

**Revision of the Corporate Governance Code and
Establishment of Guidelines for Investor and Company Engagement**

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

● ●, 2018

I . Introduction

A degree of progress has been seen in corporate governance reform due to various measures including the establishment of the Stewardship Code in 2014 (revised in 2017) and the Corporate Governance Code in 2015. On the other hand, looking at the current situation, a number of issues still exist, such as the lack of decisive decisions by management at companies. It has also been pointed out that engagement between investors and companies is often merely a formality, and there are just a limited number of cases where engagement has resulted in fruitful insights for companies.

In light of these issues, since October 2017 the Council of Experts Concerning the Follow-up of Japan's Stewardship Code and Japan's Corporate Governance Code (hereafter, the "Council") has examined the progress of Japan's corporate governance reform, and has made proposals to revise the Corporate Governance Code in order to deepen and make more substantive this reform (cf. Appendix 1 for the specific revision proposal; hereafter, the "Code Revision Draft"). In addition, in order to encourage institutional investors and companies to effectively implement the Stewardship Code and the Corporate Governance Code on a "comply or explain" basis, the Council has proposed the drafting of Guidelines for Investor and Company Engagement (hereafter, the "Engagement Guidelines") that provide agenda items for engagement. It is expected that institutional investors and companies will engage each other with respect to these agenda items, along with the Code revision (cf. Appendix 2 for the specific proposal).

II. Ideas Underlying the Revision of the Code and the Establishment of the Engagement Guidelines

The basic ideas underlying this proposal for the Code Revision Draft and the Engagement Guidelines Draft are as follows.

1. Management Decisions in Response to Changes in the Business Environment

The aim of corporate governance reform is to promote sustainable growth and increase corporate value over the mid- to long-term by encouraging decisive decisions by management. However, it has been pointed out that decisive management decisions are still not being made in response to changes in the business environment, an issue that needs to be taken very seriously. For example, it has been pointed out that the reviewing of business portfolios is not necessarily sufficient at Japanese companies, because management still does not adequately recognize a company's cost of capital.

In light of these issues, it is necessary to clarify that decisive management decisions, including reviewing business portfolios, are important, and management should accurately identify a company's cost of capital in order to make such management decisions.

2. Investment Strategy and Financial Management Policy

Strategic and systematic investments in fixed assets, R&D, and human resources are important for companies to generate sustainable growth and increase corporate value over the mid- to long-term. In making such investments, it is also important to conduct appropriate financial management which is consistent with investment strategies and recognizes a company's cost of capital.

3. CEO Appointment/Dismissal and Responsibilities of the Board

CEO Appointment/Dismissal

The CEO plays a central role in management, and CEO appointment/dismissal is the most important strategic decision for a company.*

On the other hand, it has been pointed out that initiatives with respect to the development and appointment of a CEO have been insufficient at many companies, and it is necessary to establish objective, timely, and transparent procedures to this end. For example, there are companies that still have not established policies for CEO appointment/dismissal, and there are few companies in which the board engages in sufficient oversight of succession plans. Furthermore, although increasing number of companies have recently established a nomination committee, it is important to further promote the establishment and use of nomination committees in order to strengthen the independence and objectivity of the CEO appointment/dismissal process.

Responsibilities of the Board

The board has the responsibility to support management including the CEO, and it is necessary for the board as a whole to possess appropriate knowledge, experience, and skills.

In addition, the ratio of female officers at Japanese listed companies is currently only 3.7%, and it is important to ensure sufficient diversity, including gender and international experience, in order for the board to sufficiently fulfill its responsibilities.

4. Cross-Shareholdings

While cross-shareholdings have decreased recently, the decrease by non-financial corporations is modest, and the ratio of voting rights accounted for by cross-shareholdings remains high.

* CEO appointment/dismissal has been the subject of discussion by the Council; cf. the Opinion Statement entitled "Corporate Boards Seeking Sustainable Corporate Growth and Increased Corporate Value over the Mid- to Long-Term," February 2016.

It has been pointed out that cross-shareholdings are meaningful in promoting strategic partnerships. However, it has also been pointed out that the presence of shareholders who are expected to support company management could lead to a lack of management discipline, and that cross-shareholdings are risk assets on company balance sheets that are not proactively used and therefore inefficient in terms of capital management.

Considering these circumstances, it is important for investors and companies to deepen their engagement on cross-shareholdings. Companies need to assess whether or not to hold each individual cross-shareholding, and clearly disclose and explain the results of this assessment after specifically examining the purpose, benefits, and risks of each holding. In addition, it is important to clearly disclose policies with respect to cross-shareholdings, including the policies regarding the reduction of cross-shareholdings.

The importance of discipline at companies whose shares are being held as cross-shareholdings has also been pointed out, and this issue is addressed in the revision of the Code.

5. Asset Owners

Asset owners are positioned closest to the ultimate beneficiaries and are able to encourage and monitor asset managers that are the direct counterparties in engagement with companies. The role of asset owners is thus extremely important to deepen corporate governance reform and promote the smooth functioning of the investment chain.

Among asset owners, while there have been some public pension funds that have instructed asset managers to engage in effective stewardship activities in response to the revision of the Stewardship Code in May of last year, corporate pension funds' actions have not necessarily been adequate. It has been pointed out that corporate pension funds in general have not shown interest in stewardship activities, and that few corporate pension funds actually conduct such activities, with only nine corporate pension funds having become signatories of the Stewardship Code. In addition, it has been pointed out that corporate pension funds lack human resources – in terms of both quality and quantity – for investment management including stewardship activities.

Although these are issues that should primarily be addressed by corporate pension funds themselves, plan sponsor companies should fully recognize that the management of corporate pension funds impacts stable asset formation for employees and companies' own financial standing and take measures on their own to improve human resources and operational practices, thus making sure that corporate pension funds perform their roles as asset owners. It is expected that these actions will contribute to increasing the investment management expertise of corporate pension funds and the

number of Stewardship Code signatories, and promote effective stewardship activities.

III. Closing Remarks

The Council expects that in accordance with the proposed drafts the Tokyo Stock Exchange will promptly revise the Corporate Governance Code and the Financial Services Agency will promptly issue the Engagement Guidelines.