

[Ikeo, Chairman] Thank you very much.

Mr. Takei, please go ahead.

[Takei, member] In connection with professor Kansaku's comments, I'd like to make comments on proxy advisors on page 15 of Material 1-1. As pointed out in the proposed US bill, I think the third point, "obligation to provide the subject companies an opportunity to review the draft recommendations and make comments, prior to making such recommendations to investors", is very important.

For example, there are cases where proxy advisors make recommendations to vote against companies' proposals based on factual errors, which could have been avoided, if they had received prior explanations from the companies, and eventually both parties get frustrated. I believe that proxy advisors should be accountable for the process of developing voting recommendations, and I understand that their accountability is vigorously discussed in the US and Europe.

Passive investors are more likely to rely on proxy advisors' recommendations. This is especially true among foreign institutional investors adopting a passive investment approach. I suppose the majority of such passive foreign investors have not signed up for Japan's Stewardship Code. Accordingly, in terms of enhancing the substance of governance in Japan, proxy advisors, like a kind of gatekeepers, play a very important role in enhancing the substance of exercising voting rights, which the Stewardship Code aims at. From that perspective, in looking at how proxy advisors' recommendations should be, the issue of prior review would carry a big significance.

I don't think all draft recommendations of all companies should be reviewed in advance, because it would be beyond proxy advisors' capacity. Efficiency matters. However, it is when the external accountability is questioned, or when the trust relationship with the company, which is the basis of constructive dialogue, is questioned, that prior review or confirmation would become more important. Specific examples include the outbreak of proxy fight, the recommendations by proxy advisor to vote against a company's well-intended proposal, and the recommendations by proxy advisor on underperforming companies. I'm not saying that tens of thousands of recommendations should all be subject to prior review. It is possible to limit reviewing to important recommendations in terms of accountability, trust relationships with companies as the basis of constructive dialogue, and improvement of mid- to long-term

corporate value. I think the nature of this issue is different from that of the issue of solving conflicts of interest. Yet I'd appreciate it, if we discussed the point (3).

That's all.

[Ikeo, Chairman] Ms. Takayama, please.

[Takayama, member] I'd like to make a comment on ESG.

Ms. Waring earlier emphasized the importance of the ESG integration into the Stewardship Code and stewardship activities. I totally agree with her. It is not only important from the viewpoint of investors, but also … looking at the current situations of Japanese companies, many corporate executives and boards are currently discussing how to associate corporate value improvement with ESG. Considering such situations among companies, I believe that the ESG integration is an important issue.

There is one thing we should be careful about. I believe Ms. Waring would agree. When we say "ESG", G comes last. However, basically G is above everything else – governance is essential. We need to look at "E" and "S" based on the solid foundation of governance. So, when this Council discusses or issues an opinion statement on ESG, we should keep it in mind.

That's all.

[Ikeo, Chairman] Thank you.

Mr. Callon, please go ahead.

[Callon, member] Let me make a comment on proxy advisors. I think we need more discussion to reach a consensus. With respect to "(3) prior review" on page 15, I remember that one of the reasons why this bill did not pass is because there was an opinion that the prior review might impede the freedom of speech. While they are moving toward (1), personally, I think it is better to publish issuing companies' opinions subsequently in proxy advisors' reports, instead of prior explanation or prior review. In this way, investors can compare the views of proxy advisors with those of issuing companies, and therefore, the objectivity and fairness can be secured.

Furthermore, as Mr. Takei mentioned, proxy advisors are very influential, so I believe they should be included in the scope of governance reform.

[Ikeo, Chairman] Thank you. Please go ahead.

[Oguchi, member] There is not too much time left, so I'd like to make just one remark. In

response to Mr. Sampei and Ms. Waring, I'd like to remind you that it was not like we failed to include escalation in the Stewardship Code. It was intentional. It was judged better not to include escalation in the Code. However, taking this opportunity, it would be good to discuss how we should treat escalation in the next revision. In doing so, we should look at the matter in the context of Japanese culture and the relationship between companies and investors in Japan, rather than in the global context, and discuss whether it is really useful in Japan. I'm not sure what conclusion we may reach, but if a decision is made to include escalation in the Code, then we also need to discuss various measures of escalation: for example, collaboration as Ms. Waring mentioned earlier, or the "name and shame" approach, where an investor discloses the name of a company in expectation that it would change its attitude out of a sense of shame. My point is that we need to have more discussion on escalation – what investors should do when their intentions are not addressed by companies - before having discussions on the measures. The outcomes would lead to further discussion on various points.

That's all.

[Ikeo, Chairman] Thank you.

Because I had the wrong idea about the closing time, now we have a little extra time left. I don't usually express my own views, but let me do so today.

Concerning the parent-subsidiary listing, I'd like to make 2 comments. One is similar to the issue of tax incidence, in other words, ultimately who bears the burden. Minority shareholders of listed subsidiaries recognize the fact that they may not be protected, and therefore, the share prices are discounted. The minority shareholders who purchase listed subsidiaries' shares at lower prices do so after pricing in the risks that they might not be treated fairly in various ways. So, if minority shareholders purchased their shares at a sufficiently discounted price, they would be able to eliminate the possibility of suffering losses.

Then who suffer the losses? It is the shareholders of parent companies. The losses are ultimately borne by the shareholders of parent companies. Then, the fact that the management of parent company do something which may cause its shareholders to bear possible losses means that the parent company does not have good governance. If shareholders naively purchase shares of listed subsidiaries without any discount, it is another story; but if shareholders purchase such shares at a discounted price after pricing in the fact that sufficient measures to protect minority

shareholders have not been taken, any possible losses will be shifted to parent companies. Such structure of loss-shifting should be understood.

One more point. I used to think that the purpose of having the subsidiaries listed was for financing – a kind of asset financing. However, looking at the reasons described on page 18 of the METI's reference material, it rather seems that they are largely motivated to achieve the status of "TSE First Section-listed company". Specifically, companies can take advantage of the status of "TSE First Section-listed company" to hire talented people and so forth, so they want to get their subsidiaries listed. Then, in the TSE's review of its cash equity market structure, in which I'm also involved, it would be important to consider such points associated with the parent-subsidiary listing and discuss how to deal with them.

That's all.

Professor Kanda, you have not expressed your view yet today.

[Kanda, member] I'd like to make just one remark. Listening to other members' opinions on listed subsidiaries, I'm wondering whether we should have discussions only on the case where a "dominant" shareholder, as Mr. Sampei described, is a listed company, or also where a "dominant" shareholder is not a listed company – for example, an unlisted entity, an individual or a family. In any case, there remains the issue of protecting the interests of minority shareholders of listed subsidiaries, in varying degrees.

Therefore, for our future discussions, I think we should be clear about what cases are to be discussed, in order to avoid unnecessary confusion.

[Ikeo, Chairman] Mr. Oba, please.

[Oba, member] Earlier I asked some questions about the reasons for the UK's adoption of "Apply and Explain" approach. After listening to the explanation, I have a better comprehension, and at the same time, I feel more confused. I understand that it would be too early to adopt the approach in Japan, because the "Comply or Explain" approach has just started, and concerned entities [companies and investors] have not yet achieved complete digestion of the approach. They are still in a learning process. I believe the underlying principle was to ensure that each entity considers what to do on its own. A thorough implementation of the principle is essential.

With respect to which perspective to take in the next revision of the Stewardship Code and the Corporate Governance Code, Mr. Tsukuda suggested that it is important to thoroughly identify

issues concerning constructive dialogue. For that purpose, I think it is necessary to recognize the fact that the quality of disclosure required by the current Codes is still not enough. Because disclosures are not enough, the parties are unable to have constructive dialogues. What are the shortcomings of the disclosures? Under the Corporate Governance Code, the boards are required to assess and disclose their activities. I wonder how many companies actually do as required. Under the Stewardship Code, investors are expected to assess and disclose their stewardship activities. I feel this is an important point for the next revision.

That's all.

[Ikeo, Chairman] Thank you.

Would you like to make additional comments? Ms. Waring, please.

[Waring, member] So Oba san, you are right. It is not good enough. It really isn't. I was really shocked to see the differences in quality of investor disclosure around conflicts of interest, engagement policies, it's all over the place. And this is why ICGN has produced this new guidance, and this is why it's important that regulators are focusing on that.

And to your point about constructive engagement, we need to remember that investors are responsible for preserving and enhancing the value of the assets on behalf of beneficiaries.

So the Japanese Stewardship Code primarily focuses on the preservation of value, the risk mitigation but doesn't really think about the enhancement of value which is the ESG element. We are all talking about creating long-term sustainable value not just for the benefit of companies but for society as a whole. And in order to do that, we have to talk about enhancing value, what are the triggers for enhancing value, environmental and social discussion once you got the G right first.

[Ikeo, Chairman] Mr. Kawakita, please.

[Kawakita, member] As we still have some time left, I'd like to express my view on ESG. I somewhat agree with Professor Kansaku's opinion. I'm wondering whether it is really appropriate for asset management firms to put a great deal of effort into ESG, especially when their resources are limited. The scope tends to be too broad, therefore, it may result in the lack of focus. If they would like to look at the ESG factors, they should focus on individual companies' unique ways to carry out environmental or social activities. Say if companies are conducting various activities simply because they want to be included in ESG indices or the like, it is kind of disappointing. On the premise that asset management firms need to devote limited resources, it is essential to clarify

what ESG factors they focus on.

That's all.

[Ikeo, Chairman] Please go ahead.

[Tanaka, member] It seems we still have time, so let me quickly make one remark. This Council is supposed to discuss not only the Stewardship Code, but also the Corporate Governance Code. Actually, I have an issue that remain unsolved – it's about corporate value. I strongly believe that we need to make discussions, with a bit of focus, on what corporate value is.

Mr. Kobayashi has made a very important point in his opinion statement. Listed companies are expected to provide returns to their shareholders, including Japanese and foreign pension funds, in the public stock market, thus widely supporting the economic lives of people after retirement. Simply put, this is about shareholder value rather than corporate value. In general, what is the definition of the term "corporate value"? How is it measured according to the definition? How can we judge whether corporate value increased or not? I myself have not been able to find convincing answers to these questions.

Many corporate executives, including Mr. Sakane, Councilor of Komatsu, have offered various answers. When considered in the context of the investment chain, the issue tends to feature more about market capitalization rather than corporate value. If acquisitions of businesses are made one after another, market capitalization will automatically become bigger, but shareholder value wouldn't. So, I've been thinking it is of great importance for this Council to discuss what it exactly means by "corporate value", and how it should be measured. I suggest that we should include this point in the future discussion.

[Ikeo, Chairman] Mr. Sampei, please.

[Sampei, member] I have a few more to say in relation to the comments from Professor Kansaku and Professor Kawakita. With respect to the ESG factors, [people] usually talk about ESG in the context of scoring or rating criteria; there are many items to be checked, and each company will be evaluated against them and rated, in order to decide on the companies to be included in indices or put on the exclusion list. However, when we say "ESG" here, we are not talking about that kind of thing. Instead, we are discussing the ESG integration. In the process of value enhancement or value creation, if companies have not worked on or missed something they should address while conducting businesses, investors should tell them to be more vigilant, or encourage them to get

hold of the untapped opportunities. This is the ESG integration to focus on through business.

Therefore, the various views from the members are not conflicting, they go together. I think differences stem from how we perceive ESG – whether it is about the evaluation of as many as a hundred ESG factors, or the ESG integration associated with corporate value creation, which is essential for individual companies. I just wanted to make sure that we do not mix up the differences.

[Ikeo, Chairman] Anyone else?

I'd like to apologize once again for asking you to speed up discussion so much, I was mixed up.

It's around the scheduled closing time, so let us wrap up this meeting today. Based on today's discussion, the next meeting is expected to focus on the Follow-up Council's Opinion Statement.

Lastly, the Secretariat has some announcements.

[Inoue, Director of the Corporate Accounting and Disclosure Division, FSA] As for the next meeting schedule of the Follow-up Council, we will arrange a suitable date and let you know.

That's all from the secretariat.

[Ikeo, Chairman] Thank you very much.

The meeting is now adjourned. Thank you very much.

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